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978-0-521-87083-2 - Income Tax in Common Law Jurisdictions: From the Origins to 1820

Peter Harris

Excerpt

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## Introduction

The income tax laws of about sixty countries may be said to be of a style or type that derives from or is associated with the income tax law of Britain.<sup>1</sup> Most all of these countries had some form of colonial connection with Britain. It is doubtless that many other income tax laws, which would not typically be considered to be from the 'British family', were also influenced at various stages by the British income tax, typically at their inception.<sup>2</sup> It is also doubtless that the British income tax, at least indirectly, if not directly, was influenced at its modern inception in 1799<sup>3</sup> by the tax laws of other European countries and, perhaps, its colonies. Further, it is certain that much of the content of Britain's 1799 income tax law was derived directly from earlier English direct tax laws stretching back 700 years and more.

To a more limited extent, the same is true of former British colonies. The taxes that ultimately developed into or were the precursors of the income tax were influenced by a greater variety of factors. The early tax systems of the colonies were influenced by each colony's own peculiar circumstances, other colonies with which they were affiliated, other colonial powers to which they may have been subject and, of course, Britain. Importantly, however, colonies were most prone to importation of tax laws in the early days of their founding. Accordingly, the tax system of a colony founded at a particular date was more prone to be influenced by the tax law of say Britain at that time than another colony

<sup>1</sup> Thuronyi (1998, p. xxiv).

<sup>2</sup> For example, see Selgiman (1914), with respect to France pp. 273–328, particularly at p. 325, and with respect to Italy pp. 338–55, particularly at p. 340. It seems that the first modern income tax in Germany, that of Prussia in 1891, also sought to follow the British approach in various respects. This was made clear by Professor Manfred Mössner at a presentation given at the University of Cambridge for the Centre for Tax Law of the Law Faculty on 12 November 2002.

<sup>3</sup> As this study will note, there are earlier examples of what might be (and sometimes are) termed 'income taxes' in Britain that pre-date 1799. However, 1799 is typically accepted as the inception date of the modern income tax.

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founded at a different date, which would be more prone to influence of the British tax system at that different date.

This study seeks to trace the roots of the income tax and its precursors in Britain and its former colonies up to 1820. This date is chosen because it sees the end of the first modern income tax in Britain (expired 1817) and gives a few years for that expiration to settle so far as influence in the colonies is concerned. A basic chronological order is adopted as this facilitates a clear understanding of the state of the tax system in Britain and the colonies at the time a particular change takes place. In this way, the study seeks to trace developments and place them in a historical context. The roots and developments identified in this study are not just relevant for Britain and the colonies founded before 1820. When the British income tax was reintroduced in 1842 it was virtually a copy of the law of the Napoleonic Wars. Many essential features of that law still continue today. Accordingly, those countries whose income tax laws fall within the 'British family' of income taxes ultimately have their roots in the matters discussed in this study. The period after 1820 is fruit for further picking.

### Focus of the Study

Because this study seeks to cover a period of over 700 years and developments in upwards of thirty jurisdictions, it is by necessity narrowly focused and bounded by various limitations.<sup>4</sup> First, this is a legal study. So the focus is on the development of the law and, particularly, the wording and concepts used. Of course, in order for law to be understood it must be placed in context. So economic, political and social circumstances and historic events are discussed, particularly where they may have provided the impetus for development of the tax law, e.g. wars and changes in monarchy. But these sorts of circumstances and

<sup>4</sup> A more detailed consideration of the development of direct taxation in Britain during this period is documented elsewhere and noted in references throughout this study. For general works broadly covering this time period, see Dowell (1965, Vols. I–III), Seligman (1895, pp. 37–53) and Seligman (1914, pp. 41–53) and the references cited therein. More specific time periods are covered by Mitchell (1951) [years 1154–1272], Schofield (2004) [years 1485–1547], Jurkowski *et al.* (1998) [years 1188–1688] and Soos (1997) [years 1512–1803, focusing on taxation at source]. This discussion only covers direct taxation of the laity and not the taxation of the clergy. As a general rule, direct taxes voted by parliament did not extend to the clergy. For an introduction to the history of direct taxation of the clergy, see Soos (1997, pp. 23–32, 45–62) and the references cited therein.

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events are not the focus of this study. Further, at a number of points, particularly in the earlier periods covered by this study, the administrative practice in applying a law may have diverged from the language used in the law. This may have been due to a lack of clarity in the law as written but was also influenced by a more flexible or imprecise approach to interpreting laws. While administrative practice will be mentioned at various points, the focus is on the wording of the laws. This wording becomes progressively more precise and prescriptive over the period covered by this study.

The comparative aspect of this study is limited to influence between Britain and its former colonies or between the colonies. This limitation necessarily produces some distortion. As mentioned, it is clear that the tax laws of other European powers, particularly France and the Netherlands, influenced the development of the income tax and its precursors in Britain.<sup>5</sup> The same is true in the colonies, particularly where a colony changed hands from one European power to another, such as in the cases of Nova Scotia, Quebec, St Lucia, Dominica, St Vincent, Trinidad, Tobago, Ceylon, Guyana and Cape Colony. When a colony changed hands the laws of the previous colonial power would inevitably be continued, at least initially, and many times this also included the continuation of tax laws. The influence of other European powers, whether on the tax laws of Britain or its colonies, is noted where it is obvious from the materials consulted. But such influence is not explored in any depth and is not the focus of this study.

In the same way, this study does not consider regional taxation in depth but, rather, focuses on central levies. There are exceptions where a particular approach in regional taxation is felt to have had a significant impact. This is particularly the case in the colonies, which in their infancy are likely to have viewed themselves as a regional branch of England. In this case local taxation in England may have had greater impact on the development of tax systems in the colonies than taxation by the central government of Britain. There are also points at which local taxation in the colonies is of particular importance. The colonies were far from uniform in their governmental structure. In some colonies, such as those in New England, the primary government structure was the township, in others the district was the more

<sup>5</sup> That this would be the case is obvious from the central influence of Roman and canon law, the strong links between religion and government, the Norman conquest of England and the intermarriages within the European royal families.

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important locality, such as in some of the southern American colonies, while in others the central government seems to have had prominence and this seems to have been the case in many of the colonies in the West Indies.

The purpose of this study is to provide background to facilitate a deeper understanding of the nature of the income tax for those countries whose income taxes have been influenced by Britain's income tax. It is about the origins or roots of the income tax. Therefore, it covers many taxes that are not technically income taxes but might be viewed as precursors of or from the same family of taxes as the income tax. This aspect also limits the scope of this study. Which taxes fall within that family of taxes is a matter of some conjecture and so the types or categories of taxes that are covered by this study require further explanation.

Most broad-based taxes fall on one of the stages of wealth, whether creation, holding, transfer or consumption of wealth. The reason for this connection between wealth and taxes is that taxes must be paid from wealth. Typically taxes are paid in money although, particularly during the period covered by this study, taxes were also payable in kind (whether in the form of produce such as corn, sugar or tobacco, or statute labour). An income tax is essentially a tax on creations of wealth. Wealth is created through the provision of wealth (capital), labour or both. A difficulty with the development of the income tax (and continually) is measuring the wealth created, which varies from period to period. But, as is often pointed out, the holding of wealth may be presumed to produce income (often call 'notional income') and in many ways wealth is easier to value than a stream of income flowing from it.<sup>6</sup> Accordingly, taxes on the holding of wealth may reach or act as a proxy for taxation of income.

The same is true of taxes on individuals. Such taxes are often called 'poll' or 'capitation' taxes. In their simplest form, these taxes are a flat amount per head. But even in this form the tax will be circumscribed by various limitations such as the exclusion of children and the exclusion of wives, etc. Limitations and categorisations may become more sophisticated in order to reach the 'faculty' or 'income earning capacity' of a particular person. The process here is similar to that for capital, it essentially involves the valuing of human beings, i.e. valuation

<sup>6</sup> For a start, wealth can be measured at a particular point in time whereas income is measured over a period of time.

of human capital. Hence, poll taxes may categorise individuals according to different ranks, professions, trades, occupations, etc. and tax each category differently. So in a rough and ready manner, poll taxes will reach income from labour in the same way as taxes on the holding of wealth reach income from capital.

So the types of taxes that fall for consideration in this study are wealth taxes, poll taxes and taxes more clearly on the creation of wealth. These are the taxes from which the modern income tax developed. Indeed, some of these taxes were simply incorporated into the modern income tax when implemented by Britain in 1799. This study does not consider consumption taxes and so excludes virtually all indirect taxes such as customs, excises, etc. Further, it does not consider taxes that focus on the transfer of wealth such as stamp duties and inheritance taxes. Nevertheless, an attempt to cover all aspects of all wealth taxes, poll taxes and taxes more clearly on the creation of wealth would make this study unmanageable. While the general development of these taxes is covered, this study focuses on particular issues raised by these taxes, issues peculiar to these taxes and particularly important in the modern operation of the income tax.

A problem for the student<sup>7</sup> of a British-style income tax law is that some of the central features of that law cannot be easily explained in a temporal sense. Some more than satisfactory questions may be met with quite unsatisfactory answers. This study focuses on four such questions, although many other interesting issues are addressed along the way. These four questions are:

1. Why do capital gains and losses fall outside the income tax?
2. Why is income calculated separately for different activities, that is, why is a schedular approach adopted?
3. Why are corporations treated as separate taxpayers from their shareholders?
4. Why is the income tax imposed simultaneously on a source and residence basis?

An enquirer might receive various answers to these questions but most answers will, to varying extents, be quite superficial. For example, a standard answer to the first question might be, 'because our courts followed the concept of income in the British income tax law' or

<sup>7</sup> 'Student' here is used in the sense of someone who 'studies' tax law.

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‘because our courts follow a flow concept of income’<sup>8</sup> or ‘because our courts follow a trust law concept of income’.<sup>9</sup> All of these answers may be correct but all of them are overly simplistic and add little to a deeper understanding of the issues in question. The determined enquirer will pursue further questions such as: ‘Why did the British income tax law adopt this distinction?’ ‘Why was trust law so important in this context and not, for example, the accounting treatment?’ ‘Why did trust law adopt a flow concept of income?’ and ‘What circumstances meant that the flow concept should dominate over other concepts such as accretions to wealth?’

A natural response to such questions is to turn the discussion to theoretical and conceptual approaches. With respect to the capital–revenue distinction, this may be achieved by contrasting the flow concept of income with the gain concept of income.<sup>10</sup> The same is true of the other questions. The schedular approach may be contrasted with the global approach to income taxation.<sup>11</sup> The separate entity theory of the corporation may be contrasted with the conduit theory.<sup>12</sup> Source- and residence-based taxation may be analysed by contrasting the ability to pay theory with the benefits theory or by contrasting the principles of capital import neutrality and capital export neutrality.<sup>13</sup> No doubt this style of discussion will deepen the understanding of the enquirer. But the limitation of the discussion to theoretical and conceptual approaches leaves important parts of the question unexplored and, at worst, has the potential to distort an evaluation of the importance of one theory or another.

The problem is that some theories tend to ‘pull themselves up by the bootstraps’. Often theories are developed in order to explain existing practices (including some of the theories mentioned in the last paragraph). In time, the validity of the theory may be sought to be justified by reference to the practice of countries. But the theory will not be the *reason* why many countries adopted that approach. That reason is often buried in history. The theory *may* be the reason why a country

<sup>8</sup> Regarding the flow concept of income, see Fisher (1906, pp. 51–3, 101).

<sup>9</sup> For example, Parsons (1985, p. 8).

<sup>10</sup> With respect to the gain concept, see Simons (1938, p. 50).

<sup>11</sup> See Burns and Krever (1998, pp. 495–9). The distinction is particularly important with respect to losses, i.e. losses on one activity are automatically set against profits on another activity under the global approach but not under the schedular approach.

<sup>12</sup> See Harris (1996, pp. 42–8).

<sup>13</sup> See Harris (1996, pp. 13–16, 318–20, 452–9).

continues to adopt a particular approach, but caution should be taken with such assertions. A government may be under pressure from lobby groups to change a particular policy but may not wish to do so. In continuing its existing approach a government may feint support for a particular theory that supports the existing approach when the real reason for the continuation may be revenue impact or simply the deadweight costs associated with change. Political inertia is often explained by reference to adherence to particular theories.

Searching for the historical origins of a particular approach facilitates understanding and assists in assessing theories that underlie that approach. Often particular approaches can be more clearly explained by the historical context and circumstances in which they are adopted. If those circumstances have changed or no longer exist that may lead to an appropriate reassessment of the approach. A deeper understanding of the way in which society has developed and is developing should facilitate a deeper discussion of the way in which tax policy needs to adjust. This is the importance of historical research. All of the deeper questions outlined above with respect to the capital–revenue distinction can, to varying extents, be answered by delving into history before 1799. The same is true of deeper questions with respect to the other three questions that are the primary focus of this study.

This study is not exclusively focused on these four questions but it does expand on matters that might help in seeking an answer to them. These matters include, for example, the legal and social context in which the capital–revenue distinction may be relevant. This context covers, in particular, the feudal origins of property holding in England and how that developed into the wide-scale practice of holding property first through uses and then trusts. This context also covers the feudal origins of accounting in which stewardship was so important and the strong link between the origins of accounting and the origins of trust law. In time, these areas grow into and are related with the growth in trade and the development of the corporation as a vehicle for that trade. The origins of the corporate form have a particular link with the expansion of international trade and international trade is linked with the development of overseas colonies.

### Structure

This study is structured under five chapters, which follow a basic chronological order. Chapter 1 covers the period to the outbreak of

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the English Civil War in 1642. This chapter essentially consists of discussion of English taxes, which go through a number of phases. The discussion begins with the feudal origins of the tax system and its connection with royal government, land holding and religion. The discussion then proceeds through the development of the fifteenth and tenth, a tax notionally levied on movables, and to the initial levy of poll taxes in the fourteenth century. These taxes were likely influenced by the change in society occasioned by the Black Death (bubonic plague) and mark a change in approach to taxation that developed through the War of the Roses and into the early Tudor subsidies. These subsidies were essentially a broader based wealth tax with certain income tax aspects. The end of the Tudor period was relatively stable but matters start to progress again with the unification of the crowns of England and Scotland under the Stuarts. Disputes between the Stuarts and Parliament meant less reliance on the old form of Tudor subsidy and greater emphasis on raising money through local taxes and the ship writs. This period is important because it sees the foundation of the first colonies in the new world.

Chapter 2 covers the period from the outbreak of the English Civil War, through the Commonwealth and to the Glorious Revolution. The English Civil War was a turbulent period during which the tax system moved, in its urgency, towards rationalisation and simplification. The English Civil War also had an impact in the colonies. The exodus of political refugees to the New World added to the existing exodus of people seeking to escape from religious persecution in Great Britain. Further, the preoccupation of Great Britain with the war at home facilitated the development of autonomy in the colonies. Dispute arose after the Restoration when the crown sought to withdraw that autonomy. The fallout naturally affected the tax systems of the colonies. The Restoration also saw the development of the tax system in England. New styles of tax were introduced to fund the wars with France and the Dutch Republic that followed the Restoration and these sowed the seeds for further developments after the Glorious Revolution.

Chapter 3 covers the better part of a century from the Glorious Revolution to the end of the Seven Years War, which resulted in British dominance of the east coast of America. The turbulent decade following the Glorious Revolution gave rise to substantial developments in the English tax system. In the tax laws of this period are virtually all the ingredients that go to make up the income tax of a century later. But just after the turn of the eighteenth century the English direct tax system



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first settles once again, this time in the form of the land tax, which was extended to Scotland in 1707. The land tax was, during this period, supplemented with presumptive taxes on the holding of various articles that came to be known as the Assessed Taxes.

The decade after the Glorious Revolution was also a turbulent time for the tax systems in the colonies. Not only were there substantial increases in sophistication of the colonial tax laws but also a change in the types of taxes. This period also sees the word ‘income’ start to be used on a consistent basis in direct tax laws, in particular in Britain and Massachusetts.<sup>14</sup> As in Britain, the following period saw the direct tax systems in the colonies largely settle, although there were further developments during the wars of the 1740s–60s and particularly the Seven Years War with France. Further, the acquisition of colonies during this period demonstrates the clear connection between colonial taxation and other European powers.

The period from the end of the Seven Years War to the eve of the introduction of the modern income tax in Britain is covered by Chapter 4. The major part of this period may be divided into three. First, in Britain the land tax continued, steadily supplemented with some adjustments in the Assessed Taxes. Second, this study continues to track developments in the newly independent states of the United States in order to check any cross influence with Britain and retained colonies until the income tax was introduced in Britain. Third, the most turbulence in the tax systems during this period is demonstrated in the retained colonies. Some of these were lost to other European powers during the American war and regained with the signing of the Treaty of Versailles. Others, especially the Canadian colonies, were inundated with loyalists from the former United States colonies.

In the final chapter, matters turn to focus on the new disturbances for Britain closer to home in the form of the French army under Napoleon. The chapter begins with a brief consideration of the limited tax developments during the first phase of the wars. Discussion quickly turns to the second phase of the wars and a consideration of a major effort by Prime Minister Pitt to fund the British war effort in the form of the Triple Assessment. This tax was based on a multiple of the Assessed Taxes but limited to a tenth of income. At this time there were other similarly styled taxes in British colonies, particularly the Windward

<sup>14</sup> As noted at pp. 117–9, there is an early but brief reference to ‘incomings’ in a Massachusetts tax law of 1646.

Islands in the West Indies. The chapter then turns to consider the first modern British income tax, which lasted from 1799 to 1817 (with a short interval in 1802). The chapter rounds the decade out by also considering the settling of taxes during the last three years to 1820.

The discussion in this final chapter focuses on the central questions identified above and seeks to draw conclusions about the origins of these features from the preceding discussion. There can be no categorical answers in this regard, but there can be informed suggestions, comments and assessment. The chapter also takes a brief pause to assess the point reached by the states of the United States by 1820, which is important for an assessment of Canadian developments. The last chapter finishes with a consideration of developments in the colonies. Income styled taxes continued to develop during this period, particularly in the West Indies, and continue after the expiration of the income tax in Britain. Indeed, it seems that some of the West Indian income taxes span the period from the expiration of the income tax in Britain to its reintroduction in 1842. The study finishes with conclusions.

There are five tables scattered throughout this study, one at the end of Chapter 1, another at the end of Chapter 2, two at the end of Chapter 3 and one at the end of Chapter 5. These tables seek to provide a snapshot of the various taxes imposed at various points in time. Table 1 covers taxes imposed in England to 1600. The remaining tables cover taxes of Britain and the colonies as at specific dates, namely circa 1650, 1700, 1750 and 1795. Consistent with the categories of taxes discussed above, the rows in the tables distinguish between *in rem* taxes, or taxes on wealth and returns from wealth, and personal taxes, or taxes on individuals and the activities of individuals. There are also sub-categorisations based on the type of wealth or type of activity in question.

The columns in the tables first deal with the tax base, and sub-categorises depending on whether the tax is per article of wealth (e.g. per acre of land or head of cattle), on the value of wealth or attempts to reach the return from wealth, i.e. income or profits. The second column distinguishes between taxes that are imposed at a specific rate for the whole of the jurisdiction, often called a 'pound rate', and taxes that are apportioned between sub-jurisdictions in fixed amounts so that the actual rate may vary from sub-jurisdiction to sub-jurisdiction, often called a 'quota' system. The final column is devoted to international jurisdiction, i.e. whether the tax is imposed on a source or location basis, a residence or inhabitation basis, or both. Of course, the taxes in question were not designed with these categories and sub-categories