The Law Commission
and
The Scottish Law Commission

(LAW COM. No. 43)

(SCOT. LAW COM. No. 21)

TAXATION OF INCOME AND GAINS DERIVED FROM LAND

Presented to Parliament by the Lord High Chancellor,
the Secretary of State for Scotland and the Lord Advocate
by Command of Her Majesty
April 1971

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The Law Commission was set up by section 1 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law other than the law of Scotland or of any law of Northern Ireland which the Parliament of Northern Ireland has power to amend. The Commissioners are:

The Honourable Mr. Justice Scarman, O.B.E., *Chairman*

Mr. Claud Bicknell, O.B.E.

Mr. L. C. B. Gower

Mr. Neil Lawson, Q.C.

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The Scottish Law Commission was set up by section 2 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law of Scotland. The Commissioners are:

The Honourable Lord Kilbrandon, *Chairman.*

Professor A. E. Anton

Professor J. M. Halliday, C.B.E.

Mr. A. M. Johnston, Q.C.

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To the Right Honourable the Lord Hailsham of Saint Marylebone, Lord High Chancellor of Great Britain,

the Right Honourable Gordon Campbell, M.C., M.P., Her Majesty's Secretary of State for Scotland, and

the Right Honourable Norman Wylie, V.R.D., Q.C., M.P., Her Majesty's Advocate

In 1969, pursuant to our general duty under section 3(1) of the Law Commissions Act 1965 to consider all the law with a view to its simplification, we set up a Consultative Group to consider tax legislation.* This was done with the concurrence of the Board of Inland Revenue who suggested to us that the first topic to be considered might be the taxation of income and gains derived from land. We accepted that suggestion.

Professor J. M. Halliday, C.B.E., one of the Scottish Law Commissioners, was appointed chairman of the Group and the other members working on the first topic were: Mr. H. M. Begg, who is a chartered accountant in Scotland; Mr. E. I. Goulding, Q.C.; Mr. J. P. Lawton, who is a solicitor practising in England; Mr. E. S. McNairn, C.B., who was a member of the Board of Inland Revenue; Mr. D. S. Morpeth, who is a chartered accountant practising in England; and Mr. D. A. Smith, who is a member of the Board of Inland Revenue and who replaced Mr. McNairn on the latter's retirement. Members of the staff of the Law Commission acted as secretaries.

We have now received the Group's report on the topic committed to them. We agree with it and accordingly append it to this Report.

It is a matter of common knowledge that the tax statutes are not easy reading and we had hoped that, even if nothing could be done by us about the content of the law, something at least could be done about its form. In fact, as will be seen, the Group have not in this Report been able to suggest much in the way of improvement to form or arrangement, which in this area is largely conditioned by the subject-matter.

The Group have, however, felt able to suggest a number of changes of a substantive nature which, while altering the law only in minor respects, would result in considerable simplification of the tax system, and one or two changes touching the administration of taxes. The discussion of matters on which the Group decided to make no recommendations is also of great interest: indeed, perhaps the most valuable result of the exercise—which was in the nature of an experiment—is that it has shown that it is possible for a broadly based group of experts to discuss and make useful recommendations about tax matters without impinging on fiscal policy. It is our hope, therefore, that similar investigations into other aspects of the tax code can now be instituted.

* This was reported in our Fourth Annual Reports paragraph 79 (Law Com. No. 27) and paragraph 33 (Scot. Law Com. No. 13).

Finally we wish to express our gratitude to all the members of the Group who have given so much of their time and expertise to produce this first report.

(*Signed*) LESLIE SCARMAN, *Chairman, Law Commission.*

CLAUD BICKNELL.

L. C. B. GOWER.

NEIL LAWSON.

NORMAN S. MARSH.

J. M. CARTWRIGHT SHARP, *Secretary.*

C. J. D. SHAW, *Chairman, Scottish Law Commission.*

A. E. ANTON.

JOHN M. HALLIDAY.

ALASTAIR M. JOHNSTON.

T. B. SMITH.

A. G. BRAND, *Secretary.*

23*rd February* 1971.

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APPENDED

REPORT OF THE CONSULTATIVE GROUP ON THE TAXATION OF INCOME AND GAINS DERIVED FROM LAND

I. INTRODUCTION

Terms of reference: and plan of the Report

1. Our terms of reference were:

> "To consider the taxes on income and gains derived from land with a view to improving the form and arrangement of the tax legislation so as to make the law easier both to find and to understand. Within that context, to consider taxation under cases VI, VII and VIII of Schedule D and the capital gains tax; but not betterment levy or questions of pure fiscal policy."

2. From the outset, we decided that these terms should not be narrowly construed, and we have by no means confined ourselves to questions of form and arrangement. As will appear, our discussions have been very much concerned with the content of the law, appeal machinery and administrative practice; and our recommendations and suggestions will in fact be found to relate to such matters rather than to form and arrangement. In some instances, we found that the substantive law could with advantage be changed, and that the change would not involve any question of fiscal policy or have a significant effect on the revenue yield. Those matters, which we consider are fit for legislative action, are dealt with in Part II of this Report as definite recommendations. We recognise, of course, that they are not all of equal importance.

3. Matters involving questions of pure fiscal policy were outside our terms of reference and we were unable, therefore, to discuss (for example) the general principles adopted by the tax code, although these naturally affect the treatment of income derived from land and losses sustained in activities connected with land. But we did not draw back from considering provisions relating wholly or substantially to land merely because the problems raised by them impinged on policy. In Part III we deal with certain aspects of our subject which we treated as within our terms of reference for the purposes of discussion but in relation to which we doubted whether we could properly make firm recommendations for changes in the law. Where we consider that a change in the law would effect a substantial simplification, we put it forward as a suggestion, recognising that it may not be acceptable on policy grounds. We hope, however, that these suggestions will receive serious consideration in the appropriate quarters.

4. One of the suggestions in Part III relates to a matter where the complaint is not so much that the law is complicated as that it can be unduly cumbersome in practice. Our suggestion only goes part of the way towards eliminating this difficulty but we have reason to believe that the Inland Revenue may be prepared to adopt a view which would be helpful in many cases. We cover this in Part IV.

5. For the sake of completeness we mention in Part V a number of matters which we considered but about which we make no recommendations or suggestions for changing the law.

Method of Working

6. We met ten times in all. Before our first meeting we received a Note by the Board of Inland Revenue which set out comprehensively the existing system of the taxation of income and gains derived from land ; and at that meeting it was decided that the outside bodies listed in the Appendix should be invited to make representations on certain topics and to suggest other matters for our consideration. We received substantive replies from all but one and at our second and subsequent meetings we discussed the points raised therein and in papers prepared by members of our Group. At one meeting we were assisted by the presence of Mr. P. S. Edgson, F.R.I.C.S., F.A.I. (representing the Royal Institution of Chartered Surveyors) and Mr. W. A. Hobbs, C.B.E., F.R.I.C.S., F.A.I. (Deputy Chief Valuer, Inland Revenue) ; and at another meeting we were joined by Mr. C. H. de Waal (Parliamentary Counsel). We have not provided any draft Clauses implementing our Part II recommendations because we think that must be left to the draftsman responsible for the Bill incorporating them. We are conscious of the fact that the implementation of some of the recommendations and suggestions which we make in the Report would involve making amendments to the law which would neither simplify nor shorten the legislation, at any rate until the changes were consolidated. But we are satisfied that they will simplify the law in practice.

7. The Press notice (10th April 1969) announcing the formation of our Group suggested that we would, from time to time, publish our provisional conclusions for comment. We have not done this because we think that in general our recommendations (so far as they go) would be acceptable to the bodies with whom we have been in touch.

Note : In the middle of our study the Income Tax Act 1952 and the relevant parts of the Finance Acts 1952 to 1969 were consolidated by the Income and Corporation Taxes Act 1970 ; and Case VIII of Schedule D has been renamed Schedule A. Unless otherwise stated, sections etc. referred to in the remainder of this Report are those of the 1970 Act.

II. TOPICS WITH RECOMMENDATIONS

A. Schedule A: expenditure

8. Although Schedule A is not divided into Cases dealing separately with different sources of land income falling within the Schedule, the liability to tax is not arrived at by deducting the aggregate outgoings (of a revenue nature) from the aggregate receipts. The general rule (sections 72(2) and 74(2)) is that revenue expenditure on a particular property may be deducted from income derived from that property; but the right to deduct excess expenditure from income derived from other Schedule A property is restricted.

9. The reason for the restriction is to be found in the different natures of the sources of income falling within the Schedule. Broadly speaking, these are (*a*) properties let at full rents, (*b*) properties let at less than full rents, and (*c*) rentcharges, feu duties etc. "Full rent" in this context does not mean the best obtainable market rent, but is defined (section 71 (2)) to mean a rent sufficient, taking one year with another, to cover the landlord's outgoings; and we will accordingly use the words "commercial" and "non-commercial" in relation to (*a*) and (*b*) respectively.

10. Non-commercial leases are, by definition, not sources of net income; and although permitted expenditure on a property subject to such a lease is deductible from the rent (under the general rule), expenditure in excess of that rent is not available for relief against any other income. The treatment of expenditure on owner-occupied property has been along similar lines. Up to 5th April 1963 such property was a source of taxable income and a measure of relief for expenditure on the property was given by way of maintenance relief against the Schedule A assessment on that (notional) income. The Finance Act 1963, however, abolished the taxation of that (notional) income thus removing the occasion for allowing deductions. (There is an exception, now contained in section 73, which preserves the pre-1963 position in certain cases. We refer to this again in Part V).

11. Rentcharges, feu duties and other non-rental sources of income are also treated as being in a special position because they tend to be indistinguishable in any practical sense from ordinary fixed-interest investment income. (We refer to this matter in Part III). Any excess of expenditure in connection with any such source of income is deductible from net income arising from another of a like nature (section 74(2)(*d*)), but not from the net income from a different sort of non-rental source, let alone from ordinary rents.

12. That leaves properties let on commercial leases, and here one might expect to find that the rents were "pooled" and that expenditure on the properties was deductible from the pool without discrimination. Not so. A distinction is drawn in section 72(4) between commercial leases under which the tenant is responsible for all (or substantially all) repairs, and other commercial leases; and full pooling applies only to the latter. In the nature of

things, the landlord's expenditure is unlikely, in the case of a tenant's repairing lease, ever to exceed the income from the same property; if, exceptionally, it does, the excess may be deducted from the pool income. But that arrangement is not reciprocal: if expenditure on the other properties exceeds the available pool income the excess must be carried forward and cannot be deducted at once from available income from tenant's repairing leases.

13. We understand the reasons for keeping non-commercial rents and non-rental income out of the pool for deduction purposes but as we see it the distinction between tenant's repairing and other commercial leases serves only to delay giving effect to excess expenditure, probably for no more than one year. We do not think that the complication introduced by this distinction is justified, and *we RECOMMEND that it be abolished.*

14. Expenditure on commercially let properties in the pool may exceed the pool income and in that case the excess is normally carried forward in full. Under the present law, however, the carry-forward may be restricted if a property leaves the pool, either on sale or on its ceasing to be commercially let. Expenditure may only be deducted from pool income if it is lawfully deductible from the income of the particular property on which the expenditure was incurred; and since the owner of the pooled properties cannot, in a subsequent year, deduct the earlier expenditure on a property which has left the pool from any income from that property arising in such subsequent year, he cannot deduct that expenditure from the pool income for such subsequent year.

15. The calculation of the restriction on the right to carry forward a pool loss can be complicated, but an example may serve to show how it works. A landlord has two pooled properties, A (rent £100) and B (rent £100). In a particular year his expenditure on them respectively is £250 and £50, so there is a pool loss of £100. He sells property A. He is allowed to set the whole of the pool income (£200) against the expenditure on A, but the £50 balance on A is not carried forward.

16. Quite apart from the complication involved in operating this restriction, it seems that in this matter the Inland Revenue gets the best of all worlds, to the prejudice of the taxpayer. Expenditure incurred shortly before sale is likely to affect the sale price, and so the amount of any capital gain: and there is no relief against the tax on that in respect of the excess expenditure unrelieved for Schedule A purposes. (And if the expenditure is not incurred by the vendor, but the dilapidations are afterwards made good by the purchaser, he may not get relief either, under the *Law Shipping* rule discussed in paragraphs 31–33 below).

17. We recognise that the abolition of the restriction would make available for carry-forward a large pool loss created immediately before a disposal of the majority of the properties in the pool; but in such a case the expenditure would remain unrelieved for a long time because of the relative smallness of the subsequent pool income, and it might well happen that some part of it would never be relieved. On balance, we think it would be both just and convenient *to abolish the restriction, and we so RECOMMEND.*

B. Schedule A: premiums for leases

18. A premium for the grant of a lease exceeding 50 years is regarded for tax purposes as a wholly capital payment and receipt; but a premium paid for a lease of any lesser duration is treated as containing a rental element, and this element is taxable under Schedule A as if it were rent payable in the year of the grant (section 80). Certain other sums are treated as premiums for this purpose. The taxable element is the whole premium less 2 per cent thereof for each year of the lease other than the first. A premium for a 21-year lease is thus taxable as to 60 per cent, and one for a 7-year lease as to 88 per cent. Since the taxable sum is not (from the recipient landlord's point of view) spread over the term of the lease, there are special provisions relating to the rate at which surtax thereon is payable (section 85(2) and Schedule 3).

19. The position of the tenant who has paid such a premium (and of his successors in title) is also affected (section 83). He is treated as if he were paying in each year an additional sum by way of rent equal to the sum charged on his landlord spread over the term of the lease; and if he grants an underlease, that "rent" is deductible from the rent received by him, for the purposes of his own liability to tax under Schedule A. If the underlease is also granted at a premium, the taxable amount of that premium will be reduced by reference to the taxable amount of the headlease premium.

20. These provisions are by no means simple and it was represented to us that if Capital Gains Tax had existed in 1963 they might never have been enacted. We think, however, that it would be going too far to abolish the taxation of premiums (as income) altogether: a premium for a very short lease is not sensibly distinguishable from rent in advance and should be taxed as such at income tax rates.

21. An alternative method of taxing premiums would be to provide that those for terms not exceeding X years wholly constitute payments of rent chargeable under Schedule A (thus excluding any charge to Capital Gains Tax); premiums for longer terms being treated as wholly capital, outside the scope of Schedule A.

22. This alternative method would seriously affect the revenue yield if X were pitched too short, and it would be hard on the taxpayer if it were too long. At 14 years, the premium on a 14-year lease would be wholly taxed; at present only 74 per cent of it is taxed. Nevertheless, there is no doubt that a change in the law in favour of this alternative method would represent a considerable simplification and *we RECOMMEND it.* Because of the conflicting considerations, we do not make any positive recommendation as to the term which we have called X, but if the change is to win general acceptance we think that X would have to lie in the 7–10 years range. On that footing, because of the existing exemption from short-term gains tax for leases under 21 years, the change would avoid any overlap between Case VII and Schedule A. The surtax top-slicing provisions referred to in paragraph 18 above would naturally be retained; and the position in relation to premiums which have already been paid should not be altered.

C. **Premiums: appeal machinery**

23. Whether or not the taxation of premiums is simplified as suggested above, persons other than the recipient of the premium may be affected. The interests of such other persons may be the same as that of the recipient of the premium, but their respective interests may be opposed. (For example, a covenant by the tenant to improve the demised premises, thus increasing the value of the landlord's reversion, is a "premium", but they may not be at one over the extent of that liability). Whatever the situation as between the taxpayers, it is obviously convenient that all questions relating to a single premium should be determined by the same body of Commissioners; and that so far as possible all parties interested in a particular question should be joined in any proceedings and so bound by a single determination. No such procedure at present exists in Schedule A.

24. There are, however, plenty of precedents for such a departure from the ordinary rule governing appeals etc. For example, where a claim to an allowance for a child is made and it appears that the allowance should be apportioned between the claimant and some other person, the Board may direct which body of Commissioners shall deal with the claim and apportionment and the other person is given a right of audience (or may make representations in writing)—section 11. Similar arrangements exist for the apportionment of capital allowances (Capital Allowances Act 1968, section 81); for apportionments under Schedule D Case VII (Schedule 7, paragraph 22(1)); and for similar purposes under the Capital Gains Tax Regulations 1967. The provisions in each case are not identical, but are designed to fit the particular circumstances.

25. *We RECOMMEND the adoption of a similar procedure for the determination of common questions relating to premiums.* Because a number of people may have present or potential future interests in the matter, it would not be appropriate to require all such persons to be joined (such a provision might lead to the determination being subsequently declared invalid for want of the proper parties), but persons not joined would, of course, not be bound by the determination. The cardinal features of the provision would be (i) where it appears to the Inspector that any third party may have a relevant interest, an authority given to the Inspector to give such third party notice of the proceedings and of the appellant's grounds of appeal; (ii) a right given to any person having such an interest to be joined in the proceedings, whether the matter he wishes to put in issue is already in issue or not; and (iii) if any parties are joined, rules for deciding which Commissioners should act. We think that there might usefully be added a power to make enquiries to assist the Inspector in relation to (i) above.

D. **Mining etc. rent rendered in produce**

26. Where land is used in connection with certain concerns (of which the commonest are mines, quarries and sand and gravel pits) any rent paid to the owner of the land is charged to tax not under Schedule A but under Schedule D, and is paid under deduction of tax. The reason for this is the ease of collection. If the rent is paid in kind (e.g. coal), however, the owner is directly assessed under Schedule D Case III. The Institutes of

Chartered Accountants have drawn our attention to this anomaly; and *we RECOMMEND that such rents in kind* (but not, we think, also those paid in cash—see paragraph 63) *should be put back into Schedule A where they belong.*

E. The use of schedules

27. We appreciate that considerations of Parliamentary time and procedure may sometimes make it desirable to place some substantive provisions of general application in schedules, but *we RECOMMEND that that should not be done unless those considerations are of paramount importance.* There are certain matters (such as transitional provisions which will become obsolete in due course, procedural rules, and detailed rules applying to particular cases) which are properly placed in schedules to Finance Acts, but in principle the main provisions of an Act should be intelligible without reference to its schedules.

28. Where in any year substantive provisions have unavoidably been placed in a schedule, they can be restored to their proper place in the Act on a subsequent consolidation; and we welcome the way in which this has in fact now been done in the case, for example, of the 4th Schedule to the 1963 Act with which we were much concerned. *We RECOMMEND that this be borne in mind in any consolidation of the Capital Gains Tax legislation.*

F. Miscellaneous

29. *We RECOMMEND that "owner" in section 73 be defined,* as we understand that in some circumstances doubts have arisen as to its meaning.

III. TOPICS WITH SUGGESTIONS ONLY

A. Schedule A Expenditure: extension of "pooling"

30. Even if our recommendation in paragraph 13 above is accepted, the right to deduct excess expenditure on one property from income derived from other property (treating the properties as pooled) is in general limited to the case where both properties are let on commercial leases. Expenditure on owner-occupied property and excess expenditure on property subject to a non-commercial lease cannot normally be set off (though the latter can be carried forward against rent from the same property during the currency of the lease); and we accept the exclusion of such expenditure from the pool. We are, however, less satisfied as to the need to exclude non-rental income (rentcharges for example) from the pool. We appreciate that to allow excess expenditure on a commercially let property to be deducted from non-rental income would extend the range of loss relief and that it might in consequence be more difficult to resist proposals to extend relief in other fields. On the other hand, a change in the law limited to the area of Schedule A would simplify the operation of that Schedule and *we suggest* that this should be considered.

B. Expenditure on deferred repairs

31. It is not unusual for difficulties to arise in connection with the deduction of expenditure in respect of deferred repairs to property which has been recently acquired. The problem is of a general nature, and is by no means limited to the field of Schedule A: indeed, the principal authorities relate to the computation of trading profits under Schedule D. The leading case of *Law Shipping Co. Ltd.* v. *I.R.C.* 1924 *S.C.* 74; 12 T.C. 621 has generally been taken to establish the proposition that a purchaser may not deduct expenditure incurred to make good dilapidations referable to the period of the previous ownership. This is supported on two grounds: first, that such expenditure is not sufficiently related to the earning of the purchaser's profits from which the deduction is sought; and, secondly, that although expenditure on repairs is *prima facie* of a revenue nature, in such circumstances it should be treated as an outgoing on capital account as an addition to the purchase price of the asset. So far as Schedule A is concerned, it seems that statutory force has been given to this view—section 72(2)(*b*).

32. In the recent case of *Odeon Associated Theatres Ltd.* v. *Jones** (Times newspaper, 13th November 1970), however, Pennycuick V-C. held that certain deferred repairs referable to the pre-acquisition period were deductible in computing the purchaser's trading profits. In that case the nature of the repairs was not such that they had to be carried out before the assets were commercially viable in the purchaser's hands and the *Law Shipping* case was distinguished on that ground, and on the ground that in the earlier case there had been no evidence of accountancy practice.

33. If the decision in *Odeon Associated Theatres* is not reversed on appeal and is allowed by the legislature to stand as authority, there will be a

* Now reported at [1971] 1 W.L.R. 442.

potentially more extensive right to deduct expenditure in respect of pre-acquisition dilapidations for Schedule D purposes than for Schedule A. We would not support the existence of any avoidable distinction of principle between the Schedules and *we suggest* that section 72(2)(*b*) should if necessary be reviewed.

C. Setting off Schedule A losses against income taxable under other schedules

34. An important exception to the rules on set-off is to be found in the treatment of excess expenditure on agricultural property. This is treated (section 79) as an additional Capital Allowance and is available for the reduction of income generally (and not merely within Schedule A). We understand that special political and economic considerations are at work in this area, and the question of extending this favourable treatment to other Schedule A subjects is plainly one of general fiscal policy. Equally plainly, however, it is simpler to deal with losses in the year in which they are incurred (so that the tax liability for the year more accurately reflects the net income for the year) than to require losses to be carried forward. *We therefore suggest* that consideration be given to extending the right to set-off between the schedules. This need not go as far as it does with agricultural property: though the law would be simpler if it did.

D. Capital Gains Tax: part disposals

35. The computation of a gain (or loss) involves the subtraction of the acquisition cost (increased perhaps by certain allowable expenditure) from the consideration received on the disposal of the asset. Where only part of the asset acquired is disposed of, the total acquisition cost has to be apportioned in order to calculate the gain or loss accruing on the part disposal; and the fraction of the total acquisition cost attributable to the part is the fraction $\frac{A}{A + B}$, where A is the consideration received on the disposal of the part and B is the then market value of the property remaining undisposed of.

36. Although that formula generally produces an acceptable answer, it is somewhat cumbersome and may involve the taxpayer in considerable expense. It also limits his right of election under paragraph 25 of Schedule 6, Finance Act 1965. If he has bought an estate as an investment and later sells one or two items comprised in it which he does not wish to retain, on the occasion of each part disposal all the remaining items have to be valued in order to ascertain the " B " element in the formula.

37. We considered (and rejected) two alternatives to the $\frac{A}{A + B}$ formula. The first was that apportionment might be effected by reference to the respective rateable values of the part disposed of and of the remainder. This alternative could, of course, not apply to a part disposal which was a disposal of an interest in an asset (e.g. the grant of a lease by the freeholder); nor could it apply on the outright disposal of part of a holding of agricultural land (which is not valued for rating purposes); and we found that there were other features in the system of rating valuation which would make

this alternative too unreliable as a statutory rule even for part disposals of non-agricultural land. Secondly, it was suggested to us that the formula might be replaced by a phrase such as "as may be just and equitable". To place the operation of such a phrase entirely within the discretion of the Inland Revenue would clearly be unacceptable; the initiative would be with the Revenue, but there would have to be the usual rights of appeal and the imprecision inherent in such a phrase would increase the likelihood of disputes which, at the end of the day, would probably be resolved by the application of the very formula which the alternative is designed to avoid.

38. The existence of the problem has, in fact, been recognised by Parliament. Since 5th April 1969 the $\frac{A}{A + B}$ formula has not been used in cases where A is small in relation to A+B and the total consideration received by the taxpayer in the year in respect of land disposals does not exceed £2,500. (It is understood that the Inland Revenue accepts 5 per cent or less as "small" for this purpose). Instead, the consideration received on the part disposal is deducted from the total acquisition cost and the part disposal is not treated as a chargeable event at all. This "roll-over" provision simply has the effect of postponing the taxation of any gain which may have accrued on the part disposal; the gain calculated on the occasion of a later disposal will be increased by the amount by which the acquisition cost has been reduced.

39. This roll-over provision is useful, but it would simplify matters still further if the conditions attached to it were relaxed. Although it may have been wise to have had such a limitation initially, the £2,500 ceiling is low in relation to the value of most properties. We appreciate that if the percentage and ceiling were pitched too high there would be a noticeable loss of yield in the short term; and we also recognise that the provision as it stands represents a recent advance on a much more limited provision dating from the 1966 Finance Act. Nonetheless, we suggest that the levels should now be reviewed, and we hope that this would lead to their being immediately and substantially raised.

40. Part disposals are further considered in Part IV below.

E. Capital Gains Tax: wasting assets

41. A "wasting asset" is one with a predictable life of fifty years or less. Freehold property is expressly excluded from this category, and most chattels are effectively excluded, being either non-assets for the purposes of the tax (e.g. private motor cars) or exempt on grounds of low value. The wasting assets rule applies (in their later years) to copyrights and life interests, among other things; but much the commonest assets affected by it are short leases, with fifty years or less to run.

42. On a disposal (or part disposal) of such a lease, the leaseholder's gain or loss is computed in the ordinary way by deducting the "acquisition cost" from the consideration received; but in this case the "acquisition cost" is not the sum which he actually paid for the lease, but that sum written down

(not on a straight-line basis, but in accordance with a statutory table reflecting the experience of the market) over the years which have elapsed between the acquisition of the lease and its disposal.

43. We discussed this rule at length on several occasions because we found that it was the only major topic on which we were unable to reach general agreement on principles. In those circumstances we have no suggestions to offer on the wasting assets rule itself and, but for one matter which arises as a consequence of the rule and on which we do wish to comment positively, the whole topic would have been relegated to Part V of this Report. Although what immediately follows belongs to that Part rather than to this, it will be convenient to summarise our discussions on the rule here before dealing with the connected matter.

44. The argument for the rule is this. The leaseholder has chosen to invest his capital in an asset which he knows will depreciate (eventually to nothing) and he makes use of the property between his acquisition of the lease and the disposal. Part of the term having elapsed by the time the lease is disposed of, what is disposed of is not in reality the whole of what was acquired ; and, by analogy with part disposals, he should not be able to deduct the whole of the acquisition cost from the consideration received. The writing-down formula appropriately limits the permissible deduction to the fraction of the acquisition cost attributable to the term unexpired. If there were no such rule a lease could be disposed of for a nominal sum on the day before its expiry and the leaseholder, having had the full benefit of the lease, would get an allowable loss, equal to the whole of the acquisition cost, as a bonus.

45. Against the rule, it may be argued that that bonus is justified. If the basis of the Capital Gains Tax is that it is right to tax an increase in a person's command over the nation's resources, a reduction in such command (by the loss of the lease) should give rise to an allowable loss for tax purposes. The tax makes no allowance for inflation, and money profits will be charged ; under the wasting assets rule, there may well be a computed gain when there is a loss in money terms, and it is anomalous that there should be a charge in those circumstances as well. Looked at in this way, there is no reason for treating "wasting assets" differently from any other asset which may happen to depreciate in value. The distinction between leasehold and freehold property is thought by some of us to be difficult to justify, since the latter may also in fact be "wasting" in value. Further, a short lease is ordinarily expected to bring in a higher than normal income in order to replace its capital cost ; that income is all subject to income taxation and it is argued that the application of the wasting assets rule constitutes in those circumstances a double imposition. We refer to this point again in paragraph 48.

46. It might be thought that if the acquisition cost of a lease is written down as time goes by because depreciation is inherent in the nature of the asset, the acquisition cost of a reversion would be correspondingly written up. This, however, is not so, and we are inclined to think that that is correct because the subsequent disposal of the reversion (or the sale of the property after it has fallen into possession) will produce a profit in money terms ;

and we see no reason for not charging that profit in full in the ordinary way. But that fortifies the opinions of those of us who have reservations about the wasting assets rule for leases.

47. In an attempt to compromise our differences, we considered the possibility of treating disposals of wasting assets as giving rise to neither loss nor gain unless actual money profits were realised. At first sight this was an attractive proposition and a substantial simplification of the legislation (most of Schedule 8 to the Finance Act 1965 could be repealed). There are, however, serious objections to it. In the first place, liability to tax would largely depend on whether or not the disposal occurs early in the term, before the natural depreciation factor overtakes the generally realised appreciation of the value of the land. That may not be an acceptable state of affairs. Secondly, if the lease is disposed of at a loss both in money terms and in real terms (applying the present wasting assets rule), no loss would be allowable for tax purposes; this situation could arise on the occasion of a forced sale by a leaseholder in difficult financial circumstances, and the refusal of relief would give rise to legitimate complaint. Thirdly, there would be a loss of tax which might make our recommendation in paragraph 22 above more difficult to accept, in that an under-lease premium for a term between X years and fifty years would attract tax neither under Schedule A nor (usually) under the Capital Gains legislation. If these objections can be overcome (or ignored in the interest of simplicity) the adoption of this method of dealing with wasting assets would plainly be desirable; but we are not optimistic about that.

48. We now turn to the connected matter. The effect of the wasting assets rule, as has been seen, is to deny relief in respect of the proportion of the acquisition cost notionally consumed between the acquisition and the disposal. Whatever view may be taken of the case of the leaseholder who occupies the premises himself (who may not be liable to Capital Gains Tax, and is not now liable to Income Tax in respect of those premises), the leaseholder who has made use of that part of the term by underletting the premises at a rack rent appears definitely to be prejudiced. The rack rent will represent not only a normal return on the capital expended but also something by way of a replacement of that capital: and the whole rent is taxed under Schedule A. On the assumption that the wasting assets rule is not changed we consider that there is a good case for treating the second element in the rent along the same lines as the element of capital-return in payments under purchased life annuities. Although this may not simplify the law, *we suggest* that it would be just to make an appropriate allowance in computing the leaseholder's liability under Schedule A.

IV. ADMINISTRATIVE PRACTICE ON PART DISPOSALS

49. Strictly, the disposal of any part of a whole acquired as a single asset is a "part disposal" involving the application of the $\frac{A}{A+B}$ formula described in paragraph 35 above (unless the roll-over provision described in paragraph 38 is available). The sale of a single farm forming part of a large mixed estate may well be a "part disposal"; but the application of the formula in such circumstances would be well-nigh intolerable.

50. For many years, however, the Inland Revenue have not regarded an estate of that sort as a single asset for valuation purposes. On a death, for example, it is not valued for Estate duty as a "job lot": its value is the sum of the market values of its constituent natural units. That approach to the valuation of such an estate has recently been endorsed by the House of Lords (*Buccleuch* v. *C.I.R.* [1967] 1 A.C. 506—the Derbyshire estate of the late Duke of Devonshire).

51. In practice, the sale of the single farm instanced above is also not treated as a part disposal for Capital Gains Tax provided there is available some evidence of valuation in saleable natural units at or about the time of acquisition. It is then treated as a natural unit for sale purposes, and an acquisition cost is attributed to it by ordinary valuation methods not involving the valuation of the other constituent parts of the estate. Fortunately, valuers are accustomed to valuing real property as at past dates and there is often no lack of evidence to assist them. Records of comparable sales at the material time are preserved (especially by District Valuers); and an investigation of the manner in which the acquisition cost of the whole estate was arrived at may well prove fruitful.

52. This practice is plainly a useful one and we understand that the Inland Revenue are prepared to extend it, under certain conditions, to a disposal of property which is not itself a natural unit for sale purposes: for example, part of a field belonging to a farm. We welcome such an extension.

53. The first condition is that both the taxpayer and the Revenue should agree to treat the part as a separate and distinct unit rather than as a part of a larger unit. Either must be entitled to insist on the application of the $\frac{A}{A+B}$ formula. This is necessary because, if a unit is broken up, the sum of the market values of the parts (as at the date of acquisition) may be either greater or less than the actual acquisition cost of the unit. If the difference is substantial, the suggested practice would be unfavourable to one of the parties. Having regard to this condition, we think that the enactment of the practice would not simplify the law.

54. The second condition is that the practice should not apply if the $\frac{A}{A+B}$ formula had been employed on the occasion of an earlier similar disposal.

The practice can only be justified, as a matter of administration, on the footing that it is proper to treat the land disposed of as an independent unit. The use of the formula constitutes recognition of the fact that the land disposed of is only part of a larger unit; and once it has been established that the unit is, for example, the farm (and not each of its fields), the subsequent use of the formula cannot be avoided without open disregard of the statute. We hope that this condition will not be rigorously enforced in all cases where there has already been a part-disposal to which the $\frac{A}{A+B}$ formula was applied. If the actual tax treatment on the previous disposal produced a result broadly the same as that which would have been achieved under the proposed new practice (if it had then existed), we think that the Inland Revenue might be prepared to regard the earlier assessment (for the purpose of applying the new practice to a subsequent part-disposal) as not having been arrived at by reference to the $\frac{A}{A+B}$ formula.

V. FURTHER TOPICS CONSIDERED

Schedule A

55. Tax under this Schedule is assessed on the rents etc. (less deductions) to which the taxpayer becomes entitled for the year of assessment; but an assessment is to be made in the course of the year on the basis of the final figures for the previous year, and any necessary adjustment up or down is made after the tax year has come to an end. This is an unusual mixture of "current-year" and "preceding-year" bases, and it was suggested to us that the basis should be changed. In particular, we considered whether the ordinary preceding year basis should be adopted; and whether the measure should be the rents "received" rather than those to which the taxpayer "became entitled". Rental income, however, tends to be fairly steady and we see no reason to change the law.

56. In paragraph 10 above we refer to section 73 which operates as an exception to the rule that owner-occupied (and non-commercially let) premises are outside the pool, so that expenditure on them cannot be deducted from the income from property which is commercially let. Section 73 applies only to cases where the properties were on 5th April 1963, and still are, managed as one estate; it is a speciality inherited from Schedule A (Old Style), and we rejected suggestions that the principle should be extended.

57. It was represented to us that it would be fairer if a letting were treated as non-commercial only if the rent was not an "arm's length" rent: the letting might turn out to be uneconomical from the landlord's point of view, though it was not so intended. We think, however, that it would not be a simplification to adopt that less certain test. We also considered the question whether a proportion of the expenditure on non-commercially let property (based, for example, on the relationship between the actual and a proper market rent) could be deductible from the commercial rents in the pool, but concluded that any change in that direction would be difficult to justify and in any event would not be a simplification.

58. We recommend no change in the treatment of expenditure incurred during "void" periods (that is to say, while the property is neither let nor owner-occupied). Such expenditure is deductible from the pooled commercial rents where the void follows a commercial letting, or (subject to the application of the *Law Shipping* rule, paragraphs 31–33 above) where the void follows the acquisition of the property and immediately precedes a commercial letting. Deduction from the pool is, however, not allowed where the void follows a period of owner-occupation or a non-commercial letting; nor where it follows acquisition and immediately precedes such occupation or such a letting. To permit deduction from the pooled rents in any of the latter cases would be inconsistent with the general limitations affecting owner-occupied and non-commercially let property.

59. The Chartered Land Societies suggested that the Inland Revenue should be required to keep records of all decisions relating to the value of land; and the question arose as to the usefulness and propriety of making

such records available to taxpayers. In fact, District Valuers (and other branches of the Revenue) do keep such records and readily impart information relating to the taxpayer's own property, of which he may no longer have a record. More extensive discovery, relating to other taxpayers' affairs, would not be proper. Mr. Edgson (who, as mentioned in paragraph 6, joined us at one meeting) did not press the Societies' suggestion in the light of the discussion.

Schedule D

60. The trading profits of a dealer in land are assessed to tax under Case I of Schedule D; but all rents are (strictly) assessable under Schedule A, whether they arise from land which is stock-in-trade or from other land held by the dealer as an investment. The rental income is often merely incidental to the trade and in practice, if the rents are small in relation to the dealing profits, the Inspector will permit all the rents (and deductions) to be carried into the Case I computation, thus avoiding the necessity of raising a Schedule A assessment as well. This is a useful simplification and we considered recommending its enactment. We decided against it, however, because any transfer from Schedule A to Case I of Schedule D would be limited to rents arising from stock-in-trade and a positive enactment would make it difficult to allow any small investment rents to be carried over as well (as is now the practice). Paradoxically, legislation might result in the making of more, rather than fewer, small Schedule A assessments.

61. Some rental income, namely that from furnished lettings, is assessed under Case VI of Schedule D instead of under Schedule A. It would be superficially tidier if this were transferred to Schedule A, but there are three reasons for not doing so, and we do not recommend it. First, such rent is not wholly derived from land: part of it is attributable to the use of furniture etc., and part may also be for services. Secondly, such rents tend to be irregular and the method of assessing and collecting tax under Schedule A (described in paragraph 55 above) is, in consequence, less appropriate than the more flexible basis adopted for Case VI. Finally, if it is to his advantage, the taxpayer may be able to have the liability transferred from Case VI to Case I, on a trading basis.

62. Two other aspects of the taxation of profits derived from land fall within Case VI. They are, first, certain sums received by persons other than the landlord, in lieu of premiums (sections 80–82); and, secondly, certain gains falling within section 488. Both sets of provisions are anti-avoidance and they have been very largely successful in discouraging certain abnormal transactions. Needless to say, they are fairly complicated provisions; they are intended to be deterrents and it would be no simplification to bring them under Schedule A.

63. When we considered mining (etc.) rents, the question arose whether they should all be transferred from Schedule D to Schedule A, whether they are paid in kind or in cash. In theory, it would be tidier to do so; but we accepted that where cash payments are involved the collection advantages of Schedule D (and deduction at source) are overwhelming, and we therefore excluded cash rents from our recommendation in paragraph 26. For similar reasons we recommend no change in the treatment of rents payable under electric line wayleaves (section 157).

Schedule D (or Corporation Tax) and Capital Gains

64. If a person appropriates investment property to stock-in-trade there is, *prima facie,* a disposal giving rise to a gain or loss within the Capital Gains legislation, and the property is taken into the trading accounts at market value ; but he (or the company) may elect to treat the gain (or loss) as a deduction from (or addition to) that market value, thus avoiding the immediate consequences on the capital front, but affecting the profits of the trade in due course (Finance Act 1965, Schedule 7 paragraph 1(3)). The *prima facie* rule also applies the other way about : on an appropriation from stock-in-trade to investment the profit to date will be charged as a trading profit, and any further profit as a capital profit. But in this case there is no right to a " roll-over " election. In the result a person may have made no overall profit or loss, but may have made a trading profit (on which tax will have been charged) and, after the appropriation, a capital loss (in respect of which no relief may in the circumstances be available). Such a result would admittedly, in these days, hardly be a common occurrence. It will also be noted that whereas in the first case the liability in respect of the gain made before the appropriation to stock-in-trade is likely to come home in a reasonably short space of time, the exercise of a right to elect in the second case might defer the taxation of what was a potential trading profit for a very considerable period. Moreover, the difference between the rates at which Income Tax and Capital Gains Tax are charged might give rise to abuse. On the whole, we think these considerations justify what appears at first sight to be an anomaly.

65. Short-term capital gains are charged under Case VII of Schedule D (or Corporation Tax) and there are certain differences between the rules applying to this charge and the corresponding rules for Capital Gains Tax. We understand, however, that assimilation is under consideration elsewhere and we did not pursue this matter very far. We did however discover that differences between English and Scots general law on questions such as the date of an acquisition or of a disposal may produce substantially different fiscal results. This may be worthy of investigation and rectification. In particular, it may be thought that different fiscal results should not be achieved where the disposal takes place in accordance with statutory provisions (such as those governing compulsory acquisition) which are intended to have similar effect in both countries.

The Impact of Betterment Levy

66. Although the Levy itself was excluded from our terms of reference, its existence is responsible for the presence in the legislation of provisions designed to avoid double taxation. Fortunately, we left this complication alone for a long time ; it is, we presume, about to disappear.

(*Signed*) J. M. HALLIDAY (*Chairman*).
H. M. BEGG.
E. I. GOULDING.
J. P. LAWTON.
D. S. MORPETH.
D. A. SMITH.

10*th December* 1970.

APPENDIX

OUTSIDE BODIES WHO WERE INVITED TO MAKE REPRESENTATIONS AND TO SUGGEST OTHER MATTERS FOR CONSIDERATION.

The Law Society.

The Law Society of Scotland.

The Institute of Chartered Accountants of Scotland.

The Institute of Chartered Accountants in England and Wales.

The Association of Certified and Corporate Accountants.

Chartered Land Societies Committee.

Chartered Land Societies Committee (Scotland).

The Association of Land and Property Owners.

The Country Land Owners' Association.

The Scottish Landowners' Federation.

Income Tax Payers' Association.

The National Farmers' Union.

The National Farmers' Union of Scotland.

Copies of the circular were also sent to the General Council of the Bar and the Society of Public Teachers of Law (by Professor Crane) for their information.

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