CORPORATION TAX - Non-resident life assurance company carrying on business in the United Kingdom through a United Kingdom branch - Holding by that insurance company of a portfolio of United Kingdom Government securities - Whether such United Kingdom Government securities were exempt from tax in the hands of the non-resident life insurance company - The chargeable profits of the non-resident life insurance company fell to be assessed on the I minus E basis - Whether such computation of chargeable profits for Corporation Tax purposes on the I minus E basis was a computation for taxation purposes of the profits of any trade or business carried on in the United Kingdom - Section 47 Income and Corporation Tax Act 1988

THE SPECIAL COMMISSIONERS

THE MANUFACTURERS' LIFE ASSURANCE CO LTD Appellant

- and -

ANTHONY CUMMINS

(HM INSPECTOR OF TAXES) Respondent

Special Commissioner: MR T H K EVERETT

Sitting in London on 20 March 2000

Mr Kevin Prosser QC and Miss Elizabeth Wilson of Counsel, instructed by Messrs Ernst and Young, Chartered Accountants, for the Appellant

Mr Launcelot Henderson QC of Counsel, instructed by the Solicitor of Inland Revenue, for the Respondent

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DECISION

The Manufacturers' Life Assurance Company Ltd ("Manulife") appeals against three assessments to corporation tax for the accounting periods ended 31 December 1993, 31 December 1994 and 30 September 1995.

Although in form the appeals are against corporation tax assessments laid on Manulife for the above periods, in reality the dispute between the parties centres on the Inspector's refusal of Manulife's claim to exemption from tax on considerable sums of interest received by it on United Kingdom Government securities which it held for investment purposes during the three years in question.

Section 47(1) Income and Corporation Taxes Act 1988 provided, where relevant, during the relevant accounting periods as follows:

"(1) The interest on securities which -

(a) the Treasury have power to issue for the purpose of raising any money or any loan with a condition that the interest thereon shall not be liable to income tax so long as it is shown that securities are in the beneficial ownership of persons who are not ordinarily resident in the United Kingdom, and

(b) have been issued with such a condition,

shall, … be exempt from tax accordingly."

The question for my decision is whether the interest on United Kingdom government securities received by Manulife during the accounting periods in question was exempt from tax.

There is no dispute between the parties as to the facts and the evidence before me was limited to a short statement of agreed facts and issues as follows:

1. Manulife is a company incorporated and resident in Canada and not resident for tax purposes in the United Kingdom.

2. At all material times until 30 September 1995, Manulife carried on long term life insurance business on a mutual basis, including in the United Kingdom through a United Kingdom branch.

3. The long term life insurance business carried on through the United Kingdom branch included basic life assurance business and general annuity business.

4. On 30 September 1995 the long term life insurance business carried on through the United Kingdom branch was transferred to the Canada Life Assurance Company Ltd by way of a scheme sanctioned by the High Court under Schedule 2C Insurance Companies Act 1982.

5. Before and during the period covered by the appeals Manulife held, inter alia, a portfolio of United Kingdom government securities, as an investment for the purposes of the long term business carried on through the United Kingdom branch.

6. The United Kingdom government securities included Treasury securities ("FOTRA securities") issued on terms that the interest arising would be exempt from United Kingdom tax provided that the securities were held beneficially by persons who were not resident in the United Kingdom (section 47 Income and Corporation Taxes Act 1988), subject however to the condition that the

exemption would "not apply so as to exclude the interest from any computation for taxation purposes of the profits of any trade or business carried on in the United Kingdom."

7. This condition has appeared in identical terms in every Treasury prospectus for FOTRA securities issued between 1940 and 30 September 1995.

8. A list of FOTRA securities held in the years ended 31 December 1993 and 1994 and for the period ended 30 September 1995 was produced in evidence as Appendix 1 to the statement of agreed facts and issues.

9. The interest received on the FOTRA securities during the above periods was:

Year ended 31 December 1993 £ 8,676,859 (tax deducted £1,975,134)

Year ended 31 December 1994 £10,137,000 (tax deducted £2,534,159)

Period ended 30 September 1995 £10,931,377 (tax deducted £2,732,844)

10. In respect of the life assurance and general annuity business of the United Kingdom branch, Manulife was taxable on the I minus E basis.

11. The corporation tax computation submitted to the Inland Revenue by Manulife were produced in evidence as Appendix 2 to the statement of agreed facts and issues. The interest arising on the FOTRA securities was not included in the computations.

12. The sole issue for my decision is whether or not Manulife's I minus E computation is a computation for taxation purposes of the profits of any trade or business carried on in the United Kingdom by Manulife.

Background

Section 22 of the Finance (No.2) Act 1931 provided as follows:

"22. Provisions in cases where Treasury has power to borrow money

(1) Any securities issued by the Treasury under any Act may be issued with the condition that -

(a) so long as the securities are in the beneficial ownership of persons who are not ordinarily resident in the United Kingdom, the interest thereon shall be exempt from income tax; and

(b) so long as the securities are in the beneficial ownership of persons who are neither domiciled nor ordinarily resident in the United Kingdom, neither the capital thereof nor the interest thereon shall be liable to any taxation present or future."

13. In 1938 the House of Lords decided in the case of Hughes v The Bank of New Zealand [1938] AC 366 that the Bank of New Zealand, which was not resident for tax purposes in the United Kingdom but which carried on banking business at a branch office in London, was exempt from tax on interest which it received on War Loan and certain other government securities and that the bank was entitled for the purposes of assessment to deduct from its profits its proper trading expenses including the expenses particularly attributable to the earning of the interest which it received on its holdings of government stock.

14. In order to reverse the effect of the House of Lords decision in Hughes v The Bank of New Zealand the government of the day included in the Finance Act 1940, section 60 which provided as follows:

"60. Extension of power of Treasury to attach exemptions from taxation to securities

(i) The power of the Treasury under section twenty-two of the Finance (No.2) Act 1931 to issue securities with the condition as to exemption from taxation specified in that section shall extend to the issuing of securities with that condition so modified, whether as to the extent of the exemption or the cases in which the exemption is to operate, as the Treasury may specify in the terms of the issue."

15. As appears in paragraphs 6 of the agreed statement of facts and issues, between 1940 and 30 September 1995 every Treasury prospectus for FOTRA securities issued between those dates in the following terms:

"In addition, these exemptions will not apply so as to exclude the interest from any computation for taxation purposes of the profits of any trade or business carried on in the United Kingdom."

16. In order to complete the picture it should be noted that from 1915 until 1993 the investment income of an overseas life insurance company (whether proprietary or mutual) was liable to special charge under Case III of Schedule D. That provision was to be found most recently in section 445 of the Income and Corporation Taxes Act 1988 which was repealed by section 103(2)(a) of the Finance Act 1993 in relation to accounting periods beginning after 31 December 1992. Accordingly Manulife's claim to exemption from taxation on the interest accruing on its holdings of FOTRA securities only became a live issue in relation to its accounting period ended 31 December 1993 and subsequently.

The contentions of the parties

17. Senior counsel on each side submitted written skeleton arguments to which they adhered very closely in their oral submissions. Accordingly it is only necessary for me to summarise very briefly the main contentions of each party in these appeals.

18. Mr Prosser, for Manulife, submitted that the terms of issue of the FOTRA securities should be interpreted purposively and, so interpreted, have the effect that the exemptions continue to apply where tax is charged on interest as such.

19. In the view of Mr Prosser the I minus E basis is "fundamentally different" from the Schedule D Case I charge. (See Johnson v Prudential Assurance [1996] STC 647 per Robert Walker J at page 669). The Schedule D Case I computation is clearly a computation of the profits of a trade or business but the "I minus E basis" is not. It is a computation (or series of computations) of income and gains taxed as such less expenses.

20. He further contended that the object of the business profits restriction is simply and solely to limit the FOTRA exemptions to interest taxed as such, including Manulife's interest taxed as such on the "I minus E basis". The business profits restriction applied in 1940, and continues to apply now, only to the profits of a trade or business taxed as such (to income or corporation tax under Schedule D Case I or II).

21. In conclusion Mr Prosser submitted that if there was any doubt in the matter that doubt should be resolved against the Crown as it was the Crown which had drafted the business of its restriction.

22. Mr Henderson, who appeared for the Respondent, submitted that a computation on the I minus E basis is a computation of the profits of the trade and not just a computation of Manulife's total income derived from different sources. (See Ostime v Australian Mutual Providence Society (1959) 38 TC 392 per Lord Radcliffe at page 516).

23. In the view of Mr Henderson the business profits restriction was imposed in order to ensure a level playing field between all businesses carrying on business in the United Kingdom whether of a non-resident doing so through a branch or agency or by means of a business resident in the United Kingdom for tax purposes. The evident purpose of the limitation is to prevent the benefit of the exemption extending to non- residents operating commercially in the United Kingdom.

Conclusion

24. The words which I am being asked to construe do not form part of a statute but are in effect part of a commercial contract. They lay down the terms on which the Treasury is prepared to grant exemption from tax to certain non-resident persons. The vital words are "any computation for taxation purposes of the profits of any trade or business carried on in the United Kingdom." And the FOTRA prospectuses are targeted at a very wide spectrum of the investing public, and not merely at organisations such as Manulife, which have ready access to legal and taxation advice.

Accordingly the vital words should be construed bearing in mind the wide audience at which they were aimed.

25. The main plank of Mr Prosser's argument is that the I minus E basis does not produce "profits", whereas the computation in accordance with Schedule D Case I rules does produce such "profits".

26. Mr Prosser's arguments produce very curious results, for it is quite plain that non-resident banks operating through a branch or agency in the United Kingdom would not be able to claim exemption from tax for interest received on holdings of FOTRA securities. Such banks would be assessed to corporation tax under the rules of Schedule D Case I.

27. Manulife as a mutual insurance company can be taxed only on the I minus E basis. It is not open to the Revenue to seek to tax a mutual insurance company under the rules of Schedule D Case I. The position with a proprietary insurance company is quite different for whereas they are normally taxed on the I minus E basis, it is open to the Revenue at its option to seek to tax a proprietary insurance company under the rules of Schedule D Case I. Where the Revenue exercises its option it is plain that a non-resident proprietary insurance company trading through a United Kingdom branch would not be able to take advantage of the exemption now claimed by Manulife.

28. Mr Prosser did not attempt to explain this apparent anomaly or to suggest any reason why non-resident mutual insurance companies operating through a branch in the United Kingdom should be so favoured in the way that he suggests.

29. I accept Mr Henderson's view that the limitation is aimed at non-resident traders operating in the United Kingdom and that the aim of the condition imposed by the Treasury on its prospectuses is to ensure a level playing field. There is no reason why non-resident mutual insurance companies such as Manulife should be benefitted to the disadvantage of non-resident proprietary insurance companies and non-resident banks and other similar traders operating in the United Kingdom through a branch or agency.

30. The statutory definition of the I minus E basis is to be found in section 65(3)(a) of the Finance (No.2) Act 1992 which states:

"(a) the I minus E basis is the basis commonly so called (under which a company carrying on life assurance business is charged to tax in respect of that business otherwise than under Case I of Schedule D)."

Subsection 4 of section 65 is also relevant and provides as follows:

"(4) Neither the making of a relevant claim in respect of a trading loss incurred by a company in an accounting period nor the application of any commercial or accounting principle or practice in computing that loss -

(a) shall prevent the I minus E basis being applied for that or any other accounting period in respect of the company's life assurance business;

(b) shall affect the calculation of the income or gains of that business for that or any other accounting period in applying that basis."

31. I accept Mr Henderson's contention that subsection (4)(b) clearly presupposes that application of the I minus E basis is a method of computing the income or gains of the business. Similar wording is also to be found in subsection 5(b).

In Ostime v Australian Mutual Providence Society Lord Radcliffe said in his speech at pages 515-516 on the subject of the taxation of life assurance companies:

"Rule 3 first became law in 1915, being introduced by Section 15 of the Finance Act of that year. The situation that it was framed to deal with needs to be shortly

stated. It arose from a combination of the special difficulties of establishing the true annual profit of life assurance business with the special difficulties of determining the true United Kingdom income of a non-resident life assurance company doing branch business here. If that assurance company was organised on the mutual principle a further difficulty was superimposed, but this particular difficulty was due to the quirk of English judicial reasoning which absolved a mutual company from the possibility of making a taxable profit and could have been corrected at any time by appropriate legislation. It had never been easy or convenient to raise an assessment under Case I of Schedule D on a life assurance society in respect of its trading income. To do so involved valuations of liabilities and assets which were not likely to be annually available. On the other hand, life assurance business by its own nature generates the life fund consisting of investments made out of the premium receipts and accumulated income, and the produce of those investments is at least an important part of the annual income of the business. So long therefore as the investments were such as to yield interest or dividends from a source in the United Kingdom, the interest and dividends themselves fell under charge to tax, and, given the allowance to the company of its management expenses, an adequate, though never an accurate, measure of the annual profit accruing to the business could be regarded as obtained".

32. It is apparent that Lord Radcliffe took the view that a computation for tax purposes on the I minus E basis was a rough and ready means of ascertaining the profits of a mutual life insurance company.

33. In the light of Lord Radcliffe's comments and bearing in mind the other arguments put forward by Mr Henderson which I accept, I find that the computation of Manulife's chargeable profits for corporation tax purposes on the I minus E basis is a computation for taxation purposes of the profits of any trade or business carried on in the United Kingdom within the limitation appearing on the Treasury prospectuses for FOTRA securities held by Manulife during the relevant years.

34. The appeal fails and I adjourn this hearing to enable the parties to agree figures. On their being reported to me I will determine the assessments formally.

T H K EVERETT

SPECIAL COMMISSIONER

Date of Release 30/3/2000

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Authorities cited but not referred to in the Decision

Clerical Medical and General Life Assurance Society v Carter (1889) 2 TC 437

Revell v The Edinburgh Life Insurance Company (1906) 5 TC 221

Australian Mutual Providence Society v Commissioners of Inland Revenue (1947) 28 TC 388

IRC v Ross & Coulter [1948] 1 All ER 616