THE TAX TREATMENT OF THE FAMILY UNIT

by

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VOLUME I

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ABSTRACT

THE TAX TREATMENT OF THE FAMILY UNIT

The objective of this thesis is to determine a method for taxation of the family unit bearing in mind changing social and economic conditions.

Before any criticism may be made, or improvement suggested, a review of the existing state of the law is essential. Part I of this thesis therefore contains a statement of the law as it is today in the United Kingdom. First the income tax provisions which affect husband and wife are discussed dealing separately with the general rule, its three statutory exceptions, and the beginning and end of marriage. The income tax provisions as they affect children are then summarised and the capital taxes are reviewed.

Part II then considers a number of studies and criticisms which have been made concerning the United Kingdom system dealing separately with the three main principles of aggregation, accountability and allowances.

Part III summarises the manner in which the family unit is taxed in some other countries so that any helpful comparisons may be utilized; here the tax provisions are related to the legal systems in which they operate and separate consideration is therefore given to the common law jurisdictions, the civil code jurisdictions and the Scandinavian jurisdictions and a relationship between the property laws and the tax laws is noted.
Finally, Part IV analyses the deficiencies of the United Kingdom system and contains recommendations for its reform. The conclusion is reached that husband and wife should no longer be deemed to be one person for tax purposes but should be treated in all respects as two individuals and that some recognition should be given by the tax system to the fact that children are separate individuals too.

In this thesis the Income and Corporation Taxes Act 1970 is referred to as The Taxes Act.
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THE TAX TREATMENT OF THE FAMILY UNIT

The objective of this thesis, as stated in the outline of study dated June 1977, and revised in October 1977, is to determine a method for taxation of the family unit bearing in mind changing social and economic conditions.

Before any criticism may be made, or improvement suggested, a review of the existing state of the law is essential. Part I of this thesis therefore contains a statement of the law as it is today in the United Kingdom; Part II then considers a number of studies and criticisms which have been made concerning the United Kingdom system; Part III summarises the manner in which the family unit is taxed in some other countries so that any helpful comparisons may be utilized; and, finally, Part IV analyses the deficiencies of the United Kingdom system and contains recommendations for its reform.

In this thesis the Income and Corporation Taxes Act 1970 is referred to as The Taxes Act.
Part I - Existing State of the Law in the United Kingdom

Part I discusses the existing state of the law in the United Kingdom as it affects members of the family unit. The first provisions in point of time affected the income tax treatment of husband and wife. The general rule of aggregation and husband's accountability is therefore stated first, in Chapter 1, with a summary of its historical evolution. This is followed in Chapter 2 by a discussion of the three statutory exceptions to the rule. Special provisions apply to the beginning and end of marriage, especially when marriage ends in separation or divorce, and these are then discussed in Chapter 3. The income tax rules as they affect children are then considered in Chapter 4. Although the income tax provisions are of major importance in the consideration of the tax treatment of the family unit, the position of the capital taxes must also be taken into account for a comprehensive review of the position. The capital taxes are therefore reviewed in Chapter 5 and this part ends with a short Chapter (Chapter 6) which summarises the material presented so far.
CHAPTER I - INCOME TAX - HUSBAND AND WIFE - THE GENERAL RULE

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Section 2. Historical background to aggregation and accountability.

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Section 8. Judicial interpretation of section 37.

1. The residence cases.
2. The computation cases.
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CHAPTER I

HUSBAND AND WIFE - INCOME TAX -

THE GENERAL RULE

Section

1. A statement of the general rule.
2. Historical background to aggregation and accountability.
3. The application of the general rule to certain reliefs.
4. The effect of the general rule.
5. Progressive taxation.
6. Personal allowances.
7. Examples.

This chapter discusses the general rule concerning the income tax treatment of husband and wife. The chapter commences with a statement of the general rule of the aggregation of incomes and husband's accountability. In order to appreciate the present provisions a knowledge of their historical development is essential and this is included immediately following. Attention is then drawn to five special circumstances when the rule is applied and two specific statutory exceptions when it is not. The effect of the rule is then considered within the context of the systems in which it operates, notably the systems of progressive taxation and personal allowances; in order to
appreciate the impact of these interconnected provisions some simple examples are then provided which will illustrate their effect in different circumstances. The general rule has been considered by the courts on a few occasions and no account of the rule would be complete without a reference to those judicial decisions. Finally, some conclusions are drawn from the material so far presented.

1. A Statement of the General Rule

The relevant statutory provisions containing the legislation affecting the income tax treatment of husband and wife are found in Chapter IV of Part I of The Taxes Act (as amended) and specifically in sections 37 - 42. The general rule is contained in section 37 and is to the effect that the income of a married woman living with her husband is deemed for income tax purposes to be his and not hers. As section 37 is the foundation for the present tax treatment of husband and wife it is set out in full below (emphasis added):-

"37. General rule for aggregation of wife's income.

(1) Subject to the provisions of this Chapter, a woman's income chargeable to income tax shall, so far as it is income for -

(a) a year of assessment; or

(b) any part of a year of assessment, being a part beginning with 6th April, during which she is a married woman living with her husband, be deemed for income tax purposes to be his income and not to be her income:

Provided that the question whether there is any income of hers chargeable to income tax for any year of assessment and, if so, what is taken to be the amount thereof for income tax purposes shall not be affected by the provisions of this subsection."
(2) Any tax falling to be assessed in respect of any income which, under subsection (1) above, is to be deemed to be the income of a woman's husband shall, instead of being assessed on her, or on her trustee, guardian, curator, receiver or committee or on her executors or administrators, be assessable on him or, in the appropriate cases, on his trustee, guardian, curator, receiver or committee, or on his executors or administrators:

Provided that nothing in this subsection shall affect the operation of section 152 of this Act (assessment of partnership income).

(3) Any deduction from a man's total income made under section 8 (2) of this Act shall be treated as first reducing the earned income of his wife.

(4) References in this section to a woman's income include references to any sum which, apart from the provisions of this section, would fall to be included in computing her total income, and this subsection has effect in relation to any such sum notwithstanding that some enactment (including, except so far as the contrary is expressly provided, an enactment passed after the passing of this Act) requires that that sum should not be treated as income of any person other than her.\(^1\)

The effect of section 37 is that all the income of a wife is deemed to be the income of the husband and is assessed on him. This rule has two main consequences: the first is administrative in that the husband is responsible for making a return of the joint income and for paying the joint tax liability (section 37 (2)); this is the rule of husband's accountability. The second consequence affects the amount of tax payable: the general rule is that the incomes of the husband and wife are aggregated and treated as one income for the purposes of calculating the rates of tax and amount of tax due; this is the rule of aggregation. (Section 37 (1)).

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"The system (is) that there must be the aggregation of their two incomes in order to see whether or not their total income is subject to tax and what is the effective rate at which it should be charged".  

Under the present law this is the only instance of aggregation which now remains and to appreciate its inclusion it is helpful to trace the historical origins of the rule, at the same time referring to the general law relating to the property rights of married women. The result is of interest: a rule which commenced in 1799 as a simple provision requiring a husband to return and account for his wife's tax, and which was then entirely consistent with the treatment of her property generally, later developed into a provision requiring aggregation of their incomes. When aggregation first appeared it was not in fact of great importance as the rates of tax were then proportional and not progressive. However, although the position of married women subsequently changed radically at law, and although aggregation created hardship when rates of tax became progressive, no amendment to this general rule has yet been made, although some ancillary adjustments and reliefs of an optional nature have been introduced and


2. For a reference to the temporary aggregation of infant child's investment income during the years 1969-72 see Chapter 4 page 250. Section 26 Taxes Act also contains provision for the allocation of partnership profits to individual partners for the purposes of the personal allowances in Chapter II (sections 5-27) of Part I Taxes Act. Partnership income is the converse of aggregated income, as it has to be disaggregated before individual tax reliefs and rates are applied to it whereas, with aggregation, two or more incomes are added together before the individual reliefs and rates are applied.
these will be considered in Chapter 2. The historical development of the rule, which is now found in section 37, is now considered.

2. **Historical background to Aggregation and Accountability**

The principle of aggregation which is now found in section 37 first appeared in 1805. To appreciate the background to the rule a short summary of the treatment of married women's property rights is given first; this is followed by an outline of taxation provision before 1799 when the first income tax legislation was introduced. The Acts passed in 1798, 1799, 1803, 1805, 1806 and 1842 all have some relevance to present day legislation and a reference will be made to each. The change in the treatment of the property rights of married women, which occurred in 1882, is then considered and the passage of the consolidating Income Tax Act in 1918 is noted. The Royal Commission under the chairmanship of Lord Colwyn reported in 1920¹ and commented on the tax treatment of husband and wife. Further important legislative changes in the treatment of married women's property rights were made in 1935² and these are outlined. Certain legislation amending the tax provisions was passed in 1950³ and this, and the consolidating Income Tax Act 1952, will be referred to, together with the report of the Radcliffe Commission in 1954.⁴

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A short reference will then be made to the Finance Act 1976 which contained a minor amendment to section 37 and finally the provisions of section 22 Finance Act 1978, which provided for repayments to be made to wives in certain circumstances, will be considered. The history of the rule therefore commences with a short summary of the treatment of married women's property immediately preceding the introduction of the income tax in 1799.

(1) Married women's property rights in 1798.

The rule which is now found in section 37 Taxes Act has its origins in the very beginnings of income tax itself. Income tax was first introduced in 1799 but in order to appreciate the provisions as they affected married women it is necessary to bear in mind the treatment at law of married women's property.

Before 1882 a married woman had no separate personality at law: she and her husband were one. The effect of marriage, broadly speaking, was to transfer to the husband everything that the wife possessed or acquired. This had two results: first, a married woman was unable to hold property in her own name; secondly, a married woman had no legal capacity and could not be sued either in contract or in tort.

The position at common law in 1765 was summarised in the words of Blackstone:-

"By marriage the husband and wife are one person in law. That is, the very being or legal existence of the woman is suspended.

1. Section 36.
During marriage or at least is incorporated or consolidated into that of the husband under whose wing, protection or cover she performs everything; and is therefore called in our law - French a feme-covert... and her condition during her marriage is called her coverture. Upon this principle, of union of person in husband and wife, depend almost all the legal rights, duties and disabilities that either of them acquire by the marriage.¹

Among these disabilities were the fact that all the wife's personal property vested absolutely in the husband on marriage and in real property he gained title to the rents and profits during coverture. Also:

"During the marriage the husband is, in effect, liable to the whole extent of his property for debts incurred... by his wife... [and]... during the marriage the wife cannot contract on her own behalf."²

There were, however, some borough customs which treated a woman who carried on a trade apart from her husband as, in some respects, independent.³

From Elizabethan times the court of equity had introduced modifications to the rule of unified personality by the development of the equitable doctrine of the "separate estate" so that any property which was given to a married woman expressly for her "separate use" was treated in equity as being under her separate control.⁴ She still could not hold the legal estate but this could be held by trustees in which case they and the married woman together could make a good title without the husband's concurrence.

If no trustees were appointed, and property was conveyed direct to the wife for her separate use, the legal estate passed to the husband but he was treated in equity as holding as trustee for the wife. The doctrine of the separate use gave a married woman a limited capacity to contract but her liability was proprietary only: a contract made with reference to her separate property was enforceable to the extent that the property could be seized to satisfy the liability but there was no personal liability: a married woman could not be made bankrupt or committed to prison for non-payment of a judgment debt; neither could she be sued in tort.

Thus, before 1882, the income of a married woman could belong to one of four categories, namely:

1. income from her property which became the property of the husband absolutely on marriage or subsequently; or
2. income from her "separate estate" of which the husband was trustee, either expressly or impliedly; or
3. income from her "separate estate" of which the husband was not trustee; or
4. income from certain of her activities as a sole trader.

This, then, was the general position before income tax was introduced in 1799.

(2) **Income tax before 1798**

Before 1798 there was no income tax as we know it today. The main sources of revenue were the land tax, the customs and excise duties, the stamp duties and the "assessed taxes". The "assessed taxes" comprised an expenditure tax based on the value of certain property owned by the taxpayer, including carriages, horses, servants etc., together with the window tax and an inhabited house duty.¹ The yield of these taxes in 1797² was:

<table>
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<th>Description</th>
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<tr>
<td>Customs</td>
<td>£ 6,527,882.19.3d</td>
<td></td>
</tr>
<tr>
<td>Excise</td>
<td>£12,038,210 5.9d</td>
<td></td>
</tr>
<tr>
<td>Stamp Duties</td>
<td>£ 2,262,568.12.5d</td>
<td></td>
</tr>
<tr>
<td>Land Tax and</td>
<td>£ 3,485,341.16.10d</td>
<td></td>
</tr>
<tr>
<td>Assessed Taxes</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(3) **The Triple Assessment of 1798**

In 1798 the Prime Minister, Pitt, needed to raise money to fight the Napoleonic Wars and so he introduced the "Triple Assessment".³ This Act provided that the returns which had been made in the previous year, (1797) for the assessed taxes, of each "individual's taxable establishment", were to be used as the tax base for the 1798 assessment and the rates were then doubled, tripled or quadrupled.⁴ No mention is made in this Act of the taxation of married

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³ (1798) 38 Geo 3 c 16. Statutes at Large, Volume 41, page 534.
⁴ Section 2.
women but, as the tax was based on an "individual's taxable establishment", and as a married woman could not then at law hold the legal title to her own property, it can perhaps be assumed that a married couple would have been treated as one establishment for this purpose. Although this Act did not impose a tax on income as such, it is the immediate forerunner of the first income tax Act and the concept of the "taxable establishment" which was well known in 1798, and the basis of the assessed taxes, could not have been far from the minds of those responsible for framing the first true income tax Act in 1799.

The historical fact that the assessed taxes were, in fact, based on a "taxable establishment" or "household" may also explain the subsequent frequent confusion of certain commentators who persisted in regarding husband and wife as one "household" for income tax purposes although the concept of a "household" had no relevance for income tax.

(4) The first Income Tax Act - 1799

The "Triple Assessment" was not a success and the first true income tax was introduced in 1799.¹ This Act levied tax at the rate of 10 per cent² upon the total income of the taxpayer who was required to make a general return of income. That Act contained two distinct provisions concerning married women, one in section 38 and the other in section 41.

2. Section 2.
Section 38 imposed four obligations on each householder: first to provide a list of persons resident in his house; secondly, to provide a list of beneficiaries in respect of whom he was trustee; thirdly to state his own tax contributions; and fourthly to state tax contributions to be made by him as trustee. This section is extremely lengthy but the marginal note reads:

"The Assessors shall yearly give notice to householders and persons occupying distinct apartments to deliver within fourteen days lists signed by them containing the name of every lodger, inmate etc., resident in such apartment and also lists of persons residing abroad "and of every infant, idiot, lunatick or married woman" entitled to income in receipt of such householder as trustee and the names of his co-trustees if any; and also of persons receiving income from property of which the householder is trustee which lists such householder or occupier shall make out accordingly and also a statement of the sum he means to contribute as not less than the just proportion of his income under this Act and also a like statement of a sum to be contributed by any person whose income such householder or occupier shall be in the actual receipt of".

Section 41 provided as follows:

"Income of married women shall be stated by their husbands; but the wife may be examined as to her separate property.

And be it further enacted that the income of any married woman living with her husband shall be stated and accounted for by her husband at the time of delivering his own statement under this Act: provided that the Commissioners shall be at liberty to summon the wife and examine her touching her separate property, under such rules and regulations as any party may by this Act be examined".

The result of these two sections appears to be that section 41 applied to all categories of income of a married woman living with her husband and it was thus his
responsibility to make a return of the income of his wife even, it appears, if she had separate property of which he was not a trustee. This would leave section 38 to apply to the income of a married woman not living with her husband: her property would be held by other trustees and the section makes them liable to make a return of the income and a contribution in respect of tax due.

An examination of section 41 leads one to the conclusion that the Act of 1799 was only effective to provide that the duty of a married man living with his wife extended to the making of a return of his wife's income with his own and possibly also to the payment of tax; in other words, section 41 introduced the accountability rule. Bearing in mind the general rule, that the property of a married woman then belonged to her husband, this provision is not surprising, but it is to be noted that neither section 38 nor section 41 made any mention of aggregation, that is of treating the wife's income as part of the total income of the husband. However, when tax is payable at a flat rate throughout (a proportional tax) it makes no difference whether or not income is aggregated, for the rates of tax will always be the same. The Act of 1799 did, however, introduce a system of exemptions and reliefs; for example, no tax was charged in respect of incomes below £60 and reduced rates applied to incomes between £60 and £200, the full rate applying thereafter.¹ Section 2 of the Act provided that tax should

¹ Section 2.
be charged on "the income of every such person". As no specific mention is made of the income of a married woman, and as the exemptions and reduced rates were specifically applied to the income of every "individual", it appears that a married woman could then have enjoyed her own exempt and reduced rate reliefs. Accordingly, while the Act of 1799 introduced the principle of husband's accountability, it did not introduce the principle of aggregation.

It is also interesting to note that as early as 1799 the Inland Revenue were reserving the right to ask a married woman for information about her income, even though the primary liability to make a return rested on the husband. This provision subsequently had a chequered history but the same principle is behind the rules which now appear in section 40 Taxes Act.¹

Finally, it is again interesting to note the duties given to "householders" by section 38; these are confined to delivering annual lists of persons resident with them; although there is a separate duty to deliver a list of persons on whose behalf the householder receives income as trustee and to pay tax on that income, there is no general liability on the "householder" otherwise than as trustee. Thus, it is clear from its commencement that income tax is a tax on individuals, and not on households.

(5) The Act of 1803

In 1802² the 1799 Income Tax Act was repealed but

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1. Section 40 is fully discussed in Chapter 2, post.
in 1803 the then Prime Minister, Addington, re-introduced the concept of a tax on incomes. Again, the 1803 Act contained two provisions affecting married women; the first was contained in section 89 and provided that trustees for persons under a disability (then including married women) should be chargeable to tax to the same amount as if such persons were not under a disability. The second provision, in section 91, provided that a married woman acting as a sole trader should be treated as a single woman but that a married woman living with her husband should be charged in the name of her husband and not of her trustee or trustees.

Section 89 read as follows:

"And be it further enacted that the Trustee or Trustees, Guardian or Guardians, Tutor or Tutors, Curator or Curators, Committee or Committees, of any person or persons being infants or married women lunatics idiots or insane having the direction control or management of the property or concerns of such infants, married women, lunatics, idiots or insane persons ... shall be chargeable to the said last mentioned duties in like manner and to the same amount as would be charged as if such infants were of full age, or such married women were sole, or such lunatics idiots or insane persons were capable to act for themselves". (Emphasis added).

And section 91 read:

"And be it further enacted that any married woman acting as sole trader by the custom of any city or place or otherwise shall be chargeable to such and the like duties and in like manner except as hereinafter is mentioned as if she was actually sole and unmarried: Provided always that any married woman living with her husband shall be charged in the name of the husband and not of the trustee or trustees".

1. 43 Geo 3 c 122. Statutes at Large, Volume 44, page 740.
Now, as a matter of statutory construction, events which fall within a proviso to a section are excluded from what goes before. Accordingly, the combination of these sections appears to mean that all categories of income of a married woman living with her husband were assessed on him, even separate property of which he was not trustee. In this respect no change was made from the 1799 Act. However, although the general rule, that the income of a married woman living apart from her husband was assessed on her trustee, is repeated, a new provision appears applicable to the income of a married woman who was a sole trader and living apart from her husband: she was now to be treated as a single woman. This reference provides a further link between the income tax laws and the property rights of married women; at general law the principle was recognised in some boroughs that a married woman could trade in her own name, in which case her trading profits did not belong to her husband and she could contract in her own name. This property right is reflected in the income tax provisions of section 91.

It will be noted that no mention is yet made of the aggregation of the incomes of husband and wife: the wife is only "charged in the name of the husband", and where she is chargeable in the name of her trustee it is "to the same amount" as if she were sole.

It will also be noted that in both sections 89


and 91 the reference is to "duties" which, in the context of that statute, included all taxes under all schedules and cases.

Finally, it will also be noted that the present curious reference in section 37 (2) Taxes Act to "trustee guardian, curator, committee or receiver" comes directly from section 89 of the Act of 1803; now that Act included these persons to represent "infants, married women, lunaticks (sic) idiots and the insane". Clearly, in 1803, guardians and tutors were relevant for infants; committees and curators were then relevant for insane persons; and trustees were relevant for married women. It is, perhaps, a reflection on the care with which the present legislation was recast in 1950¹ to note that these antiquated references still remain in force to the present day, even though four of the five representative persons were not, in 1803, relevant for married women, and the fifth (trustees) ceased to be so relevant in 1882.

(6) The 1805 legislation

In 1805² the system of income tax introduced by Addington in 1803 was adopted by Pitt;³ the provisions of the 1803 Act were recast and the provisions which first appeared in section 89 of the 1803 Act appeared again as section 99 of the 1805 Act. However, the provisions which had appeared in section 91 of the 1803 Act were expanded and in 1805 they

1. Finance Act 1950 section 30; see page 47 post.
2. 45 Geo 3 c 49. Statutes at Large, Volume 45, page 811.
appeared as follows:-

"101 How married women, trading as sole, or living with their husbands, shall be charged.

And be it further enacted that any married woman acting as a sole trader by the custom of any City or Place, or otherwise, shall be chargeable to such and the like duties, and in the like manner except as hereinafter is mentioned, as if she was actually sole and unmarried: Provided always that the profits of any married woman living with her husband shall be deemed the profits of the husband, and the same shall be charged in the name of the husband and not in her name or of her trustee or trustees: Provided also that any married woman living in Great Britain separate from her husband, whether such husband shall be temporarily absent from her, or from Great Britain, or otherwise, who shall receive any allowance or remittance from property out of Great Britain shall be charged as a feme sole, if entitled thereto in her own right, and as agent of the husband if she receive the same from or through him or from his property or on his credit". (Emphasis added).

Section 101 thus introduced two changes from the provisions of section 91 of the 1803 Act. First, and most important, here is the first mention of the "deeming provision", and although in 1805 the provision can have had no effect on the rates of tax payable on the joint income, (a flat rate then being charged), the provision would have had the effect of giving only one set of exempt and reduced rate reliefs in respect of both incomes. (See section 180).

Secondly the section introduced a special proviso applicable to married women who were separated from their husbands and who received remittances from abroad; such married women were to be treated as single if the payments were made to them in their own right, and as agents for their husbands if the payments came from them. The origin of this
proviso was considered by the Court in Nugent-Head v. Jacob\(^1\) when the view was expressed that it had been introduced in 1805 in order to retain the aggregation rule when taxing the incomes of the wives of soldiers in the Indian Army. Whatever the reason for its enactment the way in which the section was drafted was strongly criticised by the Court and was subsequently repealed in 1950.\(^2\)

A reading of section 101 could give the impression that the legislature intended to provide that all married women who were sole traders as defined were to be assessed as single women, whether or not they were living with their husbands, but because the proviso to a section overrules the previous provisions, this is not, in fact, what was enacted.\(^3\)

In the context of section 101 of the 1805 statute the word "profits" is used in connection with income arising under schedules C, D and E (see sections 74, 93 and 160 respectively) but not to schedules A and B. These two schedules, of course, taxed land values rather than income.

However, the special sections dealing with married women only appear within the context of schedule D and this is perhaps understandable. Schedules A and B taxed land values and, as married women could not hold the legal estate in land, the tax would be paid by the legal owner who would be either their trustees or their husbands. Schedule C taxed annuities, dividends and shares when tax would be deducted at source, and at that time, schedule E only taxed

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1. (1948) 1 All E.R. 414. For a full discussion see page 87 post.
3. Cross, Sir Rupert, Statutory Interpretation, pages 104-107, and see also Re Ward, Harrison v. Ward (1922) 1 Ch S17 at page 570 discussed at page 104 post.
certain income from certain stated public offices which were not then open to married women; schedule E did not then apply to employment generally as it does today.

However, it is a matter of historical interest that when the aggregation rule was introduced in 1805, it specifically was limited to schedule D profits. Accordingly, after the 1805 Act a married woman could be assessed in one of four ways; first, if she was not living with her husband, and carried on business as a sole trader in a borough whose custom so permitted, she was taxed as a single woman; secondly, if she was a married woman living with her husband her trading profits were deemed to be his income; thirdly, trading property was taxed in the hands of her trustees, who could be either her husband or other trustees; finally, if she lived separate from her husband she was taxed as a single woman on remittances from abroad if paid to her in her own right.

(7) The 1806 provisions

Although the Act of 1806 modified some of the provisions of the Act of 1805, no major changes were made in the sections affecting married women except that in 1806 the provisions applied to tax under all schedules. The

1. Section 101.
2. Section 101 proviso (1).
3. Section 99, repeating section 89 of the 1803 Act.
4. Section 101 proviso (2).
5. 46 Geo 3 c 65. Statutes at Large, volume 46, page 156.
provisions about married women living apart from their husbands, which were originally contained in section 89 of the Act of 1803, and which then became section 99 of the 1805 Act were re-introduced as section 54 of the 1806 Act. The provisions which originally appeared in section 101 of the 1805 Act, concerning sole traders, married women living with their husbands, and women in receipt of remittances from abroad, were re-enacted without change in section 56 of the 1806 Act. In 1816, however, all the tax legislation was repealed.¹

(8) The Income Tax Act 1842

In 1842 income tax was re-introduced² and the method was adopted of reprinting the 1806 Act with modifications. So, section 101 of the 1805 Act, which had become section 56 of the 1806 Act was re-introduced as section 45 of the 1842 Act. One change was, however, made; the section now commenced:

"And be it further enacted that any married woman acting as a sole trader or by the custom of any city or place or otherwise, or having or being entitled to any property or profits to her sole or separate use shall be chargeable"...etc. as in § 101 of the 1805 Act.³

Now a married woman who was separated from her husband was treated as single in almost all cases and her trustees were no longer liable to tax on her separate property. Again, the wording of this section leads to the thought that the legislature may have intended to provide for the separate assessment of all married women traders, and married women

2. 5&6 Vict. 35. Statutes at Large, Volume 82, page 237.
3. See page 40 above,
with separate property but, because this provision was followed by a proviso dealing with married women living with their husbands, the proviso overruled the previous provisions where it was applicable.

(9) The Married Women's Property Act 1882

It is not surprising that the framers of the early Income Tax Acts in 1799, 1803, 1805, 1806 and 1842 provided for the accounts of a married woman to be rendered by her husband who would at law have been entitled to administer her property: it was also understandable that the husband should have been made liable for payment of the tax: if a wife could not be sued either in contract or in tort it may have been doubtful if she could have been sued for unpaid income tax; it was clearly advisable, therefore, that specific provision be made for the liability to be that of the husband.

A fundamental change in the property rights of married women took place in 1882 when the Married Women's Property Act of that year was passed. First, the Act changed the property rights of a married woman by providing that all property acquired by a married woman after the passing of the Act was her separate property and that she could acquire, hold and dispose of the whole legal and beneficial estate without the concurrence of her husband, as if she were a feme sole. Secondly, the Act changed her contractual rights by providing that a married woman should be capable of entering into and rendering herself liable in respect of, and to the extent of her separate property, on any contract, and of suing and being sued in contract. However, her contractual liability remained

1. Section 1 (1).
2. Section 1 (2).
proprietary only - a married woman was still not personally liable nor could she be made bankrupt nor be committed to prison.

Despite this major change in the legal treatment of married women's property, no amendment was made to the income tax legislation. Perhaps it is understandable that the obligation to account for tax should not be taken from the husband and placed on the wife, as a wife's liability in contract and in tort was still limited: but with the abolition of the "unified personality" as far as holding property was concerned one might have expected the "deeming" provisions, which resulted in aggregation, to be repealed.

Further, the retention of the husband's obligation to make a return of his wife's income when he no longer had any means of discovering what that income was, was to lead to many difficulties in the future.1

(10) The Income Tax Act 1918

In 1918, the Income Tax Act, which consolidated all previous legislation, was passed. No amendment was made to the provisions relating to married women and the wording which first appeared in section 101 of the 1805 Act, and then in section 56 of the 1806 Act, and then slightly amended in section 45 of the 1842 Act appeared again in Rule 16 of the All Schedules Rules2 to the Income Tax Act 1918.


In 1920 the provisions of Rule 16 of the All Schedules Rules to the Income Tax Act 1918 came under

1. These difficulties are fully discussed in Chapter 8 post.
2. i.e. The General Rules applicable to Schedules A, B, C, D and E.
consideration by the Royal Commission on the Income Tax (Chairman: Lord Colwyn) who reported\(^1\) that:

"the aggregation of the incomes of wife and husband should continue to be the rule",

on the basis that this was justified by reference to the taxable capacity of a household.\(^2\)

The Report of the Royal Commission is considered more fully in Part II of this thesis,\(^3\) but here it may be noted that no change in the principle of aggregation was made in the Finance Act 1920 which contained so many other amendments designed to implement the recommendations of the Royal Commission and to modernise the income tax legislation in order to adapt it to the changing realities of contemporary life.

(12) The Law Reform (Married Women and Tortfeasors) Act 1935

It has been seen that the two principles of husband's accountability and aggregation, which were introduced into income tax law in 1799 and 1805 respectively, remained unchanged even after the passing of the 1882\(^4\) legislation which introduced radical changes in the treatment of married women's property. In 1935 further important changes were made in this area and The Law Reform (Married Women and Tortfeasors) Act 1935 provided for married women to be treated in (almost) all respects as other persons.

1. Cmd 615.
2. Paragraph 260.
3. Page 312 post.
As far as property rights were concerned, the passage of time meant that the few reservations (regarding property acquired before 1882 by a woman who was married before 1882) made by the 1882 Act had almost disappeared: a married woman was put in the same position as everyone else and all references to "separate property" were no longer appropriate. But, more important, her contractual rights were altered, and with them her liabilities. She now became personally liable in contract and she could be made bankrupt or committed to prison for non-payment of judgment debts. Once again, however, this major change was not reflected in the income tax legislation and the increasingly anachronistic provisions concerning the tax treatment of married women were strongly criticised by the Court in Nugent-Head v. Jacob¹ in 1948. Following that case the legislation was amended, in section 30 Finance Act 1950, but that change did not affect the fundamental principles of aggregation and husband's accountability.

(13) Finance Act 1950

The twin principles of aggregation and husband's accountability were re-enacted in section 30 of the Finance Act 1950 but two of the provisions previously found in Rule 16 of the All Schedules Rules of the Finance Act 1918, which were so severely criticised by the Court in Nugent-Head v. Jacob² were then repealed. In that case the main criticism was directed against the "sole trader" provisions

1. (1948) 1 All E.R. 414.
2. (1948) 1 All E.R. 414. For a summary of the facts in this case see page 88 below.
and the provisions concerning remittances from abroad; these were both repealed by the 1950 Act. The Court also criticised the fact that the treatment of a married woman living with her husband (the usual case) had been relegated to a proviso; in 1950 this provision became the main purpose of section 30. Finally, the court criticised the failure of the income tax legislation to "take any notice of the capacity given to married women to hold property, conferred by the Married Women's Property Act"; the proviso to section 30(1) provided that for purposes other than income tax the property of a married woman should not be affected by the provisions of the subsection, which continued to require the aggregation of her income with that of her husband and continued to place the responsibility for accounting for her income tax on him.

Section 30 is not set out here in full as it is in almost exactly the same terms as section 37 Taxes Act which is set out in full above.\(^1\) The only slight difference concerns a minor change made in 1976 which is referred to shortly.

(14) **Income Tax Act 1952**

In 1952 all the income tax legislation was consolidated and the provisions in section 30 Finance Act 1950 were re-enacted in section 354 Income Tax Act 1952.

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1. Page 25 above.
Between 1952 and 1955 the Royal Commission on the Taxation of Profits and Income, under the Chairmanship of Lord Radcliffe, published three Reports. The "unit of taxation" was discussed in Part II of their Second Report. A more detailed analysis of that discussion will be contained in Part II of this thesis but it may here be noted that the Commission concluded:

"that taxation of the combined incomes of husband and wife as one unit is to be preferred to their separate taxation as separate units because the aggregate income provides a unit of taxation that is fairer to those concerned".

And later the Report says:

"Our recommendation is therefore in favour of maintaining the general rule of aggregation for the incomes of husband and wife".

The Taxes Act

Income tax legislation was again consolidated in the Income and Corporation Taxes Act 1970 (the Taxes Act) when the rule which had been embodied in section 354 Income Tax 1952 was re-enacted as section 37 and that section remains in force today, with some minor amendments which were introduced in 1976.

2. Page 312 post.
4. Paragraph 120.
(17) The Finance Act 1976

A slight amendment to section 37(1) was made by section 36 Finance Act 1976. That section provided that the aggregation of the incomes of married persons was to be delayed until the commencement of the first full year of assessment subsequent to their marriage. This brought to an end the previous advantage whereby in the year of marriage the wife obtained a full single person's relief for the period before the marriage, and the husband obtained both a proportion of the married man's personal allowance for the period after the marriage and the wife's earned income relief: the latter was lost.¹

(18) Finance Act 1978

In 1978 a new legislative provision was introduced designed to transfer the legal entitlement in certain repayments of income tax from husband to wife.²

The section was designed to ensure that a married woman would become, in most cases, entitled to a direct repayment from the Inland Revenue of tax deducted from her income under PAYE; previously such repayment had to be made through her husband.

Section 22 Finance Act 1978 therefore now provides that from 21st July 1978 repayments of tax deducted under PAYE are to be made direct to the wife if the repayment is

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¹. See further Chapter 3, page 173 post.
². The reasons for the introduction of this legislation are fully discussed in Chapter 8, page 416 post.
attributable to her tax. However, the section also provides that the Inspector has to notify both husband and wife of the amount due and either spouse may appeal; the section does not apply to a wife's repayments when the husband is liable to higher rate tax, nor when the wife is assessed on earned income other than Schedule E, nor where a repayment is due in respect of a wife's investment income. In all these cases repayments must continue to be made to the husband. 1

3. The Application of the General Rule to Certain Reliefs

This chapter is a consideration of the general rule applicable to the income tax treatment of husband and wife. So far the rule has been stated with its immediate consequences and it has been placed in its historical context from 1799 to the present day. At this stage it may be useful to consider the extent to which the rule is reinforced or weakened by other statutory provisions which operate within the situation covered by the general rule, that is of a man and a wife who are living together. In Chapter 2 of this thesis attention will be drawn to certain statutory provisions enabling the general rule to be altered but the most important of these, namely those contained in section 38 of the Taxes Act relating to separate assessment, and those contained in section 23 Finance Act 1971 relating to separate taxation of wife's earnings, are only available where a deliberate option has

1. Except where an option for separate assessment is in force - see Chapter 2.
been exercised. The seven statutory provisions which will now be discussed all operate within the general rule laid down by section 37, which applies automatically where no option has been exercised.

When a husband and wife are living together their income is aggregated for tax purposes, as a general rule. It would appear to follow, therefore, that they should be treated as one person for all reliefs and deductions but an examination of the statutory provisions will reveal that this is not always so. Personal allowances and reduced rate relief will be considered later in this Chapter but here it is interesting to note five specific instances where the rule of single personality is applied and two where it is not. Husband and wife are treated as one for the purposes of life assurance relief; income tax relief for losses; income tax relief for capital allowances; mortgage interest relief and relief for investment in new corporate trades. They are, however, treated as separate persons for relief for savings bank interest and retirement annuity relief. Each of these will be now briefly discussed.

(1) **Life assurance relief**

Section 19 and Schedule 1 Taxes Act contain provisions giving relief from income tax in respect of premiums paid under "qualifying policies". The relief now operates by permitting the taxpayer to withhold a sum equal to 15 per cent of the premium and to pay the balance to the insurance company; in due course the Inland Revenue pay the shortfall to the company.  

There are three main conditions attached to this relief. The first, which is that the policy should be a "qualifying policy" (i.e. mainly an endowment or whole-life policy) applies equally to single or married persons. The second condition is that relief may only be claimed by a single person if he takes out a policy on his own life and pays the premium himself. This condition is interpreted strictly and the relief is not available where two unmarried persons take out a joint policy and jointly pay the premiums.¹ For a married couple the condition is adjusted to provide that relief is available to either spouse who takes out a policy either on his or her own life or the life of the other spouse and either spouse may pay the premiums.² The final condition for relief concerns the amount of premiums paid. For a single person the maximum is £1,500 or a sum equal to one-sixth of total income, whichever is the greater³. For a married couple the limit is the same; in other words the relief for both husband and wife is limited as if they were a single person. If the one-sixth rule applies, then there will be no disadvantage as this will be calculated on the aggregated total income but if both husband and wife have small incomes, so that, if single, each would enjoy a £1,500 limit, this will be restricted by marriage.⁴

These provisions are a logical extension of the rule of aggregation which treats the incomes of husband and

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2. Section 19(2)(b) and (c) Taxes Act.
3. Section 21(1) Taxes Act.
wife as one income. The rule can be advantageous to a married couple, who are permitted to insure each other's lives and share responsibility for the payment of the premiums. There are, however, some disadvantages: the limit on premium relief means that a married couple may obtain less than the total relief available to two single persons.

(2) **Loss relief**

(a) **Carry-forward.** Section 168 Taxes Act contains provisions giving relief from income tax to a taxpayer who has suffered a loss in any trade, profession or vocation; he is permitted to set off such loss against his other income for the same year or for the following year. Where the loss is incurred from a source of earned income it must first be set off against earned income and then against investment income: if the loss is incurred from a source of investment income it must first be set against investment income and then against earned income.¹

However, a married taxpayer whose own income is insufficient to absorb the loss may set off the loss against the income of his spouse in the same order. So, if a taxpayer suffers a loss from a source of earned income that loss will be set off first against his earned income, then against his investment income, next against the earned income of his or her spouse and finally against the investment income of his or her spouse.¹ However, a taxpayer is not obliged to set off the balance of a loss against the income of his or her spouse but may carry the balance forward

¹. Section 168 (4).
against his own future income.¹

These provisions are, in the main, a logical application of the rule of aggregation save for the option in section 168(3), that relief need not be given against the income of the spouse but may, if desired, be given by reference to the future income of the person sustaining the loss. This option was introduced in 1971.²

The loss provisions are mainly advantageous to married couples and are another logical extension of the rule of aggregation. It may well be an advantage to obtain loss relief at an early date by a set-off against current income of the spouse: but where a taxpayer would prefer to carry forward his own loss and set it against his own future income he can choose to do so.

The interaction of the loss relief provisions with section 37 was considered in the case of Re. Cameron, deceased, 1965.³ This case is considered in detail later in this Chapter⁴ but here it can be noted that the case confirmed that repayments due to a wife arising out of losses made by a trade carried on by her, and capital allowances due in respect of such trade, which were set off against her investment income, belonged beneficially to the wife but were paid to the husband, under the provisions of section 37, to hold on behalf of his wife.

1. Section 168 (3).
2. By section 16(1) (2) (a) Finance Act 1971.
3. (1965) 3 All E.R. 474.
4. See page 99 post
(b) **Carry-back.** Section 30 Finance Act 1978 contains further relief for losses suffered in the early years of a trade; briefly such losses may be "carried back" and used against any income in the three years preceding commencement of the trade. The same comments as are made in connection with section 168 above also apply to section 30 with one specific exception. Sub-section (5) of section 30 specifically provides that relief is not available to the individual who "at the time when (the trade) is first carried on by him is married to and living with another individual who has previously carried on the trade". These provisions therefore restrict the relief to married persons in this particular way and mean that carry-back loss relief against other income cannot be obtained for a failing business by transferring it to a spouse.

(3) **Capital allowances**

The provisions of the Capital Allowances Act 1968 enable an allowance to be granted for certain types of capital expenditure which enable such expenditure to be relieved against profits, or other income, over a period of years.

The 1968 Act grants capital allowances for qualifying expenditure in certain categories. These "capital allowances" may be used in one of two ways, depending on the type of expenditure. Section 70\(^1\) provides for allowances in respect of expenditure on dredging, wasting mineral deposits, machinery and plant, and industrial building and structures to be deducted from the profits of that trade or

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as a loss for setting off against other income; section 71 provides for other allowances to be used by way of discharge or repayment of tax.

The capital allowance provisions contain no specific reference to the aggregation of the income of husband and wife but the general rule applies: both incomes are treated as one, so the income of the one is available to be set off against the capital allowances of the other. To this extent, the aggregation rule is advantageous but the choice given to a taxpayer to set off a loss against his own future income does not appear to be available for capital allowances. This may be a disadvantage to a taxpayer who would prefer a deduction from his own income or a repayment or discharge of his own tax and not the reduction of his spouse's income or the discharge of his spouse's tax liability.

The amendment to section 37 which was introduced by section 36 Finance Act 1976, and which provided that the aggregation of income of married persons was to be delayed until the commencement of the first full year of assessment subsequent to their marriage, does not apply to the capital allowance provisions in section 71 Capital Allowances Act 1968.

(4) Mortgage interest relief

Section 75 and schedule 9 Finance Act 1972 give relief from income tax paid on certain loans for the

purchase or improvement of land. Section 19 and schedule 1 Finance Act 1974 restrict such interest relief and in particular paragraph 4 provides that the relief is only available in respect of a loan for the purchase or improvement of an "only or main" residence of the borrower, and paragraph 5 provides that interest on such a loan is only eligible for relief to the extent that the amount on which it is payable does not exceed £25,000. Paragraph 5(4) then states:

"For the purposes of this paragraph:
(a) any interest payable on a loan made to the borrower's husband or wife shall be treated as payable on a loan made to the borrower".

This means that only one "mortgage interest relief" is available to a married couple and again follows logically from the principle of aggregation. This provision can usually only be disadvantageous to married couples. It is possible that an advantage could be obtained where the spouse responsible for the interest payments does not have sufficient income to absorb the reliefs, which may then be absorbed by the income of the other spouse, but this situation is highly unlikely to arise in practice, as a loan will not usually be made if a borrower has insufficient income to pay both interest and capital. One situation where an advantage might arise could be the unemployment of one spouse and the payment of interest by the non-borrowing spouse. Another theoretical advantage could be obtained if the borrowing spouse makes repayments out of capital and claims interest relief against the income of the other
spouse: but under present conditions it would be more advantageous to repay the loan completely, if capital is available. Again, if both husband and wife have substantial incomes and the wife has investment income, the husband could pay the interest and deduct it from the wife's investment income thus, possibly, getting relief at 75 per cent rather than 60 per cent.

The main disadvantage of the rule is that married persons do not have a £25,000 limit each. Although an argument could be put forward that a married couple only need one relief because they both have the same residence, this overlooks two factors. First, the treatment of husband and wife as two persons would give relief up to £50,000 for the same house; secondly, it is possible for a happily married couple to own two houses, one in the place of the husband's occupation and one in the place of the wife's occupation or near the children's schools. The first could be the husband's "main" (but not "only") residence and the latter could be the wife's.

(5) Relief for investment in new corporate trades

Sections 52-67 Finance Act 1981, as amended by section 51 Finance Act 1982, provide for income tax relief to be available for taxpayers who invest in new corporate trades. Originally relief was restricted to £10,000 each year but is now £20,000 for each of the years 1982-3 and 1983-4. Section 60 Finance Act 1981 describes how husband and wife are to be treated for the purposes of the relief

2. Section 51 (2) Finance Act 1982.
and provides that the limits on the relief are to apply jointly to a husband and wife: in other words the married couple have only one relief between them.

Five examples of the application of the aggregation rule have now been considered. Some of the results are advantageous (insuring the life of another spouse, obtaining loss relief and capital allowance relief at an early date) but there are three distinct disadvantages, namely, the restriction of life assurance relief, mortgage interest relief, and relief for investment in new corporate trades to the limits applicable to one person and not two. A reference will now be made to two occasions where statute specifically provides exceptions to the aggregation rule and both are advantageous. They are, first, savings bank interest relief and secondly, retirement annuity relief.

(6) Savings bank interest relief

Section 414 Taxes Act provides for relief in respect of the first £70 of savings bank interest,¹ and subsection (1) specifically provides that for this purpose husband and wife have separate incomes notwithstanding the provisions of section 37. Thus, a married couple have a double exemption for savings bank interest but this is a departure from the general aggregation rule; however the provisions merely put husband and wife in the same position as two single persons so no positive advantage is enjoyed.

(7) Retirement annuity relief

Section 226 Taxes Act provides relief in respect of contributions for approved retirement annuity contracts;

¹. Since 1980 this is restricted to interest on deposits with the National Savings Bank, other than investment deposits.
section 227 now indicates that, for the purposes of relief, contributions are limited to 17½ per cent of an individual's "net relevant earnings". Section 226(8) provides that a married woman's "relevant earnings" shall not be treated as her husband's "relevant earnings", notwithstanding that her income chargeable to tax is treated as his income.

Thus, both husband and wife may take out separate annuity contracts and obtain relief up to 17½ per cent of their own "net relevant earnings". Previously there was a "ceiling" on contributions of £3,000 and the aggregation rule should have meant that this limit applied to a married couple jointly. This would have been disadvantageous to a married couple who were both contributing to retirement annuity contracts, if their earnings jointly were above £20,000 (when the income limit of 15 per cent became £3,000). However, section 226(8) gave them a limit each, and, with the abolition of the "ceiling" in Finance Act 1980¹ this difficulty has been removed.

4. The Effect of the General Rule

In this chapter we have now examined the general rule relating to the aggregation of the incomes of husband and wife, its historical evolution and the extent to which the principle of the rule is applied in other statutory provisions. In discussing the historical evolution of the rule it was noted that when the rule was introduced, in 1805,²

¹. Section 31(1).
². 45 Geo 3 c 49. Statutes at Large, Volume 45, page 811.
tax was levied at the same flat rate on all income, i.e. a proportional tax, and that there was an exemption for small incomes.

Under a strict system of proportional taxation aggregation of incomes is neutral; no more nor less tax is paid per £ however large the income or joint income. But in the early years of this century two major changes were made: first, the tax system became progressive and, later, personal allowances were introduced. Both these changes reflected the same concept, namely a move away from a flat rate of tax towards an assessment of an individual by reference to his "taxable capacity".

There had always been an exemption for small incomes but this, of course, was only available to those with small incomes and did not provide a "tax free" band for taxpayers with large incomes. The personal allowances on the other hand, were made available to all taxpayers and, in effect took those with small incomes out of the charge to tax altogether and gave all other taxpayers a "tax-free" slice of income. The progressive rates of tax meant that those with large incomes were taxed at higher rates and accordingly paid more of their incomes in tax.

In considering, therefore, the liability of any individual to tax, these two factors, namely the progression of the tax and the personal allowances available, are of great importance and they are of particular importance in considering the rule of aggregation of income

1. See page 33 above which describes the provisions of the 1799 Act.
which applies to a married couple. As the personal allowances, and the taxation of income at a lower rate, are given to each "individual" it follows that less tax is paid on two roughly equivalent incomes than is paid on one large one. Examples are included later in this chapter to illustrate this point.¹

Accordingly, the rule of aggregation of incomes which would have been neutral when it was introduced within the context of a proportional rate of tax, would, on the other hand, always be a disadvantage to husband and wife in a progressive system unless special provision were made to adjust the rate of progression of the tax and/or to adjust the personal allowances.

Consideration will now therefore be given to the extent to which such adjustment was made. As progressive taxation preceded the introduction of the personal allowances in point of time, that will be considered first.

5. Progressive Taxation

At the turn of this century all incomes were taxed at the same rate, irrespective of the size of the income or of whether it was earned or unearned; small incomes were, however, completely exempt and an abatement was provided for incomes just over the exemption limit so as to modify the first impact of the tax.

For many years pressure had been building up for two reforms - differentiation and graduation. First, it

¹. See page 80 post
was said, earned income should not be taxed so heavily as unearned income, and the two types of income should be "differentiated". Secondly, it was suggested that the uniform rate for incomes over the exemption limit should be modified, and the rates should be "graduated". Both these recommendations were considered by a Select Committee of the House of Commons which reported in 1906. That Committee concluded that it would be possible to differentiate between earned and unearned income, at least up to £3,000, and also to graduate the rates of tax. (Paragraph 32). The first change was made in 1907 when a rate of 9d was charged on "earned" incomes up to £2,000 as against a rate of 1/= on other incomes.

Graduated rates of tax were introduced in 1909, when a "supertax" was levied on all incomes over £5,000; this was the precursor of today's higher rate taxes.

The two underlying principles of the progressive tax system, namely differentiation and graduation, have continued to the present day and are of fundamental importance in evaluating the principle of aggregation. They will now be considered separately.

(1) Differentiation

Even though the incomes of husband and wife are aggregated for tax purposes, all their joint earned income is entitled to be taxed at the lower rate applicable to earned income. At first sight, therefore, it appears that

2. Section 19(1) Finances Act 1907.
the aggregation rule is neutral in this area and this was correct when the same relief was given at every point in the scale.

However, a unified system of personal taxation was introduced by Finance Act 1971, and took effect from the year 1973-74. This provided for the abolition of the old "earned income relief" but a distinction continued to be drawn between earned and unearned income in that the latter became subject to a surcharge when it reached a certain level. In 1973-74 the surcharge was at the rate of 15 per cent on so much of investment income as exceeded £2,000. In 1982-83 the surcharge is at the rate of 15 per cent on so much of investment income as exceeds £6,250.

Now, the limit of £2,000 in 1973-74, and the limit of £6,250 in 1982-83, applies to the total income of an individual. Because of the rule of aggregation, the incomes of both husband and wife are deemed to be the income of the husband. Accordingly, only one "band" of income free of the investment income surcharge is available for a married couple and payment of the surcharge will therefore be accelerated where both have unearned income.

(2) Graduation

When graduation was first introduced in 1909 the standard rate of tax was 1/- in the £ for earned income.

1. Section 32.
and 1/2 in the £ for unearned income. "Supertax" of an additional 6d in the £ was levied on all incomes in excess of £5,000 (in respect of income exceeding £3,000). The highest rate of tax therefore was 1/8 in the £ or 8 1/4 per cent.

In 1982-83 the following rates apply:1

<table>
<thead>
<tr>
<th>Income up to</th>
<th>30 per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>£12,800</td>
<td></td>
</tr>
<tr>
<td>then up to</td>
<td>40 &quot; &quot;</td>
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<tr>
<td>£15,100</td>
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<td>&quot;</td>
<td>45 &quot; &quot;</td>
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<tr>
<td>£19,100</td>
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<tr>
<td>£25,300</td>
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<td>55 &quot; &quot;</td>
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<td>£31,500</td>
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</tr>
<tr>
<td>remainder</td>
<td>60 &quot; &quot;</td>
</tr>
</tbody>
</table>

In addition, the investment income surcharge of 15 per cent is payable when appropriate making a top rate of tax of 75 per cent.

In considering the system of graduation different rules apply to the application of the lower rates and the higher rates to a married couple and these will be considered in turn.

(a) **Lower rates.** A lower rate of tax was first introduced in section 14 Finance Act 1978 but was abolished in 1980.2 The provisions are now of historical interest only but will be referred to as they contained special rules for married persons and they could be re-introduced in the future. The lower rate was stated to be applicable to the first band of a stated size of an individual's total income. For the years 1978-79 and 1979-80 the lower rate was 25 per cent on

a band of £750 of total income. Section 14 inserted a new subsection 1A-1D into section 32 Finance Act 1971, the effect of which was to give husband and wife a lower rate band each to the extent that the wife had earned income to absorb her band, after deduction of the wife's earned income allowance.

Suppose a wife had earned income of £1,500 in 1979-80; after deduction of the wife's earned income allowance (£1,165) there was a balance of £335 which was taxed at 25 per cent. The husband had his own £750 band at the lower rate. However, the wife's lower rate band was only available against her earned income and not against her investment income. Further, whereas after payment of tax at 25 per cent on the first £750 of taxable income a single person then had a full "slice" of £9,250 of income at 30 per cent the "slice" of a married couple's joint income which was taxed at 30 per cent was reduced by the amount of the wife's earned income taxed at the lower rate. This ensured that the basic rate of 30 per cent was payable up to £10,000 total income and that the rate of 40 per cent was payable thereafter, up to the next rate.

(b) Higher rates. Apart from the rules relating to the lower rates, the principle of aggregation is neutral where all income is taxed at the same rate and this is now effectively the case until the joint incomes reach £12,800. However, thereafter aggregation must always be a disadvantage. The principle of progressive taxation was discussed in the Radcliffe Report¹ and the following comment on the

interaction of the progressive system and the aggregation
of incomes of married couples appears in paragraph 113:

"Under a progressive system which would
normally attract more tax from one income
than from two incomes half the size this
principle of aggregation weighs heavily
upon those married couples in which each
partner is the owner of a substantial
income".

Some simple examples are included later in this chapter
which illustrate this point.

Although, since 1971, it has been possible to
disaggregate earned income, it is still not possible to
disaggregate investment income. Accordingly, a wife who
has only a small amount of investment income, possibly
representing interest on savings made out of her own
earnings, will find that income taxed at the highest rate
paid by her husband (and may also find that the investment
income surcharge is payable in addition if the joint
investment income exceeds the threshold).

(3) **Summary**

At this stage it may be convenient to summarise
the effects of the progressive tax system on the principle
of aggregation. The conclusion appears to be that
aggregation can never bring a positive advantage to a
married couple and will bring disadvantages in the following
cases:-

(a) When a couple jointly have more than £6,250 in
investment income but less than £6,250 each. If
they were single there would be no investment income

over £6,250 is taxed at an additional 15 per cent.

(b) Where the joint total income exceeds £12,800 and both have income. In this case the joint income will always be taxed at a higher rate than two separate incomes of the same total.¹

(c) When the lower rates were in force, if a wife did not have earned income (in excess of her wife's earned income relief) to set against the lower rate relief up to £750, but did have investment income. If the wife were single, the lower rate would have applied to her investment income but if she was married it was only available against her earned income.

Having considered the effect of progressive taxation a reference will now be made to the personal allowances.

6. The Personal Allowances

When the Great War started in 1914 progressive taxation had been introduced but the maximum rate of tax was 12½ per cent (1/3 income tax² and 1/4 super tax).³ When the war ended in 1918 the maximum rate was 52½ per cent (6/= income tax⁴ and 4/6 super tax)⁵. The results of this

¹. Although there is provision for disaggregating a wife's earnings - see Chapter 2.
². Section 2 Finance Act 1914.
³. Section 3 Finance Act 1914.
⁴. Section 17 Finance Act 1918.
⁵. Section 20 Finance Act 1918.
change have been summarised as follows:—

"With a low proportional tax comparatively rough and ready methods of defining and computing income are reasonably acceptable; a 10 per cent error with a ten per cent tax can only bring the effective rate to 11 per cent. But with a 50 per cent tax a 10 per cent error can have considerable effect and with a 98 per cent tax it can result in income becoming a liability to the taxpayer. As soon as it was realised, after the end of the 1914-18 war, that maximum rates of tax up to 50 per cent or higher had come to stay two consequences followed. First, there were constant pressures from taxpayers generally, and from special bodies of taxpayers in particular, to elaborate the rules for computing income for tax purposes so as to make them reflect more accurately the true income of each particular type of taxpayer and to grant reliefs and allowances to meet a large number of cases where the original simple tax had unduly severe effects". 1

These pressures for reliefs and allowances were considered in detail in the Report of the Royal Commission on Income Tax (The Colwyn Commission) which was published in 1920. 2 That Report recommended the introduction of two allowances which affected a married couple. First, a married man's personal allowance, and secondly a revised allowance for a wife's earned income. These will be considered separately.

(1) Married man's personal allowance

Although the concept of a child allowance was recognised as early as 1799 3 no allowance was made for a wife until 1918. However, section 13 Finance Act 1918 introduced a "wife allowance" which was the same as that for a child, housekeeper, dependent relative or incapacitated person, namely the tax on £25. This was

2. Cmd 615.
3. (1799) 39 Geo 3 c 13, section 3.
doubled in 1919 but in both years it was only available when taxable income did not exceed £800.

The whole system of exemptions and reliefs came under close scrutiny in the Colwyn Report\(^1\) and that Report recommended\(^2\) that it was desirable to specify separately the exemption which should be allowed to a bachelor and the exemption which should be allowed to a married couple. The exemptions should take the form of an allowance available to every taxpayer and should not be restricted, as the old exemptions had been, to those on small incomes.

The Colwyn Report suggested allowances of £150 (or £135 on earned income) for a single person and £250 (or £225 on earned income) for a married couple. "Earned income relief" was then 1/10th. A married man would thus receive an allowance equal to a single allowance plus an additional .66 of a single allowance. It was part of the Colwyn Report's recommendations that the old "wife allowance" should disappear. In discussing the philosophy underlying the relative amount of the married man's allowance the Colwyn Report said\(^3\)

"We are satisfied that the relation that now exists between the exemption limit for the bachelor and the effective exemption limit for a married couple is not consonant with justice. The two limits are now £130 and £170 and we cannot believe that these two figures represent the relation that ought to exist. If £130 is right for a bachelor, £170 is too little for a married couple; if £170 is right for a married couple £130 is too much for a bachelor. We believe that the relative positions of a single man and a married couple are much nearer represented by the figures £150 and £250 than by the figures £130 and £170 and that from a practical point of view an allowance of £100 would fairly reflect the

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2. Paragraph 245.
difference of taxable capacity between the two classes: it is for this reason that we have recommended that the exemption limit of a married couple shall be £250 and that that sum shall also be deducted as a joint allowance from all incomes of married persons. As will be seen....these figures of £150 and £250 relate to earned income and represent £135 and £225 of assessable income".

In 1920 the new concept of personal allowances was introduced. Sections 18 - 22 Finance Act 1920 provided for a single person to have an allowance of £135 and for a married man to have an allowance of £225. In the following years the allowances fluctuated. In 1931 they were £100 and £150 respectively, an addition of $.5 for a married man; in 1941 they were £80 and £140, an addition of $.75. In both 1945 and 1950 the allowances were increased and when the Radcliffe Commission reported in 1951 the allowances stood at £120 and £210 respectively, an addition of $.571 of a single allowance for a married man. The Radcliffe Commission noted that, with rising incomes, a flat rate system of personal allowances was proportionately less beneficial to higher income earners; as the incomes of husband and wife are aggregated, this comment is particularly relevant to married couples. The Radcliffe Commission suggested a rather complicated solution to this problem which was, however, not adopted.

The personal allowance for a single individual in 1982-83 is £1,565 and for a married man the allowance is £2,445. The present statutory provisions are contained in section 8(1) Taxes Act as amended by section 24(2)

Finance Act 1982. Thus, the extra allowance given to a married man is £880 which is an additional .562 of £1,565, the single person's allowance.

The additional married man's allowance is now slightly lower than that recommended by the Colwyn Commission in 1920, which was a differential of .66. On that basis the present married man's allowance would be £2,608.00.

The present married man's allowance is also lower than that for two single persons, which would be £3,130. The difference is £685.

However, in order to obtain a complete picture of the personal allowances available to a married couple these figures should be considered in conjunction with the wife's earned income allowance which is now discussed.

(2) Wife's earned income allowance

The first recognition that some special treatment was due to the separate earnings of a wife occurred in 1894. The Customs and Inland Revenue Act of 1876 had reintroduced a system of exemptions for small incomes; taxpayers with total incomes of less than £150\(^1\) were exempt altogether and if total income exceeded £150 but did not exceed £400\(^2\), the taxpayer obtained relief amounting to tax on £120, given by reduction or repayment or both. If total income exceeded £400 no relief was given.

Section 34 Finance Act 1894 raised the lower limit from £150 to £160; if total income did not exceed

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1. Section 8 Customs and Inland Revenue Act 1876.
2. Section 8 Customs and Inland Revenue Act 1876.
The taxpayer obtained relief equal to tax on £160 of income; if total income exceeded £400 but did not exceed £500 relief was given on £100 of income. When total income exceeded £500 no relief was given. In 1894 tax was at the rate of 8d in the £ so the total relief given would have been £5. 6. 8d (i.e. £160 x 8d) when income did not exceed £400 or £3. 6. 8d (i.e. £100 x 8d) when total income did not exceed £500.

Now clearly these reliefs were twice as advantageous to a single person than to a married couple whose income was aggregated. As all reliefs were lost once total income exceeded £500, the limit was more likely to be reached in cases where two incomes were aggregated, and so the reliefs were more likely to be of advantage to a single person. A special provision was accordingly made to deal separately with a wife's earnings. Section 34(2) read as follows:

"When the total income of a husband and wife charged to income tax, by way either of assessment or deduction, does not exceed £500 and, upon a claim under this section the Commissioners for the general purposes of the Acts relating to income tax are satisfied that such total income includes profits of the wife derived from any profession, employment or vocation chargeable under Schedule D or Schedule E they shall deal with such claim as if it were a claim for exemption or relief or abatement as the case may be in respect of such profits of the wife, and a separate claim, on the part of the husband, for exemption or relief or abatement in respect of the rest of such total income".

Here is the first recognition of separate treatment for a wife's earned income; if her own earnings were less than £500 her husband could claim the exemptions for small incomes for her; the rest of the joint income,
including her investment income, was still deemed to belong to the husband and if the total did not exceed £500 he could also claim an exemption for small incomes. The provisions continued virtually unchanged and ultimately appeared in section 21 of the consolidating Income Tax Act 1918.

In 1918 the relief for small incomes was given in the form of complete exemption for incomes up to £130,¹ a limitation of tax to the difference between £120 and total income when total income did not exceed £400; relief on £100 when income did not exceed £600 and relief on £70 if income did not exceed £700.² The rate of tax on earned income when total income did not exceed £500 was then 2/3 in the £. (Section 18(1) Finance Act 1918).

Accordingly if the total joint income of a married couple was £500, the exemption saved £11. 5. Od. in tax (£100 at 2/3). However, if £250 of this represented earnings of the wife then the operation of section 34(2) meant that her income was assessed separately and both she and her husband got exemptions of £120 each i.e £13. 10. Od., making a total tax saving of £27. 0. Od. Section 34(2) thus meant a tax saving of £15. 15. Od.

The treatment of the income of a married couple in 1918 can therefore be summarised as follows:

(a) both incomes were aggregated;
(b) a separate claim for exemption for small incomes could be made in respect of a wife's earned income provided that the joint income did not exceed £500;
(c) a claim for earned income relief on a graduated basis would be made if aggregated joint income did not exceed £2,500;

---

(d) the remainder of the joint income was taxed at progressive rates up to 52\% per cent.

This meant that if the joint income exceeded £500 every £ earned by the wife was taxed at the top rate applicable to the husband's income; "earned income relief" was available but only if the aggregated income did not exceed £2,500. The wife had no reduced rates of her own.

The position was considered by the Colwyn Commission\(^1\) within the whole context of the treatment of the income of married couples for tax purposes. In paragraph 261 the Commission's Report said:

"...we referred to the exceptional treatment allowed under the existing law to the earned income of a married woman when the joint income does not exceed £500. The effect of this provision, in a case where, for example, husband and wife each earn £500 and have no other income, is that two abatements of £120 each are allowed as compared with the single abatement of £100 which would be allowed if the whole £500 were earned either by the husband or by the wife. The limit of £500 has been represented to us as too low in present conditions. We agree with this point of view and recommend that the relief in its present form should be discontinued and that where the wife has £50 or more of earned income the joint exemption or abatement allowance to a married couple should be increased from £250 (earned) to £300 (earned). When the wife earns less than £50, the joint allowance for a married couple should be increased from £250 (earned) by the amount of the wife's earnings".

The relief which was introduced by Finance Act 1920 did not quite take this form. Section 18(2) provided relief for wife's earned income at the rate of 9/10 but not on income exceeding £45; this allowance was to reduce the tax chargeable on the wife's earned income only. This

maximum figure of £45 was substantially lower than the then single personal allowance of £135 but, when added to the married man's allowance of £225 brought the total allowances for a married couple to exactly the same as the total for two single persons (i.e. £270).

The Finance Act 1920 also repealed the provisions of section 21 Income Tax Act 1918.

With a maximum rate of tax of 52 per cent the most that the new allowance could bring in the way of tax saving was £23. 12. 6d, which compared favourably with the figure of £15. 15. 0d. available under the provisions of section 21. Also the new allowance was available to all taxpayers, whatever the amount of their total income, and thus was of benefit to all working wives.

In 1942¹ the wife's earned income allowance was raised to £80 which was then the same as the single personal allowance. In evidence to the Radcliffe Commission the Inland Revenue said that they thought that the additional allowance for a married man when a wife had earned income was difficult to defend and was in the nature of a concession. In its Report² the Radcliffe Commission said:

"This concession (the wife's earnings allowance) we take to have been intended as a recognition of the fact that the taxable capacity of the married couple, when the wife is earning, is generally speaking less than the taxable capacity of a couple when the wife has no employment: for the mere circumstance of her employment tends to throw upon the household some expenses that would otherwise have been avoided" (paragraph 129).

¹. Section 23 Finance Act 1942.
"In our opinion there is a valid difference between the taxable capacity of the married couple when the wife is at work and the married couple when the wife is at home ... In general our conclusion is that the special treatment of wife's earnings is not so much a rejection of the principle of aggregation as a device for securing the measure of distinction between two different kinds of taxable unit" (paragraph 132).

"Accepting, however, that there must be some difference we cannot avoid the conclusion that the present difference is excessive" (paragraph 133).

"We think therefore that we must look for some reduction of the special reliefs given to the married couple of two earners" (paragraph 134).

The Commission ultimately recommended that:-

"A wife's separate earnings should be eligible for a minimum relief in all cases but that the opportunity should be taken to reduce the figure of her special personal allowance below the existing £120" (paragraph 165).

This was not done, however, and in 1982-83 the wife's earned income allowance is still the same as a single person's allowance, namely £1,565 or the amount of her earned income if lower. The legislative provisions are to be found in section 8(2) Taxes Act as amended by section 24(2)(b) Finance Act 1982. Accordingly, if a wife has earnings exceeding £1,565 the total personal allowances available to a husband will be:

Married man's personal allowance £ 2,445  
Wife's earned income allowance £ 1,565  
_total £ 4,010  

This total is higher than the allowances available to two single individuals, which would be £3,130.

Although section 8(2) Taxes Act predictably gives
the wife's earned income allowance to the husband, to be used as a deduction from the joint aggregated income, nevertheless section 37(3) makes it clear that the allowance must be treated as first reducing the tax liability on the earned income of the wife.

An anomaly arises out of the legislative provisions concerning the wife's earned income allowance; in order to obtain the allowance the wife must have actual earnings but in order to obtain the married man's personal allowance a husband need have no income at all so long as his wife has some, because that will be deemed to be his. So, in cases when a husband has no income and the wife has earned income the husband can claim both the married man's allowance and the wife's earned income allowance against the wife's income which is deemed to be his. If, however, the sole wage earner is the husband, he can claim only the married man's allowance. If only one spouse can work, therefore, it is clearly advantageous from a tax point of view for this to be the wife.

(3) Summary

The effect of the present system of personal allowances affecting married couples may be summarised as follows:

(a) the present married man's allowance is £685 less than the allowance for two single persons;

(b) the present married man's allowance is £163 less than it would be if the proportions recommended by the Colwyn Report in 1920 were adhered to;¹

¹. The Colwyn Report recommended a differential of .66 - see page 76 above. For a biblical explanation of this differential see Leviticus 27.1.
(c) as was noted by the Radcliffe Commission, a fixed system of personal allowances is proportionately less beneficial to higher income earners: this applies to all taxpayers but, as the incomes of a married couple are aggregated, it applies particularly to them;

(d) if a wife has sufficient earned income the total allowances available to a married couple now exceed by £880 the allowances available to two single persons;

(e) both the married man's personal allowance and the wife's earned income allowance are available to a married couple when the wife has sufficient earnings, even if the husband has no income; but if only the husband has income only the married man's allowance is available.

7. Examples

During the discussion of the adjustments which have been made to the systems of progressive taxation and personal allowances in order to accommodate the particular problems arising out of the aggregation of incomes of married couples, it will have been noticed that a number of illogicalities have been introduced and it is therefore difficult to lay down general conclusions: whether these adjustments result in the payment of more or less tax will frequently depend on a combination of different factors. The following simple examples are designed to show the common differences which arise.
The figure of £15,000 income has been chosen as it allows the introduction of some rates of tax above the basic rate.

(1) Single man or woman.
A single person earns £15,000. There are no other allowances or reliefs apart from the personal allowance:

<table>
<thead>
<tr>
<th>Band</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal allowance</td>
<td>1,565</td>
<td>nil</td>
</tr>
<tr>
<td>Basic rate</td>
<td>12,800</td>
<td>30%</td>
</tr>
<tr>
<td>Higher rate</td>
<td>635</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>15,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

(2) Married man
A married man earns £15,000. His wife has no income. There are no allowances or reliefs apart from the personal allowances.

<table>
<thead>
<tr>
<th>Band</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married man's allowance</td>
<td>2,445</td>
<td>nil</td>
</tr>
<tr>
<td>Basic rate</td>
<td>12,555</td>
<td>30%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>15,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

The difference in tax paid by the married man and the single person is £327.50 which is, in effect, tax on the difference between the two allowances (880) calculated as:

\[
\begin{align*}
£245 & \text{ at basic rate } 30\% = 73.50 \\
£635 & \text{ at } 40\% = 254.00 \\
\hline
327.50
\end{align*}
\]

1. Balance of basic rate band of £12,800.
(3) Married woman
A married woman earns £15,000; her husband has no income. There are no allowances apart from the personal allowances.

<table>
<thead>
<tr>
<th>Band</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married man's allowance</td>
<td>2,445</td>
<td>nil</td>
</tr>
<tr>
<td>Wife's earned income allowance</td>
<td>1,565</td>
<td>nil</td>
</tr>
<tr>
<td>Basic rate</td>
<td>10,990</td>
<td>30%</td>
</tr>
<tr>
<td><strong>15,000</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Thus when a married woman alone works, £469.50 less tax is paid than where a married man alone works. (£3,766.50 less £3,297 = £469.50 which is the amount of tax at the basic rate (30%) on the wife's earned income allowance).

(4) Married couple - wife earns £1,565
A man earns £13,435 and his wife earns £1,565 making a total income of £15,000. There are no allowances apart from the personal allowances.

<table>
<thead>
<tr>
<th>Band</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married man's allowance</td>
<td>2,445</td>
<td>nil</td>
</tr>
<tr>
<td>Wife's earned income allowance</td>
<td>1,565</td>
<td>nil</td>
</tr>
<tr>
<td>Basic rate</td>
<td>10,990</td>
<td>30%</td>
</tr>
<tr>
<td><strong>15,000</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Thus exactly the same amount of tax is paid where only one spouse is earning (so long as it is the wife) and where both spouses are earning.

(5) Two unmarried persons earn £15,000 each
The calculation is that in (1) above multiplied by 2, i.e.

£4,094 x 2 = £8,188
(6) **Two married persons earn £15,000 each**

The total income is £30,000 taxed as follows:

<table>
<thead>
<tr>
<th>Band</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married man's allowance</td>
<td>2,445</td>
<td>nil</td>
</tr>
<tr>
<td>Wife's earned income allowance</td>
<td>1,565</td>
<td>nil</td>
</tr>
<tr>
<td>Basic rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12,800</td>
<td>30%</td>
<td>3,840</td>
</tr>
<tr>
<td>2,300</td>
<td>40%</td>
<td>920</td>
</tr>
<tr>
<td>4,000</td>
<td>45%</td>
<td>1,800</td>
</tr>
<tr>
<td>6,200</td>
<td>50%</td>
<td>3,100</td>
</tr>
<tr>
<td>690</td>
<td>55%</td>
<td>379.50</td>
</tr>
<tr>
<td>30,000</td>
<td></td>
<td>10,039.50</td>
</tr>
</tbody>
</table>

In these circumstances the couple would be advised to make an election for the wife's earnings to be separately taxed (see Chapter 5) but no such option is available for investment income.

(7) **Single person with investment income**

A single person has earnings of £15,000 and additional investment income of £6,250.

Tax on his earnings will be as in (1) above i.e. £4,094.00

Tax on his investment income will be:

<table>
<thead>
<tr>
<th>Band</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,665</td>
<td>40%</td>
<td>666</td>
</tr>
<tr>
<td>4,000</td>
<td>45%</td>
<td>1,800</td>
</tr>
<tr>
<td>585</td>
<td>50%</td>
<td>292.50</td>
</tr>
<tr>
<td>6,250</td>
<td></td>
<td>£2,758.50</td>
</tr>
</tbody>
</table>

Total £6,852.50

N.B. There is no surcharge on investment income below £6,250.

(8) **Two single persons with investment income**

Two single persons each earn £15,000 and have £6,250 of investment income each:
The calculation is as in (7) multiplied by 2 i.e. £13,705.

(9) Two married persons with investment income

Two married persons each earn £15,000 and each has investment income of £6,250. They have elected to have the wife's earnings separately taxed.

Husband's earnings taxed as in (1) above £4,094.00
Wife's earnings taxed as in (1) above £4,094.00

Two married persons with investment income

The joint investment income is aggregated with the husband's earnings and taxed as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax Rate</th>
<th>Tax Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,665</td>
<td>40%</td>
<td>666</td>
</tr>
<tr>
<td>4,000</td>
<td>45%</td>
<td>1,800</td>
</tr>
<tr>
<td>6,200</td>
<td>50%</td>
<td>3,100</td>
</tr>
<tr>
<td>635</td>
<td></td>
<td>349.25</td>
</tr>
<tr>
<td><strong>12,500</strong></td>
<td></td>
<td><strong>5,915.25</strong></td>
</tr>
</tbody>
</table>

Add investment income surcharge of 15% on £6,250

<table>
<thead>
<tr>
<th>Surcharge</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>937.50</td>
<td></td>
</tr>
</tbody>
</table>

£6,852.75
£15,240.75

Thus, aggregation has had two effects: it has lifted the income into higher rates and has imposed the investment income surcharge.

Summary

<table>
<thead>
<tr>
<th>Description</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Single person earns £15,000</td>
<td>£4,094.00</td>
</tr>
<tr>
<td>2. Married man earns £15,000, wife no income</td>
<td>£3,766.50</td>
</tr>
<tr>
<td>3. Married woman earns £15,000, husband no income</td>
<td>£3,297.00</td>
</tr>
<tr>
<td>4. Married man earns £13,435, wife earns £1,565</td>
<td>£3,297.00</td>
</tr>
<tr>
<td>5. Two single persons earn £15,000 each</td>
<td>£8,188.00</td>
</tr>
</tbody>
</table>
6. Two married persons earn £15,000 each (no option for separate taxation) £ 10,039.50

7. Single person earns £15,000 investment income £6,250 £ 6,852.50

8. Two single persons earn £15,000 each, investment income £6,250 each £ 13,705.00

9. Two married persons earn £15,000 each, investment income £6,250 each. (option for separate taxation). £ 15,240.75

8. Judicial Interpretation of Section 37

Although the provisions of what is now section 37 Taxes Act have been on the statute book in some form since 1799 they have only been interpreted by the Court on a few occasions; of course, appeals to the Court from the decisions of the Commissioners only commenced towards the end of the last century but nevertheless the paucity of judicial consideration underlines the certainty with which the rule has been administered.

It is interesting to note that the decided cases centre round three main areas of contention; first, the rules which applied where one spouse was, and one was not, resident in the United Kingdom; secondly, the effect of aggregation on the computation rules; and, finally, the rules which apply on a termination of marriage. These three categories will be considered separately but in each type of case it will be noted that judicial decisions have led to amending legislation.

(1) The residence cases

The early residence cases were based upon the contention that if, for income tax purposes, a wife's income
was deemed to be that of her husband, then a resident wife could, in certain circumstances, escape tax if her husband was non-resident. The first such case was Derry v. C.I.R.\(^1\) which was a Scottish decision; Mrs Derry was entitled to income from a Canadian trust; her husband contended that proviso (1) to Rule 16 of the All Schedules Rules Income Tax Act 1918\(^2\) meant that her income was assessable on him and therefore, as he was resident outside the United Kingdom, the income escaped any charge to United Kingdom tax. However, the Court of Session held, on the facts, that Mrs Derry was not "living with her husband"; Mr. Derry was employed in Egypt for the major part of the year and Mrs Derry, who was unwell, resided continuously in a nursing home in England. Because, therefore, Mrs Derry was a feme sole for tax purposes, the income from the Canadian trust did not escape United Kingdom tax.

A similar point was before the High Court in Browning v. Duckworth.\(^3\) In that case Mr Duckworth worked in Egypt and Mrs Duckworth spent four or five months each year in England, during which time Mr. Duckworth also took his leave coming to England for about three months each year. Mrs Duckworth claimed that, as she was a married woman, her tax assessment should be made on her husband and, as he was non-resident, her income would not be liable to tax. Finlay J held that as a "married woman living with her husband" the assessments on her were wrong and should be discharged.

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1. 13 Tax Cas 30.
2. i.e. the deeming provison - see page 87 post where proviso (1) is set out in full.
Now this may have seemed like victory for the taxpayer but only two years later the Inland Revenue returned to the attack in Duckworth v. Lowe\(^1\) where it was held that, in the particular circumstances, Mr. Duckworth became liable to assessment whenever he came into the United Kingdom, even though he was non-resident.

Another point on residence came before the court in Nugent-Head v. Jacobs\(^2\) where the Inland Revenue accepted that the husband was not resident in the United Kingdom, that the wife was resident, and that nevertheless the wife was a "married woman living with her husband". To bring certain foreign income into tax, therefore, they sought to rely on the second proviso to Rule 16.

It will be recalled that the Act of 1805\(^3\) introduced a new proviso dealing with remittances from abroad. Section 101 of that Act repeated the previous provisions providing for the separate taxation of separated married women who were sole traders. The first proviso to the section read:-

"Provided always that the profits of any married woman living with her husband shall be deemed the profits of the husband and the same shall be charged in the name of the husband and not in her name or of her trustee or trustees".

This was, of course, the origin of the "deeming" provisions.

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1. (1937) 2 K.B. 560.
2. (1948) 2 All E.R. 414.
3. 45 Geo 3 c 49, Statutes at Large, Volume 45, page 811.
The second proviso to this section continued as:-

"Provided also that any married woman living in Great Britain separate from her husband, whether such husband shall be temporarily absent from her, or from Great Britain, or otherwise, who shall receive any allowance or remittance from property out of Great Britain shall be charged as a feme sole, if entitled thereto in her own right and as agent of the husband if she receive the same from or through him or from his property or on his credit".

Thus the aggregation rule continued for married women whose husbands were abroad and sent remittances home, but if a married woman was separated from her husband and received income from abroad in her own right, she was taxed as a feme sole. It has been noted above that the 1805 provisions were re-enacted in 1842 and modified in the Income Tax Act 1918 as Rule 16 of the All Schedules Rules.

In 1940 Mrs Nugent-Head owned property in the United States of America and income from that property was remitted to her in the United Kingdom. In 1941 her husband went abroad on active service and was absent for three years. The Inland Revenue wished to assess Mrs. Nugent-Head personally in respect of this income and argued that both the provisos mentioned above could operate at once. It was agreed between the parties that at the relevant time Mrs. Nugent-Head, as a happily married woman, was a "married woman living with her husband" under the first proviso, and that her income was deemed to be her husband's income for tax purposes. The Inland Revenue contended that the second proviso also operated and that because Mrs Nugent-Head was separated from her husband by his temporary absence
the assessment could be made on her and not on him (as the income belonged to her in her own right).

Mrs Nugent-Head argued that the provisos were mutually exclusive and that, as she came within the first proviso, the second could not operate. The court upheld her claim and the tax therefore had to be assessed on the husband.

This case is no longer of direct interest as the particular provison dealing with a husband's absence abroad was repealed by the Finance Act 1950. However, the case is important historically because it led to the modernisation of the old legislation as a result of judicial criticism made in the course of judgement.

In the Court of Appeal, Scott L.J. said:—1

"The whole litigation is attributable in my opinion, to the extraordinary ambiguity of the language used in the proviso (2) of r.16 and the statutory history of that language shews how the reluctance of the Inland Revenue to see any Parliamentary change made in ancient wording to which they have got accustomed and of which they think (often rightly) they know the meaning (though the taxpayer probably does not) may lead to unnecessary disputes and therefore much public inconvenience".

And later in the House of Lords Viscount Simon said:—

"It is much to be regretted that the present statute law defining in what case a married woman is herself liable to income tax and in what case the liability to tax falls on

1. 1946 2 All E.R. 391.
her husband instead is not stated in plain and unambiguous language. Even if the heavy task of re-enacting the whole of our income tax law in less complicated terms is too great to be undertaken at present it would be well worth while to revise and re-express that part of it which deals with married women. As it is, the words now in operation are largely borrowed from Acts of 1803, 1805 and 1806 at which dates the effect of marriage on the property of the wife was very different from what it is today. Income tax came to an end after Waterloo and from 1816 there was no income tax in this country until 1842. Nevertheless, the relevant provisions of the Act of 1842 are plainly modelled on the repealed sections and now reappear practically unaltered in Rule 16 of the All Schedules Rules in the Consolidating Act of 1918.

And Lord Uthwatt later said:-

"Rule 16 one may agree is a curious rule. The married woman who was a sole trader in 1918 stood in no different position as respected her property from any other married woman and property held to the separate use of a married woman as that phrase is technically understood was in 1918 uncommon. The provision does not in terms take any notice of the capacity given to married women to hold property conferred by the Married Women's Property Act and property held by virtue of the capacity so conferred was the common form of married women's property in 1918. Again, married women who live with their husbands are treated as exceptional persons - relegated for treatment to a proviso. Lastly, a married woman living separately from her husband who receives remittances from abroad - not I imagine a common case - is treated as one whose position demands detailed treatment ... Neither the selection of remittances from abroad for separate treatment, nor the distinction between the two cases, makes any intelligible taxing principle. Astonishing conclusions may be expected to emerge from a rule so conceived and framed!!"

Faced with this scathing attack the legislature hastened to amend the provisions and in the Finance Act 1950 the legislation as we know it today first appeared.

The case of Nugent-Head v Jacob is also of interest because the result was in favour of the taxpayer.
Now the reports of the case of Nugent-Head v. Jacob do not mention, in terms, the reason for the taxpayer's case. In most cases married couples would prefer their incomes to be disaggregated; why, then, in this case, did Mrs Nugent-Head desire aggregation? It is thought that the answer lies in the case of Derry v. C.I.R. and Browning v. Duckworth; Mrs Nugent-Head was saying that her income was deemed that of her husband; that he was non-resident because he was on active service; and that although he would be liable for tax on income arising in the United Kingdom, he would not be taxable on income arising abroad, especially if it was not remitted to the United Kingdom. Thus, Mrs Nugent-Head's success took her United States income out of the charge to tax.

Clearly, this application of the aggregation rule had disadvantages for the Inland Revenue and so the 1950 amending legislation specifically provided that this method of avoiding tax was no longer available. Section 42 Taxes Act now provides that where one spouse is, and one is not, resident in the United Kingdom for a year of assessment, they are to be taxed as separate persons; accordingly, if the case were heard today Mrs Nugent-Head would be taxed on her foreign income. The 1950 legislation is but one example of the way in which amending legislation is passed as soon as it can be demonstrated that the aggregation rule might have advantages for married persons.

It has been noted above that Section 42 Taxes Act provides for a married couple to be taxed separately where one spouse is, and one is not, resident in the United Kingdom.

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1. Section 34 Finance Act 1950.

2. For another example see the option for separate assessment - fully discussed in Chapter 8.
"for a year of assessment". The meaning of this phrase fell to be considered by the court in Gubay v. Kington;¹ although that case was concerned with capital gains tax, and not with income tax, the principles discussed in the case are those which apply for income tax purposes.

Mrs Gubay left the United Kingdom on 4th April 1972. On 7th July 1972 her husband transferred shares to her and on 28th October 1972 Mr. Gubay left the United Kingdom. It was accepted that Mr. Gubay had been resident for part of the year of assessment in which the disposal took place and there was therefore prima facie liability to capital gains tax under section 20(1) Finance Act 1965. Mr. Gubay was assessed to capital gains tax by reference to the market value of the shares on the grounds that the disposal was "otherwise than by way of a bargain made at arm's length" within the meaning of section 22(8)(a).² Mr. Gubay denied that a liability to tax arose. He said that paragraph 20(1) Schedule 7 Finance Act 1965³ provided that transfers between husband and wife took place on a "no gain no loss" basis and that that paragraph applied to the disposal of shares to his wife for two reasons.

First, Mr. Gubay pointed out that paragraph 20(1) provided:

"If, in any year of assessment, and in the case of a woman who in that year of assessment is a married woman living with her husband, the man disposes of an asset to the wife, or the wife disposes of an asset to the man, both shall be treated..."

as if neither a gain nor a loss accrued. Mr. Gubay said that on that wording it followed that the condition in the paragraph

that a married woman should be living with her husband only
applied where the gift was made by the wife and not when the
gift was made by the husband. The court had no sympathy with
this point.

Secondly, Mr. Gubay said that even if that condition
did not apply he relied on section 45(3) Finance Act 1965
which provided:-

"References in the Part of this Act to a married
woman living with her husband should be construed in accordance with section 42(2)(a) of the Income
and Corporation Taxes Act 1970".

Section 42(2)(a) Taxes Act provided that a married woman was
to be regarded as separated from her husband if one of them
was, and one of them was not, resident in the United Kingdom
'for a year of assessment'. Mr. Gubay said that 'for a year
of assessment' meant 'throughout the year of assessment';
accordingly, as he, Mr. Gubay, was not resident throughout the
year of assessment, (and it was agreed that his wife was not
so resident), they were both non-resident; accordingly he was
not separated from his wife and the no gain no loss rule
applied.

The court however held that the phrase 'for a year
of assessment' in section 42(2)(a) Taxes Act did not mean
resident continuously throughout the year of assessment but
rather implied a residence sufficient to establish an income
tax liability. That meant that Mr. Gubay was resident and his
wife was not and that the exemption in paragraph 20(1) could
not apply.

In commenting on the historical background of the
relevant sections Vinelott J. said: -1

"It is common ground that section 34 of the
1950 Act and its allied sections were passed

as a result of the decision of the House of Lords in Nugent-Head v. Jacobs 1948 1 All E.R. 414 which threw into sharp relief the anomalous effect of earlier fiscal legislation stemming from the Income Tax Act 1805 when the social and economic position of women was very different from what it was in 1947...

Following that decision a new code governing the circumstances in which a married woman is to be separately assessed and in which tax assessed on the husband can be recovered from his wife was included in the Finance Act 1950".

During the course of the judgement attention was drawn to the proviso to subsection (2) of section 42 which was discussed in this way:-

"After subsections (1) and (2) of section 42 there follows a proviso under which, in effect, if separate assessments would result in an increase on the aggregate amount of the tax payable by both spouses (because, for instance, the husband does not get the full married man's allowance) relief is to be given by reduction of the assessments or by repayment".1

The meaning of the proviso was elucidated later as:-

"The proviso to subsection (2) (of section 42) makes it clear that a notional separation under subsection (2) is not to increase the aggregate amount of the tax chargeable on the incomes of both husband and wife".2

However, as the court held that there was an actual separation, and not a notional separation under section 42(2) the proviso was not effective to reduce Mr. Gubay's capital gains tax liability.

A review of the residence cases therefore shows that any possible benefit of the aggregation rule, by deeming the income of a resident wife that of a non-resident husband, has now been nullified by legislation.

1. At page 731.
2. At page 736.
(2) The computation cases

Although the twin principles of husband's accountability and of aggregation were enshrined in legislation from 1799 and 1805, the first occasion upon which the rules came before the court appears to have been in Purdie v. The King. In that case, Mrs Purdie received dividends and interest under deduction of tax and argued that, as a result of section 45 of the Income Tax Act 1842, this tax should be charged on her husband and not on her; she therefore claimed a repayment from the Crown of the tax deducted. Rowlatt J. held, however, that in such a case tax was "charged" on the paying company and the paying bankers and that there had been no breach of section 42; no repayment therefore was due. The taxpayer was, therefore, unable to use the aggregation rule to escape tax in this way.

The aggregation rule next came before the court in I.R.C.V. Brodie and four other cases heard together. These all concerned transitional liability for surtax in the years when a marriage begins or ends. Briefly, that case held that in these years the wife's income is apportioned, the husband being liable for tax in the apportioned year during which the spouses were married, the wife being liable otherwise. This discussion was, however, doubted in Leitch v. Emmott but before that case was heard the rule was considered further in Walker v. Howard.

1. (1914) 2 K.B. 112.
2. (1923) 2 K.B. 814.
3. (1929) 2 K.B. 236.
4. (1927) 13 Tax Cas 313.
In that case, at the relevant time, interest on War Loan was received without deduction of tax, which was then assessed on a preceding year basis, save that new holdings were assessed on a current year basis. Mrs Walker owned some War Loan and in 1924-5 received £9.16s.10d interest which was the basis of assessment for the year 1925-26. On 1st April 1925 Mr Walker bought some War Loan and in the year to 5th April 1926 received £3,662.10s.0d. in interest. The question arose as to whether this was a new holding (in which case the interest would be brought into charge in 1925-26 on a current year basis) or whether it was an accretion to Mrs Walker's existing holding (in which case it would come into charge one year later).

Rowlatt J. held that, as a result of Rule 16 of the All Schedules Rules Insurance Tax Act 1918 the interest of the wife was deemed to be the interest of the husband and therefore that Mr Walker's holding was not a new holding for these purposes. Now, although this decision is in favour of the taxpayer, it is doubtful if it is correct: a distinction may be drawn between deeming the income of a married woman to be the income of her husband on the one hand, and deeming the holding of securities of a married woman as a holding by her husband on the other. It is not therefore surprising that the decision in Walker v. Howard was also disapproved of in Leitch v. Emmott.¹ In that case the court was asked to decide whether a widow could be assessed on a preceding year basis on income arising before her husband's death.

¹. (1929) 2 K.B. 236.
Mrs Leitch owned some War Loan and Victory Bonds; in the year ending 5th April 1921 she received income of £2,102.10.0d. from these investments and in the year ending 5th April 1922 she received £2,115.10.0d from the same source. Her husband died on 10th April 1921. For the year ending 5th April 1922 she was assessed on a preceding year basis on the income arising in the year ending 5th April 1921 (i.e. £2,102.10.0d). She appealed saying that until 10th April 1921 she was married, and as her profits in the year 1920-21 were deemed to be the profits and gains of her husband she had no income for the year ending 5th April 1921; she was not therefore liable for any tax.

Lord Hanworth said:

"I think that Mrs Leitch cannot escape liability...the liability arises in respect of profits received in the year ending April 5th 1922 and those profits can be measured by the profits of the preceding year... There still remains a standard by which the tax can be measured, even though during the married life the profits of the two spouses were deemed to be the profits of the husband". ¹

And also:

"It appears to me that the rule (i.e. Rule 16) is intended to convey the same meaning as in section 45 of the Act of 1842 and definitely to impose a charge on the married woman in respect of her profits although collection is to be made from the husband and the profits of the wife are in that sense and for that purpose deemed the profits of the husband". ²

After this decision it appeared clear that, although for the purposes of aggregation of income,

1. Page 245.
calculation of tax, and collection and payment, a married woman's income was deemed to belong to her husband, the income in fact remained hers and could be used as a basis to measure an assessment on the preceding year basis.

The computation rules were next considered in 1937 in Elmhirst V.C.I.R. which was another case concerned with the transitional provisions in the year of marriage. Miss Payne Whitney married Mr Elmhirst on 3rd April 1925. The Inland Revenue argued that her pre-nuptial income could be used for the purpose of calculating assessments due in 1925-1928. Following Leitch v. Emmott Lawrence J. decided that, although Mrs Elmhirst was not a married woman living with her husband during the period of computation, she was a married woman living with her husband during the year of assessment and her profits in that year should be assessed and charged in his name. I.R.C.V Brooke was not followed and Leitch v. Emmott was preferred.

The decisions in the above cases were, of course, given on the wording of Rule 16 of the All Schedules Rules Income Tax Act 1918 which originated in the Act of 1805. The legislation as amended in 1950 is more explicit on this point and the proviso to subsection (1) of section 37 now makes it clear that:

"The question whether there is any income of hers chargeable to income tax for any year of assessment and, if so, what is taken to be the amount thereof for income tax purposes shall not be affected by the provisions of this subsection".

1. (1937) 2 K.B. 551.
Accordingly, for "computation" purposes a married woman's income must be treated as her own. Leitch v. Emmott was also followed in Re Cameron deceased in 1965.

The question which arose in the case of Re. Cameron deceased concerned the entitlement to repayments made in respect of a wife's losses and capital allowances. In that case Mr. Cameron had income of £3,400 and his wife had income from investments of £11,000 which suffered tax by deduction at source. In 1956 Mrs. Cameron engaged in a farming business. She made substantial losses and was entitled to set these against her other income; as that was taxed at source a repayment became due. In addition, Mrs. Cameron made certain payments of a capital nature in respect of her farming business and for these she was also entitled to repayments. Before the repayments were made Mr. Cameron died and his executors wanted to know whether they should include the amounts of the repayments in their account of Mr. Cameron's free estate for estate duty purposes. The Court held that, although by section 354 of the Income Tax Act 1952 the wife's income was deemed for income tax purposes to be her husband's income, and tax was assessable on him, yet that was only for the purposes of collecting tax and, in so far as the wife's income was relieved from tax, the income remained hers: accordingly no part of the benefit of the claims for repayment of tax should be regarded as included in the husband's free personal estate on his death. The Court did not go so far.

1. Re. Cameron deceased, Kingsley v. IRC (1965) 3 All E.R. 474.
as to say that the repayments should be made to the wife:
it was agreed that the section required that the
repayments should be made to the husband, but the Court
did say that the money belonged to the wife and that the
husband received it on her behalf.

Harman L.J. said:-

"What is said (by the Crown) is that as the
husband alone can make the claim he alone
can give a good receipt for the money
repaid: and so far I think that the Crown
is right but it does not in my judgment
follow that the money when received belongs
beneficially to the husband".

After referring to the case of Leitch v. Emmott¹
he continued:-

"Relying on that authority I would hold that
the income remains the income of the wife
and so far (as a repayment is) collected by
the husband must be accounted for to her".

Here again the Court had found in favour of the
taxpayer and, while upholding a strict interpretation of
the section, introduced the equitable concept of a con-
structive trust in order to achieve a just result. It
would clearly have been inequitable for Mrs. Cameron's
repayments to have been included in her husband's estate
and then to have borne estate duty at his top rate.

It has been noted that section 22 Finance Act
1978 now provides for some repayments to be made direct to
wives, but, as these are confined to repayments of tax
deducted under the PAYE system, and only where such
repayments are directly attributable to such tax, these

¹. See above.
provisions would not have benefited Mrs Cameron.

The next case in which the computation rules were discussed was Murphy v. Ingram.1

In 1970 a child allowance was available to a father if he had a child below a certain age whose income did not exceed £270 per annum. In the case of Murphy v. Ingram, the taxpayer had a daughter who was under the requisite age limit in the year 1969-70. Until June 1969 she attended university: on 19th July 1969 she married and in October 1969 she commenced employment as a schoolteacher. During the period from April to July her income did not exceed £10: but between October 1969 and April 1970 it was well in excess of the child allowance and one of a number of the taxpayer's submissions was to the effect that as the income tax legislation deemed her post-nuptial earnings to be the income of her new husband it was not her income, with the result that her income for the whole year did not exceed £10 thus bringing her income within the necessary limit and entitling him to a child allowance. He lost.

The court held that the deeming provisions of section 354(1) Income Tax Act 1952 operated only in the context of the system of assessment, liability and collection applied to the particular situation of a wife and husband living together: the words "for income tax purposes" in section 354(1) did not extend the operation

PAGE NUMBERS CUT OFF IN ORIGINAL
of that subsection to the tax liability of a third person. Accordingly, for the purposes of section 212, which concerned child allowances, the taxpayer's daughter was entitled in her own right to her post-nuptial income with the result that her earnings for the fiscal year were more than enough to negative the taxpayer's claim to child allowance.

Russel L.J. said:—

"In our view "for income tax purposes" in section 354(1) is to be confined in its meaning to the triangular relationship of Crown, husband and wife".

And earlier:—

"It is in the highest degree unlikely that Part XIV (of the 1952 Act) was designed to affect the amount of anybody's tax liability save that of the happy couple".

In commenting on the historical context of section 354 the judge said:—

"The group of sections forming Part XIV of the 1952 Act is headed "Special Provisions as to Married Persons" and is concerned exclusively with adjustment of the methods of assessment and collection of the tax in the situation of a man and woman living together and no other situation...This group of sections first appeared in the Finance Act 1950. The provision in section 354(1) (Income Tax Act 1952) is a deeming provision...it would not be expected in anyway that the deeming provisions of the 1950 equivalent of S.354 were intended to alter anywhere in the fiscal legislation the total charge to or liability for income tax that previously obtained".

Thus any doubt there might have been that the 1950 legislation might have removed the aggregation rule was removed by this judgment: in any event such doubt must
have been minimal in view of the clear wording of section 30, whatever view might have been taken of the desirability of the removal of the aggregation rule. In a further passage in his judgement Russell L.J. throws some additional light on the historical context of section 354: he said:

"The rewriting in 1950 of that part of the tax code special to the situation of spouses living together included a belated recognition of the fact that all property and therefore income of a married woman was now her own. It was no longer necessary to refer to her trading income or income of her separate property in this context: that went without saying. That which had been a proviso to an enactment limited to such separate property (for purposes of assessment and collection) could in effect be elevated to the substantive part of S.354(1)"

The "belated recognition of the fact that... the income of a married women was now her own" was included in the proviso to sub-section (1) and, as we have seen, provided that for purposes other than income tax she could hold property in her own name: the main purport of the subsection, however, reimposed aggregation for tax purposes. A study of the "computation" cases thus reveals that although section 37 means that a husband is liable to make a return of his wife's income and to pay tax on it and that for the purposes of calculating tax the incomes of husband and wife are aggregated, nevertheless the income in fact remains the income of the wife and:-

(a) it can be used as a basis to measure a future assessment made on the preceding year basis; (Leitch v. Emmott);

(b) any repayment of tax, not covered by section 32 Finance Act 1978, belongs to the wife beneficially although it must be paid to her husband as trustee for her; (Re. Cameron deceased); and
(c) the wife and not the husband owns the income for all purposes other than the income tax legislation; thus, where a married woman had income in excess of the child allowance limit, the income was treated as hers and not her husband's, and her father was not entitled to claim a child allowance; (Murphy v. Ingram).

(3) Termination of Marriage

The two "termination of marriage" cases are both of interest but for different reasons. The first was Re Ward\(^1\) and in that case Mrs Ward was a wealthy lady who during her lifetime paid her own income tax although there was no option for separate assessment;\(^2\) after her death some income tax due in respect of her lifetime income was assessed on her husband and the executors of Mrs Ward's estate took out a summons to determine whether Mr. Ward was entitled to be indemnified out of his wife's estate for her tax assessed on him. Peterson J. decided that there was no right of indemnity and in a useful passage on the construction of the legislation he discussed the relationship of the two provisos to the main enactment as follows:-

"The material provisions of section 45 Income Tax Act 1842 are as follows:-

"Any married woman... having or being entitled to any property or profits to her sole or separate use shall be chargeable to such and the like duties and in like manner except as is hereinafter mentioned, as if she were actually sole and unmarried".

"A married woman is thus chargeable with the tax imposed by this Act except in the case subsequently mentioned. The next part of the

1. (1922) 1 Ch S17.
2. Introduced by Finance Act 1914.
section is a proviso which states the exemption:-

"Provided always, that the profits of any married woman living with her husband shall be deemed the profits of the husband and the same shall be charged in the name of the husband and not in her name or of her trustee".

"There is also a second proviso which deals with the case of a married woman living in Great Britain separate from her husband. The first proviso, in my opinion, amounts to an enactment that where a married woman is living with her husband she shall not be chargeable under the first part of the section, but the profits in question are deemed the profits of the husband and not the profits of the wife... The proviso therefore takes the present case out of the first part of the section and imposes the liability for the tax on the husband. The result, therefore, in my view is that the liability to tax in the case of a married woman living with her husband is thrown upon the husband, and not upon the wife".

The difficulties faced by a husband in the position of Mr. Ward have now been ameliorated by section 41 Taxes Act which gives a husband a right to disclaim liability for his deceased wife's income tax.

The second "termination of marriage" case was Eadie v. IRC,¹ a most interesting decision because Rowlatt J. held that a married woman was not "living with her husband" within the meaning of Rule 16 where she was separated from him by separation deed even though both husband and wife occupied the same house; the result was that sums paid by the husband under the provisions of the deed were deductible for surtax purposes. This case, and the residence cases, indicate that "living together" is not equated to "sharing the same household"; spouses can be "living together" even if one is absent abroad for a

¹. (1924) 2 K.B. 198.
considerable period\(^1\) and conversely spouses may not be "living together" even though sharing the same household.

(4) **Summary**

A review of the judicial consideration of section 37\(^2\) leaves two main impressions; first, the fact that the unsatisfactory state of the legislation was left unchanged, despite severe judicial criticism, until an advantage to a married couple was demonstrated; secondly, the haste with which amending legislation was then introduced, which removed the advantages for married persons but, at the same time, renewed the disadvantages of aggregation.

9. **Conclusions**

In this chapter we have considered the provisions of section 37 Taxes Act which provides that, for income tax purposes, the income of a married woman living with her husband is deemed to be his income and not hers: the rule has two consequences; first the husband has to submit a return of the joint income and is liable to pay the tax on it; secondly, both incomes are aggregated in order to determine the rate of tax payable and for other purposes, notably the entitlement to certain reliefs.

The historical evolution of the rule has been traced and it has been found that when it was introduced it was consistent with the legal treatment of married women's property and that the principle of aggregation did not affect

\(^1\) i.e. three years in Nugent-Head v. Jacob 1948.

\(^2\) And its predecessors.
the total tax liability as a proportional tax was then charged. However, despite radical changes in the laws relating to married women's property and the introduction of a highly progressive tax system, and also despite certain critical judicial pronouncements, the rule has remained unchanged in principle to the present day, although some minor modifications have been made to remove some of the more blatant anachronisms.

A reference has been made to some occasions on which the principle underlying the rule has been carried through into other statutory provisions; there are five specific cases where the rule is applied and two where it is not. Those which benefit a married couple (insuring the lives of spouses, acceleration of loss relief and relief for capital allowances) and those which place a married couple in the same position as two single persons (double savings bank relief and retirement annuity relief) appear to be outweighed by those which bring positive disadvantages, (restriction of life assurance relief limits, restriction on limits for investment in new corporate trades, and mortgage interest).

The general rule was then reviewed within the context of the tax system in which it operates and it was noted how that rule is affected by progressive taxation and the system of personal allowances; under a progressive tax system the rule can never benefit a married couple and positive disadvantages will result where a couple have more than £6,250 investment income (when the investment income surcharge will apply) and when the joint income exceeds £12,800 (when the higher rates become payable).

It was noted that the present system of personal
allowances can benefit a married couple in those cases when
the wife has sufficient earned income to claim the full
wife's earned income allowance, as here the allowances
available to a married couple will exceed those available to
two single persons (the husband being entitled to the full
married man's allowance in addition). Some simple examples were
then included to illustrate these factors leading to the
conclusion that marriage can only bring a positive benefit
from a tax point of view when the double personal allowance
can be utilised and where any advantage gained is not
negatived, on the facts, by any of the number of other dis-
advantages which also result from marriage.

Finally, a reference was made to some cases where
the rule in section 37 has been considered by the courts;
from these it appears that the rule will be interpreted
strictly but that for other income tax purposes (basis for
preceding year of assessment, equitable entitlement to re-
payments and calculation of income for other reliefs) the
income remains that of the wife.

Throughout this chapter it has been stated that
the rule in section 37 is subject to variation by three
specific statutory provisions; two of these come into
operation by the exercise of an option by the taxpayer and
one comes into operation if exercised by the Inland Revenue.
Each is considered in detail in Chapter 2.
CHAPTER 2 - STATUTORY EXCEPTIONS TO THE GENERAL RULE

Section 1. Separate Assessment.

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Section 2. Collection from Wife.

(1) History.
(2) Statement of the rule.
(3) Judicial interpretations.
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Section 3. Separate Taxation of Wife's Earnings.

(1) History.
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   (d) Lower rates 1978-80.
   (e) 1920-1970.
(2) Present rule.
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(4) Effect on other reliefs and deductions.
   (a) Life assurance relief.
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      (ii) Limits on relief for premiums.
   (b) Annual payments.
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   (d) Capital allowances.
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(f) Mortgage interest relief.
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(h) Retirement annuity relief.
(5) When to make an election.
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Section 4. A Double Election.

Section 5. Conclusions.
CHAPTER 2

STATUTORY EXCEPTIONS TO THE GENERAL RULE

Section
1. Separate assessment.
2. Collection from wife.
4. Double election.
5. Conclusions.

Chapter 1 of this thesis discussed the general rule which applies for income tax purposes to the income of a husband and wife living together, namely, that the wife's income is deemed to be the income of the husband. Two results follow: first, the incomes are aggregated for the purpose of calculating the rates of tax and, secondly, the responsibility for submitting the joint income tax return and for paying the tax rests on the husband.¹

There are three statutory exceptions to this general rule which may apply when husband and wife are living together. None applies automatically; two are brought into operation by the exercise of a choice by the spouses and one by a decision of the Inland Revenue. Two exceptions (separate assessment and collection from wife) operate to vary the rule of husband's accountability and the other exception (separate taxation of wife's earnings) alters the aggregation rule.

¹ Section 37 Taxes Act.
These three statutory exceptions will be considered in the order in which they were introduced historically. The option\(^1\) for separate assessment, now contained in sections 38 and 39 Taxes Act was first introduced in 1914. The power given to the Inland Revenue to collect from a wife tax assessed on her husband but attributable to her income, now found in section 40 Taxes Act, was first introduced in the Revenue Act 1911\(^2\) and later appeared in the Finance Act 1950.\(^3\) The final election, i.e. that for separate taxation of wife's earnings, was introduced in 1971.

The option for separate assessment and the election for separate taxation of wife's earnings are entirely separate; they will be discussed initially on the basis that only one is made. It is, however, possible for both to be in force at the same time so the effect of a double election will then be considered. This chapter ends with some conclusions drawn from the discussion of the statutory exceptions.

1. Separate Assessment

(1) History.

(2) The present rule.

(3) The effect of the personal allowances.

(4) Example.

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1. Although the words "option" and "election" are interchangeable, the word "option" is used in the headnote to section 38 Taxes Act and the word "elect" is used in section 23 Finance Act 1971; the same usage will be adopted here.

2. Section 11, applicable, however, only to supertax.

3. Section 32.
(5) The effect on particular reliefs.

(6) The general effect of an option.

The option for separate assessment was first made available in 1914: the historical background is both interesting and enlightening and a short summary will therefore be given. The legislation governing the exercise of the option is contained in section 38 Taxes Act and this will be considered in detail. A reference will then be made to the method of allocating the personal allowances where an option is in force and an example will follow. The effect of an option on some particular reliefs will be examined and finally the general effect of an option will be summarised.

(1) History

It has been seen\(^1\) that the Income Tax Act 1842, which reprinted the Act of 1806, provided that the incomes of husband and wife were to be aggregated and that the husband was to be accountable for tax on the joint incomes. The early years of the twentieth century saw two changes in the general tax system. First, a reduction for earned income when total income did not exceed £2,000, was introduced in 1907;\(^2\) secondly, a "super tax" on higher incomes was introduced in 1909.\(^3\) Both these provisions penalised higher incomes and the aggregation rule began to cause hardship.

1. Chapter 1, page 43 ante.
2. Section 19(1) Finance Act 1907.
One limited exception to the principle of aggregation was contained in section 34 Finance Act 1894 which provided for a wife's earnings (but not her investment income) to be treated separately for the purposes of the exemption limit so long as the total income of the married couple did not exceed £500. However, no relaxation of the accountability rule was made, despite the provisions of the Married Women's Property Act 1882 which permitted a married woman to own her own property.

There appears to have been a certain amount of dissatisfaction with the income tax provisions and in 1912 matters came to a head in what can be called "the case of Mr. Wilks". This case is more fully discussed in Chapter 8 but a short summary of the facts is given here to enable the historical development of the option for separate assessment to be appreciated.

Mrs. Wilks refused to tell her husband what her income was although it was generally agreed that her income was larger than his. Mr. Wilks was therefore unable to make a return of her income. The Inland Revenue then made an estimated assessment on Mr. Wilks in respect of the estimated joint income. Mr. Wilks refused to pay and his wife supported him in his refusal: he had no way of knowing whether the estimate was or was not correct and further he said that it was not his income but belonged to his wife. The Inland Revenue then distrained on what appeared to be his goods but Mrs. Wilks claimed that they

1. See page 416 post.
were hers with the result that there could be no distraint. Mrs. Wilks said that since she had incurred the penalty by refusing to pay she expected to pay the penalty of imprisonment; but it was Mr. Wilks who went to gaol and his wife felt a grievance that it was not her.

The difficulty faced by Mr. Wilks was summarised later in the following way:

"The system ... is unjust to the husband because the husband can be actually put in prison because his wife does not disclose to him what her income is. He is supposed to return her income, but has no power of compelling her to tell him what it is, and he is bound to pay the tax upon her income but has no right of recovering the amount of the tax from her". 1

After much public comment a statement was made by Lord Haldane in the House of Lords and the Government authorised the release of Mr. Wilks. The plight of Mr. Wilks, and of all other husbands who could be similarly placed, aroused the sympathies of the time. The Times said:

"Mr. Wilks case is ... worth noting because it illustrates the anomalies of the law of husband and wife most of them very much to the disadvantage of the former. From one extreme the law has gone to another. The husband is liable for the wrongs committed by his wife, though he has no power to prevent her from committing them. She, for many kinds of contracts, is his agent, and can bind him practically to almost any amount ... liabilities founded upon the identity of husband and wife are continued when, by reason of the Married Women's Property Act, it no longer exists. Of these anomalies we rarely hear, though, as anyone conversant with proceedings in courts of law is aware, they lead to cases quite as hard as Mr. Wilks. Somehow, then, is kept well in the background the fact that, in a Parliament elected by men, laws placing them in a position of inferiority and disadvantage are passed".

The Law Times contained the following comment:

"The case ... draws attention to the fact that instances of considerable hardship might arise and imprisonment might be inflicted. The case, however, is useful in so far as it shows the fatuous nature of the contention that, owing to the lack of the franchise, women are placed by the law in a disadvantageous position".  

The Solicitors' Journal said:

"While the common law liabilities of husbands, however anomalous, can be explained as historically based on rational legal principles, now obsolete, no such justification can reasonably be urged on behalf of their liability for her income tax that is the creation of statute: or at least it is grafted on the common law quite unnecessarily by a statute. Our modern income tax law was created by the Income Tax Act 1842 ... although modified and amended by successive general tax Acts or annual finance Acts. Now section 45 of the Act of 1842, which is still law ... made the husband's income for purposes of taxation, include not only the income controlled by him but also the separate estate of his wife whether protected by mercantile custom or by settlement. The result is that he must pay income tax in respect of such income because it is a debt due from himself in respect of this fictitious increase to his income. Consequently, in default of payment, he is liable to the statutory penalties".  

Lord Haldane promised in October 1912 that there would be a change in the law. Although a clause to remedy the situation was introduced with the Finance Bill 1913 it was not enacted. In 1914 a deputation of ladies attended upon the Chancellor of the Exchequer (Mr. Lloyd George) and requested some reform in the general tax treatment of married women. In addressing them the Chancellor agreed

1. Law Times, October 12, 1912, page 534.
3. See further in Chapter 7 for a description of the deputation, page 337 post.
that the position was unsatisfactory and subsequently a special clause was introduced during the Report Stage of the Finance Bill.¹ The new clause provided that either husband or wife could apply to the Inland Revenue that they be assessed as if they were not married but the procedure applied only to the collection and recovery of tax and the total amount payable by the married couple remained unaffected.

"(The Clause) is really only designed to enable husband and wife to make separate returns and be assessed and to pay separately. It does not repeal the present arrangement that the two incomes are lumped together for the purpose of abatement ... the only grievance that the clause meets is in connection with the collection and recovery of income tax: no husband in future need go to prison, like Mr. Wilks, because his wife will not tell him what her income is; but no pecuniary relief is granted".²

The debates on the clause are of great interest and will be further considered in Part II of this thesis;³ there was then, and clearly had been for some time, a strong body of opinion which favoured the abolition of the aggregation rule and which criticised the provisions of the separate assessment clause as not going far enough in that direction. Other criticisms were made of the clause but most of these are now of historical interest only as they were subsequently the subject of legislative amendment.

The clause was enacted as section 9 Finance Act 1914; certain amendments were subsequently made and it was

3. See page 433 post.
later incorporated in the consolidating Income Tax Act 1918, in section 8 and Rule 17 of the All Schedules Rules. A further amendment was made in 1919: section 9, as originally enacted, provided that an election had to be made before 6th May in any year; section 26 Finance Act 1919 altered this to 6th July. Originally a separate election had to be made for surtax purposes but those provisions have now been repealed.

The option for separate assessment has not been widely used. Six years after its introduction it was discussed in the Colwyn Report\(^1\) as follows:

"The option of separate assessment dates from 1914; it applies to married men equally with married women, but does not appear to be very widely known; indeed, some of the witnesses seem to have been unaware of the existence of any such provision. The option is rarely taken advantage of, either because of this prevailing want of knowledge, or because its exercise is not in fact often desired. Although a married woman can make a separate return and be assessed separately from her husband, if she wishes it, the total of their separate liabilities to income tax, if the election is made, does not differ from the combined liability that would have arisen if the option had not been exercised. For example, if husband and wife have incomes of £2,000 and £1,000 a year respectively, and claim to be separately assessed, neither is granted exemption from super tax but the liability attaching to an income of £3,000 is divided and charged separately upon husband and wife in proportion to the size of their respective incomes".

Some of the provisions concerning separate assessment were re-enacted in 1950\(^2\) and all were consolidated in sections 355-358 Income Tax Act 1952. The option was not

2. Section 31.
mentioned at all in the Radcliffe Report\textsuperscript{1} which would appear to indicate that the use of the option was not then widely known.

The present rules relating to separate assessment are contained in sections 38 and 39 Taxes Act and these will now be discussed.

(2) The present rule

The main provisions dealing with separate assessment are now contained in section 38 Taxes Act as follows (emphasis added):

"38. Options for separate assessment

(1) If, within six months before 6th July in any year of assessment for which his income would include any of hers, a husband or a wife makes an application for the purpose in such manner and form as the Board may prescribe, income tax for that year shall be assessed charged and recovered on the income of the husband and on the income of the wife as if they were not married and all the provisions of the Income Tax Acts with respect to the assessment, charge and recovery of income tax shall, save as otherwise provided by those Acts, apply as if they were not married.

(2) Notwithstanding an application under sub-section (1) above the income of the husband and the wife shall be treated as one in estimating total income and in determining whether any or what amount of that income is chargeable as investment income: and the amount of tax payable by each of them shall be ascertained by first dividing between them, in proportion to the amounts of their respective incomes, the amount that would be payable by them if no reliefs were given under Chapter II of this part of this Act and then applying Section 39 below to give effect to those reliefs.

\textsuperscript{1} Second Report of the Royal Commission on the Taxation of Profits and Income, 1954, Cmd. 9105."
(3) Subject to subsection (4) below an application duly made by a husband or wife under subsection (1) above shall have effect, not only as respect the year of assessment for which it is made, but also for any subsequent year of assessment.

(4) A person who has made any such application for any year of assessment may give, for any subsequent year of assessment, a notice to withdraw that application; and where such a notice is given the application shall not have effect with respect to the year for which the notice is given or any subsequent year.

(5) A notice of withdrawal under subsection (4) above shall be in such form, and given in such manner as may be prescribed by the Board, and shall not be valid unless it is given within the period allowed by law for making, for the year for which the notice is given, applications similar to that to which the notice relates".

From the above it appears that: -

(a) either husband or wife can apply for separate assessment (section 38(1)); application is made on Form 115-1 obtainable from any tax office: the completed return has to be returned to the husband's tax office; the tax office will acknowledge receipt of the form and notify the other spouse;

(b) application must be made during the six months before 6th July (section 38(1));

(c) an application remains in force until the spouse who applied for it withdraws it (section 38(3) - (5)). Notice of withdrawal on Form 115-1 should be sent to the husband's tax office within six months before 6th July in the tax year when separate assessment is to cease; the tax office will acknowledge receipt of the withdrawal and notify the other spouse;

1. Inland Revenue Leaflet IR 32 describes the procedure.
(d) when an application has been made separate returns are sent to husband and wife who may if they wish declare only their own individual incomes; however, instead, a return declaring the total income of husband and wife, may be made by either spouse;

(e) any repayments are dealt with as if husband and wife were not married; for example, tax overpaid by one spouse is repaid to that spouse and not set against the tax liability of the other spouse.

(3) The effect on the personal allowances

If an election for separate assessment is made the tax bills of husband and wife are initially calculated on the basis that there are no personal allowances; when this has been done effect is given to the personal allowances as provided in section 39, which reads as follows (emphasis added):

"39. Effect of separate assessment on personal reliefs

(1) Where, by virtue of an application under Section 38(1) above, income tax for any year of assessment is to be assessable and chargeable on the incomes of a husband and wife as if they were not married, the total relief given to the husband and the wife by way of personal reliefs (meaning, in this subsection, the reliefs provided for by Chapter II of this Part of this Act) shall be the same as if the application had not had effect with respect to the year and, subject to the proviso to this subsection and to subsection (2) below, the reduction of tax flowing from the personal reliefs shall be allocated to the husband and the wife:

(c) so far as it flows from relief under Section 19 or 20 (relief for life insurance premiums and other payments) to the husband or the wife according as he or she made the payment giving rise to the relief."
(d) so far as it flows from a relief in respect of a child under Section 10(1)(b) or relief in respect of a dependent relative under Section 16 or relief in respect of a son or daughter under Section 17, to the husband or the wife according as he or she maintains the child, relative or son or daughter,

(e) as to the balance in proportion to the amounts of tax which would have been payable by them respectively if no personal reliefs had been allowable,

Provided that, subject to subsection (2) below the amount of reduction of tax allocated to the wife by virtue of paragraphs (c) to (e) above shall not be less than the reduction resulting from Section 37(3) above in the tax chargeable in respect of her earned income and the amount of reduction of tax allocated to the husband shall be correspondingly reduced.

(2) When the amount of reduction of tax allocated to the husband under subsection (1) above exceeds the tax chargeable on the income of the husband for the year of assessment, the balance shall be applied to reduce the tax chargeable on the income of the wife for that year; and where the amount of reduction of tax allocated to the wife under that subsection exceeds the tax chargeable on her income for the year of assessment, the balance shall be applied to reduce the tax chargeable on the income of the husband for that year.

(3) Returns of the total incomes of the husband and wife may be made for the purposes of subsections (1) and (2) above either by the husband or by the wife but if the Board are not satisfied with any such return they may obtain a return from the wife or the husband as the case may be".

It will be seen, therefore, that in applying the personal allowances, relief must first be given for:-

(a) life assurance relief; this is given to the spouse who pays the premiums;¹

¹. Section 39(1)(c).
(b) relief for the maintenance of:

(i) a child (other than the taxpayer's child) where the taxpayer has custody and maintains the child at his or her own expense;

(ii) a dependent relative and

(iii) a son or daughter resident with and maintained by an old or infirm taxpayer

will be given to the spouse responsible for the maintenance.

When this has been done all other reliefs are divided between husband and wife in proportion to their respective tax liabilities. But when a wife has earned income, her share of the total reliefs must not be less than the wife's earned income allowance; if the calculation produces a lesser figure the wife must be given her full wife's earnings allowance and the husband's share of allowances is correspondingly reduced.

It is most important to bear in mind that the allocation of personal reliefs cannot increase or decrease the total amount of personal reliefs due; so if the reliefs allocated to one spouse exceed that spouse's tax liability, the surplus is transferred to the other spouse.

It will be seen that the calculations which are necessary when an option for separate assessment has been made

1. Such relief is provided by section 10(1)(b) Taxes Act but does not apply after April 1982.
2. See Section 16 Taxes Act.
4. See Section 39(1)(d).
5. Section 39(1)(e).
6. Section 39(1) proviso.
7. Section 39(2).
are somewhat lengthy; an example in a simple case is now given to illustrate how the option works in practice.

(4) Example

There appear to be 12 steps in the calculation of tax liabilities where an option for separate assessment is in force. These are:

(a) Calculate total incomes separately.
(b) Calculate total joint tax liability ignoring personal allowances.
(c) Divide total joint tax liability (b) in proportions of separate incomes (a).
(d) Calculate total joint investment incomes separately.
(e) Calculate total joint investment income surcharge.
(f) Divide total joint investment income surcharge (e) in proportion to separate investment incomes (d).
(g) Calculate total tax before personal reliefs by adding (c) and (f).
(h) Calculate in terms of tax and give life assurance relief to spouse who pays.
(i) Calculate in terms of tax and give child, dependent relative and son or daughter relief to spouse who maintains.
(j) Calculate in terms of tax all other personal reliefs and divide in proportion to the tax on the separate incomes (g).
(k) Add (h), (i) and (j) to calculate total reliefs due to each spouse.
(l) Calculate tax due by subtracting total reliefs (k) from total tax (g).
The example which follows proceeds on the following basis:

- Husband's earned income: 15,000
- Wife's earned income: 10,000
- Husband's investment income: 4,000
- Wife's investment income: 4,000
- Life assurance premium - husband: 750
- Life assurance premium - wife: 500
- Dependent relative maintained by husband: 100
- Dependent relative maintained by wife: 100

**Step 1. Calculate total incomes separately**

<table>
<thead>
<tr>
<th></th>
<th>Husband</th>
<th>Wife</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned</td>
<td>15,000</td>
<td>10,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Unearned</td>
<td>4,000</td>
<td>4,000</td>
<td>8,000</td>
</tr>
<tr>
<td></td>
<td>19,000</td>
<td>14,000</td>
<td>33,000</td>
</tr>
</tbody>
</table>

**Step 2. Calculate total joint tax liability (ignoring personal allowances)**

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12,800 @ 30%</td>
<td>3,840</td>
</tr>
<tr>
<td></td>
<td>2,300 @ 40%</td>
<td>920</td>
</tr>
<tr>
<td></td>
<td>4,000 @ 45%</td>
<td>1,600</td>
</tr>
<tr>
<td></td>
<td>6,200 @ 50%</td>
<td>3,100</td>
</tr>
<tr>
<td></td>
<td>6,200 @ 55%</td>
<td>3,410</td>
</tr>
<tr>
<td></td>
<td>1,500 @ 60%</td>
<td>900</td>
</tr>
<tr>
<td></td>
<td>33,000</td>
<td>13,770</td>
</tr>
</tbody>
</table>

**Step 3. Divide total tax liability £13,770 in proportions of separate incomes 19:14**

<table>
<thead>
<tr>
<th></th>
<th>Husband</th>
<th>Wife</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>19,000</td>
<td>14,000</td>
<td>33,000</td>
</tr>
<tr>
<td>Tax</td>
<td>7,928.18</td>
<td>5,841.82</td>
<td>13,770</td>
</tr>
</tbody>
</table>

**Step 4. Calculate total joint investment incomes separately**

<table>
<thead>
<tr>
<th></th>
<th>Husband</th>
<th>Wife</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4,000</td>
<td>4,000</td>
<td>8,000</td>
</tr>
</tbody>
</table>
Step 5. Calculate total joint investment income surcharge

<table>
<thead>
<tr>
<th>Total investment income</th>
<th>£ 8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surcharge Exempt</td>
<td>6,250</td>
</tr>
<tr>
<td>@ 15%</td>
<td>1,750</td>
</tr>
<tr>
<td>Total investment income surcharge</td>
<td>262.50</td>
</tr>
</tbody>
</table>

Step 6. Divide total joint investment income surcharge in proportion to separate investment incomes as in (4).

Ratio is 1:1
Proportion is

<table>
<thead>
<tr>
<th></th>
<th>Husband</th>
<th>Wife</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned</td>
<td>7,928.18</td>
<td>5,841.82</td>
<td>13,770</td>
</tr>
<tr>
<td>Surcharge</td>
<td>131.25</td>
<td>131.25</td>
<td>262.50</td>
</tr>
<tr>
<td></td>
<td>8,059.43</td>
<td>5,973.07</td>
<td>14,032.50</td>
</tr>
</tbody>
</table>

Step 7. Calculate total tax liabilities by adding (3) and (6)

<table>
<thead>
<tr>
<th></th>
<th>Husband</th>
<th>Wife</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned</td>
<td></td>
<td></td>
<td>13,770</td>
</tr>
<tr>
<td>Surcharge</td>
<td>131.25</td>
<td>131.25</td>
<td>262.50</td>
</tr>
<tr>
<td></td>
<td>8,059.43</td>
<td>5,973.07</td>
<td>14,032.50</td>
</tr>
</tbody>
</table>

Step 8. Calculate in terms of tax and give life insurance relief to spouse who pays

<table>
<thead>
<tr>
<th>Premiums</th>
<th>Relief</th>
</tr>
</thead>
<tbody>
<tr>
<td>Husband</td>
<td>750 @ 15%</td>
</tr>
<tr>
<td>Wife</td>
<td>500 @ 15%</td>
</tr>
</tbody>
</table>

Step 9. Calculate in terms of tax and give child dependent relative and son or daughter relief to spouse who maintains

<table>
<thead>
<tr>
<th>Relief</th>
</tr>
</thead>
<tbody>
<tr>
<td>Husband (dependent relative)</td>
</tr>
<tr>
<td>Wife (dependent relative)</td>
</tr>
</tbody>
</table>
Step 10. Calculate in terms of tax all other personal reliefs and divided in proportion to the tax on the separate incomes (Step 7)

Other personal reliefs.  
- Married man's allowance 2,445
- Wife's earned income allowance 1,565

Relief in terms of tax: 4,010 @ 60% = 2,406

Divided £2,406 in the proportions 8,059.43 : 5,973.07

<table>
<thead>
<tr>
<th></th>
<th>Husband</th>
<th>Wife</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life assurance (8)</td>
<td>112.50</td>
<td>75</td>
<td>187.50</td>
</tr>
<tr>
<td>Other allocated (9)</td>
<td>60.00</td>
<td>60</td>
<td>120.00</td>
</tr>
<tr>
<td>Other proportionate (10)</td>
<td>1,381.86</td>
<td>1,024.14</td>
<td>2,406.00</td>
</tr>
<tr>
<td></td>
<td>1,554.36</td>
<td>1,159.14</td>
<td>2,713.50</td>
</tr>
</tbody>
</table>

NOTE  The wife's allowances are not less than her earned income allowance (£1,565 x 60% = £939) so no further adjustment is required.

Step 11. Add (8) (9) and (10) to calculate total reliefs due to each spouse

<table>
<thead>
<tr>
<th></th>
<th>Husband</th>
<th>Wife</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax (7)</td>
<td>8,059.43</td>
<td>5,973.07</td>
<td>14,032.50</td>
</tr>
<tr>
<td>Less total reliefs (11)</td>
<td>1,554.36</td>
<td>1,159.14</td>
<td>2,713.50</td>
</tr>
<tr>
<td></td>
<td>6,505.07</td>
<td>4,813.93</td>
<td>11,319.00</td>
</tr>
</tbody>
</table>

The impression is sometimes given that the existence of the option for separate assessment answers most, if not all, of the criticisms directed against the tax treatment of married couples. As the above example shows, the procedure is extremely complicated even in the simplest cases, and where any other reliefs are claimed, the
complications are compounded. A reference will now be made to the way in which other reliefs are dealt with where an option for separate assessment has been made.

(5) The effect on particular reliefs

(a) Life assurance relief
(b) Loss relief
(c) Capital allowances
(d) Mortgage interest relief
(e) Savings bank interest relief
(f) Retirement annuity relief

Where an option for separate assessment is in force, reliefs and allowances fall into three categories, namely, separately allocated allowances, proportionately allocated allowances and reliefs given by way of deduction from total income.

Separately allocated allowances. Section 39 (1) (c) and (d) provides that life assurance relief is to be allocated to the spouse paying the premiums and that relief for another's child, dependent relative, or son or daughter is to be given to the spouse who maintains. Section 60 (2) Finance Act 1981 provides that relief for investment in new corporate trades is to be allocated to the spouse who makes the payment for the subscription of shares.

Proportionately allocated allowances. Section 39 (1) (e) provides that all other allowances in Chapter II (i.e. all other personal allowances including the married man's allowance and the wife's earnings allowance) are to be allocated in proportion to each spouse's tax liability.

Deductions from income. There are a number of reliefs which are given by way of deduction from income. These include: loss relief, relief for capital allowances,
mortgage interest relief, savings bank interest relief and retirement annuity relief. Where an application for separate assessment has been made the reliefs given by way of deduction from income operate to reduce the income of the relevant spouse before any calculation to apportion tax liability can commence. In the example given previously these reliefs would be taken into account before Step (a) of the calculation. The amount of relief will affect the amount of the spouse's income; that will alter the proportions of incomes of the spouses; that in turn will affect the tax liability which will affect the proportions of allowances allocated to each and thus the final tax liability. Where a relief by way of deduction from income is given to one spouse, therefore, the whole calculation apportioning tax liability is delayed.

Special considerations apply to certain of the reliefs given by way of deduction from income where an option for separate assessment is in force, and each will now be considered in turn. First some comments on life assurance relief are made although it will be recalled that this is a "separately allocated allowance".

(a) Life assurance relief. In the normal case of husband and wife living together life assurance relief is given in respect of total premiums paid by either spouse; premiums may be paid up to the limits of £1,500 or 1/6th of total income whichever is the greater; spouses can insure the lives of themselves or the other spouse and it does not matter which spouse pays the premiums.¹

An option for separate assessment alters the

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¹ See Chapter 1 page 52 ante.
limits on premiums but spouses may continue to insure each other's lives, relief being given to the spouse who pays the premiums.

(i) **The limits on premiums.** Where an election for separate assessment is in force paragraph (10) (b) schedule 4 Finance Act 1976 provides that the limits on premiums of £1,500 or 1/6th of income whichever is the greater,

"shall apply separately to the amounts paid by each of them but as if for the limits specified ... there were substituted in relation to each of them, a limit of £750 or one-twelfth of their total income, whichever is the greater, plus any amount by which the payments in respect of which relief can be given to the other fall short of the limit so substituted".

This means that each spouse gets a separate (half) limit of their total income for premiums paid plus, in effect, the right for any unused allowance of one spouse to be transferred and made available to the other.

This follows from the principle in section 39 (2), that the balance of any reliefs may be set against the income of the other spouse.

(ii) **Insuring each other's life.** Spouses may continue to insure the life of the other notwithstanding an option for separate assessment, and they may also pay premiums on the life of the other spouse. This follows from the principle in section 39 (1) that

"the total relief given to the husband and the wife by way of personal reliefs (meaning ... the reliefs provided for by Chapter II of this Part of this Act) shall be the same as if the application had not had effect with respect to the year ..."
Life assurance relief comes within Chapter II and is therefore included in this provision.

(iii) Relief to the spouse who pays premiums. Section 39 (1) (c) provides specifically that relief for life assurance premiums is given directly to the spouse who pays the premiums, irrespective of which spouse took out the policy or which spouse is insured. The relief is not allocated proportionately to tax liability as happens with some other personal allowances.

(b) Loss relief. There are four ways in which a trading loss can be relieved. First it may be carried forward and set off against profits of the same trade in any subsequent year of assessment.\(^1\) Because the relief is limited to profits of the "same trade" it is not available against a spouse's income. Secondly a loss may be applied in the reduction of other income for the year in which the loss was sustained or the next year.\(^2\) In this case, the loss is first set off against "income of the corresponding class"; so, a loss from a source of earned income is first set off against earned income and a loss from an unearned source is first set off against unearned income. In the case of married persons the order of allowance is applied to the income of the spouse sustaining the loss before extending it to the other. There are also specific provisions\(^3\) enabling a married claimant to set-off the loss against his

---

1. Section 171 Taxes Act.
2. Section 168 Taxes Act.
3. In Section 169(3).
or her own income only and to carry forward unused relief to be set-off against his or her own income in the following year. Thirdly, if a trade is discontinued then terminal losses may be set against profits of that trade for the three preceding years;¹ again, as this relief is limited to profits of the same trade it is not available against a spouse's income. Finally, if a trade is commenced and a loss is sustained in the first three years it may be carried back and set off against other income in the preceding three years.²

There are no special provisions dealing with the application of loss relief where an option for separate assessment has been made, but such would appear unnecessary as the general rule in section 38 covers all eventualities. Section 38 (2) specifically provides that, notwithstanding the fact that an election has been made, "the income of the husband and the wife shall be treated as one in estimating total income". This appears to mean that in the two cases where a loss may be set against the other income of the taxpayer³ it may also be set against the income of the other spouse.

However, where an election for separate assessment is in force, it is likely that the spouse sustaining a loss will make a claim under section 168(3) to carry forward the loss to set against his own income for the following year rather than setting the loss against the spouse's

3. Under Section 168 Taxes Act or under Section 30 Finance Act 1978.
income for the year in which the loss was sustained.

As any loss set against general income reduces that income, it is taken into account before the calculation apportioning the tax liabilities for separate assessment is made. It follows that any claim for loss relief will delay the calculations but serious problems will arise when there is a claim to carry back loss relief either under section 174 (terminal losses) or under section 30 Finance Act 1978 (losses in early years of trade); in these cases it appears that all the separate assessment calculations for the previous years would have to be reopened and the tax liabilities re-allocated.

(c) **Capital allowances.** Capital allowances are given as a deduction in charging the profits of a trade to income tax. There are three ways of treating any excess. First, the excess may be carried forward and allowed against future profits of the same trade without limit.\(^1\) Secondly, the excess may be used in the same way as a trading loss under section 168 Taxes Act and set against other income for the year of loss and the next year.\(^2\) Finally, capital allowances relating to the last twelve months of a trade may be carried back like a terminal loss and set against profits of the same trade for the previous three years.\(^3\)

In the first and third case the allowances are taken into account in computing the profits and income of the trading spouse. In the second case they can also be

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2. Section 169 Taxes Act.
set against the income of the non-trading spouse in the same way as a section 168 trading loss considered above. The right given by section 168 (3) to claim the relief against the income of the trading spouse for the next year, rather than the income of the non-trading spouse for the current year, also applies.

(d) **Mortgage interest relief.** Part I Schedule 9 Finance Act 1972 contains the provisions applicable to interest relief for loans for the purchase or improvement of land. Paragraph 1 provides that interest is eligible for relief if it is paid by the person who owns the land to repay a loan used to purchase or improve the land. The relief is also subject to the provisions of Schedule 1 Finance Act 1974 which provides that relief is only available if, at the time the interest is paid, the land is used as the only or main residence of the person by whom the interest is paid. So, to get interest relief, the same person must (a) own the land (b) mortgage the land and (c) pay the interest.

Paragraph 5 Schedule 1 Finance Act 1974 limits the relief to interest on a loan not exceeding £25,000 used to purchase the borrower’s only or main residence, and we have seen that paragraph 5 (4) (a) provides that one limit of £25,000 applies to both husband and wife.¹

No indication is given as to how the relief is to be applied when the spouses are separately assessed. Where there is no option for separate assessment no problem arises: whichever spouse borrows the money, and whichever spouse pays the interest, relief is given to the husband.

¹ See Chapter 1 page 58 above.
to set against the aggregate income. So, if a wife owns the house and raises a loan, but the husband pays the interest, relief is available to the husband against the joint income.

"It is understood that the Revenue take the view that provided the property for which the loan is raised is the only or main residence of the spouses who are living together, a husband is not precluded from claiming relief from tax in respect of interest on money borrowed to buy a house by reason of the fact that the loan was raised or that the house is currently owned by the wife who lives with him".  

From this it appears that in the usual case relief is given to a husband even if it is the wife who owns and mortgages the house: relief can only be given to the wife if the husband consents.  

But, if the spouses are separately assessed, relief will only be given to the spouse making the payments so long as that spouse also owns and mortgages the home. An option for separate assessment could therefore reduce the total reliefs available to a married couple where, say, the husband owns the house and the wife makes the interest payments. The provisions of section 39 (1), (that where an option for separate assessment is in force, the total relief by way of personal relief shall be the same as if the application had not had effect) only applies to personal reliefs and not to reliefs given by way of deduction from total income.

Mortgage interest relief is given at the initial stages of the calculation apportioning tax liability; it

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2. The difficulties arising from this rule are more fully discussed in Chapter 8 below.
alters the proportions of income and thus the proportions of the liability and thus the allocation of the personal allowances.

(e) Savings bank interest relief. Section 414 Taxes Act provides that where the income of an individual includes sums paid as interest on deposits with the National Savings Bank such sums are to be disregarded for income tax purposes "if or in so far as they do not exceed £70".

The section continues:

"And for this purpose the question whether or how far those sums exceed £70 shall, where by virtue of section 37 of this Act, a woman's income is deemed to be her husband's, be determined separately as regards the part of his income which is his by virtue of that section and the part which is his apart from that section".

Thus in the normal case husband and wife receive two £70 reliefs. Where an option for separate assessment is in force, the wife's income is not deemed to be her husband's under section 37; the latter part of the section does not therefore apply and it could therefore be argued that the provisions of section 38(2) might not operate to give two £70 reliefs where an option for separate assessment has been made.

It will be recalled that these provisions are:

"Notwithstanding an application under subsection (1) above the income of the husband and the wife shall be treated as one in estimating total income and in determining whether any or what amount of that income is chargeable as investment income".

If the incomes are therefore to be aggregated, and if the exemption in section 414 only applies to section 37 and not to section 38, then it would follow that only one
£70 relief is available.

Further, the provisions of section 39 (1) (that where an option for separate assessment is in force the total relief by way of personal relief shall be the same as if the application had not had effect) only applies to personal reliefs and not to reliefs given by way of deduction from income.

If therefore the second £70 relief only applies to section 37 and not to section 38 an option for separate assessment could reduce the total reliefs available. However, it is thought that in practice this point would not be taken as it is so clearly against the spirit of the legislation.

No indication is given as to how the relief is to be apportioned but it is dealt with by reducing the amount of savings bank interest included in total income before the separate assessment calculation is made.

(f) Retirement annuity relief. Section 226 (8) Taxes Act provides that, for the purpose of retirement annuity relief, a married woman's relevant earnings shall not be treated as her husband's relevant earnings, notwithstanding that her income chargeable to tax is treated as his income.

Previous to the removal of the ceiling on contributions, in Finance Act 1980, two limits of £3,000 were given. This applied both in the usual case and where an option for separate assessment had been made. All retirement annuity relief is given by way of deduction from earnings before the calculation apportioning tax liability is made.

1. Section 227(1A) (a)) Taxes Act, now amended by section 31 Finance Act 1980.
(6) General effect of an election

Some advantages and some disadvantages result from an application for separate assessment. These are summarised below. However, it will be noted that the "advantages" do no more than place married persons in the same position as single persons for some purposes; they are "advantages" only when compared with other married couples - not when compared with single persons.

(a) Advantages of separate assessment.

(i) Under the normal system, where the husband submits the joint tax return, the husband can conceal his income from his wife but she cannot conceal hers from him. If an option for separate assessment is made, the wife can conceal her income and make a separate return to the Inland Revenue. The separation of accounting is not, however, complete - see disadvantage (ii) below.

(ii) A husband with a small income whose wife has a large income can absolve himself from liability for her tax.

(iii) A wife whose income is as much as, or more than, her husband's will benefit from the proportional allocation of the personal allowances; she will obtain a proportion of the married man's personal allowance to set against her income.

(iv) A wife who is entitled to a repayment will have it made to her direct and will not have it set against her husband's tax bill or paid to him. Section 22 Finance Act 1978, requiring certain payments to be made direct to wives, only applies
(b) **Disadvantages of separate assessment.**

(i) The total liability may in fact be increased if mortgage interest relief is refused where one spouse pays the interest but the house is owned and mortgaged by the other. A second savings bank interest relief may also be lost, although this is doubtful.

(ii) The separate accounting is not complete. The Inland Revenue tell the other spouse when an application for separate assessment is received. A "total return" is required by the Inland Revenue to apportion tax liabilities and allowances and the Inland Revenue therefore need the aggregate figures from the two separate returns. When each spouse is informed of the allowances and liability apportioned to him he can guess at the amount of the other spouse's income.

(iii) Spouses cannot check their assessments as, unless they agree to exchange information, only the Inland Revenue will have the information revealed on both returns. This factor points to the impossibility of maintaining full privacy with an aggregation rule.

(iv) The option for separate assessment means a delay in computing tax liabilities: if one spouse is assessed under Schedule D, and claims any reliefs by way of deduction from income, the calculation cannot be commenced until the taxable income is
finalised. Thus, a unilateral option by one spouse could cause difficulty for the other spouse.

(v) Calculations may have to be reopened for both spouses if one spouse wishes to carry back a loss to income of previous years under section 30 Finance Act 1978 or under section 174 Taxes Act.

(vi) The spouse to benefit from the option will most likely be the wife: as details of the existence of the procedure are included on the normal tax return, which is signed only by the husband, she may never know that it exists. The availability of the option has not always been widely advertised.

(vii) The calculations are extremely complicated and could introduce an element of uncertainty where none existed before; this would lead to the necessity of end of year adjustments in many cases.

(c) Neutral factors. There are two results of an option for separate assessment which could not be described either as advantages or disadvantages. These are:

(i) Any personal reliefs which cannot be claimed by one spouse can be used by the other - but this does not apply to reliefs given by way of deduction from income.

(ii) There is no diminution in the total tax liability.

2. Collection from Wife

(1) History.

(2) The Rule.
(3) Judicial Interpretation.
(4) Conclusions.

(1) History

The first alteration to the general rule, that a husband is liable to account for income tax on his wife's income, was enacted in 1914 when either husband or wife were given the right to opt to be separately assessed for tax purposes. However that right only applied if a request was made by husband or wife within the time limits laid down; in all other circumstances the husband remained solely accountable for tax on the joint income.

These provisions had disadvantages for husbands: if an election had not been made before 6th May (later changed to 6th July) in any year of assessment then it could not be made subsequently whatever the subsequent change in circumstances; elections made after the stated date could not, and still cannot, be backdated; after 6th July no election can be made until 6th January the following year and then only for the next year of assessment. So, if a wife acquires property after 6th July, either by inheritance, or by way of gift, or successful investments, or winnings on premium bonds or football pools, the husband has no way of disclaiming liability for tax on the income from such property until the next year of assessment.

The separate assessment provisions also had disadvantages for the Inland Revenue. If neither husband nor wife made an application for separate assessment, the

Inland Revenue could not insist that they do so, and, in the absence of an application, the Inland Revenue had no power to demand payment of tax from a wife in respect of her income. A remedy to solve these difficulties as far as super tax only was concerned was enacted in 1911 but repealed in 1914.

The anomaly was mentioned very briefly in 1920 in the Colwyn Report which recommended:

"that the Revenue should have power of assessment, apportionment and recovery of the tax against the spouses in respect of their separate incomes where necessary to the collection of the tax".

This amendment was not, however, incorporated in the Finance Act 1920.

When the sections concerning the tax treatment of husband and wife were re-enacted in the Finance Act 1950, following the criticism of the court in Nugent-Head v. Jacobs, the provisions which gave the Inland Revenue power to collect from a wife tax attributable to her income were re-enacted. The following description of the clause was made during the Committee stage of the Bill in the House of Commons:

"This clause removes what has in the past been a source of great domestic difficulty to some households and has constantly been the source of great difficulty in the collection of tax by the Inland Revenue. The clause now changes the powers of the Inland Revenue to recover tax assessed on the husband in respect of his wife's income. This is a long overdue change and I congratulate the Inland Revenue on at last having a Chancellor of the Exchequer who is prepared to shift the liability for payment

1. See further Chapter 8 page 416 post.
3. Paragraph 262.
of tax on the wife's income to the wife and not confine it to the husband. 1

The reasons behind the clause were also considered on the Third Reading in the following terms:

"In cases where a wife declines to pay income tax and surtax assessed on her income and where the husband has not the resources in his possession to pay that tax, the wife is frustrating the obvious course of the Revenue in requiring her to pay a proper share of tax". 2

Initially the clause was retrospective in effect but that was altered during the passage of the Bill. It is somewhat surprising that at no time during the debates on the Bill was a mention made of the option for separate assessment which had been available since 1914 and which, if applied for by either husband or wife, would have removed the "source of great domestic difficulty" referred to (although creating difficulties of its own). This omission re-inforces the impression that as little publicity as possible is given to the option for separate assessment.

From a reading of the debates on the clause it emerges that, in a number of cases, husbands had refused to pay tax on their wives' income, and indeed had not the resources to do so; whether or not this resulted from a form of tax avoidance whereby the assets of the husband were transferred to the wife, thus ensuring that the income belonged to her so that the Inland Revenue could not assess her to income tax if no election for separate assessment had been made, is not clear. The clause was duly enacted

1. Hansard, 19th June 1950, Col. 938.
2. Hansard, 10th July 1950, Col. 1005.
as section 32 Finance Act 1950; it became section 359 Income Tax Act 1952 and is now section 40 Taxes Act.

(2) The statement of the rule

The rule is now found in section 40 which is a very lengthy section and is not reproduced here in full. It provides that if (1) an assessment to income tax is made on a husband, and the Board are of the opinion that, if an application for separate assessment under section 38 had been made, then an assessment could have been made on the wife, and if (2) any tax due is unpaid for more than 28 days, then the Board can serve on the wife a notice giving details of the original assessment, the amount remaining unpaid and an estimate of the amount due from the wife, and requesting her to pay that amount. The same consequences about liability, recovery etc., apply as if a separate assessment had been applied for and made. After the notice the tax is no longer recoverable from the husband, and when the notice has been served husband and wife are deemed to have been separately assessed retrospectively.

The section, in effect, gives to the Inland Revenue the equivalent of a right to choose separate assessment for husband and wife, even if neither spouses wishes it.

(3) Judicial interpretation

It is not known how frequently the provisions of section 40 have been used by the Inland Revenue to collect tax direct from a wife; perhaps the mere existence of the
powers given by the section have been sufficient to deter taxpayers from the type of avoidance at which the section was aimed. Only one case on the provisions has been before the court and the taxpayer won. The case was Johnson v. Inland Revenue Commissioners¹.

In that case the husband and wife were not separately assessed to tax. Well within the usual time limits, assessments for surtax were made on the husband for the years 1961-62 and 1965-66. The assessments included surtax in respect of the wife's income. The husband failed to discharge these assessments and on 13th December 1974 a notice was served on the wife under section 40 Taxes Act. The notice demanded payment from the wife of the sum of £4,235 as the amount of the surtax unpaid by the husband which would have been payable by the wife if she had been separately assessed in the relevant years. It was common ground that if the wife had been separately assessed in those years an assessment made on her at the date of the notice, i.e. 13th December 1974, would have been out of time (being more than six years later than the years of assessment to which it related); if the wife had appealed against such assessment it would have been discharged.

On an appeal by the wife against the demand to pay under the notice the court held that the terms of section 40(2) provided that the same consequences were to follow the service of a notice under section 40(1) as would have followed the making of a separate assessment on the

¹. (1978) STC 196.
same day. Since the wife could have had an assessment made on 13th December 1974 discharged as being out of time she could also have the notice under section 40(1) discharged and therefore she was not liable to pay the sum demanded. In the words of Stamp J.¹

"An assessment on a wife who is separately assessed, like an assessment on a man, must be made within the time limited by the Taxes Acts. If not so made, objection may be taken to it on appeal.... on the ground that the time limited for making it has expired.

If the wife had been the subject of a separate assessment in respect of the years (1961-62 and 1965-66) and an assessment had been made on her on 13th December 1974, that assessment would have been out of time.... One of the consequences of that would have been that the taxpayer, who had then become a widow, would never have come under any liability to pay the tax which is now demanded....It is to be emphasised that prior to the service of the notice the taxpayer was under no liability to pay any part of the unpaid tax".

(4) Conclusions

The option for separate assessment, contained in sections 38 and 39, was the first breach of the principle of husband's accountability: section 40 is the second and it places the Inland Revenue at a unique advantage. Although the law deems the incomes of husband and wife to be one, the Inland Revenue can now ignore this fact when collecting tax on the wife's income.

If a single taxpayer does not pay his tax, the Inland Revenue can only enforce their rights of recovery against him: but tax on a married woman's income can now be enforced both against the husband or the wife consecutively.

¹. Page 199.
The principle of husband's accountability can therefore be varied completely either by the husband or wife (by opting for separate assessment) or by the Inland Revenue. The principle of aggregation of incomes is, however, subject to only one variation and that is only partial. These provisions, which were introduced in 1971, are now discussed.

3. Separate Taxation of Wife's Earnings

(1) History.

(2) Present rule.

(3) Effect on personal allowances.

(4) Effect on other reliefs.

(5) When to make an election.

(6) General effect of an election.

The option for separate taxation of wife's earnings is a genuine, although limited, exception to the rule of aggregation. It was first made available by section 23 and Schedule 4 Finance Act 1971; prior to that date it had been recognised that the taxation of a wife's earnings required some special treatment and a short summary of the historical perspective will therefore be given. The rule as enacted in 1971 will then be considered with particular attention to its effect on the availability of the various allowances and reliefs. A discussion of the circumstances in which an election should be made will follow and, finally, the general effect of the exercise of the election will be discussed and the various advantages
and disadvantages will be summarised. First, then the history of the election.

(1) History

(a) Separate taxation of wife's earnings 1894-1920.
(b) Wife's earned income allowance 1920-date.
(c) Reduced rate relief 1927-1970.
(d) Lower rates 1978-80.
(e) 1920-1970.

(a) Separate taxation of wife's earnings 1894-1920. The first recognition that some special treatment was due to the separate earnings of a wife occurred in 1894: the Finance Act that year\(^1\) provided that if the joint income of husband and wife did not exceed £500, then a separate set of exemptions and reduced rate relief could apply to the wife's earnings. The figure of £500 remained unchanged until 1920. The provisions were considered by the Colwyn Commission who, astonishingly, agreed that the figure of £500 was too low and, instead of increasing it, abolished the relief altogether, replacing it with the additional personal allowance for wife's earnings.\(^2\)

(b) Wife's earned income allowance 1920. The history of the wife's earned income allowance is fully discussed in Chapter 13 from which it will be recalled that since 1942\(^3\) the wife's earned income allowance has been the same as the single person's allowance and, in addition, the husband has been entitled to claim the full married man's allowance; this results in the fact that the total personal allowances

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1. Section 34(2).
2. The recommendations are more fully discussed in Chapter 9 below.
3. Page 73 ante.
available to a married couple with a working wife exceeds the total allowances available to two single persons.

(c) **Reduced rate relief 1927-70.** A "reduced rate relief" was available since 1927 but, as it was given to "the income of an individual" and as section 37 deemed the income of the wife to be the income of the husband, a married couple, in effect, only received one set of "reduced rate relief" in respect of their joint income. Section 28(2) Finance Act 1948 introduced for the first time the system of awarding separately to the wife's earnings reduced rate reliefs of the same amount and scale as those applicable to the rest of the income of the married couple by providing that if the joint income included any "earned income" of the wife then a second set of reliefs could be made available to set against that earned income. The definition of "wife's earned income" foreshadows the later definition of "wife's earnings" in paragraph 1 Schedule 4 Finance Act 1971 and, further, the restriction of the second reduced rate relief to wife's earnings only (giving, in effect, her investment income to her husband) foreshadows the provisions of paragraph 3(1)(c) Schedule 4 Finance Act 1971.

The relief given in 1948 was beneficial to working wives. The Radcliffe Report¹ said:—

"In effect, the married woman whose earnings are high enough to make them liable to standard rate tax on the margin receives through the reduced rates a further tax-free allowance of £172".

(This "further allowance" of £172 can be compared with the

single person's allowance which was then £120).

The provisions in the Finance Act 1948 applied automatically; no formal election or claim had to be made. Although clearly the provisions benefited wives with earnings up to the basic rate the rule of aggregation still applied and married couples with aggregated joint income liable to surtax were still at a disadvantage as there was no general exception to the rule requiring the aggregation of the joint income. The double entitlement to reduced rate relief continued until the relief itself was abolished by section 14(1)(b) Finance Act 1970.

(d) Lower rates 1978–80. A "lower rate" of income tax was introduced by section 14 Finance Act 1978; this lower rate was 25 per cent on a band of £750 of total income taxable at that rate. Husband and wife were, in effect, entitled to two "lower rate reliefs" but the wife's relief was only available against her earned income, the husband's relief being available against the rest of the joint income, including the wife's investment income. There was no transferability of unused relief between the spouses. This lower rate only remained in force for two years as it was abolished by section 18(2) Finance Act 1980.¹

(3) 1920–1970. Between 1920 and 1970, apart from the reduced and lower rates, the only relief for the earnings of a married woman was the additional personal allowance for wife's earned income. The existence of the additional personal allowance coupled with the aggregation rule results in two anomalies: where the joint income of the married couple, after deduction of allowances and reliefs, is

¹. See discussion in Chapter 1 above, page 66.
taxed only at the basic rate the married couple are better off than two single persons as their joint personal allowances amount to more than two single allowances. If, however, their joint income, when aggregated, is liable to higher rate tax, they will be worse off than two single persons when the disadvantages of aggregation nullify the advantages of the larger personal allowances.

Perhaps in times when social conditions inhibited the earning of high salaries or profits by married women the disadvantages of aggregation were not widely felt. The late 1960s, however, saw the emergence of many professionally qualified young women who did not wish to abandon their careers on marriage but who also did not consider that marriage should make any difference to the tax treatment of their earnings. In 1967 the Council of the Law Society recommended a change:-

"The Council consider that the present system of taxation of the income of married couples is anomalous and leads to injustices. One result of the present tax system is that when one spouse has a moderately high income there is a disincentive for the other spouse to work. Another result is that a couple who live together without being married can pay less tax than a couple who are married. The Council see no justification for this and suggest that the time is ripe for reconsideration of the whole income tax and surtax position of married couples". ¹

The Memorandum then referred to the American system of a joint return and suggested that it be applied in this country. This recommendation was repeated in 1968² and again in 1969 as follows:-

1. Memorandum on the Reform of Revenue Law, October 1967 paragraph 16.
"The Council wish to repeat their recommendation for rationalisation but, if this cannot be implemented forthwith then the Council recommend that, as an initial step, a husband's and wife's earned income should be treated as the earned income of two separate individuals for all tax purposes".1

This recommendation was repeated in 19702 and the Council were no doubt pleased to note the contents of the Finance Bill the following year.

(f) Finance Act 1971. The legislation giving effect to a separate taxation of wife's earnings was introduced by section 23 and Schedule 4 Finance Act 1971. The provisions have many limitations, which will shortly be discussed, but the importance of the legislation cannot be overestimated as it represents the only genuine exception to the general rule that the incomes of husband and wife are aggregated for tax purposes.

The rule and its limitations are now considered.

(2) Present rule

Section 23 Finance Act 1971 provides that a husband and wife living together can jointly elect that the earnings of the wife shall be chargeable to income tax as provided in Schedule 4 to the Act. The section contains detailed provisions concerning the making and revocation of the election; there are time limits but the Board of Inland Revenue have power to extend these where appropriate.

Paragraph 1 of Schedule 4 defines "wife's

"earnings" as any earned income other than payments made to her in respect of her husband's past employment and other than national insurance payments unless these relate to her own contributions. Paragraph 2 sets out the general rule - that section 37 Taxes Act still applies but if the election under section 23 is made, the wife's earnings are taxed as if she were a single woman with no other income and the remainder of the joint income is assessed on the husband. Paragraph 3 discusses the application of the personal allowances and paragraph 4 provides for the treatment of certain payments, losses and capital allowances and both these paragraphs will be considered in more detail shortly.

Paragraph 5 deals with assessments and provides for these to be made on the wife and for repayments of tax to be made to her, whether or not an election under section 38 is also in force. Paragraph 6 has been repealed and paragraph 7 provides that the husband remains responsible for making a return of his wife's earnings (unless application is also made for separate assessment under section 38).

(3) **Effect on personal allowances**

As mentioned above, paragraph 3 Schedule 4 Finance Act 1971 describes how the personal allowances are allocated after an election for separate taxation of wife's earnings has been made. The main rule is that the reliefs are given as if the husband and wife were not married. The practical effect of this rule is that each spouse gets the
single person's allowance of £1,565 but the husband loses
the married man's allowance of £2,445 and the wife loses
the wife's earned income allowance of £1,565. There is
thus a loss of personal allowances of £880.

Although the wife may claim any other personal
reliefs which would be available to a single woman (e.g.
dependent relative relief for an incapacitated or aged
relative of hers whom she supports)\(^1\) such reliefs can
only be set against the wife's earnings; if unused they
cannot be transferred and used against the husband's
income or even against the wife's investment income.

Paragraph 3(3) specifically provides that if an
election for separate taxation of the wife's earnings is
made no relief is given either to the husband or to the
wife in respect of age allowance\(^2\) or additional relief in
respect of children\(^3\). There may be some logic in excluding
the additional relief in respect of children, as this is
specifically stated to be available only to unmarried per-
sons, and the treatment of husband and wife as single
persons by virtue of an election for separate taxation of
wife's earnings, is an artificial concept. It is more
difficult to see why age allowance is excluded from both
parties just because an election is made.

(4) Effect on other reliefs and deductions

(a) Life assurance relief.
(b) Annual payments.
(c) Losses.
(d) Capital allowances.

1. Under Section 16 Taxes Act.
2. Under section 8 (1A) Taxes Act.
(e) Relief for investment in new corporate trades.
(f) Mortgage interest relief.
(g) Savings bank interest relief.
(h) Retirement annuity relief.

As mentioned above, the rules concerning annual payments, losses and capital allowances are contained in paragraph 4 Schedule 4 Finance Act 1971 and the rules relating to investment in new corporate trades have been enacted by reference to paragraph 4,1 and these will shortly be considered; they will be followed by a discussion of the effect of an election on mortgage interest relief, savings bank interest relief and retirement annuity relief. First, however, the anomalous rules relating to life assurance relief will be discussed.

(a) Life assurance relief.

(i) Policies on the life of the other spouse.
(ii) Limits on relief for premiums.

(i) Policies on the life of the other spouse.

The provisions concerning relief for life insurance premiums were altered by section 34 and schedule 4 Finance Act 1976 to take effect from 1979 - 80. Paragraph 9 of schedule 4 provides that, where an election under section 23 Finance Act 1971 is in force, the life assurance relief to which either the husband or the wife is entitled under section 19 Taxes Act in respect of premiums paid by them on an insurance contract on the life of the other or made by the other shall not be affected by paragraph 5 Schedule 4 Finance Act 1971 (which requires relief to be determined as

1. Section 60(2) Finance Act 1981.
if the husband and the wife were not married). In other words, husbands and wives can still insure each other's lives and pay premiums on policies taken out on each other's lives even if an election for separate taxation of wife's earnings is in force. These provisions are a specific exception to the general rule that reliefs are assessed as if the husband and wife were not married. (One of the reasons given for the existence of this anomaly is that, under the new system of relief for life insurance premiums, the relief is obtained by deducting tax from the payment of premiums at source instead of, as previously, submitting a claim to the Inland Revenue. Life Offices therefore would have no way of knowing whether deductions were correctly made if their validity altered with changes in the status of the policyholder or the making or revocation of an election).

(ii) **Limits on relief for premiums.** The effect of an election for separate taxation of wife's earnings on the amount of life assurance relief available is less certain. Paragraph 3 schedule 4 Finance Act 1971 provides that the reliefs in Chapter II of the Taxes Act (which include life assurance relief) are to be determined as if the husband and wife were not married. At first sight, the effect of this would appear to be that each spouse could pay premiums in the same way as an individual,
with limits of 1/6th of total income or £1,500 whichever was the greater, the wife by reference to her earned income and the husband by reference to the rest of the joint income.

However, paragraphs 7 - 10 Schedule 4 Finance Act 1976 lay down specific rules applicable to life assurance relief for husband and wife commencing when the new system came into force in 1979-80. Paragraphs 9 and 10 are relevant. Paragraph 9 says:-

"Where an election under section 23 of the Finance Act 1971 is in force, the relief to which either the husband or the wife is entitled under section 19 in respect of an insurance or contract on the life of the other or made by the other shall not be affected by paragraph 3 of Schedule 4 to that Act (which requires relief to be determined as if the husband and the wife were not married)."

Paragraph 9 has been discussed on page 155 above but here it will be noted that it only relates to relief to which either spouse is entitled "in respect of an insurance on the life of the other or made by the other" and for these purposes, it will be recalled, husband and wife are treated as remaining married - they can insure each other's lives and pay premiums on policies taken out on each other's lives. This paragraph, however, makes no reference to policies taken out by a spouse on his or her own life and, in the absence of further provision, one would assume that paragraph 3 Schedule 4 Finance Act 1971 did apply and that each spouse was treated as a single person and so entitled to a set of limits each. This would be an important advantage of a section 23 election as it would, in effect, double the limits on life assurance relief available to a married couple.
However, paragraph 10 reads:—

"Where, throughout a year of assessment, a woman is a married woman living with her husband, then—

(a) if no election under section 38 is in force, section 21 and paragraph 15 below shall apply as if any relief to which a wife is entitled under section 19 were relief to which the husband is entitled; and

(b) if an election under section 38 is in force, section 21 and paragraph 15 below shall apply separately to the amounts paid by each of them, but as if for the limit specified in section 21 there were substituted in relation to each of them a limit of £750 or one-twelfth of their total income, whichever is the greater, plus any amount by which relief can be given to the other fall short of the limit so substituted".

Section 21, of course, sets out the limits on relief of £1,500 or one-sixth of total income whichever is the greater and paragraph 15 deals with repayments where insufficient deductions are made.

It will be seen that no specific mention is made in paragraph 10 of what applies where only an election under section 23 Finance Act 1971 is in force. Although it is not absolutely clear, it is likely that the effect of the provisions of the paragraph will be that these cases would fall within paragraph 10(a) and thus only one set of reliefs will apply; further, the husband only will be entitled to any repayments due to either spouse in respect of tax underdeducted. On the other hand, the right to transfer relief between spouses would be maintained.

Although the position is far from clear two factors may point to the above conclusion: first, the
general reference to reliefs in paragraph 3 schedule 4 Finance Act 1971 includes other personal reliefs as well as life assurance relief and if it did not apply to the latter it could still apply to the former; and, secondly, the Finance Act 1976 is later in time than Finance Act 1971 and paragraphs 7 - 10 schedule 4 do lay down a reasonably comprehensive statement of the application of the new system of life assurance relief to husband and wife; although no specific provision is made setting out the limits on relief for policies on spouses own lives where an election for taxation of wife's earnings is in force, it would not be straining the language of the statute to include this within paragraph 10(a); the better view appears therefore to be that there is only one set of reliefs but that they may be transferred between the spouses.

(b) Annual payments. Paragraph 4 Schedule 4 Finance Act 1971 provides that relief for annual payments made by a wife is only available against her earnings, if an election for separate taxation of wife's earnings is made. Relief for annual payments made by the husband is available against the rest of the joint income, including the wife's investment income. An election, therefore, could result in a loss of relief if a wife did not have sufficient earnings to support an annual payment: there is no provision for transferring unused relief between the spouses.

(c) Losses. The same rule applies to losses: if a wife is actively involved with a trade any losses due to her under section 169 can only be set against her earnings and not against any other income which she may have or against her husband's income. On the other hand, if the loss is the
husband's, or if it relates to the wife's investment income, or if it relates to a business in which the wife is not actively engaged, it cannot be set against the wife's earnings.

There is, however, a specific provision in paragraph 4(2) schedule 4 Finance Act 1971 that terminal losses under section 174 Taxes Act can be carried back to a year prior to an election and thus used against income of the other spouse for that year. Apart from this exception, the transfer of unused losses from one spouse to another is forbidden.

(d) **Capital allowances.** The same provisions as for losses apply to capital allowances, with the same possible disadvantage.

(e) **Relief for investment in new corporate trades.** Section 60(2) Finance Act 1981 provides that, where an election for separate taxation of wife's earnings is in force, then any payments made by a wife for subscription of shares giving rise to the relief are treated as reducing her earnings only. Unused relief cannot be transferred.

(f) **Mortgage interest relief.** It has been seen that paragraph 4 schedule 4 Finance Act 1971 provides that where an election under section 23 has been made then annual payments, losses and capital allowances which reduce the wife's earned income, or which are to be deducted in respect of any payments made by her, shall be treated as reducing the wife's earnings; in any other case the deduction is to be claimed by the husband. As far as mortgage interest is concerned, this is not deductible from a wife's earnings.
and it would appear, therefore, that it is given to the husband to be set off against the rest of the joint income. However, a major problem could arise if, in such a case, the interest is paid by the wife, or if the wife owns the property in respect of which it is paid, and the question could arise as to whether the relief would have to be apportioned if both spouses had an equitable interest in the property. In any case of doubt there would clearly be tax advantages in providing for the legal estate to vest in the spouse who wishes to claim the relief, i.e. the husband at the same time regulating the equities by means of a deed of trust.

(g) **Savings bank interest relief.** Savings bank interest relief is given against investment income; where an election under section 23 is in force the investment income of both husband and wife is treated as belonging to the husband who would therefore be given the savings bank interest relief in respect both of his wife and himself.

(h) **Retirement annuity relief.** Section 227 Taxes Act provides that retirement annuity relief is given in respect of premiums paid by an individual as a deduction from his earnings. The relief therefore clearly comes within paragraph 4(1)(a) schedule 4 Finance Act 1971 and is treated in the same way as annual payments, losses and capital allowances, i.e. the premiums paid by the wife can only be deducted from her earnings and there is no transferability of reliefs.
(5) **When to make an election**

From the previous discussion it will be seen that the disadvantages of an election for separate taxation of wife's earnings are a loss of some personal allowances and a possible restriction on the right to claim relief for certain deductions and payments. The main advantage is that, in assessing higher rate tax, the joint income can be divided between husband and wife, higher rate tax being assessed on each part separately.

It will therefore be clear that any couple whose joint income is taxed no higher than the basic rate should not make an election; they will definitely lose £880 of personal allowances and may have some other reliefs restricted. The election should only be considered when the joint income is liable at the higher rates but, even then, the following points should be borne in mind:

(a) The saving of higher rate tax must exceed the lost allowances and the amount of any restricted reliefs; a married man must, therefore, save higher rate tax in order to offset tax at his highest rate on the difference between the married and single allowance (i.e. £880).

(b) As the election is a "wife's earning election" the wife must have earnings and these must be sufficient to support a single person's allowance, any other personal allowances claimed by her, relief for any losses or capital allowances due to her in respect of a trade in which she is actively engaged, and relief for any annual payments, investment in
corporate trades, or retirement annuity premiums paid by her; once an election is made, transferability of these reliefs to her husband will be lost.

(c) The husband must also have sufficient "other income" (his earnings, his investment income and his wife's investment income) to support the same reliefs, allowances and deductions due to him.

(d) Finally, the advantages of an election will depend on the rates of tax relative to the size of the joint incomes. Any change in either could affect the desirability of an election. Whether or not an election is made in one year, a married couple with a high joint income and wife's earnings should make a calculation each year, after the Budget, to decide whether to make, retain or revoke their election.

It will be seen that a number of factors have to be considered and there is no simple answer to the question as to whether an election for separate taxation of wife's earnings should be made. Each individual case has to be considered separately with reference to the current rates of tax. A calculation should be made as to the tax payable if no election were made and the tax payable after an election: if the calculation shows a net saving of tax then the election should be made.

The Inland Revenue publish a very useful pamphlet\(^1\) which contains a table showing the limits within which an election should be considered. Unfortunately, although the tax rate changes are announced in March, the pamphlet is not

usually revised until the following October.

(6) **General effect and comments**

Some advantages and some disadvantages result from the exercise of a wife's earnings election. These are summarised below. However, it will be appreciated that, as with the option for separate assessment under section 38, the "advantages" are limited and, at their best they do no more than give married persons the same tax treatment as a single person: the election therefore gives married couples no positive benefits but may reduce their disadvantages.

**Advantages of a wife's earnings election**

(a) Where the total income of husband and wife is liable to tax at higher rates an election will usually result in a saving of tax (but the disadvantages mentioned below should also be considered). Where an election is advisable, maximum advantages would be gained where one spouse had a large income and the other had at least enough to exceed the wife's earned income allowance.

(b) The wife is assessed in respect of her own earnings and is entitled to her own repayments on earnings.

(c) Spouses are specifically entitled to continue to insure the lives of each other or pay premiums on a policy on the life of the other; however, this is accompanied by a restriction on reliefs - see disadvantage (g).

**Disadvantages of a wife's earnings election**

(a) The election must be made jointly by husband and wife. Once the election is made, the wife will have a more
favourable tax treatment, and the husband a less favourable one. There could, therefore, be cases where one spouse would not be disposed to join in the election, e.g. if a wife were taxed under PAYE and the husband would lose his married man's allowance.

(b) The election only applies to a wife's earnings - her investment income is still treated as belonging to the husband and is aggregated with his total income to ascertain the rates; the husband remains responsible for the tax also.

(c) The husband remains responsible for making the return of wife's earnings (unless an application for an election under section 38 is also in force).

(d) There is a loss of personal reliefs: the married man's allowance of £2,445 and the wife's earned income allowance of £1,565 are lost and two single allowances of £1,565 each are given instead: the loss amounts to £880 of allowances.

(e) Personal reliefs available to the wife are available only against her earnings, not against her investment income nor against her husband's income. If her earnings are insufficient to support the reliefs they cannot be transferred and are lost.

(f) Some personal allowances are lost altogether (e.g. age allowance).

(g) The election appears to have no effect on the limits of life assurance relief: the wife's relief is still given to the husband and the limits on relief for the joint premiums are those of one single person.
(h) An election under section 23 could result in loss of relief for annual payments, losses, capital allowances, investment in corporate trades made by a wife and her retirement annuity premiums if the wife's earnings are not sufficient to support such relief.  
(i) The election has no effect on savings bank interest relief all of which will continue to be given to the husband.  
(j) The factors determining the election are complex and, as personal circumstances change each year (especially if, say, the wife runs a business with fluctuating profits and losses), and as tax rates change each year, the calculations for an election will need to be made regularly to determine whether an election should be made or, if already made, whether it should be revoked.

It does appear unjust that a wife who actively runs a business and makes a loss, can only set the loss against her earnings but her husband, in the same position could set his loss against his earnings, his investment income and his wife's investment income. An election for separate taxation of wife's earnings could therefore result in a disallowance of loss relief if one spouse has losses in excess of his or her income as defined; the unrelieved losses cannot be transferred to the other spouse.

4. A Double Election

In this chapter we have discussed the two elections available to husband and wife (option for separate assessment

1. See page 154 above.
under section 38 Taxes Act and election for separate taxation of wife's earnings under section 23 Finance Act 1971) on the basis that only one election was in force at the same time. It is, however, possible for both to be in force together. In such a case the following procedure is followed:

First, the separate liabilities of husband and wife are calculated under the section 23 rules; this establishes the amount of tax payable on:

(a) the wife's earnings and

(b) the rest of the joint income (the husband's earnings, the husband's investment income and the wife's investment income).

Then the separate assessment calculations under section 38 are applied to (b) (the rest of the joint income less the wife's earnings).

A double election would have the following advantages over a section 23 election alone:

(1) The wife would be able to return her own earnings; (it will be recalled that even when a section 23 election is in force, the husband remains responsible for making a return of the wife's earnings).

(2) A wife could get a repayment relating to her investment income paid directly to her; if a section 23 election only is in force, the repayment relating to her investment income would be paid to the husband.

(3) A wife would become entitled in her own right to life assurance relief up to one-half of the usual limits.

The main disadvantage of a double election is the
enormous complexity of the computations and the uncertainty about tax liabilities. Only when the figures under a wife's earnings election are finalised can the lengthy section 38 calculation commence. Where a wife or husband is actively engaged in a trade and, say, suffers a loss or claims a capital allowance, even the first calculation cannot be commenced until the profits of the trade are determined and the losses etc. deducted. As most businesses operate on the preceding year basis of assessment it can be many months before tax liabilities are finalised. More severe problems may arise where a spouse chooses to "carry back" a loss under section 174 Taxes Act (carry-back of terminal losses) or under section 30 Finance Act 1978 (carry-back of initial losses) as in these cases the calculations for the preceding years will have to be re-opened and recomputed. It may then be revealed that an election under section 23 was, in fact, disadvantageous and a decision might then be made to revoke the election; all the calculations would then have to be re-worked. The uncertainty affects both spouses as a reduction or increase in one income affects the proportions of income. Until these lengthy and complex calculations are complete neither spouse can be sure of his or her tax liability.

5. Conclusions

Chapter 1 of this thesis discussed the general rule which applies to the income tax treatment of husband and wife, namely that the wife's income is deemed to be that of the husband, that it is aggregated with his for the
purpose of calculating the relevant rates and that the husband is liable to render the joint return and to account for and pay the tax on the joint income.

In this chapter we have discussed the three statutory exceptions to the general rule. First, the option for separate assessment under section 38 Taxes Act. This option may be made by either husband or wife; the option has no effect on the total amount of the tax payable by the married couple but each spouse makes a separate return of his or her own income and is liable to pay his or her own tax; the wife may receive a repayment of tax direct. Further, the personal reliefs and allowances are allocated between the spouses in the manner described fully in section 39. There are a number of advantages and disadvantages of an election, which are summarised at pages 138-140 above. Perhaps the most significant advantage is the ability of husband and wife to adopt separate accounting in their dealings with the Inland Revenue but it must be borne in mind that this cannot be completely separate; as the Inland Revenue need a "total return" of the joint income in order to apportion tax liabilities and allowances, they may require either spouse to supply the information: when the allowances are then allocated by the Inland Revenue spouses can guess at the contents of each other's return. However, they cannot check that the Inland Revenue's allocation is correct unless they both agree to exchange information. On the other hand it is appreciated that it is impossible for the Inland Revenue to achieve total privacy and full access where there is a separate liability on a joint income but it is thought that there is no other
circumstance in tax legislation when the entitlement of an individual to an allowance or relief depends on information which is available only to the Inland Revenue and access to which the individual has no right. Perhaps the most significant disadvantage of a section 38 election is the complexity of the calculations which are required which must result in spouses being uncertain as to the extent of their tax liabilities for some considerable time and which must deter many spouses from making an election at all.

The second statutory exception to the general rule is that found in section 40 Taxes Act, which gives the Inland Revenue power to ignore the rule in section 37 when it suits them to do so, and to collect tax on the wife's income from the wife direct. One cannot help concluding that the Inland Revenue are thus enabled to have the best of both worlds and, in effect, can choose whether to collect a wife's tax from her husband or from her.

The first two statutory exceptions are breaches in the principle of husband's accountability; the third, which is contained in section 23 Finance Act 1971, is a limited exception to the principle of aggregation. If both spouses so choose, tax on a wife's earnings can be assessed as if she were a single person; her investment income, however, remains aggregated with her husband's income. Again, there are many advantages and disadvantages resulting from such an election and these are summarised at pages 162-164 above. Perhaps the most important advantage is that an election may result in an actual saving of tax if the couple have an income taxed at higher rates and the wife
has earnings sufficient to support her own allowances and reliefs; the main disadvantage is surely the complexity of the provisions which require calculations to be made each year to see if the inter-relation between the current income, the current reliefs and allowances, and the current rates of tax result in an election being advantageous or disadvantageous.

Although the three statutory exceptions have been considered separately a reference has been made to the fact that an election for separate assessment under section 38 Taxes Act and an election for separate taxation of wife's earnings under section 23 Finance Act 1971 can be in force at the same time: the resulting complications are formidable.

The overwhelming impression left by a consideration of the three statutory exceptions to the general rule is that such a complicated and confused system could never have been conceived as an homogeneous whole. The exceptions have been introduced at different times in response to pressures resulting from the unsatisfactory application of the general rule. Instead of amending the rule a system of elections has been introduced which elections are each so hedged about with conditions and complications that the end result is manifestly illogical. A fundamental re-appraisal of the whole system is clearly desirable.

Chapter 1 considered the general rule of husband's accountability and the aggregation of incomes and this chapter discussed the three statutory exceptions to that rule. All these provisions operate in any year of assessment during which a "woman is a married woman living with her
husband". Chapter 3 therefore looks at the rules which apply where, during part of the year of assessment, the couple are not married and living together. Different considerations apply to the beginning of marriage, to the death of either husband or wife, or to the termination of the marriage by separation, divorce or nullity.

1. See section 37(1) Taxes Act.
CHAPTER 3 - THE BEGINNING AND END OF MARRIAGE

Section 1. Beginning of Marriage.

(1) Allowances.
   (a) The married man's allowance.
   (b) Other allowances - housekeeper and children.
   (c) Wife's earned income allowance.

(2) Aggregation.

(3) Accountability.

(4) Anomalies.
   (a) Limits on life assurance relief.
   (b) Transfer of excess reliefs.
   (c) Losses and capital allowances.
   (d) Bridging loan interest.
   (e) Overlapping mortgages.

(5) The operation of the statutory elections.

(6) Conclusions.

Section 2. Death of the Husband.

(1) Allowances.

(2) Aggregation.

(3) Accountability.

(4) The statutory elections.
   (a) Separate assessment.
   (b) Separate taxation of wife's earnings.

Section 3. Death of the Wife.

Section 4. Termination otherwise than on death.

(1) Effect of termination.
   (a) Allowances.
   (b) Accountability.
   (c) Aggregation.
   (d) Reliefs.
      (i) Mortgage interest relief.
      (ii) Life assurance relief.

(2) The date of termination.
   (a) Order of the court.
      (i) Separation.
      (ii) Divorce.
      (iii) Nullity.
   (b) Deed of separation.
   (c) De facto separation.

(3) Payments after the end of marriage.
   (a) Separation deed - position of payer.
      (i) Basic rate tax.
         (a) Deduction under section 52.
         (b) Is it an annual payment?
         (c) Is it chargeable under case III of schedule D?
      (ii) Higher rate tax.
      (iii) Investment income surcharge.
      (iv) Clawback under settlement provisions.
   (A) Transfers by married persons.
(B) Is a separation deed a settlement?

(C) Section 457 - Higher rates - most settlements.

(D) Section 445 - All rates - power to diminish or revoke.

(E) Section 434 - All rates - short dispositions.

(b) Separation deed - position of recipient.

(c) Separation deed - Summary.

(d) Order of the court - normal payments.

(e) Order of the court - small maintenance payments.

(f) Voluntary payments.
   (i) The personal allowances.
   (ii) Deductibility.

Section 5. Conclusions.
CHAPTER 3

THE BEGINNING AND END OF MARRIAGE

Section

1. Beginning of Marriage.
2. Death of Husband.
3. Death of Wife.
4. Termination otherwise than on Death.
5. Conclusions.

Chapter 1 of this thesis discussed the general rule which applies to the income tax treatment of husband and wife, and Chapter 2 considered three statutory exceptions to the general rule. In both chapters it was assumed that husband and wife were living together throughout the year of assessment but an indication was given that special rules apply at the beginning and end of marriage and these special rules will be considered in this chapter. There is only one way in which a marriage can commence but the wedding can take place at any time within a year of assessment; a start, then, is made with a discussion of the effect of the marriage on the income tax position of the spouses in that year. A marriage can end in one of a number of ways; the husband may die; the wife may die; or the spouses may cease to live together; thereafter, the separation may be regulated either by separation deed or order of the court for separation, divorce or nullity. For tax purposes it is the date of separation which is relevant in all these cases.
Each of these will be considered in turn. First, then, the beginning of marriage.

1. The beginning of Marriage

   (1) Allowances
   (2) Aggregation
   (3) Accountability
   (4) Anomalies
   (5) The statutory elections
   (6) Conclusions

Prior to 1968 the position in the year of assessment in which the marriage took place was reasonably clear; the wife was treated as a single woman and the husband as a single man up to the date of the marriage; thereafter they were treated as a married couple and then all the provisions mentioned in chapters 1 and 2 of this thesis applied.

The simplicity of this rule, which treated the spouses as single persons up to the date of the marriage and which treated them as a married couple after that date, was first complicated in 1968 when the personal allowances to which the couple were entitled were restricted; further provisions were introduced in 1976 affecting the principles of aggregation and accountability in the year of marriage, and also introducing some anomalies. These will now be considered in turn and will be followed by a note on the operation of the statutory elections in the year of marriage.

(1) Allowances

   (a) Married man's allowance.
   (b) Other allowances (i) Section 12 - Housekeeper
        (ii) Section 14 - Additional relief for children.
(c) Wife's earned income allowance.

(a) **The married man's allowance.** It has been seen\(^1\) that a man who is married and living with his wife is entitled to a higher personal allowance under section 8(1)(a) Taxes Act as amended by section 24(2)(a) Finance Act 1982. In the year 1982-83 the allowance for a single person is £1,565 and that for a married man is £2,445. The higher married man's allowance was introduced in section 18 Finance Act 1920 which provided:—

"(1) The Claimant, if he proves that for the year of assessment he has his wife living with him..."

should be entitled to the married man's personal allowance. These provisions were interpreted in practice to mean that a man was entitled to the higher allowance if he was married in any part of a year of assessment.\(^2\) So, prior to 1968, a man who married on 4th April was entitled to the full higher personal allowance (instead of to the single person's allowance) even though he was only married for one out of the 365 days of that year of assessment. For this reason weddings in the first few days of April were very popular.

Accordingly, a couple marrying during a year of assessment were then entitled to the following maximum allowances:—

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1. Chapter 1 page 70 above.
2. This practice was consistent with the interpretation later placed by the court on the meaning of the words "for a year of assessment" in the case of Gubay v. Kington (1981) STC 721 discussed in Chapter 1 above.
The wife: single person's allowance against income up to date of marriage.

The husband: full married man's allowance and full wife's earned income allowance against wife's earned income after date of marriage.

In 1982 terms this would have amounted to:

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<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Wife</td>
<td>1,565</td>
</tr>
<tr>
<td>Husband</td>
<td>2,445</td>
</tr>
<tr>
<td>Wife's earned income:</td>
<td>1,565</td>
</tr>
<tr>
<td>Total:</td>
<td>5,575</td>
</tr>
</tbody>
</table>

If, therefore, a wife was working and intended to continue working after marriage, it was advisable for the wedding to take place mid-way through the year of assessment so that the wife would have sufficient income before the marriage to support the single person's allowance and sufficient income after the marriage to support the wife's earned income allowance. For working wives, weddings in October were clearly advisable.

The first radical alteration to these provisions was introduced in 1968; section 14(2) of the Finance Act that year provided that the higher personal allowance would only be given to a man who was married throughout the full year of assessment: in the year in which the marriage took place the full relief was available only for that part of the year during which the man was actually married; the apportionment was calculated on a monthly basis, one-twelfth of the higher relief being given for each month (beginning on the sixth day) of the marriage and also for the month in which the marriage took place: for the other months an apportioned part of the single person's allowance was given.
When these provisions were introduced it was stated that the change would produce £12m in its first year (1968-69) and was expected to produce £15m in a full year. In 1968 the differential between the higher (married man's) allowance and the single person's allowance was £120 (the allowances were then £340 and £220 respectively); so, in fact, the apportioned allowance was £10 per month.\(^1\) When the consolidating Taxes Act was passed the differential was also £120 (the allowances then being £375 and £255 respectively);\(^2\) that Act therefore stated, in section 8(3) that the apportionment should be at the rate of £10 per month. However, personal allowances fluctuate and so section 14(a)(iv) Finance Act 1970 re-instated the rule of apportionment as being one-twelfth of the difference between the single person's and the married man's allowance for each month.

The provisions are now found in the amended section 8(3) Taxes Act which provides that the apportionment shall be calculated on a monthly basis, one-twelfth of the higher relief being given for each month (beginning on the sixth day) of the marriage and also for the month in which the marriage takes place; for the other months an apportioned part of the single person's allowance is given to the husband.

Before the marriage a man may be entitled to the allowance for a housekeeper given by section 12 Taxes Act or the additional allowance in respect of children given by section 14 of the same Act. Section 15 contains specific

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1. Section 10(2) Finance Act 1965.
2. Section 8(2) Taxes Act.
provisions about the effect of the entitlement to those allowances in the year of marriage and these provisions will now be considered.

(b) Other allowances

(i) Section 12 - Housekeeper

(ii) Section 14 - Additional allowance in respect of children.

Section 15 Taxes Act provides that a man who becomes married during a year of assessment may claim that his marriage should be disregarded for the purposes of any claim under section 12 (housekeeper allowance) or section 14 (additional relief for single person with children). In other words a new husband can, in the year of marriage, choose to claim either of these allowances if appropriate or an apportioned part of the higher married man's allowance. A short reference will be made to each.

(i) Section 12 - Housekeeper allowance

An allowance of £100 is available to a widower or widow in respect of a relative or other person who resides with him to act as housekeeper, subject to a number of conditions. As the relief is specifically only available to a "widower or widow" it cannot also be claimed by a married man. In the first year of marriage a husband who was previously a widower can choose to claim either the housekeeper allowance or his higher married man's allowance apportioned by reference to the date of marriage. Much will therefore depend on the date of the marriage: a wedding between 6th March and 5th April will only produce a married man's allowance of £73.33 (£880 ÷ 12) but a
wedding before 6th March will produce at least £146.66 which is better than the housekeeper allowance. Accordingly, for weddings in the period 6th March - 5th April the housekeeper allowance would be the better choice; for weddings at other times the apportioned part of the married man's allowance would be more advantageous.

A condition of the housekeeper allowance is that it is not available to a person claiming the additional relief in respect of children under section 14 of the Act (see section 12(1) proviso (iv)).

(ii) Additional relief for single persons in respect of children - Section 14. Section 14 Taxes Act provides that a single person who has a child resident with him or her is entitled to an additional allowance of £880; several conditions attach to the relief and, in particular, subsection (4) provides that where a husband, before his marriage, was getting the additional personal allowance for children he can, in the year of marriage, continue to get this allowance only if he does not claim the higher married man's allowance as well. The present differential between the single person's allowance and the married man's allowance is also £880 and a man would only be entitled to claim this full amount in the year of marriage if the wedding took place between 6th April and 5th May; after that a proportion of the differential will be lost so the additional relief in respect of children will almost always be more favourable.
In the first full year of marriage there is no choice - the man gets the full married man's allowance and no relief under section 12 or section 14. One other relief given to the husband has special rules in the first year of marriage and this is the wife's earned income allowance.

(c) Wife's earned income allowance. It has been seen\(^1\) that where a wife has sufficient earned income a husband is given an allowance equivalent to the single person's allowance in respect of such earned income. The relief was introduced in 1920\(^2\) and in 1942\(^3\) was raised to the amount of the single person's allowance. From the time of its introduction it was available to a man who was married in any part of a year of assessment. As mentioned above, a wife was originally able to claim the single person's allowance against income up to the date of the marriage and the husband was able to claim the full wife's earned income allowance against her earned income after the marriage. The second radical alteration to the beginning of marriage provisions occurred in 1976 with the enactment of section 36 of the Finance Act that year. Section 36 (1) provides that the aggregation of the income of married persons is delayed until the commencement of the first full year of assessment subsequent to the marriage. This means that the husband is unable to claim wife's earned income relief in the year the marriage takes place.

Accordingly a couple who now marry in the middle of a year of assessment (say 6th October) may only claim:

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1. Chapter 1 page 73 above.
2. Section 18(2) Finance Act 1920.
The wife: single person's allowance.
The husband: apportioned single person's allowance up to the date of the marriage
apportioned married man's allowance after the date of the marriage.

In 1982 terms this would amount to:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Wife</td>
<td>£1,565.00</td>
</tr>
<tr>
<td>Husband</td>
<td>£782.50 (apportioned single)</td>
</tr>
<tr>
<td></td>
<td>£1,222.50 (apportioned married)</td>
</tr>
<tr>
<td>Total</td>
<td>£3,570.00</td>
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</tbody>
</table>

The combination of the 1968 and the 1976 provisions, therefore, result in this case in a loss of £2,005 of allowances. 1 Having considered the treatment of allowances in the first year of marriage, a reference will now be made to the operation of the aggregation rule in that year.

(2) Aggregation

The distribution of the personal allowances in the first year of marriage has now been considered and a reference has already been made to section 36 Finance Act 1976; although that section had the effect of removing a husband's entitlement to wife's earned income relief in the year of marriage, it also had other more far-reaching consequences concerning aggregation and accountability.

When section 37(1) Taxes Act was enacted it provided that:

"a woman's income chargeable to income tax shall, so far as it is income for a year of assessment or part of a year of assessment during which she is a married woman living with her husband be deemed..."

In fact, the words underlined first appeared when the

1. See page 178 above for previous calculation.
statutory provisions were re-drafted in 1950 as section 30 of the Finance Act that year. Previously the aggregation provisions appeared in Rule 16 of the All Schedules Rules to the Income Tax Act 1918 which had provided that:

"the profits of a married woman living with her husband shall be deemed the profits of the husband..."

Although Rule 16 did not specifically so state, the practice was to treat a woman as being a single woman up to the date of her marriage and for aggregation only to take place in respect of income accruing after the date of marriage.

The general principles applicable in the year the marriage takes place were considered in the case of IRC v. Brooke¹ (and four other cases heard together).² The cases concerned assessments to surtax, which was then assessed on an individual's total income, and for surtax purposes an individual's total income was his total income for the previous year of assessment. The cases were decided on the basis that the assessments actually related to income in the previous year, the entitlement to which was not affected by the marriage. (This can be distinguished from income taxed on the preceding year basis of assessment where the relevant factor is the marital status in the year of assessment, not in the preceding year).³

In IRC v. Brooke¹ it was decided that a wife who was entitled to income in the year of assessment preceding

1. (1923) 2 K.B. 814.
her marriage was also liable to be assessed to surtax on it, even if, by the time the assessment was made, she had become a married woman. Where a wife was entitled to income throughout the year of assessment in which she married she was liable for the tax on the income up to the date of the marriage (even though assessed later) and the husband was liable after the date of the marriage, thus confirming that aggregation took place for the part of the year after the marriage.

In giving judgment Rowlatt J. said:—

"The idea that the husband can be assessed for his wife's pre-nuptial income is intolerable"

and:—

"It would be perfectly grotesque to say that under the provisions of the Act the total income of a husband includes his wife's pre-nuptial income".

Although the main argument in the case was directed towards accountability, which is considered next, the same principles applied to aggregation.

Income taxed on a preceding year basis of assessment is treated differently. Here, tax is assessed on the statutory income of a particular year although it is computed by reference to profits earned in a preceding year. So, after marriage, a husband is liable for tax on his wife's income for that year although it may be computed by reference to a preceding year when she was not married.¹

¹ Cf. Leitch v. Emmott discussed in Chapter 1 page 96 which decided that a wife was assessable in the year after her husband's death for income which was computed by reference to her income in the previous year when she was married.
Before 1976 income computed on a preceding year basis of assessment used to be apportioned in the year of marriage, the appropriate fraction for the period before the marriage being assessed on the wife, and the appropriate fraction for the period after the marriage being assessed on the husband.

The principle that, in the year of marriage, the wife's income from the date of marriage was aggregated with the husband's was however completely abolished by section 36(2) Finance Act 1976; that section specifically amends section 37(1) Taxes Act so that no aggregation now takes place in the first year of marriage. Income is only aggregated if husband and wife are married for a full year of assessment or a part year beginning with 6th April (i.e. the year the marriage ends). Accordingly, in the year of marriage the wife's income computed on a preceding year basis will all be assessed on the wife. The amendment contained in section 36 also affected the rules as to accountability which will now be considered.

(3) **Accountability**

As has been seen,¹ the general rule applicable to the income of husband and wife provides both for aggregation of the joint incomes and for the husband's accountability. A further effect, therefore, of the amendment of section 37 Taxes Act by section 36 Finance Act 1976 is that, for the year of marriage, both husband and wife complete their own tax returns and the wife (and not the husband) is

¹. Chapter 1 page 25 ante
responsible for paying tax on her own income, including her investment income. If any repayment is due to the husband or wife on tax paid for the year of marriage it will be made to the person on whose income it has arisen.

Certain provisions in section 36 follow logically from the basic change; these are:

- sub-section (3): which provides that the option for separate assessment does not apply in the first year of marriage, and
- sub-section (5): which provides that a life assurance premium paid by a wife shall be treated as having been paid by her husband only for years of assessment in which the incomes are aggregated.

But certain other provisions in section 36 are anomalous and these will now be considered; in addition, reference will be made to two anomalies covered by a recent Practice Statement.

(4) **Anomalies**

Although section 36 Finance Act 1976 provided, in effect, that for tax purposes a husband and wife were not to be treated as married until the first full year of assessment following the marriage, nevertheless the section retained three anomalies. These are:

- (a) limits on life assurance relief: section 36(6);
- (b) transfer of excess reliefs: sections 36(7) and (8); and
- (c) treatment of losses and capital allowances: section 36(9).
In addition two further anomalies arising out of the application of mortgage interest relief in the year of marriage will also be mentioned. These are:

(d) bridging loan interest, and
(e) overlapping mortgages.

(a) **Limits on life assurance relief: section 36(6).** It has been mentioned\(^1\) that in a year of assessment in which their incomes are aggregated husband and wife are only entitled to one life assurance relief. If, in the year of marriage, there is no aggregation of incomes, it should follow that they are entitled to a limit each. Section 36(6) gives effect to this but goes further and provides, in effect, that if the premiums of one spouse exceed one-sixth of his or her income but those of the other spouse do not exceed 1/6th of his or her income then the unused relief may be transferred to the spouse paying the excess premiums. No claim has to be made; the transfer will be applied automatically. Clearly this anomaly favours the spouses.

(b) **Transfer of excess reliefs: section 36(7) and (8).** Although section 36(2) Finance Act 1976 provides that the income of husband and wife is not aggregated in the first year of marriage, sub-section (7) provides that if either of them has insufficient income to utilise all available reliefs, within named categories, that spouse can make a claim transferring certain unutilised reliefs to the other spouse. These reliefs are specified in sub-section (8) and, in the case of the husband, they are the personal reliefs

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1. Chapter 1 page 52 ante
and also interest relief, and, in the case of the wife, they are the personal reliefs excepting single person's relief, single age relief, housekeeper relief, relative with care of brother or sister relief, and additional relief for children; also, relief for interest paid while husband and wife are married to each other. Again, this anomaly favours the spouses. This provision is of interest in the context of this thesis as it provides an existing precedent for the transfer of unused allowances between spouses.¹

(c) **Treatment of losses and capital allowances: Section 36(9).** In spite of the general provision in section 36 Finance Act 1976 that, in the year of marriage, the income of the wife is not aggregated with that of the husband, sub-section (9) specifically provides that it is to be treated as aggregated for the purposes of the set-off of losses and capital allowances against general income. Thus losses and capital allowances of the husband can be set against the wife's income for the period after the date of the marriage and losses and capital allowances of the wife for the same period can be set against the husband's income. No claim has to be made. Again, this anomaly favours the spouses.

(d) **Bridging loan interest.** Paragraph 6 Schedule 1 Finance Act 1974 provides relief for mortgage interest where there is an overlap of loans where a private residence is purchased with the aid of a loan before the loan on the house to be sold is paid off; the paragraph provides, in effect, that double relief is allowable for

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¹ This concept will be developed more fully in Chapter 16 post.
twelve months, or for a longer period if the Board thinks it reasonable. The application of these provisions in the year of marriage, where prior to the marriage each spouse may have a qualifying loan but on marriage both move to a new house, was considered in Inland Revenue Statement of Practice 10/80 which confirms that in these circumstances the bridging loan provisions in paragraph 6 Schedule 1 Finance Act 1974 apply to all the properties of both spouses.

(e) **Overlapping mortgages.** The Statement of Practice¹ above referred to applies when each spouse sells a house and both buy a new one. But the spouses may decide that, after marriage, one house will be sold and they will both live in the other. If the vacated property is not sold immediately then there is no relief at law for interest from the date of vacation until the date of sale. However, this situation formed the subject of an extra-statutory concession² published on 24th September 1980 which indicates that relief will be available provided the property is sold within twelve months from the date it is vacated. That interest is also disregarded in determining what relief is due in respect of interest payable on the property which becomes the matrimonial home; in other words, for the transitional period, the spouses have a maximum limit of £50,000 rather than £25,000. This extra statutory concession does raise the question as to why it can be recognised that two married people should have two reliefs in

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the year of marriage but only one relief thereafter.

(5) **The operation of the statutory elections in the year of marriage**

Section 36 Finance Act 1976 specifically provides that, for tax purposes, husband and wife are not to be treated as married until the first full year of assessment. Sub-section (3) provides that the option for separate assessment under section 38 Taxes Act 1970 does not apply in the first (part) year of marriage. No mention is made of the option to elect for separate taxation of wife's earnings under section 23 and Schedule 4 Finance Act 1971. However, as for all purposes, the spouses are to be treated as single persons, and as there is no aggregation of incomes, earned or unearned, such an election would appear irrelevant.

(6) **Conclusions**

Before 1968 a husband and wife were treated as married for the whole of the year of assessment in which the wedding took place, for the purpose of calculating the personal allowances. Changes made in that year, and in 1976, now result in the spouses being treated as not married until the first full year of assessment after the marriage. The main result of these changes has been a loss of personal allowances; the married man's allowance is now apportioned on a monthly basis and the husband cannot claim wife's earned income relief in the year of marriage. However, section 36 Finance Act 1976 retained three anomalies which
are helpful to spouses in the year of the marriage; excess life assurance premiums paid by one spouse may be set against the other spouse's unused reliefs; a claim may be made for certain excess reliefs to be transferred to the income of the other spouse; and income can still be treated as aggregated for the purposes of setting off capital allowances and losses. Further, two concessions apply to mortgage interest relief; the relief for bridging loans is allowed on three houses, and relief is also allowed when one spouse vacates a house on marriage to move in with the other and sells it later. It is difficult to see the reasoning behind this illogical package of provisions; whereas the reduction in personal allowances, clearly penalises most married persons, especially where the wife works, the anomalies introduced by section 36 Finance Act 1976 are all of benefit to the spouses.

Having discussed the provisions which apply at the beginning of marriage a reference will now be made to one way in which the marriage can end, namely, the death of the husband.

2. The Death of the Husband

(1) Allowances.
(2) Aggregation.
(3) Accountability.
(4) The statutory elections.

It has been noted above that, before the changes introduced in 1968 and 1976, a man and woman were treated

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1. One possible explanation is mentioned more fully in Chapter 5, post, namely that at about the time the Sex Discrimination Act 1975 was passed all amendments affecting the tax treatment of husband and wife were favourable rather than otherwise.

as single persons up to the date of the marriage and thereafter they were treated as a married couple: this meant a favourable treatment as far as allowances were concerned. The allowances were then restricted in 1968, and, in 1976, the rules of aggregation and husband's accountability were suspended during the first part-year of marriage. These amendments did not, however, apply to the year in which the marriage ends. It may therefore now be useful to summarise the provisions concerning allowances, aggregation, accountability and the statutory elections which apply to the end of a marriage with particular reference to one way in which the marriage can end, i.e. by the death of the husband.

(1) Allowances

When the higher married man's allowance was introduced in section 18 (1) Finance Act 1920 a married man became entitled to the higher personal allowance if he was married in any part of a year of assessment. The 1968 provisions introduced a limitation by monthly time apportionment but only where "a man becomes married in a year of assessment"; these provisions now appear in section 8(3) Taxes Act 1970. Accordingly, in the year of assessment in which the marriage ends, whether by the death of the husband or otherwise, the husband (or his personal representatives) is entitled to the full higher married man's allowance under section 8(1) Taxes Act 1970. Further, if the husband's income in the year of his death includes any earned income of his wife, he (or his personal representatives) is also entitled to the wife's earned income relief.
After the date of her husband's death the widow is treated as a single person. She therefore can claim the full single person's allowance in respect of her income after the date of death. She can also claim the additional relief in respect of children under section 14 Taxes Act, if appropriate, as being now a widow she is specifically within that section.

Finally, she can also claim the new widow's bereavement allowance introduced by section 23 Finance Act 1980 and now to be found in section 15A Taxes Act. The allowance is available to widows who were living with their husbands when the husband died; the amount of the allowance is £880, i.e. the difference between the married man's allowance and the single person's allowance. The widow's bereavement allowance is only available in the year of assessment in which the husband dies and cannot be claimed in any future year.

It follows from the separate taxation of the widow after her husband's death that if the allowances due to the husband in respect of the period before death, or the allowances due to the widow in respect of the period after death, exceed the relevant income, they cannot be transferred.

In the first full year of assessment following the husband's death the widow is taxed as a single person with a single person's allowances.

(2) Aggregation

Although section 36 Finance Act 1976 removed the
principle of aggregation in the year the marriage begins, no amendment was made in respect of the year in which the marriage ends. Section 37(1) Taxes Act provides that aggregation applies to all full years of assessment during which a married woman is living with her husband and also to a part of a year of assessment if the part begins with 6th April, i.e. the year the marriage ends. Accordingly, if no statutory elections are in force, the joint incomes of husband and wife up to the date of death will be aggregated for tax purposes. The income of the widow after her husband's death is regarded as her income and she is taxed separately in respect of it. The principles were discussed in IRC v. Brooke\(^1\) above referred to\(^2\) where it was held that, in the year the husband died, the wife was assessable on the income arising after his death but not on the income arising before it. Where in the year of assessment of her husband's death, a widow is entitled to income calculated by reference to the preceding year of assessment (i.e. the year before the death took place) the income is apportioned in the year of death and the part apportioned to the period before death is aggregated with the husband's income for that year and he (or his personal representatives) is liable for tax on it and the wife is chargeable in respect of the part apportioned to the period after death.\(^3\) So, if in the year of her husband's death a wife was entitled to, say, interest assessed under Case III of Schedule D, her liability would be determined by

1. (1923) 2 K.B. 814.
2. Page 184 above.
apportioning the amount received in the previous year by reference to the periods in the year of assessment before and after her husband's death.

(3) **Accountability**

It therefore follows that the husband, or his personal representatives,¹ will be accountable for the tax on the joint incomes before death and the widow will be accountable for tax on her income after that date; she will then be responsible for completing her own tax return in respect of the period following death and any repayment in respect of such income will be paid direct to her.

(4) **The statutory elections**

(a) **Separate assessment under section 38 Taxes Act.** If an option for separate assessment under section 38 Taxes Act is in force in the year the husband dies, the above principles concerning aggregation will apply. The wife will, of course, be accountable for her own tax up to the date of death and will be responsible for making her own returns and will be entitled to receive any repayments due and this will continue after the death. The allowances before death will have to be apportioned as outlined in Chapter 2.²

(b) **Separate taxation of wife's earnings under section 23 Finance Act 1971.** If an option for separate taxation of wife's earnings under section 23 Finance Act 1971 is in force in the year the husband dies, the husband would not have been entitled to either the higher married man's

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1. Or the wife's personal representatives if the Board serve a notice on them under the provisions of section 40(1) Taxes Act.

2. See page 119 above.
allowance or the wife's earned income allowance but would have claimed the single person's allowance instead; the wife will have been entitled to her own single person's allowance. Death will have no effect on these arrangements: the practical difference will be that the aggregation of the wife's investment income will cease on death and she will become accountable for tax on it; she will also become liable to make her own tax returns and will become entitled to any repayments due in respect of her income in the period following the death.

3. The Death of the Wife

On the death of a wife during a year of assessment the above provisions apply mutatis mutandis. The widower receives the full married man's allowance for that year, and the single person's allowance in the following years. However, special provisions appear in section 41 Taxes Act 1970 permitting a husband to disclaim liability for his deceased wife's tax. That section provides that, within two months after the date of probate or letters of administration to the estate of his wife, a husband may disclaim liability for any tax then unpaid in respect of her income for any year of assessment during which he was her husband and she was living with him. Such tax then becomes the liability of the wife's personal representatives and is computed as if separate assessment under section 38 Taxes Act had been claimed before death. These provisions were first introduced by section 33 Finance Act 1950 when, it

1. Overruling the decision in Re Ward (1922) 1 Ch 517.
will be recalled, a certain reorganisation of the tax treatment of married couples took place.\textsuperscript{1} At that time the provisions of what is now section 40 Taxes Act 1970 were also revised giving the Inland Revenue power to collect tax from a wife if it was assessed on her husband but attributable to her income; if such tax is unpaid after twenty eight days the Inland Revenue can claim payment from the wife; if the wife is dead, the Inland Revenue can claim from her personal representatives and liability then arises in the same way as if separate assessment had been claimed.\textsuperscript{2}

4. **Termination otherwise than on Death**

- (1) Effect of termination.
- (2) Date of termination.
- (3) Payments after the end of marriage.
- (4) Conclusions.

It has been seen\textsuperscript{3} that where a marriage ends by the death of the husband or wife the couple are taxed as a married couple up to the date on which the marriage terminates and the surviving spouse is thereafter treated as a single person. The same principle broadly applies when a marriage terminates otherwise than on death (i.e. by separation, divorce or nullity) and the rules as to allowances, aggregation, accountability and reliefs will be considered as affected by the termination. In addition, two special problems apply where a marriage terminates otherwise than on death; first, the date the marriage actually ends may be difficult to determine and reference

\begin{itemize}
  \item 1. See Chapter 1 page 47 ante.
  \item 2. For a discussion of Section 40 see Chapter 2 page 140 ante.
  \item 3. Page 193 ante.
\end{itemize}
will be made to some special rules; further, special provisions apply to payments made by one spouse to another after the end of marriage. These will now be considered in turn.

(1) Effect of termination

(a) Allowances.
(b) Accountability.
(c) Aggregation.
(d) Reliefs:
   (i) mortgage interest relief.
   (ii) life assurance relief.

The same rules which apply when a marriage terminates on death apply also when a marriage terminates otherwise than on death. These may be summarised as:-

(a) Allowances. In the year the marriage ends -
   The husband: can claim the married man's allowance for the full year; and can claim wife's earned income allowance against his wife's earnings up to the date of the end of the marriage, if no election for separate taxation of wife's earnings is in force;
   The wife: can claim the single person's allowance against her income after the end of the marriage;
   Either spouse: can claim the additional relief in respect of children given by section 14 Taxes Act 1970 if they have actual custody of a child.
In subsequent years:-

Both husband and wife: can claim the single person's allowance;

The husband: may, alternatively, be entitled to claim the higher married man's allowance if he maintains his wife with voluntary payments and she has no other income;

Either spouse: can claim the additional relief in respect of children given by section 14 Taxes Act 1970 if they have actual custody of a child.

(b) **Accountability.** From the date the marriage ends each spouse is responsible for his or her own returns, must pay his or her own tax, and is entitled to receive repayments of tax direct.

(c) **Aggregation.** Aggregation ceases when the marriage ends and the income of each spouse is then treated as belonging to him or her individually. This rule has far-reaching effects in the field of maintenance payments\(^1\) where it is possible to save tax by dispositions by one spouse to another where no tax saving would be possible, because of the aggregation rule, if the spouses remained married.

(d) **Reliefs.** There are two anomalies in the tax rules which apply where a marriage terminates otherwise than on death; these are (1) mortgage interest relief and (ii) life assurance relief.

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1. For a discussion of the tax treatment of maintenance payments see page 207 post.
(i) **Mortgage interest relief.** Relief is given by Part I Schedule 9 Finance Act 1972 as amended by Part II Schedule 1 Finance Act 1974 for mortgage interest if three conditions are satisfied:-

(a) the interest must be paid by the claimant;
(b) the claimant must own the house; and
(c) the house must be used by the claimant for his private residence.

There is therefore the triple requirement of payment, ownership and use. Where spouses separate it is customary for the wife to remain in the matrimonial home with the children and the following situations can arise:

(a) The husband may own the house but the interest may be paid by the wife who uses the house as her private residence (payment and use by wife but ownership in husband).

A reference to paragraph 5(4) and (5) Schedule 1 Finance Act 1974 will reveal that although, where the spouses are married, relief will be given (to the husband) even where the spouse who makes the payment does not own the property, this provision does not apply to separated spouses. Strictly, therefore, the wife cannot claim relief in the circumstances mentioned above but in practice the Inland Revenue allow relief to a wife who pays the interest, even if she does not also own the house.

(b) The husband may own the house and continue to pay the mortgage interest but the wife uses the house as her private residence.

Here, paragraph 4(1) (a) Schedule 1 Finance Act 1974
permits the husband to claim the relief: the paragraph specifically extends the "use" requirement to the former or separated spouse of the person paying the interest.

(c) The husband owns the house but he transfers the ownership to the wife, who uses it for her private residence, the husband continuing to pay the interest. Here, the husband gets no relief; paragraph 4(1)(a) Schedule 1 Finance Act 1974 contains no saving for the transfer of ownership, only for separate use, so the principles of Part I Schedule 9 Finance Act 1972 still apply and no relief is available.

(d) The husband owns the house but he transfers it to the wife, with the lender's consent, and she uses it for her private residence and pays the interest. Here, it is not clear whether the provisions of paragraph 1 Schedule 9 Finance Act 1972 (which provides that relief is only allowed on interest on a loan used for "the purchase" of an estate or interest in property) apply, but again the practice of the Inland Revenue is generally to allow relief to the wife in these circumstances.

When the husband is allowed relief for payments of interest for a residence for his separated wife (circumstance (b) above) he will want to know if he can also claim relief for payments of interest on a residence for himself. He may, following the provisions of paragraph 4(1)(a) Schedule 1 Finance Act 1974: but in that case the £25,000 limit in paragraph 5 of the same schedule applies to both properties i.e. the aggregate amount of both
loans cannot exceed £25,000.

If it is desired to obtain two "reliefs" of £25,000 each the husband should consider transferring the house to his wife (circumstance (b) above) and arranging for her to pay the interest, increasing her maintenance payments to enable her to do so. The "relief" on the matrimonial home will thus be transferred to the ex-wife, and the husband can then buy a new house with a full "relief" of his own. It should be noted that in all cases where the spouses are separated relief is always given to the person who actually pays the interest; of course, while the spouses remain married, relief is always given to the husband unless an option for separate assessment is in force when the relief is given to the spouse who makes the payments.

(ii) Life assurance relief. The rules giving relief for premiums paid on life assurance policies are contained in section 19 Taxes Act and schedule 4 Finance Act 1976. Section 19(2) gives relief to the person who pays premiums but only if the insurance is on his life; there is thus the double requirement of payment and own life policy. Married persons, however, are permitted to take out policies on each others lives, relief still being given to the spouse who pays the premiums. The rule that relief is available to the paying spouse applies after separation or divorce but, although it may be thought that thereafter relief would not be available for policies taken out on the life of a former spouse, this is not so. Paragraph 8 Schedule 4 Finance Act 1976 specifically
provides that even after divorce premiums paid by one spouse on the life of the other will be allowed provided that the parties were married at the time the policies were taken out, (and the marriage was not dissolved before 6th April 1979). However, two limits on relief will, of course, become available after divorce or separation.

(2) The date of termination

(a) Order of the court
   (i) Separation
   (ii) Divorce
   (iii) Nullity

(b) Deed of separation

(c) De facto separation

Section 42 Taxes Act 1970 provides, in effect, that a married woman is not treated for income tax purposes as living with her husband if:—

(a) they are separated by order of the court

or (b) they are separated under a deed of separation

or (c) they are in fact separated in such circumstances that the separation is likely to be permanent.

As well as sanctioning separation the court may grant a decree of divorce or nullity; similar considerations apply to all these orders except that it must be borne in mind that a separated spouse is still a spouse (although the spouses do not live together), whereas after an order of divorce or nullity the spouses are spouses no longer but "former spouses" or "ex-spouses". This distinction is of importance within the context of capital transfer tax where the exemptions are given to "spouses".
(a) **Order of the court.** An order of the court can be for separation, divorce or nullity.

(i) **Separation.** An order of the High Court for judicial separation or of the Magistrate's Court for separation will bring the marriage to an end for tax purposes: the relevant date is the date of the order.

(ii) **Divorce.** Similarly, a decree of divorce will bring the marriage to an end but for tax purposes the parties are treated as married until the decree of divorce is made absolute.

(iii) **Nullity.** Nullity has the same effect as divorce: the end of the marriage occurs when the decree is made absolute.

(b) **Deed of separation.** A separation deed also ends the marriage for tax purposes and the relevant date will be the date of the deed. It must, however, be borne in mind that the common law rules apply and that the deed will be void unless followed immediately by actual separation and if the parties subsequently cohabit it ceases to have effect.

(c) **De facto separation.** Section 42 Taxes Act 1970 specifically provides that for tax purposes a marriage ends when the parties "are in fact separated in such circumstances that the separation is likely to be permanent". The Inland Revenue in practice accept that a separation is "likely to be permanent" if the parties have been separated in fact for one year. So, if the parties do in fact separate, and if no court order for separation, divorce or nullity is made, the marriage will end for tax purposes one year after

the de facto separation. However, the parties can establish a right to separate taxation at an earlier date by appealing to the Commissioners and establishing that they are separated as a matter of fact and that such separation is "likely to be permanent". This could be as early as the day after separation if the facts support it.

It should also be borne in mind that such a date could and often would precede a decree of divorce, nullity or separation in which case the relevant date for tax purposes for the end of the marriage will not be the date of the decree but the anniversary of the de facto separation or any earlier date that is satisfactorily established.

An interesting case on de facto separation was Eadie v. IRC\(^1\). In that case a husband executed a separation deed and covenanted to pay annual sums to his wife out of which she agreed to pay the household expenses. The husband was allowed, under the terms of the deed, to live in the same house, but after a few months did not in fact do so. The court held that he was entitled to deduct the payments from his income for tax purposes and that his wife's income was not to be aggregated with his because they were not in fact "living together", even though they resided in the same house. This case illustrates the principle that the present tax rules impose a penalty on marriage - during marriage a husband cannot save tax in this way, yet this is possible as soon as the marriage ends, even though the spouses remain in the same "household".

After the marriage ends payments may be made by one spouse to another and the rules which apply will now be considered.

\(^1\) (1924) 2 K.B. 196.
(3) **Payments after the end of marriage**

(a) Separation deed - position of payer  
(b) Separation deed - position of recipient  
(c) Separation deed - summary  
(d) Order of the court - Normal payments  
(e) Order of the court - Small maintenance payments  
(f) Voluntary payments

Payments by one spouse to another after the end of the marriage fall into four categories and different rules apply to each. Payments under separation deeds will be considered first as these may be the first made in point of time by the parties and they raise some interesting points in tax law; payments under an order of the court will then be considered, first the normal rules and then the special rules which apply to "small" maintenance payments. Finally, the position of voluntary payments (made without any legally binding agreement or court order) will be considered.

In order to understand the tax treatment of payments under separation deeds it may be helpful to look separately at the provisions which affect the payer and the recipient. As far as the payer is concerned three different sets of rules operate to give relief from basic rate tax, higher rate tax and investment income surcharge. When any income payments are made by one taxpayer to another tax relief can be "clawed back" by the "settlement provisions"; these will be considered and their application to separation deeds will be discussed. A reference will then be made to the tax treatment of such payments in the hands of the recipient and it will then be possible to summarise the position from the point of view of both payer and recipient.
(a) **Separation deeds - position of payer**

(i) **Basic rate tax.**

(A) Deduction under section 52.
(B) Is it an annual payment?
(C) Is it chargeable under case III of schedule D?

(ii) **Higher rate tax.**

(iii) **Investment income surcharge.**

(iv) **Clawback under settlement provisions.**

(A) Transfers by married persons.
(B) Is a separation deed a settlement?
(C) **Section 457 - Higher rates.**
(D) **Section 445 - All rates - power to diminish or revoke.**
(E) **Section 434 - All rates - short dispositions.**

(i) **Basic rate tax.** There is no specific provision in the Income Tax Acts which gives income tax relief for maintenance payments under separation deeds. The fact that relief is available results from two facts: first, and most important, the parties are no longer married for tax purposes and so aggregation of income no longer applies; secondly, the payments come within the definition of "annual payments" and, in some circumstances, relief for basic rate tax is given for these by means of the operation of the "section 52" procedure which will now be discussed.

(A) **Deduction under section 52.** Payments made by a husband to a wife under a separation deed may be capital or income. If the payments are capital they are not affected by the income tax legislation. Usually, however, the husband covenants to make income payments to his wife. Now from the very beginning of the income tax system a taxpayer has been allowed to deduct from his total income for tax purposes not only his personal allowances but also certain "annual payments". Now that interest (which is the most typical annual payment of all) can no longer, by statute, be treated
in this way, the underlying philosophy which explains the treatment of annual payments is more difficult to understand.\textsuperscript{1} An attempt to explain the principles was made by Lord Radcliffe in IRC v. Frere\textsuperscript{2} as follows:-

"Now take...the annuity which is by legal right charged upon property...A man comes into the right to that income subject to the charge of the annuity. Under the tax system, as in ordinary thinking, his own income is reduced by the amount of the charge. The gross income accruing to him is divided in ownership right, a part equal to the annuity figure belonging to the annuitant the balance to him. The reality of this situation was recognised and allowed for by the tax system, because, while the payer of the annuity was assessed and charged on the gross income he was from the earliest days allowed to deduct from his payments a proportionate part of the tax which he had borne or was to bear on the total...This recognition of a division of ownership between two or more persons entitled to rights in a single 'fund' of income was not, however, confined to such cases as those where there was...an annuity charge. There was also the case of...interest...payable under a mortgage the characteristic feature of which seems to have been that, in setting up the mortgage, the borrower had, in effect, divided the gross income of his estate between himself and the mortgagee.

Up to this point it could fairly be said that the division corresponded with and followed the lines of enforceable legal rights in an identifiable fund of property, the accruing income. But the tax system can be seen to go further than this, for it applied the same idea of division of proprietary right to situations in which legal distinctions draw no dividing line.

Thus, an annual payment, secured by personal covenant only, involving no charge on any actual security...was treated in the same way for tax purposes".

\textsuperscript{1} See Article [1981] BTR 263 "The Repeal of Section 52 of the Taxes Act 1970" by J. Tiley.

\textsuperscript{2} (1965) AC 402, at page 419.
Whether or not the same underlying philosophy is justifiable today the fact remains that certain "annual payments" may be deducted from total income for tax purposes.

A theme which runs throughout the taxing statutes is that, as far as possible, direct assessment is replaced by a system of deduction of tax at source. The first Income Tax Act of 1799\(^1\) failed because it relied on a system of direct assessment and when he re-introduced income tax in 1803\(^2\) Addington also introduced the system of deduction of tax at source. Perhaps the most widely known application of the system is the PAYE system, which was introduced in 1943, where an employer deducts tax from payments made to employees and accounts for the tax to the Inland Revenue: the system of deduction of tax at source is also used in other areas, e.g. payments by trustees to beneficiaries and payments of interest by building societies. The rules governing the deduction of tax at source from annual payments are found in sections 52 and 53 Taxes Act which will now be considered.

Section 52 applies to "any annuity or other annual payment charged to tax under case III of Schedule D and payable wholly out of profits or gains brought into charge to income tax". The section provides that if a payer makes an annual payment out of taxed income then, when making the payment, he may deduct tax at the basic rate (in force when the payment is due). Having deducted income tax at the basic rate the payer may retain it for himself. There is no obligation to deduct tax as section 52(1)(c) specifically states that the person making the payment is "entitled" to

2. 43 Geo 3 c 122. Statutes at Large, Volume 44, page 740.
deduct and retain the income tax whereas section 53 says he "must" do so. If no deduction is made under section 52, the Inland Revenue do not lose, as the payee's income has already suffered tax, but the payer, in effect, loses his relief by a failure to deduct. If the payment is, in fact, made gross, the right of deduction is lost unless an adjustment can be made to future instalments in the same year of assessment. However, in the special case of payments made to a separated wife the Inland Revenue operate a concession whereby relief may be given to a husband who fails to deduct tax under section 52 but only up to the limit of the wife's unused allowances. ¹

Section 53 also applies to "any annuity or other annual payment charged with tax under Case III of Schedule D" but which is not payable, or not wholly payable, out of profits or gains brought into charge to income tax. So, if a payer makes an annual payment in circumstances where it is not made out of taxed income he must deduct tax at the basic rate in force at the date of payment. He must then account for the tax deducted to the Inland Revenue, who may also assess him direct. As with section 52, the recipient receives the payment after deduction of tax but unlike section 52, the payer may not retain the tax deducted and therefore obtains no relief for such payments.

It has been seen ² that section 52 in effect provides relief from basic rate tax if a payment is "an annuity or other annual payment charged to tax under Case III of Schedule D" and section 53 provides for a

¹. See a Memorandum on Tax and Marriage Breakdown published by The Law Society 1981 p. 15 paragraph 9.1.
². Page 210 ante.
deduction of tax from the same type of payment with a provision that tax deducted must be handed over to the Inland Revenue where the payment is not made out of taxed income. In order to determine whether these procedures apply to payments under a separation deed it will be necessary first to examine whether such payments are "annual payments" within the meaning of the sections and secondly, whether they are "charged to tax under Case III of Schedule D"; if the answer to both is in the affirmative then the sections 52 and 53 procedures apply to the payments and if section 52 applies it will thus give relief from basic rate tax if paid out of taxed income.

(B) Is a payment under a separation deed "an annual payment?" There is a large body of case law on the meaning of the phrase "annual payment" from which it appears that it has five characteristics: first, it must be ejusdem generis with "interest" and "annuities" as all three phrases originally appeared together in sections 52 and 53 and also in section 109 which will be mentioned shortly; next, it must be paid under a binding legal obligation e.g. a deed or court order; thirdly it must recur or be capable of recurrence; fourthly it must be income and not capital; and, finally, it must be "pure income profit" in the hands of the recipient. There is no dispute that income payments under a separation deed are "annual payments" so the concept will not be examined more closely at this stage.¹

(C) Is it "charged" to tax under case III of schedule D?" Section 109(1) Taxes Act provides that tax is to be charged

¹. However, a reference may be made to Whiteman and Wheatcroft on Income Tax, Second Edition, pages 88-108 for a full exposition of the meaning of "annual payment".
under Case III of Schedule D on:

"any interest of money, whether yearly or otherwise, or any annuity or other annual payment, whether such payment is payable within or out of the United Kingdom, either as a charge on any property by the person paying the same by virtue of any deed or will or otherwise, or as a reservation out of it, or as a personal debt or obligation by virtue of any contract..."

It appears to be accepted that section 109(1) covers all annual payments and that the circumstances mentioned after the word "whether" are just examples. As payments under separation deeds are annual payments, and as they are also a "personal debt or obligation by virtue of a contract" they clearly are charged to tax under Case III of Schedule D. ¹

Now that it has been established that payments under separation deeds are "annual payments" and are "charged to tax under case III of schedule D" it can be concluded that the sections 52 and 53 procedures apply to them with the following results:

Where a payment is made out of taxed income the payer may deduct basic rate tax and keep it. Where a payment is not made out of taxed income the payer must deduct basic rate tax and account for it to the Inland Revenue.

It will be seen therefore that relief for basic rate tax for payments made under separation deeds will depend to a large extent on whether the payer makes the payment "out of profits or gains brought into charge to tax".

¹. Note that section 65 Taxes Act specifically provides that "small" maintenance payments are also to be assessed under Case III of Schedule D although, because they are paid gross, they are excluded from deduction of tax at source under the section 52 or 53 procedure. See page 232 later in this chapter for a discussion of small maintenance payments.
If he does, he gets the equivalent of tax relief at the basic rate; if he does not he gets no relief.

It is thought, however, that most payments under separation deeds will be payable out of taxed income thus giving relief from basic rate tax. If a husband does not have sufficient taxed income to support the payments he might be advised to make "voluntary payments"\(^1\) and claim the higher married man's allowance if appropriate.

(ii) **Higher rate tax.** It has been seen that relief from basic rate tax is given indirectly by the section 52 procedure; but that section only applies to tax at the basic rate. To determine whether relief from higher rate tax is available it will be necessary to consider the provision under which higher rate tax is charged. This is found in section 32 Finance Act 1971 the relevant parts of which read:-

"32(1) Income tax shall be charged:

(b) In respect of so much of an individual's total income as exceeds £........ at such rates respectively as Parliament may determine..."

So higher rate tax is only assessed on an individual's "total income" (if it is above a specified amount). Clearly, then, the next thing to look at is the definition of "total income" and this appears in section 528 and schedule 13 Taxes Act. The relevant portions of section 528 read:

"(3) In estimating the total income of any person -

(b) any deductions which are allowable on account of sums payable under deduction of income tax at the

\(^1\) See page 233 later in this chapter for a discussion of voluntary payments.
basic rate in force for any year out of the property or profits of that person shall be allowed as deductions in respect of that year".

Schedule 13 sets out the manner in which returns of total income are to be made and clearly anticipates that a deduction will be allowed for annual payments where tax has been deducted before payment.¹

It appears to follow, therefore, that annual payments can be deducted before arriving at "total income" and as higher rate tax is only assessed on "total income" it follows that section 52 payments in effect gain relief from higher rate tax.

(iii) Investment income surcharge. It has been seen that relief from basic rate tax is given indirectly by the section 52 procedure and also that relief from higher rate tax is also given because the higher rates are assessed on "total income" and section 528 (3) (b) provides that in estimating "total income" section 52 payments may be deducted.

It remains to consider the position where the payer has investment income liable to the additional rate (the investment income surcharge). Section 32 Finance Act 1971 provides:—

(1) Income tax shall be charged:—

and where an individual's total income includes investment income and that investment income exceeds £...... income tax shall also be charged in respect of the excess at such additional rate or rates as Parliament may determine".

So, here again is a reference to "total income", and it

¹. In Earl of Howe v. IRC (1919) 2 K.B. 336 Scrutton L.J. held that the form of the return in schedule 13 was statutory authority for relief from higher rate tax; see page 351.
has been seen that this is arrived at after allowing a deduction for section 52 payments. So relief is also given from the investment income surcharge in respect of such payments. The conclusion may therefore be drawn that payments under a separation deed, if made out of taxed income, 'in effect reduce the top slice of the payer's income chargeable to tax and thus give relief from basic, higher and additional rates.

Here it may be mentioned that although section 52 payments reduce "total income" and thus effectively save higher and additional rates of tax for the payer, there could be a disadvantage resulting from this procedure. The reason is that the personal allowances in Chapter II (Sections 8 - 27) Taxes Act are given as deductions from "total income"; it would therefore appear that in reducing a payer's "total income" a section 52 payment could reduce the payer's income available to claim personal allowances.

(iv) Clawback under "settlement provisions"

(A) Transfers by married persons.
(B) Is separation deed a settlement?
(C) Section 457 - Higher rates - most settlements.
(D) Section 445 - All rates - power to diminish or revoke.
(E) Section 434 - All rates - short dispositions.

It has been mentioned that in certain circumstances relief from basic, higher and additional rate tax for "annual payments" can be nullified by the "settlement provisions". These will now be considered but first a reference will be made to the application of the provisions to transfer by married persons.

(A) Transfers by married persons. It has been noted that
section 37 Taxes Act deems all the income of a married woman to belong to her husband for income tax purposes. There would be nothing to stop a husband, should he so desire, covenaniting to make annual payments to his wife and/or transferring income producing assets to her direct, or to trustees to hold on her behalf. However, such an arrangement could not save any tax; all the wife's beneficial income under such arrangements would continue to be aggregated with the husband's income for tax purposes. An election for separate taxation of wife's earnings under section 23 and schedule 4 Finance Act 1971 would not assist as the trust income would always be "investment income" and that is always aggregated with the husband's income. Indeed the husband might, under such an arrangement, find himself paying more tax if he made annual payments to his wife out of earned income, as although he would get a section 52 deduction at basic rates the income would be "added back" as investment income under section 457 (considered later) and thus taxed at both higher rates and additional rates. ¹ In addition, the saving of basic rate tax would be nullified by the aggregation rules as the income in the hands of the wife would be deemed to be the husband's income.

The aggregation provisions of section 37 are therefore sufficient to nullify any tax advantages which might be gained by the transfer of income or income-producing assets from husband to wife and there is therefore no need for the application of the "settlement provisions". Here it may be noted, however, that certain of the provisions,

mainly designed to prevent the reservation of a benefit by the settlor, or to prevent the settlor receiving back as capital income taxed at the favourable trust rates, also provide that capital benefits should not return to the wife of a settlor, either.  

It will be recalled that section 37 only applies where husband and wife are living together; once they are separated within the meaning of section 42 Taxes Act the aggregation rules no longer apply and there could be advantages in "splitting" incomes between the spouses in order to maximise allowances and reliefs and reduce the higher rates applicable to the aggregated income. In considering these advantages the "settlement provisions" must be considered in the same way as they require consideration when any individual transfers income or income producing assets to or for the benefit of another individual.

Before considering the detailed application of the settlement provisions to a separation deed one fundamental question should be considered - is a separation deed a settlement?

(B) *Is a separation deed a settlement?* To determine whether a separation deed is a settlement a reference will be made to the settlement provisions and the definitions of a settlement found there. The provisions are found in Part XVI Taxes Act which comprises four chapters, each of which deals with a different set of provisions and each of which contains its own definition of "settlement". The definitions may be summarised as follows:-

1. See sections 439, 445, 446, 447, 448, 450(5) and 451(8) Taxes Act.
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title of Chapter</th>
<th>Section defining settlement</th>
<th>Definition</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Dispositions for short periods - Sections 434-6</td>
<td>434(2)</td>
<td>&quot;Disposition&quot; includes any trust, covenant, agreement or arrangement</td>
<td>Section 434(1) also excludes a &quot;disposition made for valuable or sufficient consideration&quot;.</td>
</tr>
<tr>
<td>II</td>
<td>Settlements on children. First introduced 1936. Sections 437-444</td>
<td>444</td>
<td>&quot;Settlement&quot; includes any disposition, trust, covenant, agreement, arrangement or transfer of assets.</td>
<td>Includes &quot;transfer of assets&quot;.</td>
</tr>
<tr>
<td>III</td>
<td>Revocable settlements. Sections 445-456</td>
<td>454</td>
<td>&quot;Settlement&quot; includes any disposition, trust, covenant, agreement or arrangement.</td>
<td>Does not include &quot;transfer of assets&quot; but probably not significant.</td>
</tr>
<tr>
<td>IV</td>
<td>Surtax liability of settlor. First introduced in 1946. Sections 457-459</td>
<td>459</td>
<td>Same definition as for Ch. III.</td>
<td>Does not include &quot;transfer of assets&quot; but probably not significant.</td>
</tr>
</tbody>
</table>
It will be seen that these definitions are in extremely wide terms and could include almost any transaction or "arrangement". However, from the earliest time, the definitions have been limited, first to arrangements which were not bona fide commercial arrangements and more recently to arrangements where there is no element of bounty. The most recent decision in which the definition of "settlement" has been clarified is the case of IRC v. Plummer\(^1\).

In that case the taxpayer entered into an agreement with a charity named HOVAS under which HOVAS paid the taxpayer a capital sum of £2,480; the taxpayer covenanted to pay HOVAS £500 net after deduction of tax at basic rate each year for five years. In order to secure the annual payments the taxpayer used the £2,480 capital sum he had received and purchased five promissory notes for £500 each (making up the balance out of his own money). He lodged the promissory notes with HOVAS as security for his annual payments. Each year he paid the annual payment from an overdraft, HOVAS released one promissory note, the taxpayer cashed it and paid off the overdraft.

There were two purposes behind the scheme. First, HOVAS wished to reclaim the tax deducted by the taxpayer under the section 52 procedure on the basis that it was a charity and that its income was exempt from tax. HOVAS would then have received £2,500 net, which, grossed up, would be in the region of £4,000 for a payment of only £2,480.

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1. (1979) STC 793.
However, this claim was abandoned at an early stage.

The second purpose was to provide the taxpayer with a capital sum of £2,480 (with no tax liability) in return for five payments of about £800 pounds each (£500 net) which could be deducted from his income for the purposes of higher and additional rates (as previously discussed), thus saving him a considerable amount of tax. The Inland Revenue put forward a number of arguments against this arrangement, one of which was that the transaction was a "settlement" and that therefore the provisions of section 457 applied to add back the income for the purposes of the higher rates. A separate reference will be made to section 457 shortly, but here it is interesting to note the developments in the meaning of the word "settlement" which took place in the Plummer case.

Lord Dilhorne was of the view that no qualification could be inserted into the very wide statutory definition and that the previously accepted exclusions of "bona fide commercial transactions" and/or transactions "with no element of bounty" were not justified by the terms of the statute; Lord Diplock agreed with him. But the other three judges found the other way.

Lord Wilberforce said that he preferred the "no element of bounty" test although in the particular case he held that the transaction was a "bona fide commercial transaction" and was not a settlement on that ground. Lord Keith

1. See page 225 post.
2. At page 806.
of Kinkel agreed with him and Lord Fraser went slightly further and said that he thought that the true test of a settlement was a transaction "with no element of bounty". In referring to section 457(1) Lord Fraser said:

"Paragraph (c) makes an exception for income arising under a settlement in favour of a former spouse of the settlor...There is no express requirement in paragraph (c) for full consideration as that would clearly be inappropriate but it is reasonable to assume that payments in the circumstances mentioned in this paragraph would usually be motivated by obligation, legal or moral, rather than bounty".

In the light of the judicial interpretation of the meaning of the word "settlement" the question can now be asked as to whether a separation deed is, or is not, settlement? The answer is not absolutely clear, a number of factors carrying weight on each side. These may be summarised as:-

Factors indicating that a separation deed is not a settlement

(1) The test, following IRC v. Plummer, is that a transaction is not a "settlement" if it contains "no element of bounty". As mentioned by Lord Fraser, separation deeds are "usually motivated by obligation, legal or moral, rather than bounty". If there is no element of bounty there is no settlement.

(2) The Inland Revenue appear to accept that transfers of capital assets on divorce are not gifts but are made in consideration of the renunciation by one of the parties of existing rights; if the same view applies to income paid under a separation deed, there is no element of bounty and therefore no settlement. A better view would however be that there can
be no element of bounty if a husband is doing no more than complying with his legal duties. If an order of the court regulated the matter, the transfer would be made to comply with the legal duty to obey the court and there would be no element of bounty. A separation deed can also be viewed as no more than an agreement whereby a husband complies with his legal duties so long as the payments are no larger than the court would award.

(3) Section 457 specifically excludes from its operation a number of transactions which are clearly bona fide commercial transactions (partnership annuities and annual payments made under a liability incurred for full consideration); none of these are usually considered settlements and as payments under a separation deed are also mentioned in the same context, such payments could not constitute a settlement either.

Factors indicating that a separation deed could be a settlement

(1) The new test of "no element of bounty" has, in fact, never been applied in a decided case and could be regarded as obiter dicta: in all the cases the transactions were business or company transactions and in the cases where they were held not to constitute settlements they were held to be "bona fide commercial transactions". There has been no case dealing with personal transactions, such as separation deeds, and different rules could apply.
(2) A particular settlement deed might, on the facts, contain an element of bounty as it might be more generous than a normal negotiation would produce, bearing in mind the rights renounced by the recipient or bearing in mind the amount that a court would award. It is not clear to what extent the "moral obligation" mentioned by Lord Fraser would nullify an element of "bounty" and so an excessive arrangement could constitute a "settlement".

(3) If the wording of section 457 is examined closely it could be held to indicate that all "dispositions, trusts, covenants, agreements or arrangements" are included in the phrase "settlement" and that the stated exceptions in the section are not "non-settlements" but "settlements to which the provisions of the section do not apply" (but to which the provisions of other settlement sections could). Support for this view would be obtained by reading the stated exception in section 457(1)(c), namely:

"is income arising under a settlement made by one party to a marriage by way of provision for the other after the dissolution or annulment of the marriage or while they are separated..."

This appears to indicate that a separation deed is a settlement but one to which the provisions of section 457 do not apply (although other settlement sections might). On the other hand, with the Plummer case, an element of bounty appears to be crucial to a "settlement"; no doubt as the consequences of including non-bounteous arrangements within the
definition would be far-reaching Parliament could be deemed to have excluded them.

(4) Also, in another connection, the editors of Potter and Monroe's Tax Planning with Precedents,¹ appear to come to the same conclusion:

"It will be observed that the draftsmen of the latest version of the section appear to have no doubts that an agreement to make annual payments in a commercial context can still be a "settlement".

Until the matter is finally decided it may therefore be safer to assume that a separation deed could be a settlement and the "settlement provisions" will now be considered on that basis: the first to be discussed is in fact section 457 which, as we have seen, conveniently excludes payments under separation deeds by a specific provision.

(C) **Section 457 - Higher rates - Most settlements after 7th April 1965.** Nearly all the "settlement provisions" deem the income of the settlement to be the income of the settlor for all tax rates: section 457, however, only affects the higher rates. The provisions were first introduced in section 28 Finance Act 1946 and the section enacts that, for the purposes of higher rate tax, income arising under any "settlement" shall be treated as the income of the settlor and not of any other person: the provisions apply to all income under any settlement unless it can be brought within a stated exception.

However, as has been seen, payments under separation deeds are specifically excluded from the

¹. Eighth edition at page 11.
provisions of section 457 by subsection (1) (c) which excludes:

"Payments made under a settlement by one party to a marriage to provide for the other party after dissolution or annulment of the marriage or if made while they are separated under a court order or under a separation agreement or in such circumstances that the separation is likely to be permanent".

So, there is no charge under section 457. The next section which could apply is section 445.

(D) **Section 445 - All rates - Power to diminish or revoke.**

Section 445 appears in Chapter III of Part XVI Taxes Act which Chapter is concerned with revocable settlements and which, in the main, provides that any settlement in which the settlor retains an interest is not effective to save tax: the income is deemed the income of the settlor for all rates. Section 445(1) provides that if, under the terms of the settlement, any person has a power to revoke or otherwise determine the settlement, resulting in the settlor ceasing to be liable to make any annual payments, then any sums payable by the settlor are treated as his income for that year for all tax rates, and not the income of any other person. Sub-section (2) provides that a power to diminish the amount of the payments is deemed to be a power to revoke. If, therefore, any separation deed gave the power to any person to diminish the amount of the payments, section 445 would operate to deem the whole of the sums paid to the wife to belong to the husband. On the other hand, the case of Wolfson v. IRC\(^1\) decided that the power

1. (1949) 1 All E.R. 865.
to diminish or revoke had to be in the settlement; if it was an extraneous power, the section did not apply. This should therefore be borne in mind.

If it is desired that the husband's liability should be reviewed if his own income is reduced, the following suggestions could be considered:

(1) An adjustment could be incorporated in the agreement which applied automatically; for example the deed could provide that payments were automatically adjusted to the husband's income in predetermined bands, e.g.:

<table>
<thead>
<tr>
<th>Husband's income below</th>
<th>Payments under deed</th>
</tr>
</thead>
<tbody>
<tr>
<td>£5,000</td>
<td>£2,000</td>
</tr>
<tr>
<td>£10,000</td>
<td>£4,000</td>
</tr>
<tr>
<td>£15,000</td>
<td>£6,000</td>
</tr>
</tbody>
</table>

It could be argued that as the adjustment is automatic the settlement does not give any person "power" to diminish the payments.

(2) The deed could provide that it should only continue while the husband's circumstances remained unchanged, but must not give the husband a power to revoke.

Section 445, therefore, requires careful consideration when drafting and considering separation deeds. The next section which could apply is section 434.

(E) Section 434 - Voluntary covenants for short periods - all rates. Section 434 applies to voluntary covenants; if these do not exceed six years all the income is deemed that of the settlor for all rates. Most separation deeds will, in fact, not fall into the category of "short dispositions"
as, even if they end before six years, (by, say, the death of the husband) they are not usually framed so that they "cannot exceed" six years. Further, it will be recalled that section 434 specifically excludes "dispositions made for valuable or sufficient consideration" and is in fact the only settlement provision to do so. Therefore, in the unlikely event of a separation deed being, in fact, a "short disposition" there is a possibility that it could be excluded from section 434 as being made for "sufficient" consideration, although there is some doubt as to whether the consideration would be "sufficient" if the analysis is adopted of regarding a separation deed as a mechanism for regulating existing rights. ¹

It has been seen that a payer who makes payments under a separation deed will, if he makes the payments out of taxed income, get relief in effect at basic, higher and additional rates. Although there is some doubt as to whether a separation deed is a "settlement" it is probably safer to assume that it is, especially if the payments are larger than a court would award; even so, the tax relief will not be "clawed back" under the settlement provisions as section 457 (higher rates on most covenants) specifically does not apply and section 434 (voluntary covenants for short periods) probably will not apply as the deed will usually be capable of exceeding six years. The only provision which will require attention therefore is section 445 (all rates - power to diminish or revoke) and no separation deed

¹. See page 223 ante.
therefore should contain a provision enabling any person to exercise a power to diminish or revoke the payments. That, then, is the position of the person who makes payments under a separation deed: the position of the recipient is somewhat simpler.

(b) Separation deed - position of recipient. A wife who receives maintenance payments under a separation deed will always receive them under deduction of tax at the basic rate, whether under section 52 or section 53. She will therefore be assumed to be in receipt of a gross sum in respect of which she has paid basic rate tax. Four possible results could follow:

(A) A claim for repayment. If the wife has no other, or little other, income and has not been able to use up her personal allowances and other reliefs she can claim a repayment of income tax from the Inland Revenue.

(B) A neutral position. If the wife has other income so that she is liable to tax at the basic rate on her income she will be treated as having paid the tax on her maintenance payments: no repayment will be due but no more tax need be paid.

(C) Wife liable at higher rates. If the wife has other income so that she is assessed to tax at the higher rates she will be directly assessed under Case III Schedule D to higher rate tax in respect of the maintenance payments also; these will be grossed up for this purpose.

(D) Investment income surcharge. In years gone by the recipient of maintenance payments could also be assessed to the investment income surcharge on her maintenance payments
if she had sufficient unearned income to attract that rate. However, section 15 Finance Act 1974 specifically provides that maintenance payments under a separation deed are not investment income if they are made directly by the other party; however, if they are made under a settlement created by the other party then they are only exempt from the investment income surcharge during the life of the other party. This provision could affect separation deeds where, instead of covenanting to pay income to his ex-wife, the husband transfers income-producing assets to trustees for her benefit; such income paid after the husband's death would be liable to the investment income surcharge in the hands of the wife.

(c) Separation deed - summary. A person who makes payments under a separation deed:

: out of taxed income:

- deducts tax at the basic rate and provides the recipient with a certificate of deduction under form R185 (section 52);
- keeps the tax deducted (section 52);
- if assessable at higher rates, obtains relief because the gross amount of the payment is treated as a deduction from total income before the higher rate is assessed; and
- can deduct the payment from investment income before the additional rate is assessed.

: not out of taxed income:

- deducts tax at basic rate as above (section 53);
- pays the tax to the Inland Revenue.
A person who receives income under a separation deed:

- receives a net sum after deduction of basic rate tax (section 52 or section 53);
- can reclaim a repayment of tax if her allowances and reliefs are not otherwise covered;
- has to include the grossed-up amount of the payment in the computation of her income for the purposes of the higher rates of tax;
- is not charged with investment income surcharge on the payments.

Having considered the tax consequences of separation deeds, the treatment of payments made under a court order will now be considered.

(d) Order of the court - Normal payments. Special provisions apply to "small" maintenance payments made under an order of the court and these will be considered shortly. As far as "non-small" payments made under a court order are concerned the result is the same as those made under a separation deed, but for slightly different reasons. First, it is thought that the payments are "annual payments"; they are a "charge on the property of the person paying the same", not by deed or will but "otherwise" and they are made in pursuance of a binding obligation, not under a deed but by order of the court. So, they are effective for saving basic, higher and additional rate tax for the payer. However, as a court order is not usually a "settlement" (although a settlement could be made pursuant to a court order) payments made under a court order would not be "clawed back" for the higher rates under section 457; further a
provision to diminish the payments could be included in a court order without any danger of coming within section 445 (revocable settlements). There is, however, a possibility that a consent order, if for substantially more than a court would award, could be a settlement as the excess payments would have the necessary "element of bounty".

Apart from these minor variations, however, the same rules, which apply to separation deeds, apply also to payments under court orders.

(e) Order of the court - Small maintenance payments.
Section 65 Taxes Act 1970 provides that certain payments, defined as "small maintenance payments", if made under an order of the court, and if below certain limits, should be made gross: tax is not to be deducted by the payer and the recipient is not put to the trouble of reclaiming income tax if she has little, or no, other income. If the recipient has other income, and is liable to tax on the payments, a direct assessment is raised under Case III Schedule D. The payer is allowed to deduct the gross sums paid from his total income to reduce his income liable at the basic, higher and additional rates but his total income is also reduced for the purposes of the personal reliefs which therefore may be restricted. The present limits were enacted in section 33 Finance Act 1982 which provides that "small maintenance payments" are payments not exceeding

2. Section 65(3).
3. Section 65(4).
£33 per week or £143 per month. The limits may be varied by Treasury Order.

(f) **Voluntary payments.** A husband and wife may be de facto separated within the meaning of section 42 Taxes Act but there may be no provision for maintenance payments by a separation deed or court order. The husband may, however, make "voluntary payments", i.e. not under any binding legal obligation, and the position of these will now be considered.

(i) **The personal allowances.**

It will be recalled that as soon as a marriage has been terminated within the meaning of section 42, the husband and wife are taxed as single persons with a single person's allowance each and the husband loses the married man's allowance. However, a special provision applies where he makes voluntary payments. Section 8 (1)(a)(ii) Taxes Act provides that the higher married man's allowance is also available to a husband, even if he is separated from his wife, if he can prove "that his wife is wholly maintained by him during the year of assessment and that he is not entitled in computing the amount of his income for that year for income tax purposes to make any deduction in respect of the sums paid for the maintenance of his wife". It will be noted that the husband must "wholly" maintain his wife; in other words, she must have no other income apart from his payments. The reasoning behind this extension of the married man's allowance would appear to be that, as the payments are not "income" in the hands of the wife, and as she has no other income she cannot
claim her own personal allowance, so the Inland Revenue 'permit' the husband to continue to be treated as a married man, so far as personal allowances are concerned. (ii) Deductibility. There is no deductibility of voluntary payments from the husband's income: they are not made "under a binding legal obligation" (a deed or an order of the court); therefore they cannot be "annual payments", and therefore there would be no deduction from total income for such payments. Conversely, voluntary payments are not treated as "income" in the hands of the wife.

5. Conclusions

The provisions which have been considered in this chapter are of importance in two respects: they illustrate the increasing complexity of the income tax rules as they affect married persons and they highlight the advantageous treatment which can follow separation.

The recent changes in the rules which apply at the beginning of marriage also illustrate the tendency of the legislation to withdraw any advantages which might be enjoyed by married persons, even if the result is to create anomalies. The fact that a couple are no longer treated as being married for tax purposes until 5th April following their wedding must raise the question as to why any special provisions are necessary at all for married persons.

1. 1968 and 1976.
The advantageous tax provisions which apply following separation also illustrate the way in which the aggregation rule has become an incentive to divorce. After separation, a husband can obtain deductions from basic, higher and additional rates of tax for payments made to his wife or ex-wife; no such deduction is available when the spouses are living together; when a separated wife receives payments from her husband, she can claim a repayment of tax up to the amount of the single personal allowance and other reliefs and can utilise her own basic rate band for the balance; during marriage a wife has no personal allowance of her own (her earned income allowance in fact being given to her husband for use against her earned income only). While the marriage subsists neither spouse can claim the additional relief in respect of children given by section 14 Taxes Act but after separation each spouse can claim this relief (which amounts to £880 each year) so long as he or she has a qualifying child resident with him or her. Indeed, if an ex-spouse then resides with another person who also has a qualifying child then, so long as the two adults do not marry, each can claim the additional relief for a child.

During marriage the spouses are only entitled to one mortgage interest relief of £25,000 and there are other limits on the amount of joint life assurance relief to which they are entitled: after separation each spouse is entitled to a limit each. During marriage the spouses have to share one threshold of £6,250 for the investment income surcharge: after separation they receive a threshold each.
There are some advantages for married persons. A two-earner couple receives more in personal allowances than two single persons, but a one-earner couple receives less. Again, there are certain advantages in the areas of the capital taxes\(^1\) - in particular, transfers between spouses are exempt from capital gains tax and capital transfer tax. As far as capital gains tax is concerned, these advantages are now counteracted by three factors: first, since 1980\(^2\) all gifts between individuals have been exempt; secondly, during marriage spouses have to share one set of reduced rate reliefs and exemptions; and, thirdly, during marriage the spouses can only claim one "principal private residence" exemption between them. The disadvantages of marriage appear therefore to outweigh the advantages. As far as capital transfer tax is concerned, the complete exemption for transfers between spouses has lost some of its value since the increase of the exemption level to £55,000\(^3\) and the ten year accumulation rule introduced in 1981.

It will be seen in Chapter 7 that the argument has frequently been put forward that married persons should pay more tax than if they were single because they form 'one household' and it would thus follow that advantages should be gained on divorce or separation as thereafter the spouses comprise two households. The logical fallacy of the

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1. See Chapter 4.
4. Page 313 post.
"household test" is more fully discussed in Chapter 7 but here it may be noted that the tax rules on separation bear no relation to the number of households involved. In Eadie v. IRC\(^1\) a man and wife were held to be separated for tax purposes even where they shared the same household; again, a married couple can, in fact, operate two 'households' but are taxed as one person if they are not separated; finally, two unmarried persons sharing the same household are taxed as two single persons.

\(^1\) (1924) 2 K.B. 198.
CHAPTER 4 - INCOME TAX - CHILDREN

Section 1 - Introductory - the present position.

Section 2 - Child allowances:

(1) 1799-1805. A child allowance.
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(3) 1910-1920. The child allowance re-introduced.
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(5) 1920-1954. Allowance increased and modified.
(6) 1954 - The Radcliffe Report - Further modifications recommended.
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(3) The present position.

Section 4 - Trusts - Non-parent settlors.

(1) All trust income taxed at basic rate in the hands of trustees.
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CHAPTER 4

INCOME TAX - CHILDREN

Section
1. Introductory - the present position
2. Child allowances
3. Aggregation of investment income
4. Trusts - non-parent settlors
5. Trusts - parents settlors still married
6. Trusts - parent settlors and court orders
7. Summary

1. Introductory - the present position

Although the income tax treatment of children within the family unit has a long history the present rules are of recent origin and can be stated simply: a child is treated for all purposes as a separate person in respect of his own income except where such income arises from a disposition made by his parent. A married parent obtains no tax allowance in respect of a child; the previous system of tax allowances has now been replaced by a system of cash benefits. On the other hand, a single person having a qualifying child resident with him does obtain a tax allowance.¹

This Chapter will consider briefly the history of child allowances and also the provisions which, temporarily,

¹. Section 14 Taxes Act.
provided for the aggregation of a child's investment income with that of his parent. A reference will then be made to the rules which apply where a child receives income as a result of a disposition made by a person who is not his parent; then the separate provisions which apply to income arising as a result of dispositions made by a parent can be discussed, distinguishing dispositions made by a married parent from those made by a divorced parent. Some conclusions about the income tax treatment of a child in the family can then be drawn. However, before taking a brief look at child allowances a word will be said about the meaning of the word 'child'.

As a result of section 1(1) Family Law Reform Act 1969 a person now attains full age on attaining the age of eighteen; prior to that legislation the age of majority was twenty one. Section 12 of the same Act provides that a person who is not of full age may be described as a minor instead of as an infant, which was the traditional term in use before 1970; the term "minor" is generally used in modern legislation.

As a result of the Family Law Reform Act the separate provisions in the income tax legislation which affect children only apply to children under the age of eighteen. Although a more correct term would be 'minor', the word 'child' and 'children' will be used in this chapter for two reasons; first because this thesis is mainly interested in children in the family context and secondly because the word 'child' is in fact used widely in the income tax legislation, in particular in
sections 10, 11 and 14 Taxes Act, which contain the provisions concerning child allowances, and again in section 437 which contains the provisions which deem as the income of the parent-settlor any income paid to his child as a result of a settlement made by such parent.

The fact that infancy now ends at 18 or earlier marriage explains the popularity of deeds of covenant by parents for young adults with little income of their own (e.g. students); such arrangements are not effective before the age of eighteen as they are treated as settlements by parents and all the income is deemed to remain that of the parent: this result is discussed in section 5 of this Chapter.\(^1\)

2. **Child Allowances**

1. 1799-1805 - A child allowance.
2. 1805-1910 - The child allowance withdrawn
3. 1910-1920 - The child allowance re-introduced
4. 1920 - The Colwyn Report - Modifications recommended
5. 1920-1951 - Allowance increased and modified
6. 1951 - The Radcliffe Report. Further modifications recommended
7. 1951-1979 - Further increases and modifications
8. 1979 - Child allowance withdrawn
9. The additional allowance in respect of a child
10. Child benefit
11. The present position

The history of child allowances is just as fascinating as the history of the personal allowances of married persons, traced and discussed in Chapter 1 of this thesis. However, the history of the personal allowances of married persons remains of interest today as it helps to

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\(^1\) See page 260 post. For a suggested Form of Deed Covenant see Inland Revenue Press Release of 24th September 1982 and Form IR47 published at the same time.
explain the present structure of those allowances; the same cannot be said for the history of the child allowance which no longer exists. However, a brief résumé of the development of the allowance must add to a general understanding of the tax treatment of the child in the family unit and may be of assistance when considering the future tax treatment of the child in the family.

(1) 1799-1805 - A child allowance

Although a "wife allowance" was not introduced until 1918 the concept of a child allowance was recognised from the very commencement of the income tax provisions. In the first Income Tax Act in 1799\(^1\) an allowance for children was incorporated. Section 3 of that Act provided that "every person having a child or children born in wedlock and maintained principally by such person at his or her expense" was entitled to a child allowance on a sliding scale: where a taxpayer's income was in the band £60 - £400, the allowance was 5 per cent for each child; between £400 and £1,000 the allowance was 4 per cent for each child if any child was above the age of six; if all the children were below the age of six then the allowance was 3 per cent for each child. For income in the band £1,000-£5,000 the allowances were at the rates of 3 per cent (if any child over six) or 2 per cent (if all children under six) although the appropriate percentage was payable for each child. Where income exceeded £5,000 the rates were 2 per cent for each child (if any child was over six) or 1 per cent for each

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child (if they were all under six).

Income tax was repealed in 1802 and then re-introduced in 1803 when the allowances for children were only available if there were more than two, i.e. for the third and subsequent children. Section 195 of the Income Tax Act 1803\(^1\) provided for child allowances again by reference to the band of income of the taxpayer but only if he had more than two children; for income in the bands £60 - £400 the allowance was at 4 per cent each for the third child and subsequent children; for income in the bands £400 - £1,000, the rate was 3 per cent for each child above two); where income was between £3,000 - £5,000 the rate was 2 per cent and above £5,000 it was 1 per cent.

(2) 1805-1910 - The child allowance withdrawn

In 1805\(^2\) the income tax provisions were recast and the child allowance was withdrawn. Income tax was abolished in 1816; when it was re-introduced in 1842\(^3\) the device was adopted of re-printing the 1805 Act with modifications. The child allowance therefore remained inoperative and it was not re-introduced until 1910.

(3) 1910-1920 - The child allowance re-introduced

Section 68 Finance (1909-10) Act 1910 provided that if an individual proved that his total income exceeded £160 but did not exceed £500, and that he had a child or

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1. 43 Geo III c 122. Statutes at Large, Volume 44, page 740 at page 835.
2. 45 Geo III c 49. Statutes at Large, Volume 45, page 811.
children under the age of sixteen, he was entitled to relief equal to the amount of income tax upon ten pounds. It will be seen that this child allowance depended on the parental income not exceeding a stated limit but at that stage it was not dependent on the income of the child remaining below a stated limit. The allowance was increased from £10 to £20 by section 7 Finance Act 1914 and to £25 by section 24 Finance (No.2) Act 1915. The allowance was extended to adopted children by section 13 Finance Act 1917 and the limits on parental income were raised to above £130 and below £700. Section 27 Finance Act 1918 raised the upper limit to £800 and introduced a special relief for parents with three or more children whose income exceeded that limit but did not exceed £1,000; a relief of £25 for each child above two was given. It is interesting to note that in the year 1918 the child allowance and the wife allowance were of the same amount (£25). By section 21(2)(b) Finance Act 1919 the allowance for the first child was increased to £40.

(4) 1920 - The Colwyn Report: Modifications recommended

The Report of the Royal Commission on the Income Tax (The Colwyn Commission) published in 1920 dealt very briefly with the subject of child allowances in four short paragraphs (paragraphs 280-283) and made four recommendations: first, that the amount of the allowance for the first child should remain at £40 but that the allowance for subsequent

1. The wife allowance was introduced for the first time by section 27 Finance Act 1918.
2. Cmd 615.
children should be increased from £25 to £30; secondly, that the age limit of the child (sixteen) should remain unchanged, thirdly that the limit on parental income, above which the allowance was not available, should be withdrawn; and finally "that the allowance should be withheld when the income of the child in its own right exceeds the amount of the allowance".

(5) 1920-1954 : Allowance increased and modified

Section 21 Finance Act 1920 extended the child allowance to children over sixteen receiving full-time instruction at an educational establishment and section 20 Finance Act 1938 extended these provisions to all children undergoing training (e.g. apprentices). The allowances were subsequently increased and stood at £70 for each child in 1951. The limit on parental income was withdrawn and a provision was introduced withholding the allowance entirely when the child's own income exceeded the amount of the allowance.

(6) 1954 - The Radcliffe Report: Further modifications recommended

The Second Report of the Royal Commission on the Taxation of Profits and Income (the Radcliffe Report) discussed child allowances in some detail (paragraphs 174-193). The Radcliffe Commission was concerned at the fact that all fixed allowances ... "did not produce a very satisfactory distinction between taxpayers in the middle and upper levels

1. Section 18(3) Finance Act 1951.
2. Cmd 9105.
of income; the allowances ... become proportionally smaller as income increases" (paragraphs 155-156). On the other hand the Commission did not think that the allowances should be calculated as a fixed proportion of income without limit; they therefore recommended (paragraph 177) a single proportional child allowance subject to a maximum and minimum; i.e. a minimum of £85 with an addition according to fractions of income with a maximum of £160 (paragraph 179). The upper limit suggested is of interest as it then exceeded the amount of the single person's allowance (then £120). The Radcliffe Commission also recommended (paragraph 181) that the allowance should reduce total income for surtax purposes. The Report then dealt with three distinct points; the income limit of the child, "rival claimants", and full-time education.

It will be recalled that, as a result of the recommendation in the Colwyn Report, a provision had been introduced withdrawing the child allowance completely where the child's income exceeded the amount of the allowance. The Radcliffe Commission thought this provision unduly harsh:

"An income of £85 in the child results in £170 in all being relieved £85 in the child and £85 in the parent; an income of £86 in the child gives the parent no relief" (paragraph 182). The Commission did not put forward a recommendation that the parental allowance should be reduced by one pound for every pound of the child's income, as this was thought to be too difficult to administer, but a system of tapering marginal relief was suggested. Where there were "rival claimants" to the allowance the Commission recommended that it should be given to the person actually maintaining the
child: (the law had already provided for divorced or separated parents to agree on the division of the allowance and failing agreement the allowance was allotted to them in proportion to their contribution to the maintenance of the child: but if an adoptive parent and a natural parent conflicted there was no procedure to resolve the claim without the consent of the natural parent which might not be forthcoming). Finally, the Commission made recommendations designed to put apprentices with small incomes in the same position as university students with scholarship income.

(7) 1954-1979 - Further increases and modifications

Following the Radcliffe Report the child allowances were modified and these modifications were consolidated later in sections 10 and 11 Taxes Act and remained in force until repealed in 1979. The relief was given to any person (without limit of income) who maintained a child so long as two conditions were fulfilled. First, the child was not to be in receipt of income exceeding £115 per year; if so, the allowance was reduced by the excess so that the full allowance was lost when the child had income equal to the allowance plus the £115. Secondly, the child had to be either under the age of 16, or, if over 16, undergoing full-time instruction at an educational establishment. When the relief was withdrawn, in 1979, the amount was £280 for a child not over 11 years; £275 for a child over 11 and not over 16; and £305 for a child over 16 under full-time instruction.

1. Section 1(4).
2. Section 10(5) Taxes Act.
(8) 1979 - Child allowances withdrawn

Relief for children was withdrawn, by section 1(4) Finance Act 1979, but it was then retained for certain students and children normally resident overseas. An allowance for such children had been introduced by section 25 Finance Act 1977; the limits were altered for the year 1981-82 by section 25 Finance Act 1980 to be £165 for children over 16, £135 for children between 11 and 16, and £100 for children under 11. Section 25(3) Finance Act 1980 also abolished this relief after the year 1981-82.

(9) The additional allowance in respect of a child

A discussion of child allowances would not be complete without a reference to the additional allowance in respect of a child given by section 14 Taxes Act. However, it is a feature of this allowance that it is not generally given to the married parent; it is only available to single persons (widows, widowers, single parents and others) or to a married man whose wife is incapacitated by physical or mental infirmity. Such persons can claim an allowance equal to the difference between the (higher) married man's allowance (£2,445) and the single allowance (£1,565) i.e. £880. The idea of the allowance is to put the single parent in the same position as a married man. Any 'single' person with a qualifying child can claim the allowance; if two persons can claim the allowance for the same child, it is divided between them (section 14 A); if there are two children with two adults, two allowances can be claimed but if one adult has two children then only one allowance is available.
(10) **Child benefit**

Although child tax allowances are no longer generally available it may be noted that, on their withdrawal, the cash benefits payable for children were increased. These had been known previously as "family allowances" and then as "child benefit". At present the amount payable is £5.25 per week for each child. A system of cash benefits for children is of greater assistance to low income families who may not have been able to take advantage of tax allowances. Child benefit is not taxable.

(11) **The present position**

After a long and varied history the tax treatment of child allowances in the family unit can be simply stated: if the parents are married they will get no tax allowance for their children but they do get a cash benefit of £5.25 per week for each child which benefit is not taxable. Persons who are not married and who have a 'qualifying' child obtain a tax allowance of £880 each year in addition to the cash benefit.

Although an allowance for children resident overseas was available until April 1982 it was abolished after that date. A married man with an incapacitated wife is treated as a single person for the purpose of claiming the additional relief given by section 14 Taxes Act.

3. **Aggregation of Investment Income**

(2) 1968-72 - Aggregation of child's investment income.
(3) The present position.

1. Family allowances were taxable as earned income under Schedule E (Section 219(1) Taxes Act) and Section 24 Taxes Act reduced the personal reliefs of the recipient; some higher rate taxpayers found it more advantageous to disclaim the allowances.
1) The Radcliffe Report

Before the Radcliffe Commission reported in 1951 there had never been any aggregation of a child's income with its parents' income for tax purposes. In paragraphs 122-126, the Report discusses the question because:

"it may be asked why the rule of aggregation, if correct in the case of husband and wife, is not correct also in the case of children still living as members of the family group". (Paragraph 122).

On this suggestion the Commission recorded divergent views; the majority were against aggregation; they

"did not accept the validity of the generalisation...that the income of an infant...is never anything in substance but a part of the family income...It would be doubtful justice therefore to attribute the whole of the child's income to the parent".

A minority were in favour of aggregation on the grounds that -

"parents and children forming part of a single family normally share the same standard of living and...not to aggregate children's income with the income of their parents involved the privileged tax treatment of those particular families whose children happened to be possessed of property given to them by someone other than their parents".

Having recorded their divergent views the Commission made no recommendation for a change in the existing law.

2) 1968-1972 - Aggregation of child's investment income

No change in the law was in fact made until section 15 Finance Act 1968 introduced the concept of taxing the family unit by aggregating the investment income of unmarried infant children with that of their parents.
The arrangements had effect for three fiscal years only, namely 1969-70, 1970-71, and 1971-72. The provisions were repealed by section 16(1)(a) and schedule 14 Finance Act 1971. In 1975 an indication was given that the provisions might be re-introduced; a Government spokesman stated that "because of the strict order of priorities for the Budget it was not possible to introduce the aggregation of children's investment income in the current financial year" with the implication that it would be re-introduced in the near future.¹ A brief look at the provisions may therefore be of interest.

For the provisions to apply the child had to be (1) an infant, (2) unmarried and (3) not regularly working. (For a discussion of the word 'infant' see the commencement of this Chapter). Three categories of income were excluded, namely, earned income, personal injury compensation, and maintenance paid to a young unmarried mother. Finally, there was a de minimis limit of £5 so that the provisions did not apply if the child's investment income did not exceed this figure.

Where the provisions did apply the child's investment income was treated as income of his parent; payments out of the child's investment income qualifying for deduction or relief (annual payments, interest, life assurance premiums) were treated as if made out of the parents' income.

If the parents were married and living together

the father was the parent for these purposes; if the parents were not living together then the father was still the parent unless the mother had actual custody of the child in which case the child's investment income was aggregated with the income of the mother. On the other hand, if the child was in the legal custody of a non-parent no aggregation took place.

The assessment was made on the parent who could recover the tax from the child (or its trustees) and who had to account to the child for any repayment.

(3) **The present position**

At present, a child's investment income is not aggregated with the income of his parents but, in discussing the question of the aggregation of a child's investment income with that of its parents it should always be borne in mind that any investment income derived from the parent has, since 1914, been deemed to be that of the parent; these provisions are discussed later in this Chapter under the heading - "Trusts - parent settlors". So it is only a child's investment income not derived from a parent that is not aggregated at present and which would become aggregated if the 1968 provisions were re-introduced.

4. **Trusts - Non-parent Settlors**

Adult taxpayers can be in receipt of earned income and investment income and both types of income will be taxed, the additional rate of 15 per cent being applied

1. Enacted in Section 20(1)(C) Finance Act 1922.
to investment income in excess of the threshold limit of £6,250. Children can, of course, have earned income paid to them directly in which case they are taxed in the same way as adults; but children cannot always hold investments in the same way as adults: such investments are usually held by trustees on behalf of a child and, because trustees are taxed differently from other individuals, different tax rules will apply to the investment income of a child which is paid by trustees. Of course, adults can also be beneficiaries under trusts but where children are concerned a trust may be the only way of holding the investments.

Because, therefore, the taxation of trust income is of importance when considering children in the tax system a summary will be given of the rules which apply. Special provisions apply where a parent settles funds on his child and these will be considered in the next section of this Chapter; in this part the rules concerning the tax treatment of income provided by a non-parent settlor will be discussed.

A non-parent settlor who wishes to provide income for a child can do so in one of two ways: he can transfer income to the child, preferably under a deed of covenant which will enable him to deduct the covenanted amount from his income, leaving the child to make a repayment claim if the net sums paid do not exceed his personal allowances or reliefs. Alternative, he can transfer income producing

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1. For a discussion of this procedure see Chapter 3 page ante, bearing in mind that there can be no saving of higher rate tax for the payer because of section 457 Taxes Act.
assets to trustees directing them to hold the income for the child. These trust deeds can contain any direction desired by the settlor (within legal limits) but some powers are implied by statute and these can be relevant for tax purposes.

Part II Trustee Act 1925 contains provisions relating to the general powers of trustees and personal representatives and sections 31 and 32 contain powers of maintenance and advancement. In the context of income tax section 31 is of importance, and section 32 is relevant in the context of the capital taxes.

Section 31 Trustee Act 1925 provides that where trustees hold property in trust for an infant then the trustees have power during infancy to pay the whole or any part of the income for the maintenance, education or benefit of the infant. Subject to this, the income must be accumulated and held for the infant until he attains a vested interest at 21\(^1\) or earlier marriage; the accumulations then become an accretion to capital but the trustees may, during infancy, apply the accumulations as if they were income of the current year.

In considering the tax treatment of income derived by a child from a trust made by a non-parent settlor, five principles will be considered:

1. All trust income taxed at basic rate in the hands of trustees.
2. Additional rate for discretionary and accumulation trusts.

1. The Trustee Act has not yet been amended to accord with Section 1 of the Family Law Reform Act 1969. See page 240 ante.
(3) Trustees do not pay higher rate.

(4) Trustees cannot claim personal reliefs.

(5) Trust income taxed in hands of beneficiary: different rules for (a) vested interests; (b) contingent interests.

(1) All trust income taxed at basic rate in the hands of trustees. The general rule is that all the income of a trust is liable to be taxed at the basic rate in the hands of the trustee. Most usually the tax is paid by deduction when the trustee receives the trust income. However, the trustee is not assessable at the basic rate if the income of the trust is paid directly to a beneficiary without passing through the hands of the trustee. If the trustee supplies the Inland Revenue with the name, address and particulars of income of the beneficiary in question, the beneficiary will then be assessed direct. (Section 16 Taxes Management Act 1970). Further, a trustee can answer a particular assessment to basic rate tax by showing that the income belongs to a beneficiary who is not liable to income tax.

(2) Additional rate for discretionary and accumulation trusts. When the investment income surcharge was introduced by the Finance Act 1971¹ it applied the additional rate of tax (now 15 per cent) only to the investment income of individuals, so that where income was accumulated under a discretionary or accumulation trust the additional rate was not payable until the income was distributed and became the income of an individual beneficiary. So section 16 Finance Act 1973 extended the additional rate to any accumulated income or income payable at the discretion of the trustees

¹ Section 32(1).
and section 17 provided that where discretionary beneficiaries
had payments made to them or applied for their benefit by
the trustees such payments were treated as a net amount from
which tax at both basic rate and additional rate had been
deducted so that the grossed-up amounts of the payments
were treated as part of the total income of the beneficiary
allowing him to claim a repayment of tax if appropriate.

The charge to the additional rate under section 16
also applies to income subject to the provisions of
section 31 Trustee Act 1925 (the statutory power to apply
income for the maintenance, education or benefit of a minor
with power to accumulate the remainder).

(3) Trustees do not pay higher rate. Although all trust
income is taxed at the basic rate in the hands of the
trustees, usually by deduction but otherwise by direct
assessment, and although all the income of a discretionary
or accumulation trust is also taxed at the additional rate,
by direct assessment, trustees are not individuals and
therefore do not pay higher rate tax (although, of course,
the higher rate may be paid by a beneficiary who receives
trust income). At present the basic rate is 30 per cent
and the additional rate 15 per cent so together the rate
is 45 per cent. Where, therefore, the income of a settlor
is taxed at a rate higher than 45 per cent there can be tax
advantages in transferring income producing assets to
trustees with power to accumulate the income, but if a
settlor is taxed at a rate lower than 45 per cent there are
no tax advantages in this arrangement.

(4) Trustees cannot claim personal reliefs. All trust
income is taxed at basic rate and at the additional rate if
appropriate: the trustees cannot claim any personal reliefs in respect of the trust income, as they are not individuals.

(5) Trust income taxed in hands of beneficiary. The treatment of trust income in the hands of the beneficiary will depend on whether the beneficiary has a vested or contingent right to the income. A vested right means that the beneficiary is entitled as of right to receive the income as and when it arises: a useful test to apply to determine this is to see if his personal representatives would be entitled to the income if the beneficiary died immediately after the income arose. If funds are held by trustees on behalf of an infant and the infant has an absolute right to the income and it is not paid to him by reason only that he cannot give a good receipt, then the income is treated as his and he has a vested interest; most usually, however, an infant's interest will be contingent upon his attaining a specified age or marrying. If the beneficiary has a vested interest (i.e. he is entitled to the income as and when it arises) he is liable to tax on that income whether he receives it in that year or not; he is liable at basic, additional and higher rates, if appropriate, subject to a deduction for expenses properly incurred and paid by the trustees out of the trust income. However, when the trustees have paid tax at basic or additional rates then the payments received by the beneficiary are treated as net amounts from which tax at those rates has been deducted; the grossed-up amounts form part of the beneficiary's total income and he can claim a repayment of tax if appropriate.

Where, however, the title of the beneficiary is
contingent (i.e. liable to be divested on some later event) then the tax treatment of the trust income in the hands of the beneficiary will depend upon whether the income is retained by the trustee or distributed. If such income is retained then it is treated as the income of the trustee and not of the beneficiary: with infants such events will usually occur when the trust deed directs income to be accumulated during minority and where the infant's right to the income is contingent upon his attaining his majority: the trust deed will provide that if he does not attain his majority the income will pass to someone else. If, however, income from a contingent trust is in fact paid to an infant beneficiary, either because it is a discretionary trust and the trustees exercise their discretionary power in favour of the beneficiary, or because it is an accumulation trust and the trustees make payments under the statutory power contained in section 31 Trustee Act 1925, then the income actually distributed will be treated as the beneficiary's income for tax purposes and the same rules as are outlined above for vested interests will apply.

Where income is accumulated (after payment by the trustees of tax at the basic and additional rates) Section 31 Trustee Act 1925 provides that it becomes an accretion to capital: as, of course, payments of capital are not subject to income tax, the payment of the accumulations to the beneficiary will not be further taxed. There is, however, one exception to this rule: payments out of capital can be treated as income in the hands of the beneficiary if they are "of an income character" in the
hands of the beneficiary. The meaning of the phrase was discussed in Brodie's Will Trustees v. IRC¹ and in Cunard's Trustees v. IRC². For this reason trustees who wish to make advancements of capital for children for, e.g. school fees, should take care to make infrequent lump sum payments. If such payments are regarded by the Inland Revenue as being of an income nature the trustees will initially be assessed to tax under Section 16 Finance Act 1973.

(6) **Summary**

To summarise, therefore, a minor will be taxed as a separate person on his earned income and on income from any investments held in his own name (e.g. building society accounts). He will also be taxed on any income from a trust of which a person other than his parent is settlor, if he has a vested right to such income (whether he receives it or not) or if he has a contingent right and actually receives payments of income. Where the minor has a contingent interest in a trust, and the income is accumulated, he is not liable for tax.

All trustees are liable for tax at the basic rate on trust income and trustees of discretionary and accumulation trusts are also liable to pay the additional rate; when beneficiaries are assessed they are treated as having received a net amount after deduction of tax at the appropriate rate or rates and can claim a repayment of tax if appropriate.

1. 1933 17 TC 432.
2. 1945 27 TC 122.
Where a parent is in receipt of income taxed at very high rates there would be many advantages to be gained if he could dispose of tranches of that income to his children: he would not be liable for tax at his high rates on the income so transferred and each child would be able to claim its own personal allowances and other reliefs against such income. Such a transfer could be either of income paid under a deed of covenant, taking advantage of the section 52 procedure mentioned above,\(^1\) or of income-producing assets so that the income became no longer payable to the parent settlor (and taxed as his income) but became payable direct to the child; the assets would of course be held by trustees.

Such an obvious method of tax saving was first prevented in 1914.\(^2\) Those provisions are now found in paragraph 8 schedule 14 (as interpreted by sections 435 and 436) Taxes Act. However, those provisions are now of historical value only as they were amended and widened in 1936 and transfers after 22nd April 1936\(^3\) now come within the provisions of sections 437-444 Taxes Act. These sections comprise Chapter II of Part XVI of the Taxes Act. Part XVI has been referred to above and Chapter II may be shortly summarised as follows:

1. See Chapter 3 page 208 ante.
2. By section 20(1)(C) Finance Act 1922 which was retrospective to dispositions made after 5th April 1914.
<table>
<thead>
<tr>
<th>Section</th>
<th>Side Note</th>
<th>Effect of Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>437</td>
<td>The general rule</td>
<td>If, as the result of any settlement, income is paid to the minor child of the settlor, that income is deemed to be the income of the settlor for all tax purposes.</td>
</tr>
<tr>
<td>438</td>
<td>Accumulation settlements.</td>
<td>Income which may be payable in the future to a child of the settlor is deemed to be the income of the settlor; but there is an exemption for an irrevocable settlement of capital assets if the income is accumulated during the infancy of the child.</td>
</tr>
<tr>
<td>439</td>
<td>Meaning of &quot;irrevocable&quot;</td>
<td>Does not in fact define the word but three types of settlement not deemed to be irrevocable and a further three deemed not to be revocable.</td>
</tr>
<tr>
<td>440</td>
<td>Interest paid by trustees</td>
<td></td>
</tr>
<tr>
<td>441</td>
<td>Adjustments between disponor and trustees</td>
<td></td>
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<td>442</td>
<td>Application where more than one settlor</td>
<td></td>
</tr>
<tr>
<td>443</td>
<td>Power to obtain information</td>
<td></td>
</tr>
<tr>
<td>444</td>
<td>Interpretation</td>
<td>&quot;Child&quot; includes stepchild, adopted child and illegitimate child; &quot;settlement&quot; includes any disposition trust, covenant, agreement, arrangement or transfer of assets. Also defines &quot;settlor&quot; and &quot;income&quot;.</td>
</tr>
</tbody>
</table>

The main rule is contained in section 437 which provides that if, as a result of any settlement, income is paid to the minor child of the settlor that income is deemed to be the income of the settlor for all tax purposes. Section 437(3) contains a saving for amounts of less than £5. Because
of the very wide definition of "settlement" in section 444 an outright gift is caught, as well as a covenant transferring income or the transfer of capital assets into trust. The meaning of the word "settlement" has been discussed in Chapter 3 above and it will be recalled that a bona fide commercial transaction without any element of bounty is not a settlement.¹

Section 438(1)(a) provides that where, in consequence of a settlement, income will or may become payable in the future to or for the benefit of a child of the settlor then it is deemed to be paid to the child (and if the child is an infant and unmarried the income will thus be deemed to be the income of the settlor). Section 438 (1)(b) deals with a settlement for future payments to a class of children and provides that a part of the income, proportionate to the number of unmarried infant children of the settlor, is deemed the settlor's income for tax purposes.

Section 438(2) however exempts from the operation of section 438(1) any income which is the subject of an irrevocable settlement of capital assets the income from which is accumulated during the whole infancy of the child. (Any income which is in fact paid out by the trustees to the child in exercise of the statutory or any other power in section 31 Trustee Act 1925 is deemed to be the income of the settlor).

For any tax saving to be available, therefore, a trust made by a parent settlor must be irrevocable; Section 439 does not define the word but it describes three types of settlement which are not deemed to be irrevocable

¹. See page 220 above.
and a further three types which are deemed not to be revocable. A settlement is not irrevocable if (a) any income or assets can be applied for the benefit of the settlor or the spouse of the settlor (except on the bankruptcy of any child); (b) if the settlement can be determined by any act or default, including an unlimited power of advancement, (but not if such determination cannot benefit the settlor or the settlor's spouse) or (c) if the settlor has to pay a penalty for failure to comply with the settlement. On the other hand a settlement is not deemed to be revocable by reason only that it is a settlement on protective trusts. It will be seen, therefore, that any income arising under a settlement by a parent on an unmarried infant child is deemed to be the income of the parent unless:-

1. the income is accumulated; and
2. the settlement is irrevocable i.e. it cannot possibly benefit the settlor or the spouse of the settlor; and
3. the settlement is of capital assets; (covenanted income is excluded by section 438(2)(a)).

If the income is deemed that of the settlor the usual income tax consequences will follow: it will be taxed at the settlor's highest rates, credit being given however for any tax paid by the trustees. If the income, however, is accumulated in an irrevocable settlement the income will bear tax at the basic and additional rate in the hands of the trustees (section 16 Finance Act 1973). The net income after tax is then treated as an accretion
to capital and no further income tax is paid when it passes to the beneficiary.

Between 1952 and 1969 there was a provision in section 228 Income Tax Act 1952 entitling an infant beneficiary for whom income was accumulated contingently on attaining a specified age to claim, when the contingency actually occurred, any reliefs or exemptions from tax available to him in the years of assessment in which the income arose; the claim had to be made within six years of the occurrence of the contingency. In this way a parent could, in effect, make his own income available for use against the reliefs and allowances available to the child but the provisions are no longer available, having been repealed by section 11(5) Finance Act 1969.

Because all the income of accumulation trusts is taxed at both the basic and the additional rate, such trusts are not advantageous as tax-saving devices for taxpayers whose marginal rate is less than 45 per cent, unless the trust invests in non-income producing assets.

6. Trusts - Parent Settlors who are not Married

The rules outlined in section 5 above (trusts - parent settlors who are married) apply also where financial provision is made by a parent on divorce: the child continues to be the parent's child even after divorce. Accordingly, any agreement on divorce providing for a payment to a child will come within section 437 and the income will be deemed to be the income of the settlor. (Payments to a spouse are discussed in Chapter 3 above).
It is thought that, although financial provision for a spouse could well be without any "element of bounty" there will always be "bounty" in such arrangements for a child, which will therefore constitute a "settlement".

Similarly, any provision for payments to trustees for a child, whether by agreement or following an order of the court, will again bring the income within section 437 (unless, of course, the settlement is an irrevocable settlement of capital assets the income from which is to be accumulated during infancy in which case sections 438 and 439 will apply and the income will be taxed at the basic and additional rates in the hands of the trustee). Where property is set apart as "secured maintenance" it is frequently paid to trustees and the provisions of section 437 and 438 must always be borne in mind.

On the other hand, a payment to a mother for the child will usually be treated as a payment to the mother, with the consequences outlined in Chapter 3.

However, if the court makes an order directing a parent to make payments direct to a child this does not constitute a "settlement" within the meaning of section 437. The Inland Revenue take the view that although there is an element of "bounty" in a separation agreement, a court order is not an "arrangement" as the judge is always acting pursuant to powers granted by the legislation; a court order does not therefore come within the definition of "settlement" and thus the question as to whether there is, or is not, any element of bounty does not arise. 2

Accordingly, a divorced or separated parent can, in this way, transfer income to his child without such income being deemed to be the income of the parent; the child can utilise its own allowances and reliefs against such income. Further, if payments of income are made by the parent out of taxed income then section 52 Taxes Act permits the amounts to be deducted from the parent's income thus giving relief from basic higher and additional rate tax if appropriate.

From a tax point of view, therefore, advantages can be gained by obtaining a court order for annual payments direct to the child; if security is required this should be provided in a separate settlement, making the fund subject to an overriding charge to discharge any payments not made; however, the relief given by the section 52 procedure in fact provides an incentive for the payer to make the payments out of his taxed income.¹

7. Summary

When income tax was introduced child allowances were available for each child as a proportion of the parents' income and a parent was able to provide a separate income for his child by transferring assets to trustees to be held on the child's behalf. After a long and varied history child allowances now no longer exist for the married parent

¹. For the first time, section 33 Finance Act 1982 provides for the "small maintenance payments" procedure (see Chapter 3 page ante) to apply to payments made direct to a child.
and the last remaining allowances (for children resident abroad) were abolished on 5th April 1982. On the other hand, single persons with a qualifying child receive the additional allowance in respect of a child given by section 14 Taxes Act. All parents receive a cash benefit of £5.25 each week for each child, which benefit is not taxable.

As early as 1914 provisions were introduced to prevent a parent transferring income or assets to his child in order to save tax. Now, any income deriving from a settlement made by a parent is deemed to remain the income of the parent unless the settlement is an irrevocable accumulation settlement of capital assets. The previous provision which enabled a child on attaining its majority to use up its previous reliefs and exemptions against accumulated income was abolished in 1969.

The only exception to the rule which deems income derived from a parent to be income of the parent occurs when payments are made direct to a child under an order of the court.

Where a child is in receipt of income from a source other than his parent he is treated in all respects as a separate person with his own set of allowances, reliefs, reduced rates, etc. Most usually the investment property of a child will be held by trustees and the special rules applicable to trusts will apply.

Although for three years from 1969-72 a child's investment income was aggregated with that of his parent, these provisions are not in force today.

The development of the income tax provisions concerning children has seen a shift against the assistance
of child allowances (originally only given for children born in lawful wedlock) and the effectiveness of transfers of assets for the benefit of children towards the complete abolition of child allowances (albeit replaced by cash benefits) and the disallowance of all transfers of assets except for irrevocable accumulation trusts of capital assets.

Divorced parents, on the other hand, now have two important advantages; they are entitled to the additional allowance in respect of a child given by section 14 Taxes Act and, by order of the court, they can effectively transfer income direct to the child in respect of which they themselves can obtain a tax deduction by using the section 52 procedure¹ and the child can claim a repayment of tax up to the level of his personal allowances and other reliefs if appropriate.

¹. Or, since section 33 Finance Act 1982 amended section 65 Taxes Act, by a direct deduction under the authority of section 65(4) if the payments are "small maintenance payments" as defined in section 33(2)(1)(b) Finance Act 1982.
CHAPTER 5 - THE CAPITAL TAXES

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CHAPTER 5

THE CAPITAL TAXES

Section
1. Introductory
2. Stamp Duty
3. Capital Gains Tax
4. The Death Duties
5. Capital Transfer Tax
6. Development Land Tax
7. Wealth Tax
8. Summary

1. Introductory

So far this thesis has considered the income tax provisions only; first as they affect husband and wife, (Chapters 1-3) and then as they affect children (Chapter 4). The income tax rules were, of course, the first in time from the historical point of view and their historical development is of continuing importance as the principles permeate the more recent capital taxes. With the exception of stamp duty, the capital taxes are of modern origin but they must be considered before any attempt can be made to evaluate the complete structure of the taxation of the family unit. The capital taxes will therefore now be considered in the order in which they appeared historically, beginning with stamp duty which is the oldest of the taxes
still in force today. Capital gains tax, the first modern capital tax, was introduced in 1965 and received its first codification in 1979. Capital transfer tax was introduced in 1975 but was preceded by a number of different duties on death; the most significant of these was estate duty. Before referring to the present provisions of the capital transfer tax, therefore, a reference will be made to the now defunct death duties and to some interesting features of estate duty. Development land tax was introduced in 1976; it has not the same widespread application as capital gains tax or capital transfer tax but its provisions are of interest in the context of this thesis as it shows some surprising departures in this respect from the principles adopted for the other taxes. Finally, no survey of the existing capital taxes would be complete without a reference to the wealth tax; the proposals for a wealth tax were considered by a select committee who reported in 1975; a wealth tax has not, in fact, been introduced but the proposals will be referred to as it is interesting to note how it was intended to treat the family unit for the purposes of that tax. To begin, then, a summary of the stamp duty position will be given.

2. Stamp Duty

Stamp duties were first imposed by the Stamp Act 1694 for four years. The present legislation is mainly found in The Stamp Act 1891 as subsequently (frequently) amended. It is a fundamental rule of stamp duty law that
it is a charge on instruments and not on transactions.¹

There are no personal exemptions in stamp duty law as the exemptions all relate to the particular transaction the subject of the instrument, perhaps the most widely known exemption being that for conveyances on sale certified as being below stated limits. It is, perhaps, therefore not surprising that, apart from one special provision of limited application, the legislation contains no special rules for husband and wife. There is no rule that husband and wife should be treated as one person and, indeed, such a rule would be inappropriate in the context of stamp duty. There are no general reliefs, therefore, for spouses, as in the other capital taxes, but no disadvantages resulting from aggregation, as in income tax. On the other hand it is somewhat anomalous that a transfer of property between husband and wife can be specifically exempted from capital gains tax and capital transfer tax but can still be liable to stamp duty.

The special provision of limited application, referred to above, where stamp duty law does recognise the special relationship of husband and wife, is contained in section 74 Finance (1909-10) Act 1910; that section made voluntary dispositions liable to stamp duty. It is understood that the reason for this was that many taxpayers were seeking to avoid the charge of duty on death, levied by estate duty since 1894, by giving away their property in their lifetime despite the provisions of section 11 Finance Act 1900 which brought in lifetime gifts made within one year.

¹. See IRC v. Angus (1889) 23 Q.B.D. 579.
of death.

The Finance (1909-10) Act 1910 sought to counteract this form of tax avoidance in two ways; first by making voluntary dispositions liable to stamp duty and, secondly, by extending the charge to estate duty to gifts made within three years of death; the period of three years was later extended to seven years. These estate duty provisions will be referred to later but here it is interesting to note that the charge to stamp duty on voluntary dispositions specifically exempted gifts "where marriage is the consideration". The estate duty charge on gifts within three years of death was similarly limited.

The meaning of the phrase "where marriage is the consideration" was considered in the case of Rennell v. IRC which will be referred to later and as a result of that case the phrase was more strictly defined. Section 64 Finance Act 1963 provided that the restricted definition for estate duty purposes, introduced by section 53 of the same Act, was to apply for the stamp duty exemption in section 74(5) Finance (1909-10) Act 1910. The relevant capital transfer tax definition, which replaced the estate duty definition in 1975, now appears in paragraph 6 schedule 6 Finance Act 1975 and will be considered later.

Briefly, the effect of these provisions is that only gifts to the parties to the marriage, and their issue and the wife

1. See page 289 post.
3. 1964 AC 173.
4. See page 290 post.
5. See page 297 post.
or husband of such issue, are within the stamp duty exemption.

3. Capital Gains Tax

(1) Aggregation.
(2) Assessment on husband.
(3) Application for separate assessment.
(4) Returns and claims for relief.
(5) Aggregation of gains and losses.
(6) Exemptions.
(7) Disposals between spouses.
(8) Separated spouses.
(9) Settled property.

(1) Aggregation

Capital gains tax was introduced in 1965 and codified in the Capital Gains Tax Act 1979. It provides for a tax (currently at the flat rate of 30 per cent) on a capital gain made on the disposal of an asset. The principles governing its application to husband and wife closely follow those already described for income tax. Husband and wife are, in the main, treated as one person; the assessment is made on the husband who completes the relevant returns, but there is an option for separate assessment. All gains and losses are aggregated; only one set of exemptions is given but on the other hand no charge to tax arises where spouses dispose of property to one another. When the spouses separate they are once more treated as two persons. There are no special capital gains tax rules affecting children but, as mentioned in Chapter 4, the tax treatment of settled property is relevant where children are concerned as a child's property is frequently held in trust. Each of these facets of the tax will now be considered in turn.
(2) **Assessment on husband**

Section 45(1) Capital Gains Tax Act 1979 provides that the capital gains tax on chargeable gains accruing to a married woman is assessed and charged on the husband. The section does go on to say that this provision does not affect "the amount of capital gains tax chargeable on a man apart from this subsection nor result in the additional amount of capital gains tax charged on a man by virtue of this subsection being different from the amount which would otherwise have remained chargeable on the married woman". The effect of this phrase is obscure, but it may have been included in order to make it absolutely clear that, for example, the gains of a non-resident wife are not the husband's gains. On the other hand specific provisions apply to aggregate gains and losses of married couples and to restrict their exemptions and reliefs; further capital gains tax is a proportionate and not a progressive tax. It is thought therefore that if progressive rates of tax were introduced, and if no special provision were made for husband and wife, the phrase would result in a reduced set of rates being available for each spouse.

(3) **Application for separate assessment**

Section 45(2) Capital Gains Tax Act 1979 contains an option for separate assessment of capital gains. The result of the option is that subsection (1) of the section does not apply and therefore that the assessment will be made on the married woman. The option for separate assessment appears therefore to be procedural only, and does not
operate to remove the special provisions to be considered shortly, e.g. aggregation of gains and losses, unified exemptions and disposals between the spouses. The option appears therefore to follow the principles of section 38 Taxes Act rather than section 23 Finance Act 1971 in the field of income tax.

The application for separate assessment must be made before 6th July in the year next following the year of assessment to which it relates, and when made has effect not only for the year of assessment to which it relates but also for any subsequent year of assessment. A notice to withdraw the application may be given for any subsequent year of assessment.

It might be thought that an application for separate assessment might nullify the right to set unrelieved losses of one spouse against gains of the other, and might remove the exemption for disposals between spouses, but these results do not follow.

(4) Returns and claims for relief

The provisions for the submission of returns and claims for relief are found in section 45(3) Capital Gains Tax Act 1979. As might be expected, they are required from the husband, or from the wife but only if there is an option for separate assessment under section 45(2). The returns referred to in the section are those under either section 8 or section 42(5) Taxes Management Act 1970; section 8, of course, provides for a return of income (and gains) to be made on request from the Inland Revenue and section 42(5) provides for the making of claims for relief.
(5) Aggregation of gains and losses

Capital gains tax is assessed at a flat rate of 30 per cent and so, of course, aggregation of gains by itself brings no disadvantages. Further, the fact that the losses of husband and wife are also aggregated can be advantageous as it can accelerate the giving of loss relief.

Initially, gains and losses of husband and wife are calculated separately for each spouse, losses incurred by either spouse being set primarily against that spouse's gains. The normal rule for other taxpayers is that if the allowable loss accruing in a year of assessment exceeds chargeable gains the excess may be carried forward and deducted from the chargeable gains of a subsequent year (section 4(1) Capital Gains Tax Act 1979) but not of an earlier year (section 29(5) Capital Gains Tax Act 1979). However, section 4(2) provides that the unrelieved losses of one spouse can be set against the gains of the other. Such a provision might, however, not always be welcome; the spouse with the losses might prefer to carry them forward for use against his own future gains, rather than reducing the tax charge on his spouse's gains; the subsection therefore contains a proviso that it shall not apply if either spouse makes an application to the Board.

As mentioned above, it might have been expected that an option for separate assessment would preclude the right to set off unrelieved losses of one spouse against gains of the other but this does not appear to be the case.
(6) **Exemptions**

For the purposes of the capital gains tax exemptions husband and wife are treated as one person and the rule is followed strictly. Two main exemptions require discussion; the exemption for the first £5,000 of gains and the exemption for an only or main residence.

(a) **The first £5,000 of gains.** Section 5 Capital Gains Tax Act 1979 (as amended) gives an individual exemption for the first £5,000 of gains made in any year; section 5(6) however provides that, for this purpose, special rules apply to husband and wife and that these are set out in schedule 1. Paragraph 2 schedule 1 contains the special rules: husband and wife are given only one exemption to be divided between them either as they agree or, if their aggregate chargeable gains exceed £5,000, then in proportion to their respective taxable amounts for that year.

(b) **The only or main residence.** Section 101 Capital Gains Tax Act 1979 gives relief from capital gains tax where an individual realises a gain on the disposal of his only or main residence. Although the section recognises that 'an individual' might have two or more residences, and permits him to choose which is to have the exemption, (see sub-section (5)), a husband and wife are only allowed one residence between them (sub-section (6)). If husband and wife have two residences any choice relating to the exemption must be made by both; no doubt if they cannot agree the question will be "concluded by the Inspector" within sub-section 5(b) leaving either husband or wife to appeal to the General Commissioners or the Special Commissioners. An unenviable task for the Inspector.
Section 102 provides that, in general, the relief is only available for so long as the individual actually occupies the dwellinghouse; there are, however, some exceptions to this rule and, in particular, absence by reason of employment outside the United Kingdom can be ignored if it occurs between periods of occupation.

Difficulties could arise if, say, a wife owned property on which relief was to be claimed but was absent from it because she accompanied her husband abroad while he was employed outside the United Kingdom. Because the wife owned the property, and because her absence abroad was not by reason of her employment outside the United Kingdom, her absence would not be ignored and relief would be reduced. This problem has been recognised by the Inland Revenue and extra-statutory concession D3 provides that the owning spouse can still claim exemption for absence abroad by reason of employment even if it is the non-earning spouse who is so absent. It is understood that the concession also applies where property is jointly owned.

(7) Disposals between spouses

The concept of treating husband and wife as one person is carried through to cases where property is disposed of by one spouse to the other. Section 44 Capital Gains Tax Act 1979 provides that, in such a case, neither a gain nor a loss arises. Paragraph 17 schedule 5 then provides that, on a subsequent disposal to a third party, the gain or loss is computed by reference to the acquisition of the first-owning spouse, thus bringing in the complete
gain or loss during the period of ownership of both spouses.

Before 1980 the exemption from a charge when one spouse disposed of property to another was a valuable relief but section 79 Finance Act 1980 now provides a similar relief for gifts between other individuals. The relief in section 44 will, however, remain relevant for transfers between spouses for a consideration; if the Inland Revenue view is right that property transfers on divorce are not "disposals by way of arm's length" within the meaning of section 79 Finance Act 1980 but are "in consideration of the renunciation of further claims by the transferee" then section 44 could be useful to provide an exemption if such transfers can be concluded before the spouses cease to live together within the meaning of section 42 Taxes Act.

(8) Separated spouses

Section 45 Capital Gains Tax Act 1979 only treats husband and wife as one person for capital gains tax purposes while the wife is a "married woman living with her husband". Section 155(2) of the same Act provides that references in the Act to a married woman living with her husband "shall be construed in accordance with section 42(1) and (2) of the Taxes Act". It will be recalled that under that section a married woman is treated as "living with her husband" unless they are separated under an order of the court, or by deed of separation, or they are in fact separated in such circumstances that the separation is likely to be permanent. Accordingly after separation a husband and wife once more become treated as two persons.
The change does not, however, take place until the year of assessment following the separation: section 45(1)(b) provides that the aggregation rule applies to a woman who is living with her husband "in a year of assessment or any part of a year of assessment beginning with 6th April". So, in the year of marriage the woman will be assessed separately; in the year in which the separation occurs she is treated as if married; and if a reconciliation is effected she is treated as separated in the year of the reconciliation.

The view has been expressed\(^1\) that the phrase "and in the case of a woman who in that year of assessment is a married woman living with her husband" which appears in section 44 Capital Gains Tax Act 1979 means that for the relief to apply a married woman only has to be living with her husband if she was the disponor and that the conditions did not have to be satisfied where the husband was the disponor. This view can no longer be maintained in view of the recent decision in Gubay v. Kington\(^2\). It is understood that although the taxpayer intends to appeal against the decision, this particular point will not be taken further.

In the year of assessment following separation, therefore, the wife will be assessed in respect of her own gains and must make her own returns and claims for reliefs; the losses of one spouse can no longer be set against the gains of the other but each spouse will be entitled to a relief for gains not exceeding £5,000 in each year and a

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2. [1981] STC 721. For a fuller discussion see Chapter 1 page 92 ante.
separate relief for an 'only or main residence'.

Another effect of separation is that a disposal between spouses will no longer attract the relief under section 44 but of course can take advantage of the relief under section 79 Finance Act 1980 if it is a disposal 'not at arm's length' within the meaning of that section. Because most divorce proceedings occur when the parties are separated for tax purposes, any transfer of property to give effect to an order of the divorce court for financial provision would not obtain the relief in section 44 and would involve a charge to capital gains tax on a consideration equal to market value. In any event, a court order under section 24(3) Matrimonial Causes Act 1973 does not take effect unless and until the decree is made absolute so there can be no disposal in such a case until after the parties have ceased to be married. It is thought that once the order is enforceable the transferor will hold the property as bare trustee for the transferee and thus the date of disposal will not be postponed to the subsequent transfer.

It appears that the Inland Revenue take the view that the relief in section 79 Finance Act 1980 cannot apply as a transfer following a court order is not "a disposal otherwise than under a bargain at arm's length" within the meaning of that section. The Inland Revenue take the same view of property transfers made by agreement in divorce cases where there is no court order. They say that whether the transfer of property is made voluntarily or by order of the court, it is made "in consideration of the renunciation
of all claims by the transferee" and cannot therefore obtain the relief in section 79 Finance Act 1980. It is thought, however, that financial provision on divorce does not involve a renunciation of rights but is merely declaratory of existing rights or obligations. If this is so, section 79 Finance Act 1980 could apply and the court could make it a term of the order that the wife should make the necessary election.

It will be recalled that, for income tax purposes, it is accepted that court orders do not constitute "settlements" for the purposes of section 437 Taxes Act (which deems the income of property transferred from parent to child to remain that of the child). On the other hand voluntary transfers have been treated on some occasions as settlements for income tax purposes, the usual example being a separation deed giving benefits to both spouse and child (see Chapters 3 and 4). It would appear, therefore, that a spouse might be able to argue for income tax purposes that a separation deed constituted a consideration for her renunciation of claims against her ex-husband; that thus there was no element of bounty; and thus there should be no "settlement" for income tax purposes. A child on the other hand, might find such an argument difficult. To return to capital gains tax, it is clearly advantageous if property transfers following marriage breakdown are made in the same year of assessment as the separation although in practice this must be difficult. A particular capital gains tax problem can arise where the spouses separate and the spouse who either owns the property or an interest in
it ceases to occupy the matrimonial home. Subsequently, as part of the financial settlement on divorce, that spouse might dispose of the home (or his interest in it) to the other spouse. Because the owning spouse has ceased to occupy the property the exemption for a private residence is, strictly, lost and a capital gains tax charge should arise on the transfer (although this would be reduced under the time apportionment rules by reference to his period of actual occupation). However, the strict position is ameliorated by extra-statutory concession D6 which provides that in the circumstances mentioned the home may continue to be regarded as the residence of the transferring spouse from the date his occupation ceases until the date of transfer, thus preserving the exemption. However, throughout this period it must have been the transferee spouse's only or main residence and, if the transferring spouse has another residence, he must not have elected that the exemption should apply to that other residence.

9. Settled property

Because settlements are relevant to tax considerations within the family unit, and especially children, a short note will here be included about the application of capital gains tax to settlements. There are special provisions where property is held by a trustee for "any person who would be absolutely entitled against the trustee but for being an infant". Section 46 Capital Gains Tax Act 1979 provides that in these cases the Act applies as if the property were vested in the infant; so, acquisitions
from and disposals to the infant by the trustees are disregarded.

The meaning of section 46's predecessor was considered in Tomlinson v. Glyn's Executor & Trustee Co. In 1960 Mr. Knox set up a trust for the benefit of "such of the children of his son Gerald as should be born before the closing date and should attain the age of 21 or marry under that age". The closing date was the day on which the first child attained 21. At the time of the hearing there were four children under 11.

The trustees disposed of investments and were assessed to capital gains tax at 30 per cent; if the section had applied and the children had been assessed directly, their individual exemptions would have reduced the assessment to nil.

The trustees therefore appealed on the ground that the children were "persons who would be absolutely entitled against the trustee but for being an infant" within the meaning of the predecessor to section 46.

Although the special commissioners agreed, both the High Court and the Court of Appeal held that the assessment had been properly made on the trustees. The Master of the Rolls said:—

"In my opinion those words are directed to a case where property is held by a trustee for a person who would be absolutely entitled to call for the payment but for the fact that he is an infant or is of unsound mind. If his infancy or other disability is the only impediment which prevents his being absolutely entitled then he can be regarded as an ordinary individual and he is entitled to the benefit of the alternative rate...."

1. (1970)Ch.112.
In the present case, none of these four children, if they were not infants, would be absolutely entitled at that time to call for the money or to give the trustees a proper receipt. Their interests were contingent on their living to the age of 21. They were defeasible pro tanto if other children were born. The section only applies where the child has...a vested and indefeasible interest in possession. None of these four children came within that category. None of them was absolutely entitled to the money. Each of their interests was defeasible and contingent. It might never vest at all.

As regards other types of settled property, section 53 used to provide that a gift into settlement was a disposal of the entire property becoming settled but this must now be read subject to the provisions of section 78 Finance Act 1981 which provides an exemption for gifts into settlement. A charge to capital gains tax does arise when the settlement comes to an end, except on death: Section 54 provides that when a person becomes absolutely entitled to settled property as against the trustee all the assets are deemed to have been disposed of at market value. The same rule applies when a life interest in possession terminates and assets remain subject to the settlement (section 55). Where a life tenant dies, however, there is no charge (section 56). Finally, when an interest in a settlement is disposed of there is no chargeable gain (section 58) although special rules were contained in section 88 Finance Act 1981 about the disposal of interests in non-resident settlements.
4. The Death Duties

(1) Probate Duty.
(2) Legacy Duty.
(3) Succession Duty.
(4) Account Duty.
(5) Estate Duty.
(6) The surviving spouse exemption.
(7) The "small" exemption for widow or widower.
(8) Gifts made in consideration of marriage.

Capital transfer tax, which was introduced in 1975, was preceded by a number of duties payable on death. The main such duties were Probate Duty (1694 - 1894), Legacy Duty (1780 - 1949), Succession Duty (1853 - 1949), Account Duty (1881 - 1894) and Estate Duty (1894 - 1975).

(1) **Probate duty** was a flat rate tax. When it was abolished in 1894 it was 3 per cent and was payable in respect of almost all property passing on death except land. There were no specific provisions for spouses or children.

(2) **Legacy duty** was payable on all legacies or shares in personal residue; again land was not included. When it was introduced in 1780 there was an exemption in favour of husband and wife and the rate depended on the relationship between the legatee and the deceased ranging from 1 per cent for legacies to a parent or child, 3 per cent for a brother or sister, 5 per cent for an uncle or aunt, 6 per cent for a great uncle or great aunt and 10 per cent for other legatees. The rates were adjusted in 1910 and the duty was then imposed on husband and wife at the 1 per cent rate.

(3) **Succession duty** filled the gaps in legacy duty, as it
applied to real property and to all other property passing on death not subject to legacy duty. The rate of succession duty depended on the relationship of the 'successor' to the 'predecessor'; here again, property passing between husband and wife was exempt until 1910 when duty was imposed at the rate of 1 per cent.

(4) **Account duty** was in reality a stamp duty, with no reliefs or exemptions for members of the family.

(5) **Estate duty.** When Estate Duty was introduced in 1894 it contained no specific exemptions or reliefs for spouses or children. Subsequently two reliefs were introduced for spouses; the "surviving spouse exemption" for settled property in 1914 and the "small exemption"of £15,000 for a widow or widower in 1971. Special rules for lifetime gifts were introduced in 1910 and an exemption was incorporated for "gifts in consideration of marriage". Each will now be considered briefly.

(6) **The surviving spouse exemption.** Section 14 Finance Act 1914 established the principle that estate duty was levied in respect of settled property on every death but there was an exception in the case of the parties to a marriage. So, if estate duty had been paid in respect of settled property on the death of one of the parties to a marriage it was not payable on the death of the other party to the marriage (unless the latter was competent to dispose of the property). Although, no doubt, this was a welcome relief, it had its limitations. First, it only
applied to settled property in respect of which the surviving spouse enjoyed a limited interest; it did not apply to property passing to a spouse absolutely. Secondly, the duty was payable on the first death, the exemption being given on the second: thus, the property available for the use of the surviving spouse was diminished by the payment of the duty on the first death but the relief became available when the surviving spouse died and the property passed to the remainderman under the settlement. The benefit of the relief was thus enjoyed by the remainderman (who might be a stranger to the spouses) and not by the surviving spouse. As will be seen neither of these disadvantages apply to the capital transfer tax spouse exemption.

(7) The "small" exemption for widow or widower. Section 121 Finance Act 1971 introduced three important estate duty reliefs; first all property left to a "heritage body" was exempt without limit; secondly, property given to a charity was exempt up to a limit of £50,000; finally, property devolving on the deceased's widow or widower was exempt up to a limit of £15,000. In addition there was already in existence exemption for estates below a certain figure; in 1971 this was £10,000 and section 120(2) Finance Act 1972 increased this to £15,000. There was thus a total exemption of £30,000 so long as at least £15,000 was left to a surviving spouse.

(8) Gifts made in consideration of marriage. Estate duty was originally a tax on death but Section 11 Finance Act 1900 brought within the charge gifts made within one year
of death; this period was later increased by stages to three years by section 59 Finance (1909-10) Act 1910 and later to seven years. Section 59(2) however introduced an exemption for gifts made within three years before death if they were made "in consideration of marriage". The meaning of this phrase was considered in Rennell v. IRC. 1

In that case the deceased, on the occasion of his daughter's marriage, settled property on discretionary trusts for the benefit of his whole family some of whom were within the marriage consideration and some of whom were outside it. The deceased died within five years (the then "statutory period") of the making of the settlement and the question then arose as to whether it came within the estate duty exemption for "gifts in consideration of marriage". The House of Lords held that the relevant statutory provisions exempted from estate duty, without qualification, gifts which were made in consideration of marriage and that there was no justification for limiting the exemption to persons within the marriage consideration.

The case was first heard in 1961 and the Inland Revenue did not wait for the case to reach the House of Lords before amending the law. Section 63 Finance Act 1963 was enacted to restrict the estate duty exemption either to outright gifts to a party to the marriage or to settled gifts when the benefits could only be enjoyed by persons entitled under 'normal' marriage settlements, usually the issue of the marriage or the husband or wife of such issue. As has been seen section 64 of the same Act similarly

1. (1964) AC 173.
restricted the stamp duty exemption. The relevant capital transfer tax provisions, which have now replaced the estate duty provisions in section 63 Finance Act 1963 appear in paragraph 6 schedule 5 Finance Act 1975 and will be considered later.

There appear to have been no special estate duty rules relating to children.

5. **Capital Transfer Tax**

1. Transfers between spouses.
2. Exemptions available to each spouse.
3. Transitional provisions - the surviving spouse exemption.
5. Gifts for maintenance of the family.
7. Settled property.

Capital transfer tax was introduced in 1975 and replaced estate duty. Tax is charged on all lifetime gifts as well as on property passing on death. The provisions for spouses can be simply stated: all transfers between spouses are exempt (thus reinforcing the 'one person' rule) but spouses obtain a complete set of reliefs and exemptions each (thus departing from the 'one person' rule). There are also some transitional provisions dealing with the old 'surviving spouse exemption' under estate duty. Two other aspects of capital transfer tax have a special relevance for spouses and children; first, the continuing exemption for gifts made in consideration of marriage and, secondly, the special provisions for gifts made for the maintenance of members of the family. As with capital gains tax, a discussion of this tax will conclude with a reference to the charges on settled property and the position of separated
spouses.

(1). Transfers between spouses.

Schedule 6 Finance Act 1975 describes a number of transfers which are exempt from a charge to capital transfer tax. Paragraph 1 deals with transfers between spouses. The exemption applies whether the gifts are made during lifetime or on death and whether the property is settled or not. There is usually no limit to the exemption except where the transferor spouse is domiciled in the United Kingdom and the transferee spouse is domiciled overseas in which case there is a cumulative limit of £55,000 to the exemption.

The exemption is stated to be subject to the provisions of Part II of the schedule; these are found in paragraph 15 and their effect is to nullify the inter-spouse exemption where:-

(1) the transfer is not immediately in favour of the spouse; however, many wills provide, for example, that the surviving spouse should only benefit if he or she survives for a specified period and such a transfer is specifically saved from withdrawal of the exemption (paragraph 15(1)); or

(2) the transfer is made on a condition which is not satisfied within twelve months, (paragraph 15(2)); or

(3) the property is given in consideration of the transfer of a reversionary interest which is excluded property (paragraph 15(2A)); or
(4) the reversion falls in after a person has acquired a reversionary interest for a consideration in money or money's worth (paragraph 15(4A)).

The exemption for transfers between spouses reinforces the treatment of the spouses as one person.

(2) **Exemptions available to each spouse**

On the other hand, the 'one person' rule is surprisingly departed from when the other exemptions from capital transfer tax are considered; one would have expected that, like capital gains tax, only one set of exemptions would be available between the two spouses. However, these exemptions are available to both husband and wife. It is not quite clear why this was decided upon; although both husband and wife had their own exemptions for estate duty purposes there are two major distinctions between estate duty and capital transfer tax; first, there was no exemption for transfers between spouses for estate duty purposes (other than the limited interest for surviving spouse); and, secondly, estate duty, being chargeable mainly on death was a 'consecutive' tax - the spouses being unlikely to die together, the use of the separate exemptions given to each was not likely to occur at the same time. Whatever the reason for giving each spouse a set of exemptions, they are no doubt most welcome as the exemptions are quite valuable. They are mainly found in schedule 6 but most important is the general exemption for cumulative

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1. For a personal theory on this, see page 192 post.
transfers for each individual under £55,000 and the reduced rates set out in the Tables to section 37 Finance Act 1975 as amended. Here are the exemptions in schedule 6:

paragraph 2: Transfers not exceeding £3,000 in any one year.
paragraph 4: Gifts not exceeding £250 to the same person each year.
paragraph 5: Normal expenditure out of income.
paragraph 6: Gifts in consideration of marriage (details later).
paragraph 10: Gifts to charities on death not exceeding £250,000.
paragraph 11: Gifts to political parties on death not exceeding £100,000.
paragraph 12: All gifts "for national purposes".
paragraph 13: All gifts "for public benefit".

Because of the exemption for transfers between spouses it is possible, say, for a husband wishing to make a gift of £6,000 in any one year to transfer £3,000 direct to the donee and £3,000 to his wife who can then transfer it to the donee. Both spouses would thus have utilised their paragraph 2 exemption and the gift would be completely exempt. However, in arrangements such as these the "associated operations" rule must always be borne in mind.

Section 44 Finance Act 1975 contains rules designed to prevent the avoidance of tax when a gift is made by a number of transactions referred to as "associated operations", even though one or more of these is not by itself a transfer of value. Broadly, operations may be "associated" if they affect the same property or form a chain of linked operations. They may take place at different
times and do not necessarily have to be made by the same person; two operations are "associated" if one is effected with reference to the other, or with a view to enabling the other to be effected, or facilitate its being effected".

This particular provision could apply to transfers made by husband and wife, in particular to the case mentioned earlier where the husband makes an exempt gift to the wife who then utilises her own exemptions and "passes the gift on".

The Inland Revenue issued a Press Notice on 8th April 1975 stating their view of the application of the associated operations rule to gifts by husband and wife as follows:—

"Section 44 is not seen as affecting the ordinary case where a gift between husband and wife is followed by a gift by the recipient spouse to a third party unless it was a condition of the first gift that the second should be made. It may, however, be apt to apply in more complex situations where a transfer between husband and wife forms part of a series of associated operations...which as a whole are merely the means whereby one of them makes a disposition in favour of a third party".

The effect of these views is illustrated in a useful example published in Dymond's Capital Transfer Tax (1977 Edition) at page 89 as follows:—

"If a husband transfers, say, £5,000 to his wife and she, of her own volition, subsequently gives £5,000 to her son, and the husband gives another £5,000 to the son directly each £5,000 gift to the son may obtain any exemption available to the particular spouse...even if the husband thought it likely that the wife would make such a gift: and each gift will pay tax only at the rate applicable to the particular spouse. On the other hand, if the gift to the wife had been made on condition that she passed the money on to the son the associated operations clause will be applied so as to
constitute the £5,000 given by the wife a disposition by the husband to the son which will have to be aggregated with his own gift of £5,000, and viewed in the light of any previous chargeable transfers made by him, for the purpose both of ascertaining the rate of the tax and the extent of any exemption of either gift".

It is doubtful, however, whether it could in fact be possible for spouses to prove that a "gift on" was not an associated operation and the Revenue's views appear, therefore, to operate as a concession.

(3) **Transitional provisions - the surviving spouse exemption**

When discussing estate duty reference was made to section 14 Finance Act 1914 which imposed a general charge to estate duty on settled property but which provided that where settled property had borne duty on the death of one spouse no further duty was payable on the death of the surviving spouse if the latter had had only a limited interest (the surviving spouse exemption).

When a spouse died before 13th November 1974 (the date when capital transfer tax came into force) estate duty may have been paid on the death in the expectation that if the surviving spouse took only a limited interest no further duty would be payable on the second death. As has been seen, however, capital transfer tax gives the exemption on the first death and not on the second so such property would have lost its exemption. Accordingly, section 22(4) Finance Act 1975 provides relief in these circumstances and there is no charge to capital transfer tax on the death of the surviving spouse with a limited interest in property in respect
of which estate duty had been paid. Paragraph 4 (7) Schedule 5 gives a similar relief where the interest is disposed of or comes to an end otherwise than on death.

(4) Gifts in consideration of marriage

It has been seen that since 1910 relief from both stamp duty and estate duty was available for gifts "in consideration of marriage" and that since 1963 relief was limited to those cases where the gift was made to the party to the marriage or some other person within the normal marriage consideration, being the issue of the marriage or the wife or husband of such issue.

The detailed rules which apply for capital transfer tax are now found in paragraph 6 schedule 6 Finance Act 1975. Gifts by a parent are exempt up to a limit of £5,000; gifts by one of the parties to the marriage or a grandparent are exempt up to a limit of £2,500; and other gifts are exempt up to £1,000. It will be recalled that husband and wife have an exemption each.

(5) Gifts for the maintenance of the family

Section 46 Finance Act 1975 provides a useful exemption from capital transfer tax for gifts for the maintenance of a spouse, including a former spouse. As will be seen, this is helpful when dealing with financial arrangements on divorce.

A gift for the child of the donor or his spouse is also exempt so long as it is for the maintenance, education or training of the child up to the age of 18 years
or until the completion of full time education if later. This is a most useful exemption as otherwise payments for school fees would most likely be charged to capital transfer tax; usually these are in excess of £3,000 per annum and usually are not part of "normal expenditure out of income". Apart from this provision, there is no capital transfer tax exemption specifically for disposals to children although, of course, the general exemptions mentioned above can be utilised where transfers are made to children.

In any event, some transfers for the maintenance of the family will be exempt in any event as 'normal expenditure out of income' within the meaning of paragraph 5 schedule 6.

(6) Separated spouses

The capital transfer tax exemptions all apply to "spouses". The word is not defined and would therefore appear to include a separated spouse but not a divorced spouse. But a divorced spouse can obtain exemption for property transfers under section 46 if they are for the maintenance of the ex-spouse; section 46(1) specifically exempts such dispositions made by one party to a marriage in favour of the other party and section 46(6) provides that, in relation to a disposition made "on" divorce or annulment (or a variation of such disposition) "marriage" includes "former marriage". Presumably a property disposal following a divorce or annulment will be considered to be "on" divorce or annulment for this purpose but the position
with regard to lump sums and periodical payments is not entirely free from doubt. Difficulties can also arise as to the meaning of "maintenance" in section 46, and doubts have arisen as to whether the exemption includes lump sum payments to an ex-spouse as well as periodical payments. Published correspondence with the Inland Revenue\(^1\) indicates that capital transfer tax will not be charged on lump sum provision on divorce so long as it is not excessive,\(^2\) on the ground that the donor has no gratuitous intent within the meaning of section 20(4) Finance Act 1975. Similar relief under section 46 will be available for transfers for the maintenance education or training of children after divorce in the same way as during marriage. If income payments are made to a former spouse after divorce the 'normal expenditure out of income' exemption in paragraph 5 schedule 6 will probably also be available.

(7) **Settled property**

The capital transfer tax charge on settlements distinguishes between settlements with an interest in possession and settlements with no interest in possession, and there are special rules relating to children's maintenance and accumulation settlements. The provisions are found in schedule 5 Finance Act 1975 as amended by sections 101 - 127 and schedule 15 Finance Act 1982.

(a) **Settlement with an interest in possession.** A charge

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2. This will reduce the incidence of husbands existing applications to make decrees absolute before all property is transferred.
to capital transfer tax will, of course, arise on the settlor when he gives property to a settlement either on its creation or subsequently. The rate of tax and availability of exemptions will depend on the state of the settlor's cumulative total. It appears that a gift into settlement giving a spouse an interest in possession would be exempt. This follows from the combination of paragraph 3(1) schedule 5 (person entitled to interest in possession deemed entitled to the property) and paragraph 1 schedule 6 (transfer exempt where property becomes comprised in spouse's estate).

After the settlement has been created the person with the interest in possession is treated as owning the property beneficially. Although a further charge to capital transfer tax arises when the interest in possession terminates, whether during the beneficiary's lifetime or on his death, the tax is calculated by reference to the state of the beneficiary's cumulative total. There is, however, no charge if the property reverts to the settlor and, because spouses are treated as one person, there is no charge if the property reverts to the settlor's spouse.

(b) Settlements with no interest in possession - 'discretionary trusts'. The charge on the creation of a settlement with no interest in possession is again by reference to the settlor's cumulative total when the settlement is created. Further charges to tax are made on each ten year anniversary of the trust and when payments out of the trust are made, an appropriate fraction of the ten yearly charge becomes payable.¹

Usually, therefore, the tax burden on discretionary trusts is frequent and, as we have seen, this type of trust is frequently used for children, either under sections 31 and 32 Trustee Act 1925 or to take advantage of the income tax provisions which encourage irrevocable accumulation settlements for children in certain circumstances.

(c) Children's maintenance and accumulation trusts. Special rules are contained in paragraph 15 schedule 5 which apply to children's maintenance and accumulation trusts. These are trusts where there is no interest in possession and one or more persons will become entitled to the property, or an interest in it, by the age of 25. The income must be payable for the maintenance, education and benefit of the children or accumulated. If the conditions set out in paragraph 15 are complied with there may be a charge to capital transfer tax when the settlement is created (depending on the settlor's available reliefs) but no further charge arises when payments are made out of the settlement and there is no periodic charge. It will be seen that 'paragraph 15 trusts' closely coincide with the income tax advantages for irrevocable accumulation settlements for children described in Chapter 4.

6. Development Land Tax

Development land tax was introduced in 1976; it is charged on persons who realise development value from disposals of interests in land in the United Kingdom. From the point of view of this thesis it is a most interesting
tax because it represents a complete departure from the principle of treating husband and wife as one person.

In some respects the tax is similar to capital gains tax; for example, there is an exemption for the first £50,000 of development value in each financial year (section 12 Development Land Tax Act 1976) and also an exemption for an 'only or main residence' (section 14). The relief under section 12 is available to 'any person' and that under section 14 is available to 'any individual'. Because there are no specific references to husband and wife each can claim a £50,000 exemption and each can claim an exemption for an 'only or main residence'.

Section 15 Development Land Tax Act 1976 provides for an exemption when a person builds a dwellinghouse, on land owned on 12th September 1974, for occupation by himself or an adult member of his family. This means his spouse, or their children over 18 or their parents and children's children or parents of divorced spouses. On the other hand there is no exemption in development land tax for transfers between spouses.

7. Wealth Tax

(1) Husband and wife.
(2) Minor children.

There is as present no wealth tax in the United Kingdom but a Green Paper was published in August 1974 (Cmd 5704) with proposals for such a tax and it was referred to a Select Committee on the 12th December 1974 "to consider the Green Paper proposals for a wealth tax
and to report thereon". The Select Committee reported on 11th November 1975 (H.C. 696.1) to the effect that they had been unable to agree upon a Report. However, the proceedings of the Committee were published and included draft Reports proposed by the Chairman (Mr. Douglas Jay), by Mr. John Purdoe, by Dr. Jeremy Bray, by Mr. Maurice Macmillan, and finally the Chairman's first draft Report as amended by the Committee but not adopted.

The views of these members, about the treatment of the wealth tax in the family unit, are of interest: the position of husband and wife will be considered first, and then that of minor children.

(1) **Husband and wife**

Paragraphs 8 and 9 of the Green Paper offered a choice between two methods of treating married couples for wealth tax purposes; their wealth could be aggregated following the income tax practice and taxed on the wealth of one person but with a higher threshold and higher rate bands. Alternatively, each spouse could be taxed as a separate single person in respect of his or her wealth, as for estate duty and capital transfer tax.

It is interesting to note the departure from the strict aggregation rules, both in the proposal for a higher threshold and higher rate bands and also in the alternative proposal for treatment of husband and wife as two separate single persons. (Here it may be recalled that development land tax was in fact introduced shortly afterwards (1976) adopting the treatment as two separate
single persons). The Chairman's first draft report (paragraph 49) found difficulties with both these suggestions and recommended the adoption of a "quotient" system "under which the spouse's wealth is aggregated but the tax charged is twice the tax which would be payable on half the aggregate wealth". Mr. John Pardoe and Mr. Maurice Macmillan agreed with this approach: Dr. Jeremy Bray disagreed. He favoured complete aggregation on the grounds that this reflected "the realities of the matrimonial situation". He said:

"It should be appreciated that the effect of separate assessment would be simply to double the threshold and substantially reduce the rates for most taxpayers. If separate assessment is granted the rates should be reconsidered" (paragraph 19).

However, when the Chairman's first draft report was amended by the Committee it contained the recommendation for the "quotient" system and not that for complete aggregation. Dr. Jeremy Bray was in a minority.

(2) **Minor children**

The Green Paper proposed that the wealth of minor children should be aggregated with their parents' "on the grounds that the parents' own wealth is to a certain extent freed of claims against it by the child; that if, as the Government intends, aggregation of children's income is re-introduced, aggregation of wealth follows: and that any other course would encourage reduction of liability by wealth splitting".

The Chairman's first draft report recommended that aggregation should be the rule where the child was a
minor and unmarried except that compensation for personal injury should be excluded; he did not think it unreasonable to give a modest allowance in respect of each child but, if that course was unacceptable, he recommended that a first slice of a child's wealth should be exempt from aggregation (paragraphs 51 - 56). Mr. John Pardoe agreed with the Chairman's comments and Mr. Maurice Macmillan did not comment on the proposals for minor children. Dr. Jeremy Bray agreed with the case for aggregation but not with the child allowance "since the relief granted a wealthy family by the income tax child allowance is already quite sufficient by comparison with family allowances received by a poor family". The final version of the Chairman's Report did not differ from the first draft.

8. Summary of Capital Taxes

A review of the capital taxes reveals that the principle of aggregation was strictly adhered to in 1965, when capital gains tax was introduced; that it was both adhered to and departed from in 1975 when capital transfer tax was introduced and that it was completely abandoned in 1976 for development land tax. The Green Paper on the wealth tax adopted an ambivalent approach but the Committee, while not agreeing on any recommendation, amended a report putting forward a "quotient" system.

The following table illustrates the historical progress:
(A) = Married couple obtaining an advantage over two single taxpayers.

(D) = Married couple at a disadvantage compared with two single taxpayers.

(N) = Married couple in same position (neutral) as two single taxpayers.

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<td>No estate duty exemption for property left to spouses (N).</td>
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<td>Stamp duty exemption for gifts in consideration of marriage (A).</td>
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<tr>
<td>1910</td>
<td>Estate duty exemption for lifetime gifts in consideration of marriage (A).</td>
<td></td>
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<tr>
<td>1914</td>
<td>Estate duty limited interest for surviving spouse exemption (A).</td>
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<tr>
<td>1965</td>
<td>Capital gains tax - both husband and wife assessed on husband (D).</td>
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<tr>
<td>1965</td>
<td>Capital gains tax - possible to apply for separate assessment (N).</td>
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<tr>
<td>1965</td>
<td>Capital gains tax - husband must submit forms and claims (D).</td>
<td></td>
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<tr>
<td>1965</td>
<td>Capital gains tax - aggregation of gains and losses - unrelieved losses of one spouse set against gains of other (A).</td>
<td></td>
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<tr>
<td>1965</td>
<td>Capital gains tax - only one £5,000 exemption (D).</td>
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<tr>
<td>1965</td>
<td>Capital gains tax - only one residence exemption (D).</td>
<td></td>
</tr>
<tr>
<td>Date</td>
<td>Rule of aggregation applied</td>
<td>Rule of aggregation departed from</td>
</tr>
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<td>------</td>
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<tr>
<td>1965</td>
<td>Capital gains tax - no tax on disposals between spouses (A). But note: the value of this relief reduced by section 79 Finance Act 1980 which gave similar relief to gifts between other individuals.</td>
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<tr>
<td>1965</td>
<td>Capital gains tax - separated spouses assessed as two persons (N).</td>
<td></td>
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<tr>
<td>1971</td>
<td>Estate duty - exemption for £15,000 left to widow or widower (A).</td>
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<tr>
<td>1975</td>
<td>Capital transfer tax - transfers between spouses exempt (A).</td>
<td></td>
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<tr>
<td>1975</td>
<td>Capital transfer tax - exemption for gifts in consideration of marriage (A).</td>
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<tr>
<td>1975</td>
<td>Capital transfer tax - each spouse has own exemptions (N).</td>
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<tr>
<td>1976</td>
<td>Development Land Tax - each spouse has own exemptions (N).</td>
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<tr>
<td>1976</td>
<td>Development Land Tax - each spouse can have an only or main residence (N).</td>
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<tr>
<td>1976</td>
<td>Development Land Tax - no exemption for transfers between spouses (N).</td>
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<tr>
<td>1975?</td>
<td>Wealth tax proposes a quotient system (A).</td>
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</tbody>
</table>

It will be seen that whereas the abandonment of the aggregation rule will always make spouses neutral as against two other taxpayers, adherence to the rule either brings positive advantages or positive disadvantages to married couples. The advantages occur when the spouses
wish to make large transfers of assets to each other (smaller transfers would be exempt under the rules applicable to all individuals). The disadvantages occur when spouses make transfers to third parties in excess of the single exemption. The benefits will therefore accrue when one spouse owns most of the property; the disadvantages will occur where property owning is roughly equal as between spouses. To this extent the effect of aggregation on the capital taxes is different from the effect on the income tax.

It will also be noted that a change of emphasis occurred in 1975. Before that date the capital taxes had adopted an inconsistent approach to spouses which resulted in married persons obtaining the worst of all worlds; for the death duties they had been treated as two persons, thus resulting in two charges, one on each death; for capital gains tax they had been treated as one person thus substantially reducing their entitlement to reliefs. Capital transfer tax, introduced in 1975, adopted an ambivalent approach which was most advantageous: spouses were treated as one person for the purposes of transfers to each other but as two persons for the purposes of the other reliefs. Development land tax, introduced in 1976, completely abandoned the "unified personality" rule and gave each spouse a full set of reliefs, even an 'only or main residence' relief each. A personal theory to explain this change of emphasis relies on the fact that in 1975 the Sex Discrimination Act was passed. Now that Act only makes illegal discrimination in certain stated areas (e.g.
provision of finance, employment etc). and specifically did not apply to existing legislation. Although, therefore, the Act did not render it illegal to discriminate against women in the tax field, nevertheless it would have appeared remarkably inconsistent for any Government to be legislating with one hand, as it were, to eradicate discrimination while encouraging it with the other hand in the area of taxation. This may be the reason, therefore, why in 1975 and 1976 the capital tax legislation either favoured (or at least did not penalise) married persons.

Unfortunately, the change was short lived because as recently as 1981 husband and wife were once more being treated as only one person for a new set of income tax reliefs.

The capital taxes make little special provision for children. Again, they are as a rule treated as separate persons. Capital transfer tax contains two helpful exemptions for children: the section 46 relief for gifts for their maintenance education and benefit and the paragraph 15 schedule 5 relief for maintenance and accumulation trusts for persons under the age of twenty five. The development land tax exemption for a dwellinghouse built for occupation only extended to an adult child.

If the wealth tax proposals had been adopted the proposed aggregation of a child's wealth with his parents would have introduced a completely new approach, especially in view of the fact that the corresponding income tax provisions only lasted three years and have not been re-introduced.

1. Section 60 Finance Act 1981. (Relief for investment in new corporate trades)
CHAPTER 6

SUMMARY OF PART I

A review of the historical development and the present state of the law concerning the tax treatment of the family unit leaves three main impressions. First, the prolonged attachment to the principle of aggregation, long after it had outlived its useful purpose, and the way in which it has given rise to numerous anomalies and injustices. From time to time attempts are made to remedy the injustices; some remedies give married couples positive advantages over other taxpayers (the 2.56 personal allowances available to a two-earner married couple); some remedies do not go far enough (the option for separate taxation of wife's earnings which did not extend to investment income). But all these attempts only add to the complexity of the system.

Secondly, the deep suspicion in which the family has been held by those responsible for the tax legislation. Clearly tax advantages can be gained where a high rate taxpayer transfers income or income producing assets to a low rate taxpayer and these have been counteracted to some extent by the "settlement" provisions. But the family has been singled out for special treatment; not spouses so much, as of course while spouses are married the principle of aggregation precludes any tax avoidance of this sort, but dispositions to children have been particularly attacked, only the "maintenance and accumulation" trust being grudgingly allowed.
Finally, this Part highlights the positive tax advantages that can flow from separation. The husband can get relief from basic, higher and additional rate tax for maintenance paid and the wife and children can reclaim tax, if appropriate. The wife and children can all obtain single personal allowances. If both separated spouses have a qualifying child they can each obtain the additional allowance of £880 given by section 14 Taxes Act; none of these reliefs is available while the parties remain married.

After separation each spouse obtains a mortgage interest relief limit of £25,000 and a capital gains tax annual exemption for gains not exceeding £5,000; each can have an 'only or main' residence for capital gains tax relief and each can have a threshold of £6,250 of investment income below which the additional rate is not payable. During marriage they have to share all these limits between them, and of course, during marriage, all the wife's investment income is taxed at her husband's highest tax rate.