PO-CH/NL/0025
PART A

CONFIDENTIAL

PO -CH /NL/0025

PART A

TAX REFORMS 1987 - 1988
INCLUDING INDEPENDENT
TAXATION, CAPITAL GAIN
TAX AND BENEFITS

DD'S 25 years N Azis 30-03-95.

PO -CH /NL/0025
PART A

21-7-87

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE
From: W Gonzalez
Date: 8 January 1987

1. MR CALDER ✓ 8/1
2. CHANCELLOR OF THE EXCHEQUER

GONZALEZ TO CH/EX 8/1

CAPITAL GAINS TAX REFORM : RELATIONSHIP BETWEEN GAINS AND INCOME

1. Preliminary results are now available from the small survey we have carried out linking the capital gains of individuals in 1983-84 with their marginal rates of income tax. They are based upon replies received from tax districts up to 2 January - about 80 per cent of the sample. Districts were simply asked for information about the income tax position in 1983-84 of certain individuals. No reference to capital gains or to the purpose of the inquiry was made in the questionnaire.

2. The proportions of individual capital gains tax payers liable to income tax at each marginal rate in 1983-84 were as follows:

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c. Chief Secretary	Mr Battishill
Financial Secretary	Mr Isaac
Economic Secretary	Mr Calder
Sir P Middleton	Mr Houghton
Sir T Burns	Mr Cayley
Mr Cassell	Mr Hamilton
Mr Scholar	Mr Michael
Miss Sinclair	Mr Gonzalez
Mr Cropper	Mr Quinn
	PS/IR

TABLE 1

1983-84

Marginal Rate of income tax %	Proportion of individuals liable to CGT %
NIL	8
30	51
40	10
45	10
50	7
55	4
60	10
	100

More than 85 per cent of capital gains tax assessments are made on individuals, the remainder being on trusts. Taking trusts into account, about 35 per cent of all CGT assessments were on individuals paying income tax at the higher rates. The other 65 per cent were assessments on individuals with no income tax liability or with liability at the basic rate only and on trusts. Individuals with no income tax liability will generally have incurred business losses or have sheltered their income by means of interest or other relief eg we know of one case with gains of more than £500,000 with no tax liability. Income of about £300,000 was reduced for income tax purposes by

losses	£150,000
capital allowance	£ 25,000
loan interest	£125,000

3. These results differ from the assumptions made in producing the initial costings of the CGT reform. We had assumed that 60 per cent of CGT payers would be individuals

liable at higher rates and it seems unlikely that the proportion will have changed so greatly since 1983-84.

4. On the other hand the survey has confirmed our assumption that the distribution of gains by size varies very little with the income tax rate. Top rate taxpayers do tend to have larger gains (some exceeding £5 million) whereas the largest gains for non-taxpayers are between £500,000 and £1 million. Between these extremes, the largest gains lie between £1 million and £5 million and the spread by size of gain is very similar for all levels of taxable income (see Table 2).

TABLE 2

1983-84

Percentage of individual taxpayers within income tax marginal rates by range of capital gains

Range of chargeable gains £	Income tax marginal rates				
	NIL	30%	40%-55%	60%	Total
5,301 to 7,500	22	26	28	17	26
7,501 to 10,000	29	19	14	7	17
10,001 to 25,000	32	37	38	24	35
25,001 to 50,000	11	13	13	23	14
50,001 to 100,000	4	4	5	11	5
100,001 to 500,000	2	1	2	14	3
500,001 to 1,000,000	0.5	0.1	0.4	2	0.4
1,000,001 to 5,000,000		0.01	0.1	1	0.2
5,000,001 and over				0.1	0.01

[Columns do not always add to 100 because of rounding]

5. There has not been time to rework all of the costings on the basis of the new information but we have looked at the effect of applying the 1983-84 proportions on the cost of Option 2 with a threshold of £6,500. The full year

yield, previously shown as +£60 million is reduced to +£30 million. Taxpayer numbers change by the same amount as before (+35,000). Because of the lower proportion of higher rate taxpayers the yields with the other possible thresholds will also be reduced but probably not in proportion.

6. While the survey gives a significant increase in our knowledge, there are still many areas where it is limited or non-existent. Incorrect assumptions about these could cause errors in the estimates which therefore remain very uncertain.

7. All the costs and yields quoted so far have, for consistency, used the same data base, derived from an early round of the Autumn forecast. This needs to be brought into line with current Treasury forecasts and our preliminary impression is that, in spite of the change in the assumption about the proportion of higher rate taxpayers, the estimated yields as quoted in the table on page 13 of Mr Cayley's note of 18 December are likely to increase. For the £6,500 threshold the full year yield could be as much as +£100 million. We shall carry out the re-basing and revise the costs as soon as possible. It seems likely that the costings are quite sensitive to the forecasting assumptions and are therefore liable to change significantly between now and the Budget.

8. These data are the only information we have about the relationship between individuals' income tax and capital gains. We shall not be able to obtain anything further before the Budget. We shall need to consider how best to present the information should one of the options be included in the Budget package.

9. A technical note on the survey is available.

W GONZALEZ

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON
9 JANUARY 1987

HOUGHTON TO CH/EX 9/1

CHANCELLOR OF THE EXCHEQUER

CAPITAL GAINS TAX: RELATIONSHIP BETWEEN GAINS AND INCOME

1. Two general points emerge from Mr Gonzalez' note of 8 January.

2. The first is that, on the evidence available (and Mr Gonzalez stresses that we are relying on a small sample), over half of CGT payers are basic rate taxpayers. This is a higher proportion than we had assumed. Under the reform, the majority (though by no means all) of basic rate taxpayers would tend to be gainers - especially in relation to disposals of shares. So the balance between gainers and losers alters, and gainers might well be in the majority, especially if the threshold were increased. This means that it might be possible to present the reform as tending to help smaller investors and being in line with the policy of encouraging wider share ownership.

3. The second point is that, if initial impressions are confirmed, the yield from individuals and trusts under the reform would, on the updated data base we are now beginning to incorporate, be greater than the figures we have been quoting up to now. As a result the level of threshold at which the reform could, for individuals, be revenue neutral may well be in the region of £10,000 (though we need

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cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Minister of State
Mr Ross Goobey

Mr Battishill
Mr Isaac
Mr Calder
Mr Houghton
Mr Cayley
Mr Hamilton
Mr Michael
Mr Gonzalez
Mr Quinn
PS/IR

to do further work to confirm this). This reinforces the point that the change benefits the smaller investor - the higher threshold provides the ultimate tax simplification for those with gains below the limit - removal from the system entirely. The break-even threshold would of course be lower if expensive special measures were built in for hard cases. But as Mr Gonzalez explains, the costings will be sensitive to change in the forecasting assumptions and could change significantly between now and the Budget.

Br

B T HOUGHTON

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

The proposal

NICs: 10% for employer & employee alike; no UEL; LEL converted into a threshold. (It goes without saying that there will be no lower rates for NICs.)

Income tax: 25% for first £20,400 of taxable income; 40% thereafter.

CGT: Capital gains taxable as income. No indexation after 1988, but indexation for 1982-88
a) retained and liability for pre-1982 accrued gains abolished;
(b) abolished & liability for pre-1982 accrued gains abolished;
(c) retained & no other change
(d) abolished & no other change

Consider also simplification of 82/88 indexation.

NL

MR 9/108

SECRET AND PERSONAL

FROM: A C S ALLAN
DATE: 5 May 1987

PS/SIR P MIDDLETON

cc: PS/CST
PS/FST
PS/EST
PS/MST
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Battershill - IR
Mr Isaac - IR

TAX REFORM

... The Chancellor has approved the attached annotated agenda for the meeting at 10.00 am this Friday.

2. Please note that the venue has been changed to the Chancellor's room, Treasury, instead of No.11.

Ch
Peter Cropper has commented on the agenda — see below — not copied to others
AJK 7/5

ACSA

A C S ALLAN

psl/50A

SECRET AND PERSONAL

DIRECT TAX REFORM: WORK PROGRAMME

Business tax

Is it right to assume that reform here is now completed?

Personal tax

2. Can we take it that the objective is:

(a) to widen the tax base;

(b) to simplify the system;

(c) to reduce the marginal rate of tax?

Can we take it that we are aiming for a big bang approach rather than a series of piecemeal changes? Are we thinking of a Green Paper or not? If no Green Paper, is there any method of giving a longer period of discussion at Finance Bill stage if there is to be a complete reform? A Green Paper on the taxation of savings was promised in the 1985 Budget Speech.

3. Should we get on with analytical work on some illustrative packages: eg a basic rate of 25 per cent, and a single higher rate of, say, either 50 per cent or 40 per cent but combined with abolition of the upper earnings limit on employee NICs? Anything else on employee NICs?

4. Is NICIT worth a further look?

Ch / See separate pps on yours fingers folder dJK

5. Now that transferable allowances are further away, should we be envisaging significant further real increases in the basic allowances over the years ahead (to deal with some of the problems identified in the Personal Taxation Green Paper)? Or should we leave the allowances roughly where they are (perhaps clawing back their benefit to higher rate taxpayers or perhaps indexing to earnings) and use the fiscal adjustments for further cuts in income tax rates?

6. Should we begin working up a Lorna Bourke independent taxation scheme (retain married man's allowance but tax wives separately on all their income), at a cost of £0.7 billion? Or would it be more sensible to confine ourselves to Wife's Income Election, at a cost of £0.3 billion (possible to implement within two years, as against four years for independent taxation)?

7. Any other moves on tax penalties on marriage? (See also 10(iv)).

8. Should we produce an analysis of the distributional and other effects of combining measures like those in paragraph 3 with abolition of capital gains tax on individuals, taxing their gains at the new income tax rates, on various bases - eg retain or remove indexation of post-1982 gains, rebasing the tax on 1982?

9. Any further work on inheritance tax - abolition, with or without substitution of a capital gains tax charge on death?

Widening the tax base

(a) **Special reliefs**

10. On mortgage interest relief, should we work up schemes for some or all of:

(i) restricting relief to the basic rate;

(ii) restricting relief to first-time buyers;

(iii) restricting it to purchase, abolishing relief for improvements;

(iv) confining it to the residence for unmarried couples;

(v) absorbing MIR in wider "ration of savings" scheme?

11. Is there merit in aiming to include further pensions reform (eg taxation of lump sums) in the 1988 Finance Bill? Anything else on taxation of savings (including 10 (v) above)?

Ch/see recent major note on your CST bilateral folder AWK

12. What other tax privileges could we seek to remove - eg forestry? Are any new privileges - eg tax relief for private medical expenses - a threat?

13. Can we avoid further concessions on the BES and the tax regime for wider share ownership, research and development, training etc? Are there any new special reliefs that we should contemplate? Are there any reliefs we can envisage dispensing with?

14. Minimum tax?

(b) **Financial services.**

15. Is it accepted that financial services are under-taxed in relation to other goods and services, and that, given the EC ban on VAT, we should be looking for a surrogate?

16. Is consumer credit duty the best surrogate? Should we push forward with existing work on this, including or excluding mortgages? Will any wider consultation than we have been able to carry out so far be acceptable?

17. Is an insurance premium tax dead?

18. Should we be envisaging the elimination of Stamp Duty?

CAPITAL GAINS TAX

HOUGHTON TO CH/EX 7/5

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

cc PS/CST
PS/EST
PS/MST
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Ross Goobey
Mr Tyrie

FOR TAX REFORM MEETING AT 10.00AM

AWK 7/5

FROM: B T HOUGHTON
DATE: 7 MAY 1987

1. MR ISAAC 7.5

2. CHANCELLOR OF THE EXCHEQUER

CAPITAL GAINS TAX

1. This note responds to your request (Mr Kucyzs' minute of 14 April) for a paper, together with worked-out examples, on ways of simplifying indexation calculations. (Options for structural reform were the subject of previous notes dated 6 and 7 April.)

Background

2. Over the past few years we have received complaints about the complexities of indexation. Almost without exception, these complaints relate to the computations which have to be made for disposals of shares and securities. Some of the complaints come from those who would like to see tax on capital gains abolished altogether, and who complain about the complexities of indexation as a means of trying to cast disrepute on the tax itself.

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cc Financial Secretary
Mr Cassell
Mr Scholar
Mr Cropper
Mr George
(Bank of England)
Mr Battishill
Mr Isaac
Mr Houghton
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Michael

3. Since 1982 we have given a good deal of thought to the possibilities of simplifying indexation. We have also looked at a number of suggestions from outside - but none of these would have produced simplification and many of them, on examination, turned out to involve additional complexities.

4. Despite the complaints there is no doubt that taxpayers themselves welcomed the introduction of indexation in 1982, and indeed, as Ministers will be aware, there are regular representations that indexation relief ought to be given for the period from 1965 to 1982.

5. Moreover, with the present relatively high threshold the vast majority of investors - including new investors - never have to worry about CGT and indexation computations. We estimate that less than 200,000 individuals and trusts will be liable to CGT on disposals of assets of any kind in 1987-88. This compares with, for instance, an estimated 8.4 million shareholders in the country. For the minority who do have to cope with CGT, the task is made increasingly easier by the development of special computer programs and by the availability from many stockbrokers and investment managers of services to provide a lot of the necessary figures.

Other countries

6. It is also worth noting that Ireland, which introduced indexation several years before the UK, has provisions essentially on the same lines as ours; and in the USA, where indexation was at one stage proposed as part of the recent tax reform (and subsequently dropped), what was in mind was essentially a UK-style scheme although the details were not fleshed out. Australia also has a system similar to ours.

Assets other than Shares and Securities

7. For the most part, the indexation calculation for assets other than shares and securities will be straightforward and we have not received representations that it gives rise to

computational difficulties. An example showing how indexation applies is at Annex A.

8. There have been a few complaints about the compliance burden for taxpayers of establishing 31 March 1982 values where an asset was acquired before 1982 (the burden on us (particularly our valuers) is, if anything, more significant). But we have streamlined procedures here, so that, within certain tolerance limits, Inspectors can accept valuations offered without reference to our specialist valuation staff; any compliance cost for the taxpayer will in most cases be more than offset by extra indexation relief obtained by opting for a 31 March 1982 valuation.

<u>Shares</u>

9. It is disposals of stocks and shares which give rise to difficulties. It is however fair to say that they have recently become rather less troublesome - probably, in part, because

i. people are becoming more familiar with the system;

ii. for shares held some years, the tax value of indexation relief has built up; and

iii. the general restoration of share pooling in 1985 reduced the burden of record keeping and significantly reduced the compliance burden.

10. The issue in the last year, with your approval, of an explanatory leaflet, has also helped. This is aimed primarily at the small investor and illustrates how the calculations need not always be as complex as is sometimes suggested. (Work on the preparation of a more comprehensive booklet was suspended last summer when we embarked on the recent general review of CGT and the possibility of abolishing indexation).

11. Many of the indexation problems associated with shares arise because the relief has to accommodate fungible assets and has to

have regard to the period of ownership and an adjustment related to acquisition cost. In practical terms this means that -

- indexation must be computed on a "cumulative" basis (ie. on the occasion of either a disposal or acquisition) so as to ensure, in relation to the pooling arrangements, that expenditure is only indexed from the date it is actually incurred to the date of disposal, and

- special rules are required to deal with situations (which of themselves may not involve a disposal for capital gains purposes) where the expenditure per share is otherwise either increased or decreased, for example, rights issues, reorganisations, conversions etc.

A further tier of complexity is then imposed by the facility to compute indexation on March 1982 values which necessarily entails separate share pooling for pre and post-1982 acquisitions though over time, as pre-1982 holdings become less common, pre-1982 pools will disappear.

12. The short example at Annex B - which assumes neither pre-1982 acquisitions nor other complications - illustrates the application of the indexation provisions to shares.

Constraints

13. There are three main constraints on any scheme of indexation:-

i. It must be related to acquisition (or 1982) values. So records have to be maintained.

ii. It must be able to cope with rights issues, bonus issues, share reorganisations, disposals of part of a holding and additions to existing holdings. These unavoidable external factors in practice account for quite a bit of the complication of indexation.

iii. It must be compatible with share pooling. When indexation was first introduced, the pooling facility was denied. Larger - particularly institutional - investors complained that they could not cope with the resulting need to keep separate records for each share transaction and an interim system of "parallel pooling" was introduced in 1983. The general restoration of pooling in 1985 was a significant simplification, substantially reducing the burden of record-keeping and welcomed particularly by the large institutional investors.

14. It is these constraints which have led to the evolution of the present rules. Despite the attention given to this subject over the past four years it has not proved possible to identify any means of achieving a radical simplification. But there are one or two minor changes which could help taxpayers in preparing their calculations.

Possible changes

(a) Abolishing the rounding rule and introducing direct uprating.

15. Indexation applies slightly differently to shares and securities acquired since 1982 as compared with other assets. For these other assets such as land and pre-1982 shares the rise in the RPI is first rounded to the nearest third decimal place before being applied. From April 1985 onwards the uprating of 1982 holdings of shares (ie post 1982 acquisitions) can be achieved by applying the rise in the RPI since 1985 to the relevant expenditure without rounding. This slight mis-match is, in part, a by-product of the speed with which the 1985 changes had to be put together.

16. It is a little anomalous to have this difference in the computational basis. It would be possible to legislate to abolish the rounding rule for other assets.

17. This of itself would make virtually no difference to compliance costs; and we would have to continue to publish RPI derived factors which people could use when doing indexation calculations. But it could pave the way for a rather more significant simplification.

18. At present the indexation allowance is computed as a separate element in the calculations. With the rounding rule abolished, the computations could be short-cut: all calculations could be done on indexed expenditure, with no need to keep separate records for actual (nominal) expenditure. Annex C provides an example of a calculation on this basis.

19. To apply this across the board would involve fairly complex legislation. It can however be applied in practice to the uprating of 1982 holdings of shares after 1985. Because of the way the statutory indexation rules for such shares have been drafted, if direct uprating were confined to them it could be done without legislation. The simplified leaflet on indexation for shares does in fact mention that, in practice, we will accept computations on this short-cut basis. If Ministers wished to avoid complex legislation in this tricky area, it would thus be possible to confine direct uprating to post-1982 shares (where it would be of most practical benefit) without legislation. In that event we would recommend issuing a Statement of Practice on the point to give greater publicity to our willingness to accept short-cut computations.

20. There is, though, one important consideration. Doing this would only be really worthwhile if we were to tell people that they no longer needed to keep records of actual (nominal) cost. But once we do this, we rule out any possibility of abolishing indexation relief for RPI movements up to a current date: if at some point Ministers wished to abolish indexation, they would be able to do so only for future RPI increases: accrued entitlement to indexation would have to be preserved. This would also mean that the indexation calculations would have to be continued until all assets acquired before the date of abolition were disposed of.

Ch/ But you may feel this is inevitable anyway? AWK

Frequency of Indexation Adjustments

21. Indexation is currently computed by reference to monthly changes in the RPI. The resulting table is looking increasingly long and daunting. It would be possible to give indexation relief by reference to RPI movements over a longer period - for instance a calendar quarter. (When the USA contemplated indexation, it was to be on a quarterly basis.) Someone who acquired and disposed of an aset within this period would get no relief.

22. There would be an incentive for people wishing to dispose of an asset towards the end of the calendar period to hang on into the next period, so as to get an extra tranche of indexation - and the longer the period the greater this "lock-in" effect. But if the adjustments were done on a quarterly basis (by reference to the RPI for the mid-month of each calendar quarter) it is questionable whether, with present levels of inflation, there would be subtantial market distortions.

23. There is a rule at present to counter this "hanging on" effect for monthly indexation which has the effect of denying indexation for assets acquired and disposed of within a period of 10 days overlapping the end of the month. If quarterly indexation were introduced it might be necessary to extend the straddle period to 30 days. The disadvantage with this system is that it requires identification of disposals with acquisitions for a larger number of transactions - a significant counterbalance to the marginal simplification achieved by the adoption of a quarterly basis.

24. Quarterly indexation was considered, and rejected, in 1982. But inflation is now lower and this could be used as the justification for moving to a quarterly basis.

25. A switch of this kind would not simplify the actual computations. But it would substantially reduce the length of the tables with which taxpayers and their advisers are faced.

Rebasing the 1982-1986 RPI Figures

26. The RPI has just been re-referenced to a 1987 base. For CGT this affects the way we compute the published rounded indexation factors for assets other than shares and securities, but that has no implications for the compliance burden. The change is more material for shares and securities, where the actual move in the RPI is used in computations.

27. The difficulty is that the RPI for the period before 1987 is in law the RPI as published at the time, with a 1974 base. The Department of Employment have published a formula to enable the two RPI series to be linked, and in law this has to be used when computing indexation for shares acquired before 1987. In this we and taxpayers are in the same legal position as anyone else who has for legal or contractual purposes to compute the RPI movement for a period spanning January 1987.

28. The formula involves an irritating extra layer of complication. It would simplify things if we could use a series of RPI figures going back to 1982 which were converted to a 1987 = 100 base. But this series would have no legal standing and would produce slightly different results - in some cases making taxpayers marginally better off, in others marginally worse off. So if we are to do this, we would need legislative cover. In the meantime we could issue a press release saying that we will accept figures on this basis where the taxpayer wishes. This would be by way of a extra statutory concession.

Comprehensive Booklet

29. As mentioned above, last year we put aside work on a comprehensive booklet on indexation because of the general CGT review. We could now revive this. But it is questionable whether this is worth doing if you wish to keep open the option of abolishing indexation next year.

Monthly Press Release

30. Finally, we could review the format of the monthly press release giving indexation factors to see if we can improve it by, for instance, including a simplified example.

CONCLUSION

31. We have done a good deal of work over the years on the possibility of simplifying indexation. All our studies have suggested that there is no scope for major simplification if the relief is to be inflation related.

32. This note has however identified some minor changes that might be made:-

(i) abolishing the rounding rule and introducing direct uprating

- Removes the need to maintain actual cost records: all records can be kept in terms of indexed cost.

- If applied generally, probably complex legislation.

- Can be done without legislation for shares in post 1982 holdings, and we have said we will accept computations on this basis. We could give more publicity to this through a Statement of Practice.

- But the main simplification is not in computations but in not needing actual cost records: the price of telling people they need not keep such records is that, were indexation abolished in the future, abolition could be only for future RPI increases: existing accrued indexation would have to be preserved.

(ii) Reducing frequency of indexation adjustment

- Indexation could be done on, say, a calendar-quarterly basis.

- Could be justified by reference to reduced level of inflation.

- Does not simplify computations but reduces length of table taxpayers must consult.

(iii) Reworking 1982-1986 RPI Figures

- Could publish 1982-1986 figures reworked to a 1987 = 100 base and allow these to be used.

- Removes complication resulting from re-referencing of RPI.

- Especially as some would be (marginally) worse off, needs legislation. Meanwhile could tell taxpayers, extra statutorily, that they can, if they wish, do their calculations on this basis.

(iv) Issue of Comprehensive Booklet on Indexation

- Doubtful if worth doing if abolishing indexation next year is still an open option.

(v) Making the monthly Press Release more comprehensible.

- By including illustrative examples of how it is used.

33. I am sorry that we have not been able to find anything more than the above for your consideration but the barrel has been very well scraped. I doubt whether you will wish to pursue (i) - direct uprating, or (ii) - quarterly indexation. The benefits seem to be swamped by the disturbance the changes would cause, the loss of the ability to cut off indexation cleanly should the need

or opportunity arise and the complications of the legislation to achieve such small effects. The other substantive option, (iii), is hardly worth the legislation.

Mu

B T HOUGHTON

ANNEX A

EXAMPLE ILLUSTRATING THE INDEXATION RULES FOR LAND

An individual acquires land in 1970 for £6,000 and sells for £100,000 in January 1987 (RPI = 394.5). The land is worth £80,000 in March 1982 (RPI = 313.4) and an election is made to compute indexation on this value rather than actual cost.

The calculation is as follows:-

Sale proceeds	£100,000
less cost	6,000
Unindexed gain	£94,000
less indexation allowance	
*0.259 x £80,000	£20,720
Indexed gain	£73,280

*This factor is obtained from the ready reckoner supplied with the Press Release

ANNEX B

EXAMPLE ILLUSTRATING THE INDEXATION RULES FOR SHARES

An individual makes the following acquisitions and disposals of shares in the same company -

December 1982	-	Acquisition :	25,000 shares for	£40,000
August 1985	-	Disposal :	5,000 " "	£15,000
March 1986	-	Acquisition :	4,000 " "	£14,000
May 1986	-	Disposal :	8,000 " "	£29,000
January 1987	-	Acquisition :	3,000 " "	£12,000

The RPI is as follows -

December 1982	-	325.5
April 1985	-	373.9
August 1985	-	376.7
March 1986	-	381.6
May 1986	-	386.0
January 1987	-	394.5

ANNEX B

STATUTORY POOLING

	Number of shares	Qualifying expenditure	Indexed Pool
STEP 1	25,000	£40,000	£40,000
Add indexation allowance for Dec. 1982 to April 1985 £40,000 x 0.149			5,960
	25,000	£40,000	£45,960
STEP 2			
Disposal of 5,000 shares for £15,000 in August 1985.			
Add indexation allowance for April 1985 to August 1985. $£45,960 \times \frac{376.7-373.9}{373.9}$			£345
	25,000	£40,000	£46,305
Disposal $\frac{5,000}{25,000}$	(5,000)	(£8,000)	(£9,261)
	20,000	£32,000	£37,044

Computation

Sale proceeds	£15,000
Indexed cost	9,261
Gain	£5,739

STEP 3

Acquisition of 4,000 shares for £14,000 in March 1986.			£37,044
Add indexation allowance for August 1985 to March 1986. $£37,044 \times \frac{381.6-376.7}{376.7}$			£482
	20,000	£32,000	£37,526
Shares to enter pool	4,000	£14,000	£14,000
	24,000	£46,000	£51,526

STEP 4

Disposal of 8,000 shares for £29,000 in May 1986.			
Add indexation allowance for March 1986 to May 1986 $£51,526 \times \frac{386.0-381.6}{381.6}$			£595
	24,000	£46,000	£52,121
Disposal $\frac{8,000}{24,000}$	(8,000)	(£15,333)	(£17,374)
	16,000	£30,667	£34,747

Computation

Sale proceeds	£29,000
Indexed cost	£17,374
Gain	£11,626

STEP 5

Acquisition of 3,000 shares for £12,000 in January 1987.			£34,747
Add indexation allowance for May 1986 to Jan 1987			
$£34,747 \times \frac{394.5-386.0}{386.0}$			£766
	16,000	£30,667	£35,513
Shares to enter pool	3,000	£12,000	£12,000
	19,000	£42,667	£47,513

ANNEX C

EXAMPLE ILLUSTRATING SIMPLIFIED SHARE POOLING (USING THE SAME ASSUMED FACTS AS AT ANNEX B)

	Number of shares	Indexed Pool
	25,000	£40,000
STEP 1		
Add indexation allowance for December 1982 to April 1985 0.149 x £40,000		5,960
		45,960
STEP 2		
Disposal of 5,000 shares for £15,000 in August 1985.		
Indexation of pool : £45,960 x $\frac{376.7}{373.9}$	25,000	£46,305
Indexed cost : £46,292 x $\frac{5,000}{25,000}$	(5,000)	(£9,261)

Computation

Sale proceeds	£15,000
Indexed cost	9,261
Gain	£5,739

	Number of shares	Indexed Pool
	20,000	£37,044
STEP 2		
Acquisition of 4,000 shares for £14,000 in March 1986		
Indexation of pool : £37,044 x $\frac{381.6}{376.7}$	20,000	£37,526
Shares to enter pool :	4,000	£14,000
	24,000	£51,526

STEP 3

Disposal of 8,000 shares
for £29,000 in May 1986

Indexation of pool : £51,516 x $\frac{386.0}{381.6}$	24,000	£52,110
Indexed cost : £52,110 x $\frac{8,000}{24,000}$	(8,000)	(£17,370)

Computation

Sale proceeds	£29,000
Indexed cost	17,370
Gain	£11,630

STEP 4

Acquisition of 3,000 shares
for £12,000 in January 1987

Indexation of pool : £34,740 x $\frac{394.5}{386}$	16,000	£35,505
Shares to enter pool	3,000	£12,000
	19,000	£47,505

RT4.6

SECRET AND PERSONAL

28

FROM: A W KUCZYS
DATE: 11 May 1987

MR HOUGHTON

cc Mr Cayley - IR
Mr Michael - IR

CAPITAL GAINS TAX

The Chancellor was most grateful for your minute of 7 May, which was discussed at the meeting on Friday which Mr Battishill and Mr Isaac attended.

A W KUCZYS

5-3

SECRET AND PERSONAL

FROM: M C SCHOLAR
DATE: 5 JUNE 1987

A ~~few~~ marginal comments.
2. This must be pursued without delay, and with the utmost urgency. It is priority No. 1. L.

SIR PETER MIDDLETON

cc Sir Terence Burns
Mr Byatt
Mrs Lomax
Miss Peirson
Miss Sinclair

A STRATEGY FOR TAX REFORM

At your meeting on 1 June you asked me to let you have an aide memoire on the tax reform work programme, for your post-Election discussion with Mr Lawson if he is Chancellor.

... 2. I attach an aide memoire, cleared with the Revenue. In addition to the points covered, there are two others which you will want to make to the Chancellor:

(i) Does the Manifesto commitment to "keep the present system of mortgage tax relief" rule out any changes in the near future (this has implications for any new tax on financial services)? Is it compatible with eg abolishing relief for improvements or confining it to the residence?

I can explain exactly what is intended

(ii) There are likely to be strong pressures from the Business Managers and the Prime Minister (we have had a talk with Murdo McLean: see our Conservative Brief A16 for details) not to try to get the 100 or so clauses left over from the 1987 Finance Bill through Parliament by the Summer Recess. But this is an argument we should try to win given the ambitious programme of work sketched out below for the 1988 Budget, Autumn preoccupations with public expenditure etc.

Not ~~everything~~ (am checking) RJL.

(iii) Just about anything on VAT now looks ruled out by the Prime Minister.

3. The timetable for papers up to the recess is as follows:

By end June: Papers on husband and wife; CGT

By end July: Papers on income tax/abolition of UEL; NIC changes at lower end; IHT; and financial services.

MCS

M C SCHOLAR

SECRET AND PERSONAL

PERSONAL TAX

Income tax/abolition of UEL

Proposal: 25p basic rate; single 40p higher rate, combined with abolition of UEL on employees' NICs.

Considerations: cost, (including effect on fringe benefits etc); distributional effects; impact on National Insurance Fund/contributory principle and thus on pressures for improved benefits; administrative implications for DHSS (1988-89 is first year of new social security regime) and Inland Revenue.

Timing: if package announced in 1988 Budget, earliest date for implementing abolition of UEL would be October 1988; although there are many precedents for an in-year change, it could provoke complaints from employers. Alternative would be implementation from 1 April 1989. In either event, implementation of higher rate tax change might be staged in parallel, with final reductions from April 1989.

There are now going [illegible] [illegible]

Too bad

Next step: Treasury/Revenue paper in July examining distributional effects of package.

NIC changes at lower end

Proposal: targeted changes to NICs at lowest earnings levels, to help ease poverty and unemployment traps.

Considerations: cost; interaction with post 1988 social security changes.

Timing: if changes announced with Autumn Statement, could be implemented from 1 April 1988; if announced in 1988 Budget, earliest date for implementation would be October 1988.

Must be part of Budget

Next step: Treasury paper in July examining distributional/trap effects.

Husband and wife

Proposal:

(i) separate taxation of wife's income, combined with retention of Married Man's Allowance ("Lorna Bourke"), or

(ii) extension of Wife's Income Election to unearned income.

Considerations: cost; distributional effects; countervailing action on convenants and other, more familiar, tax penalties on marriage; relationship with transferable allowances. Reduction in higher rates of income tax will further reduce already limited attractions of option (ii).

Timing: substantial package, particularly if tax penalties on marriage to be covered. Full scale working-up ought to start before recess if to be included in 1988 Budget. Early decision in principle therefore desirable. Earliest implementation date (i) April 1991 (ii) 1989.

Next step: Revenue paper on options (i) and (ii) by end June.

CGT

Proposal: tax fully indexed gains at full marginal income tax rates.

Considerations: methods of simplifying indexation (rebase to 1982?); level of threshold; distributional, market and economic effects.

Timing: include in 1988 Budget, to take effect from 1988-89.

Next step: Revenue paper on illustrative packages and their likely effects by end June.

IHT

Proposal: abolish IHT and replace by CGT/income tax charge on death.

Considerations: size of exempt slice; rollover relief for gifts, private houses; cost; regime for trusts.

Timing: include in 1988 Budget, to take effect from 1988-89.

Next step: Revenue paper on possible options in July.

Financial services

Proposal: re-examine case for tax on financial services (Mr Cassell's 1983 Report).

Considerations: scope for effective VAT surrogate on financial services; effect of excluding mortgage below £30,000; effect on business loans; enforceability and other administrative questions.

Timing: decisions in principle needed very soon to avoid nugatory work or to allow time to work out tax for 1988 Budget.

Next step: Treasury paper by end July on case for new tax.

TAX STRATEGY

RA3.73

SECRET AND PERSONAL

RJP

FROM: A C S ALLAN
DATE: 15 June 1987

MR SCHOLAR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mrs Lomax
Miss Peirson
Miss Sinclair
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR

TAX REFORM: WORK PROGRAMME

Sir P Middleton passed the Chancellor a copy of your minute of 5 June, with the aide memoire on the tax reform work programme ... (copies attached for those who did not receive it).

2. The Chancellor wishes this work to proceed without delay, as the main priority. A slightly wider group of officials will now need to be brought in on particular aspects of this work. You and the Revenue Departments are therefore authorised to consult those who need to know on the normal pre-Budget basis.

3. He had two comments on the possible NIC changes:

(i) He was not concerned about complaints from employers about an in-year change, if the UEL was abolished in October 1988; though he thought there were more options on the timing than those covered in the aide memoire.

(ii) He felt that any NIC changes at the lower end must be part of the Budget, rather than being announced in the Autumn Statement.

ACSA

A C S ALLAN

PPNo

C.

CPS LECTURE

The CPS want a title for your lecture on 19 January, so that they can send out invitations etc. Difficult to say, until we ~~has~~ decide what the speech is going to say, which we might have a small meeting about soon. David Willetts suggests, however, "Conservatism for the Future" - do you think that is sufficiently broad to take in anything you are likely to cover?

I gather there is a minute
from E. McGivan IR, of
26 Oct, to Ch Ex,
1988 Budget: Corporation Tax.
Pl. cd I see it, along with
any reply.

AH

(1) Meeting 14 or 15 October. Allow 2 hours

"Tax reform: distribution and costings"

minute notice classified SECRET.

[redacted] Byatt

[redacted]

FST

Sir P Middleton

Cassell Sir T Burns

Michael Scholar. Cropper.

[redacted]

IR: Tony Battishill

John Isaac* [redacted]

Brian Mace [redacted]

Michael Cayley

~~Leonard Beighton~~

[redacted] ~~+ statistician~~

*+ invite to bring statistician

Independent Taxation

Copy no 2 of 15

~~BUDGET~~ SECRET AND PERSONAL

Rps

ISAAC → FST 25/6

RP

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

FROM: A J G ISAAC
25 June 1987

FINANCIAL SECRETARY

The FST's other minute commissioning new work was, as you requested, withdrawn. But this one (dated same day) slipped through. I have now made sure PS/FST realises that this subject is under your personal supervision. And I shall make same point to John Isaac, especially given this lengthy response where none was called for AA

1988 BUDGET: TAX REFORM

1. I thought that it might perhaps be helpful to let you see (though you have kindly said that you do not require anything) a very quick tour d'horizon, in response to your Private Secretary's note of 23 June.

2. Your first comment is that proposals for tax reform here should have regard to "reducing Inland Revenue manpower". With respect, we agree. If I may say so, "simplification" as such is very much of an Irishman's pay rise to us, if it ends up by adding to our administrative costs. I attach at Annex A a very short note indicating in broad terms the manpower implications, so far as we can yet judge them, of the main Budget options. As you will see, the case for the principal reforms rests on broad policy grounds, and not on administrative considerations. But there are possibilities, perhaps at the margin of reform policy, which could in due course yield much better than marginal offsetting staff savings.

---

cc	Chancellor of the Exchequer	Mr Battishill
	Chief Secretary	Mr Isaac
	Sir P Middleton	Mr Painter
	Sir T Burns	Mr Beighton
	Mr Byatt	Mr Johns
	Mr Cassell	PS/IR
	Mr Scholar	
	Mr Cropper	

3. Your second comment is that we need to look, in particular, at the area of benefits in kind. In my note to you of 19 June I gave a list of topics either before you, or coming forward shortly. The main bulk of the work here, applying to directors and the higher paid, is among the most cost effective areas of our compliance effort. If I may say so, however, I agree that other areas are less cost effective and more troublesome. A number of the papers foreshadowed in my note of 19 June will discuss ideas which could either save significant numbers of staff (though in some cases with some transitional extra costs for recoding etc) or avoid the need for staff increases.

4. I attach at Annex B a short note on the specific suggestion that benefits should not be tax deductible to the company. As you will see, there are reasons for doubting (though this has been looked at a number of times) whether the way forward is more promising here than elsewhere. We are of course at your disposal, if you would like a fuller note, or if a meeting would be helpful. (The treatment of benefits generally will, of course, need to be looked at carefully in connection with the removal of the UEL.)

5. Your third point arises from Sam Brittan's suggestion that we might move towards assessing people according to estimates and scales. We will be discussing one possibility of this kind in one of the submissions promised in my note of 19 June (Car Parking - though I don't think it will in practice be our preferred option). However, Sam Brittan is, of course, talking of Schedule D tax here, not Schedule E; and we shall let you have a note separately.

6. Fourth, you ask about self-assessment. I do not know if you would like for this purpose to glance again at the note which I sent to the Chancellor on 25 March (Non-cumulative PAYE). As the heading indicates, that note was addressed to the specific question of non-cumulation for PAYE. You can either stop at that point (with continuing Revenue assessment) or you could (if you wished) move on to self-assessment, as such. It is generally

accepted - for the reasons explained in the Personal Tax Green Paper - that non-cumulation is a necessary precondition of self-assessment. And my note of 25 March discusses both possibilities.

7. My note of 25 March did not range more widely, to discuss the implications of self-assessment outside PAYE. In practice, however, the detailed work on this has confirmed (as one would expect) that self-assessment could not be confined to Schedule E alone. It would have to extend to Schedule D (self-employment income) and to the large numbers of people who have income taxable under both Schedules D and E.

8. There are some wider implications here, which (as you will remember) we touched on in the course of Wednesday's presentation of the DDP. In particular

- There is the long-standing argument for simplifying the present Schedule D procedures. This is necessary if Ministers want **either** to modernise and streamline the Revenue assessment system (with something like "pay and file" for Schedule D, and "total income assessing"), **or** to move towards more radical change and self-assessment.

- In either case, however, this means picking up again the work on the possible move from a "previous year" to a "current year" basis for Schedule D and

- if Ministers want to keep open the possibility of action here, reasonably soon after it becomes practicable when BROCS is in place in the early 1990s, we need to make a start fairly soon down the (long) critical path.

AJGI

A J G ISAAC

ANNEX A

1988 BUDGET: TAX REFORM: MANPOWER IMPLICATIONS

Income tax

1. The front runner - a 2p reduction in the basic rate of income tax, to 25% - has no significant staff implications, as such. The question is, how much money will be available, in addition, to raise the tax threshold. If the money can do no more than finance statutory indexation in line with prices - if thresholds cannot at least keep pace with earnings - then I fear our staff costs continue to increase.

2. Similarly, reductions in higher tax rates and simplifications in the higher rate structure above the higher rate threshold hardly affect our staff needs either way. What matters is the first higher rate threshold. If the higher rate threshold increases only in line with prices (statutory indexation) - if again the threshold does not increase at least in line with earnings - again our staff needs increase. (The proportion of tax units liable to higher rate tax in 1987/88 - 5.7% - is the highest for a decade (1978/79 3.6%).)

3. Changes to NICs at either the top or bottom end do not of themselves affect our staff costs. But abolition of the UEL will add to pressure on benefits in kind and, if countervailing action were taken in that area, there might be significant additional staff needed.

4. Other structural changes which have been discussed, but are not current front runners - such as a reduced rate band, a vanishing exemption, personal allowances restricted to the basic rate of tax - could add substantially to our staff costs.

5. Reforms of the tax treatment of husband and wife would add to staff costs - possibly around 300 for wife's income exemption, around 1,200 for independent taxation.

Capital gains tax and IHT

6. The principal front runner - integration with income tax and rebasing at 1982 - does not seem likely, on the work so far, to have large staff implications. There may be a moderate net staff cost. (The big simplification and staff saver - terminating indexation - is no longer on the table).

7. Work is less far advanced on the other possible package - abolition of IHT and reintroduction of CGT on death. There would be savings in the Capital Taxes Offices from abolition of IHT offset by additional staff costs in tax offices. Where the balance would be would depend on where the threshold for CGT on death was set.

8. To avoid staff increases the thresholds for CGT and IHT ((leaving aside radical reform) need to increase at least in line with the relevant asset values (which recently have risen faster than the RPI) - notably share prices (CGT, IHT), commercial property (CGT), domestic houses (IHT).

Other reforms

9. Apart from the point mentioned at paragraph 3 above, I reviewed in my note of 19 June several "runners" for benefits in kind. Administrative considerations will of course be only one amongst several factors. Having said that, a number of options would either reduce staff costs (though in some cases with some transitional extra costs for recoding etc) or avoid the need for staff increases.

10. In my note to the Chancellor of 22 June (Tax Reform: Work Programme) I suggested that we might set in hand a review of other reform possibilities, taking advantage of the wider reductions in rates and simplification of structure. Again, administrative considerations would be only one amongst many factors. Again, however, these could (in due course) yield

significant staff savings building up to a total - over the years - of many hundreds. Ministers have already authorised work to be done on two of the biggest options here - the receipts basis for Schedule E (a "technical" matter, but significant administrative simplification and revenue earner) and the tax treatment of covenants and court-ordered maintenance payments (obvious political and other constraints on too radical a reform, but what we have now is administratively ludicrous). Others also could be worth while in this context, if Ministers would like us to take up the work.

ANNEX B

BENEFITS IN KIND: TAX DEDUCTIBILITY TO THE COMPANY?

1. The suggestion is that the company should no longer have a deduction for the cost of benefits in kind and (by implication) perhaps the director or employee should no longer be chargeable to personal income tax on the value of benefits he or she receives.

2. The arguments for this approach are essentially administrative. Could one get a reasonably effective tax charge on benefits by seeking a single (large) payment from the employer, rather than seeking a multitude of (smaller) payments from each of the directors and higher paid employees? If so, could this save substantial Revenue staff costs?

3. This note summarises very briefly the considerations arising under this approach for

- principle;

- the incentive to take benefits in kind, rather than straightforward cash salary;

- administrative costs.

<u>Principle</u>

4. The principles here are clear enough.

- When an employer spends money on providing his employees with a benefit, he is incurring a "business expense" - in precisely the same way and to precisely the same extent as when he pays them a cash salary.

- When the employee receives a benefit, he receives remuneration for his services - again in the same way as when he receives his salary.

Thus, the employer should get a deduction for his business expense, and the employee should be liable to tax on his total income. In this way, the tax system can be "neutral" as between payments in cash and in kind - leaving employers and employees to arrange their affairs on straightforward commercial grounds.

5. Having said that, we entirely accept - and I myself shall be saying this in our submission on the benefits threshold - that tax policy must in the final analysis be a matter for pragmatism. And, of course, the approach described above is the one the Chancellor is envisaging on entertainment and gifts - where the circumstances do clearly appear to justify a departure from "pure" principle and on which we shall be submitting a draft consultative document shortly.

Incentive to convert income from cash to kind

6. As I have said, the tax system is at present (and subject to the favourable scale charge for company cars) broadly "neutral" as between income in cash and in kind. However, the NIC treatment favours benefits: they escape both the employer's contribution of 10.45% and the employee's contribution of 9%, up to the UEL. It is widely recognised that abolition of the UEL on the employer's contribution gave a significant stimulus to the spread of benefits in kind.

7. A change of the kind proposed would remove the present "neutrality" for tax purposes. For high paid employees - obviously the area most at risk - its effects would seem likely to be as follows on 6 main groups of businesses.

i. Companies paying corporation tax at the 35% rate. For these companies, there would be a new tax advantage for paying benefits in kind, as against cash, to their most senior employees - measured by the difference between the 35% CT rate and the top rates of income tax between 60% and 40%). This would be in addition to the existing NIC advantage.

ii. For companies paying at the small companies rate of (currently) 27%, the new tax advantage would be similar but obviously significantly larger.

iii. For companies with substantial overseas income, whose UK tax liability is covered by double tax relief, the tax advantage for benefits would be very large. There would (as now) be no effective UK tax charge on the company. And there would (by contrast with cash income) be no tax charge on the UK director or senior employee. In effect, benefits would be tax-exempt.

iv. Similarly, with companies that are "tax exhausted" including some of the nationalised industries.

v. Similarly again with public sector bodies, including local authorities (and also pension funds, mutual insurance companies, charities etc).

vi. For unincorporated business (the self-employed) the balance of advantage might be different. There would remain an NIC advantage for benefits. But the marginal tax rate of the partners would probably be higher (in most cases) than the marginal tax rate of the employees. So, there could often be a tax disadvantage for benefits paid by the self-employed.

8. For categories (i) and (ii) above the position would be different with basic rate employees, where the position would be disadvantageous for (i) and neutral for (ii).

9. On balance, it seems likely that the new regime would add significantly to the incentive to pay benefits in kind, rather

than in straightforward cash salary - over and above the existing NIC incentive. In some important categories of case the incentive would seem likely to be almost irresistible.

Administrative savings

10. In paragraph 2 above I ask the question whether it would be possible to seek tax in respect of benefits in kind through a single large payment from the employer. Self-evidently, for that to be possible, the employer must be able to calculate the amount of the benefits chargeable to tax, ie the gross expenses/benefit payable less the expenses due under the Schedule E expenses rules. In some cases, as one would expect, this is straightforward. In other cases, however, it is very much more difficult. Thus

i. There is no problem with the "pure" benefits. An obvious example is the BUPA subscription which an employer pays on behalf of his employees. The employer knows how much he is paying. It is scarcely conceivable that the employee can claim this cost to be incurred "wholly, exclusively and necessarily" in the performance of his duties. In this kind of case, therefore, "gross" and "net" would be the same figure and there would be no technical difficulty in disallowing the cost in the hands of the employer.

ii. Things get a little more complex in the case of company cars. The cost to the employer is the full cost of the car; and there could presumably be no question of disallowing the entire costs which companies incur for their car and truck fleets, including costs incurred wholly and exclusively in the course of business, visiting clients, delivering goods and so forth. Even the present scale charges vary with the circumstances of the individual taxpayer (not just the size of the car or its cost, but also the amount of business mileage). Previous Treasury Ministers suggested in

1982 that employers should be responsible for calculating the amount of the taxable benefit for their employees' company cars; but the suggestion had to be withdrawn, in face of fierce criticism by employers of the additional work that this would entail for them.

iii. At the other extreme, there is the huge variety of "expense" payments where the net amount chargeable to tax will commonly be half or less than half the gross payment. Some of these will be paid ad hoc (for example, a daily subsistence rate); some will be paid in round sums, but separately from normal pay; and in some cases total pay will be set at a level at which the employee is expected to fund certain necessary expenses out of his pocket. Again, some of the expenses will - and should - clearly be allowable for tax purposes: for example, travel in this country or abroad on business: cost of employees engaged in the business. Other expenses will not - and should not - be allowable for tax purposes: for example (normally) the wife's travel, or the "incentive holiday"; the personal chauffeur or nanny whose pay is carried in the business books. In this kind of case, there seems no escape from checking what each individual employee did with the money: whether it was a personal or a genuine business occasion; and the facts will vary widely between one employee and the other.

The figure for 1983/84 showed total gross payments of £1,700m, allowance expenses of £800m, benefits chargeable of £900m.

11. It is, of course, in category iii. above that the risks of abuse are, notoriously, greatest. However, given that the facts would in any event have to be established on an employee-by-employee basis, there would be an additional administrative cost, in (in addition) bringing together the facts for all the business's employees, in order to impose a

consolidated charge on the employer (rather than the employees concerned).

12. It was very much for these reasons that the Government decided in 1985 that it would be impracticable to impose an NIC employer's charge on benefits and expenses, to offset the removal of the employer's UEL - and the incentive which that gave to benefits in kind. But no doubt we shall need to look at all this again in examining the possible effects of removing the employee's UEL.

BUDGET SECRET

not sure this is right classification yet.

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

I wd like a paper on suggestions, but pse fix a v. brief & small mtg 1st (NL, PEM, AMB, AJGI, TB, MCS, FC, PJC). NL

Ch
This seems helpful. Shall I minute back with your suggestion to PEM about company cars/perks more/generally?
AA

FROM: A J G ISAAC
22 JUNE 1987

PS. I am v. concerned abt security over all this. NL

CHANCELLOR OF THE EXCHEQUER

1988 BUDGET: TAX REFORMS

1. As you know from Sir Peter Middleton's aide-memoire, we shall, within the next few weeks, be letting you have a series of papers, providing some "sighting shots" on the distributional and other effects of

- reducing the basic rate of income tax to 25%

- cutting the top rate of income tax to 50% or 40%

- abolishing the UEL

- taxing capital gains as income (with rebasing to 1982).

2. This is reform on a scale which has rather few recent precedents in this country (other than the 1984 reform of corporation tax) and which one would not in the normal course of events look to see again for years. As I see it, it raises - at

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cc		
	Chief Secretary	Mr Battishill
	Financial Secretary	Mr Isaac
	Economic Secretary	Mr Painter
	Paymaster General	Mr Beighton
	Sir Peter Middleton	Mr Johns
	Sir Terence Burns	PS/IR
	Mr Cassell	
	Mr Byatt	
	Mr Scholar	
	Mr Cropper	

NB leakage. How often would go for all? How far for IR?

least - questions about a number of constraints or shibboleths, which were part of accepted wisdom when marginal tax rates were much higher and the gap between the taxation of income and capital much wider. (I say "it raises questions", which should perhaps not go unasked. At this stage I do not think that any of us has yet taken our thinking to the point where we wish to anticipate the answers.)

3. I do not want to overstate the obvious analogy with the United States tax reforms. As you yourself have said, we have already accomplished in this country much of what the United States are now doing, alongside **their** reductions in marginal tax rates, and integration of capital gains with income.

4. However, having discussed this with a few colleagues, I wonder whether you would welcome an opportunity to review with us some possible wider implications. The objective - as with the US tax reforms - might be to see whether the (proposed) major changes in tax structure and reductions (for most people) in tax burden would also make possible a degree of more detailed simplification and streamlining - which went with the grain of your tax reforms - broadening the tax base and/or "levelling the playing field" and/or (where possible) simplifying the legislation.

5. In making this suggestion, I have tried not to set our sights too high. In particular, I have very much in mind that

- there are clear commitments on some things, such as mortgage interest and pensions, which might otherwise be candidates for a review of this kind;
- it must be expected that the major tax reforms would themselves produce a significant number of losers, as well as gainers; and this may itself restrict the options to the extent that some of these would necessarily entail removing existing reliefs or concessions;

- considerations of timing, pressure of Finance Bill space - and also security, with Budget proposals as sensitive as these - taken together, point strongly away from anything requiring further complex technical legislation in the 1988 Finance Bill.

Accepting that, however, I wonder if you would like to consider whether there are other possibilities which could contribute to a rather wider ranging reform package.

6. Our own lateral thinking so far has concentrated in three main areas.

7. First, there are the remaining special reliefs whose original justification lay in the need to mitigate the effects of a steeply progressive income tax schedule. The Government has already taken action on the special reliefs for foreign earnings and foreign emoluments. Other examples (we have not yet tried to draw up a comprehensive list) might include the complex rules for "top slicing" and farmers' averaging.

8. Second, there is the variety of things which come under the heading of "privileged income" or tax shelters. Examples here might be forestry and the (still pretty unrealistic) scale charges for company cars - in particular the more expensive cars. You know of the problems with covenants and court-ordered maintenance payments (which will have new light thrown on them by any change to independent taxation of husband and wife). In principle, one could under this heading re-examine the continuing need for such things as BES and PEP; but you may feel that this would be going a little too far at this stage. (Yes?)

9. Third, there is the complex and uncertain area, where (more highly taxed) personal income may shade into (potentially less highly taxed) income routed through a corporate or trust regime, or routed into the form of capital. The reform package would

narrow the differences of tax treatment - though of course by no means eliminate them.

10. What we would have in mind, if you think that would be helpful, is to mount a first review of the possibilities, confined to those here and in the Treasury who in any event strictly need to know on a Budget Secret basis. In putting forward any suggestions, we would obviously have regard to the competing pressures on Ministers' time, on our own resources, and on what promises to be a heavy 1988 Finance Bill. However, the idea would be to let you have a more considered paper during the summer, identifying specific options and (perhaps) indicating which, if you find any of them attractive, might be worked up in more detail for consideration as possible items

a. for the 1988 Finance Bill;

b. for announcement (or announcement of a consultative document) in the context of the 1988 Budget package, though legislation might be for a later Finance Bill;

c. for further work and review over the longer term.

11. The only questions for decision at this stage ~~is~~ are whether you would find it helpful to have a paper of this kind from us; and, if so, whether there are any items which you would want us to ~~out~~ leave outside the ambit of review from the outset. We are of course wholly at your disposal, if you would like to discuss.

C.L.C.I.

A J G ISAAC

CHANCELLOR OF THE EXCHEQUER

28

NOTE OF A MEETING HELD IN HM TREASURY
ON TUESDAY, 30 JUNE

Those present:
Chancellor
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR

1988 BUDGET: TAX REFORMS

Paper: Mr Isaac of 22 June

The Chancellor said he was most grateful for Mr Isaac's paper, which was very helpful. Following this discussion, he would be grateful for a further paper. He stressed the importance of maintaining the security of these proposals.

2. Introducing his paper, Mr Isaac said he thought there were three areas to be looked at. First, the special reliefs that went hand in hand with high marginal rates (eg farmers' averaging). Second, the whole range of tax shelters, including those which he would not expect the Chancellor to want to curtail (BES, PEPs) and ones that certainly ought to be looked at (treatment of forestry, maintenance payments, Schedule E receipts basis, treatment of non-residents). Third, the differences in tax treatment of different forms of income and capital. It would not be practicable to take action on all of these in 1988. But it might be worth floating some ideas in the 1988 Budget. Officials would welcome guidance from the Chancellor on how far to pursue all this.

3. The Chancellor said that he would want to legislate for as much as possible of any reform in the 1988 Finance Bill. It was far preferable to introduce an overall reform package then, than to have a number of possibly controversial items hanging on until future years. In choosing from the menu which Mr Isaac had presented, we had to decide priorities - the constraints included resources in the Inland Revenue, and how much political capital would be used up on particular proposals. The meeting then considered a number of particular items in turn.

Mortgage interest relief

4. The Chancellor recorded the position agreed with the Prime Minister. Mortgage interest relief would continue at full marginal rates against the first tranche of interest - for the time being the
interest on the first £30,000, although this could be reviewed. Some changes, such as putting the relief on a residence basis, or denying relief for home improvements, were still available as options.

Benefits in kind

5. The Chancellor said that this was an obvious area in which to take action. One option was to increase the charge on car benefits by more than 10 per cent. He wondered whether there was scope for attacking other perks, such as cheap loans. Mr Isaac argued that there was no tax advantage in the case of subsidised loans, and Mr Battishill said that what was needed there was improved compliance, not a change in the legislation.

6. The Financial Secretary noted that the fall in the real value of the £8,500 threshold had led to some rather trivial benefits being pursued by the Revenue. Mr Isaac said that trivial cases usually only arose as part of a larger investigation. The Chancellor, however, said that this was an area which was creating increasing friction with taxpayers. He asked the Revenue to look again at cost-effectiveness in this field. (One option might be a de minimis rule).

7. Nonetheless, the Chancellor did want to take the opportunity to improve the effectiveness of the tax system in relation to high value perks of top earners. Mr Battishill agreed that this was a problem which would need to be addressed in any case, as a result of the proposed UEL change, which would tend to reinforce the trend towards payment in kind at the top end. The Chancellor noted one conflict of objectives: the Government wanted to encourage employee share schemes. Any action taken should not discourage genuine use of employee trusts.

Taxation of savings

8. Mr Battishill pointed out that the reduction of top marginal rates would reduce the attractiveness of, for example, the BES. The Chancellor accepted that if, as a result, use of the scheme tailed off, there might be a case for bringing it to an end. But that was not a matter for the 1988 Budget.

9. The Financial Secretary wondered if there was a case for looking again at the taxation of different forms of savings, to achieve a more level playing field. It was noted, however, that the Green Paper undertaking meant that we were effectively confined to "levelling up". Sir P Middleton said we were already looking at financial services, and were about to announce a review of the tax treatment of life assurance.

10. The Chancellor had hoped that the review of the tax treatment of life assurance would be completed in time for the 1988 Budget. Mr Battishill, however, explained that this would not be possible. Although the 30 per cent rate of tax on policyholders' gains would be a clear anomaly, the position could be justified as a holding action until the tax regime for life assurance more generally was changed. Moreover, there were precedents in this area - the so-called "pegged rate". The Chancellor reluctantly accepted that further change would not be possible in 1988. And given the need to get the present Finance Bill through very quickly, it was not

feasible to enact the 35 per cent rate, as proposed in the Budget, in the present Finance Bill.

Corporation tax

11. The Chancellor said that we would come under increasing pressure from the CBI and others to reduce the main rate of Corporation tax, as the yield continued to increase. He asked for a note from the Revenue showing how the corporate sector would benefit from the Corporation tax reforms, as the cash flow effects worked through fully.

Conclusions

12. There was already a very heavy Finance Bill in prospect for 1988. For that reason, it might turn out that we only tackled a small number of items from the programme Mr Isaac had put forward. In particular, the general review of the tax treatment of savings was on a slower time track. Nonetheless, the Chancellor looked forward to receiving Mr Isaac's further paper.

A W KUCZYS

Circulation

Those present
Chief Secretary
Paymaster General
Economic Secretary
Mr Tyrie

CAYLEY
CH/X
6 JULY

Inland Revenue

Policy Division
Somerset House

BUDGET SECRET

From: M F Cayley
Date: 6 July 1987
Extn: 7571

1. Mr Houghton Pl see note below. [initials] 6/7
2. Chancellor

CGT:MINOR SIMPLIFICATIONS OF INDEXATION

1. In my note of 1 July on CGT reform, I said that we would let you have a separate paper on the possibility of minor simplification of the indexation rules. This paper is now attached.

2. As it explains, we have looked further at the options in Mr Houghton's 7 May note. Our general conclusion is that in two cases - quarterly indexation and providing a slightly simpler way of coping with the recent RPI re-referencing - the frictional irritations of making the change would probably outweigh the marginal simplifications. The third - introducing "direct uprating" for post-1982 shares - would be useful and could be achieved and publicised by a Statement of Practice (we already accept computations on this basis, though this is not widely known). This Statement could be published on Budget Day if you wished to link this simplification with CGT reform.

below

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cc Financial Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

Mr Battishill
Mr Isaac
Mr Houghton
Mr Calder
Mr Beighton
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Michael
PS/IR

3. We have also looked at the possibilities of publishing a comprehensive Revenue booklet on indexation and of revising slightly the presentation of the monthly press release which gives indexation factors. We did a good deal of initial work on a booklet last year but put it to one side because of the general CGT review. If we issued a full booklet this year and CGT reform went ahead in 1988, the booklet would need substantive revision. We therefore think that the better course would be to continue to defer further work on the booklet for the time being.

4. As regards the monthly press release, people are familiar with the present format, and again we would need to take a fresh look at it if reform went ahead next year. So here too it is probably better to leave things as they are for now.

Michael Cayley

M F CAYLEY

My note of 7 May and this note by Mr Cayley indicate how limited is the choice of changes in the CGT indexation rules which seem likely to commend themselves as simplifications of the present system.

Even the one now recommended (publicising by a Statement of Practice the use of "direct up-rating" for post-1982 shares) has a drawback in that it would allow taxpayers to cease maintaining records of actual acquisition costs, thus fixing accrued indexation irremovably in the system. This may go too far - for such a slight computational change. We can continue to accept informal calculations which are offered on this basis but without removing or weakening the statutory assumption that acquisition cost records are being maintained (many taxpayers would anyway wish to keep this information).

You may therefore see advantage in leaving the indexation arrangements as they stand and let attention concentrate on the other, far more important structural changes which are in contemplation.

B T HOUGHTON

SIMPLIFICATION OF INDEXATION

1. We have been looking at various possibilities for simplifying indexation. As we mentioned before the Election, none of the options here would make substantial inroads into the complaints which have been levelled against the indexation provisions. At most their effect would be marginal. And a further consideration which perhaps needs to be borne in mind is that neither we nor Ministers would get any thanks from practitioners for tinkering around with the legislation and making what might easily be seen as purely cosmetic changes.

2. As previously, we have identified three options:-

i. A change from a monthly to a quarterly basis for giving indexation relief.

ii. Rebasing the 1982-86 RPI figures.

iii. Simplified rules for shares acquired since 1982 (and possibly other assets generally).

These options and other possibilities (a comprehensive booklet on indexation and improving the format of our monthly press release) are fully discussed in the Annex. Broadly speaking, however, the picture which emerges is as follows.

Option (i) : Quarterly indexation

3. On balance we think that this is not worth doing. It does, of course, have some superficial attractions (for example, it would reduce the size of the table of factors) but on the other hand it would do nothing to simplify the calculations themselves. Moreover, there would be a pattern of gainers and losers. In general, these would only occur at the margin but there could be relatively large sums involved in a minority of individual cases.

Option (ii) : rebasing the 1982-1986 RPI figures

4. For assets other than post 82 shares, we regularly publish a table of factors to be used in indexation computations. For technical reasons, the indexation allowance on post-82 shares has to be calculated using actual RPI figures rather than our published factors. In order to calculate indexation on shares relief the RPI figures for the months of acquisition and disposal need to be on the same basis. Until now this has not been a problem because the RPI has always had a pre-indexation base date of 1974=100. Recently, however, the RPI has been re-referenced to make January 1987=100. Consequently, RPI movements for periods

spanning January 1987 have to be calculated using a linking formula provided by the Department of Employment. This formula has to be used for all official purposes.

5. On operational grounds there is a case for legislation to put the RPI figures since 1982 on a consistent (1987=100) basis for capital gains indexation purposes, thus removing the need to use the official linking formula for calculations for post-82 shares. However, the difficulties which re-referencing has created are likely to be of a transitional nature only and, as a matter of working practice, local offices will be able to accept computations where taxpayers have, in fact used re-worked RPI figures (published in some journals) rather than the official formula. In addition, by the time legislation appeared others will have become familiar with the linking formula and it is likely that many outside agencies will already have re-programmed their computers on this basis. And legislation on this would make some people slightly worse off: it would therefore be difficult to make the change retrospective to the start of 1987, and it would be confusing to have the linking formula serve as the official basis of calculation up to the date any legisaltion was effective, with a revised basis thereafter. A further change might not, therefore, be

welcomed. And by the time any 1988 legislation became effective the number of cases where the official linking formula causes a little extra complication will have already started to diminish. On balance we think this is a change whose marginal benefits will be outweighed by the irritation factor of the change itself.

Option (iii) : simplified rules for post-1982 shares

6. Indexation operates slightly differently for shares acquired since 1982 as compared with other assets. As a result, there is scope for applying indexation by direct uplift rather than having to compute the relief as a separate step in the calculations.

7. We think that this would be a worthwhile simplification. It could be presented as a positive response to some of the criticism which the rules for shares in particular have attracted and significantly it could be achieved by Statement of Practice. If the restructuring goes ahead next year this could be published on Budget Day as a component in CGT reform. We would not advocate a comparable change for assets other than shares: the benefits of the simplified approach would generally be virtually nil, could only be achieved by complex legislation and would probably not be worth the candle.

ANNEX

SIMPLIFICATION OF INDEXATION

1. This annex takes a rather more detailed look at the following ways of simplifying indexation:-

i. a reduction in the frequency of indexation adjustments;

ii. rebasing the 1982-1986 RPI figures; and

iii. direct uprating for post-1982 shares (and possibly other assets).

We also consider the possibilities of issuing a comprehensive booklet on indexation and improving the format of our monthly press release.

Frequency of indexation adjustments

2. At present, indexation is computed by reference to the monthly changes in the RPI. The resulting table of indexation factors is looking increasingly long and daunting.

3. It would be possible to give indexation relief by reference to RPI movements over a longer period - for instance a calendar quarter. (When the USA contemplated indexation it was to be on a quarterly basis). Someone who acquired and disposed of an asset within this period would get no relief.

4. Quarterly indexation (by reference to the RPI for the mid-month of each calendar quarter) was considered, and rejected, in 1982 for the following reasons.

i. First, in the context of a future only indexation scheme it was felt to be too restrictive.

ii. Secondly, it would produce odd results. For example, taking an extreme case, someone holding an asset for 18 months would receive only the same indexation as someone holding for 12 months and a day.

The first point would not, of course be of significance if the tax is rebased at 1982 and, in any event, quarterly adjustments would be much more tolerable with current low rates of inflation. Inevitably, the second point would give rise to all the usual complaints about anomalies but this would have to be the price for "rough and ready" indexation.

5. There would be an incentive for people wishing to dispose of an asset towards the end of the calendar period to hang on into the next period, so as to get an extra tranche of indexation - and the longer the period the greater this "lock-in" effect. But if the adjustments were done on a quarterly basis it is questionable whether, with present levels of inflation, there would be substantial market distortions.

6. There is a rule at present to counter this "hanging on" effect for monthly indexation which has the effect of denying indexation for assets acquired and disposed of within a period of 10 days overlapping the end of the month. If quarterly indexation were introduced there would be an argument for extending the straddle period to, perhaps, 30 days. The disadvantage with this system is that it requires identification of disposals with acquisitions for a larger number of transactions - a significant counterbalance to the marginal simplification achieved by the adoption of a quarterly basis.

7. A switch of this kind could be achieved by about half a page of legislation. It would not, of course, simplify the computations themselves. But it would reduce the frequency of calculations and hence the overall compliance burden on both sides. The principal beneficiaries under the change would be investors in shares (because of the velocity of disposals and acquisitions as compared with non-fungible assets such as land).

Rebasing the 1982-1986 RPI figures

8. In order to calculate the amount of indexation relief available it is necessary for the RPI for both the months of acquisition and disposal to be on the same basis. Hitherto, this has not been a problem because the RPI has always had a pre-1982 base date of 1974=100. Recently, however, the Department of Employment has re-referenced the RPI to a 1987 base. This means that whenever it is necessary to compute the RPI movement for a period spanning January 1987 a special linking formula has to be used. In this we and taxpayers are in the same position as anyone else who has for legal or contractual purposes to use movements in the RPI for whatever purpose.

9. For technical reasons, the change is more material for shares acquired since 1982, where the actual (unrounded) move in the RPI is used in computations. For all other assets (including shares acquired pre-1982) the indexation adjustment is rounded before being applied and we publish a table of indexation factors - the linking formula is not relevant to actual tax computations as people simply use our published factors.

10. Nevertheless, the formula involves an irritating extra layer of complication. It would simplify things if we could use a series of RPI figures going back to 1982 which were converted to a 1987=100 base. But this series would have no legal standing and would produce slightly different results - in some cases making taxpayers marginally better off, in others marginally worse off. So if we are to do this, we would need legislative cover. The necessary legislation should be fairly short - perhaps less than one page - and would need to be preceded by consultation with the Department of Employment.

11. However, the operational difficulties which have arisen as a result of re-referencing will work their way out of the system over time and,

significantly, we have not so far received representations on the point. Moreover, we have told local tax offices that, as a matter of practice computations submitted on re-worked RPI figures - and some outside agencies have already published tables - may be accepted. In addition, it is probable that by the time any legislation was introduced other taxpayers will have become familiar with the formula - which we suspect has already been incorporated in computer programmes. A further change might not, therefore, be greeted with enthusiasm.

Direct uprating for shares acquired since 1982 (and possibly other assets)

12. Much of the criticism which the indexation provisions have attracted has been directed at the rules for shares. If indexation is to continue some complication is inevitable. Nevertheless, there is scope for streamlining the calculations to a significant extent.

13. At present indexation applies slightly differently to shares acquired since 1982 as compared with other assets. For these other assets such as land and pre-1982 shares the rise in the RPI is first rounded to the nearest

third decimal place before being applied. From April 1985 onwards the indexation of 1982 holdings of shares (ie post 1982 acquisitions) is achieved by applying the rise in the RPI to the relevant expenditure without rounding. This slight mis-match is, in part, a by-product of the speed with which the 1985 changes had to be put together.

14. In all cases, the indexation allowance is computed as a separate element in the calculations. But with the rounding rule already abolished for post 1982 shares, the computations here could be short-cut: all calculations could be done on indexed expenditure, with no need to keep separate records for actual (nominal) expenditure. Examples comparing the existing and alternative (simplified) arrangements are attached.

15. To apply this change across the board would involve the abolition of the rounding rule for other assets (at the margin this would produce gainers and losers) and fairly complex legislation. It can however be applied in practice to the uprating of 1982 holdings of shares after 1985. Because of the way the statutory indexation rules for such shares have been drafted, if direct uprating were confined to them it could

be done without legislation. The simplified leaflet on indexation for shares issued last year does contain an oblique reference to the fact that we will accept computations on this short-cut basis. If Ministers wished to avoid complex legislation in this tricky area, it would thus be possible to confine direct uprating to post-1982 shares (where it would be of most practical benefit) without legislation. In that event we would recommend issuing a Statement of Practice on the point to give greater publicity to our willingness to accept short-cut computations. The alternative basis would, of course, be optional so that people who wished to continue on the strict statutory basis could do so.

16. There is, though, one important consideration. Doing this would only be really worthwhile if we were to tell people that they no longer needed to keep records of actual (nominal) cost. But once we do this, we rule out any possibility of abolishing indexation relief for RPI movements up to a current date: if at some point Ministers wished to abolish indexation, they would be able to do so only for <u>future</u> RPI increases: <u>accrued</u> entitlement to indexation would have to be preserved. This would also mean that the indexation

calculations would have to be continued until all assets acquired before the date of abolition were disposed of.

EXAMPLE ILLUSTRATING THE INDEXATION RULES FOR SHARES

An individual makes the following acquisitions and disposals of shares in the same company -

December	1982	-	Acquisition :	25,000	shares	for	£40,000
August	1985	-	Disposal :	5,000	"	"	£15,000
March	1986	-	Acquisition :	4,000	"	"	£14,000
May	1986	-	Disposal :	8,000	"	"	£29,000
January	1987	-	Acquisition :	3,000	"	"	£12,000

The RPI is as follows -

December	1982	-	325.5
April	1985	-	373.9
August	1985	-	376.7
March	1986	-	381.6
May	1986	-	386.0
January	1987	-	394.5

STATUTORY POOLING

	Number of shares	Qualifying expenditure	Indexed Pool
STEP 1	25,000	£40,000	£40,000
Add indexation allowance for Dec. 1982 to April 1985			
£40,000 x 0.149			5,960
	25,000	£40,000	£45,960
STEP 2			
Disposal of 5,000 shares for £15,000 in August 1985.			
Add indexation allowance for April 1985 to August 1985.			
$£45,960 \times \frac{376.7-373.9}{373.9}$			£345
	25,000	£40,000	£46,305
Disposal $\frac{5,000}{25,000}$	(5,000)	(£8,000)	(£9,261)
	20,000	£32,000	£37,044

Computation	
Sale proceeds	£15,000
Indexed cost	9,261
Gain	£5,739

STEP 3

Acquisition of 4,000 shares for £14,000 in March 1986.			£37,044
Add indexation allowance for August 1985 to March 1986. $£37{,}044 \times \frac{381.6-376.7}{376.7}$			£482
	20,000	£32,000	£37,526
Shares to enter pool	4,000	£14,000	£14,000
	24,000	£46,000	£51,526

STEP 4

Disposal of 8,000 shares for £29,000 in May 1986.			
Add indexation allowance for March 1986 to May 1986 $£51{,}526 \times \frac{386.0-381.6}{381.6}$			£595
	24,000	£46,000	£52,121
Disposal $\frac{8{,}000}{24{,}000}$	(8,000)	(£15,333)	(£17,374)
	16,000	£30,667	£34,747

Computation

Sale proceeds	£29,000
Indexed cost	£17,374
Gain	£11,626

STEP 5

Acquisition of 3,000 shares for £12,000 in January 1987.			£34,747
Add indexation allowance for May 1986 to Jan 1987			
$£34,747 \times \frac{394.5-386.0}{386.0}$			£766
	16,000	£30,667	£35,513
Shares to enter pool	3,000	£12,000	£12,000
	19,000	£42,667	£47,513

EXAMPLE ILLUSTRATING SIMPLIFIED SHARE POOLING (USING THE SAME ASSUMED FACTS AS AT IN THE PREVIOUS EXAMPLE)

	Number of shares	Indexed Pool
	25,000	£40,000
STEP 1		
Add indexation allowance for December 1982 to April 1985 0.149 x £40,000		5,960
		45,960
STEP 2		
Disposal of 5,000 shares for £15,000 in August 1985.		
Indexation of pool : £45,960 x $\frac{376.7}{373.9}$	25,000	£46,305
Indexed cost : £46,292 x $\frac{5,000}{25,000}$	(5,000)	(£9,261)

Computation	
Sale proceeds	£15,000
Indexed cost	9,261
Gain	£5,739

	Number of shares	Indexed Pool
	20,000	£37,044
STEP 2		
Acquisition of 4,000 shares for £14,000 in March 1986		
Indexation of pool : £37,044 x $\frac{381.6}{376.7}$	20,000	£37,526
Shares to enter pool :	4,000	£14,000
	24,000	£51,526

STEP 3

Disposal of 8,000 shares
for £29,000 in May 1986

Indexation of pool : £51,526 x $\frac{386.0}{381.6}$	24,000	£52,121
Indexed cost : £52,121 x $\frac{8,000}{24,000}$	(8,000)	(£17,374)

Computation	
Sale proceeds	£29,000
Indexed cost	17,374
Gain	£11,626

STEP 4

Acquisition of 3,000 shares
for £12,000 in January 1987

Indexation of pool : £34,747 x $\frac{394.5}{386}$	16,000	£35,513
Shares to enter pool	3,000	£12,000
	19,000	£47,513

BUDGET SECRET

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE
DATE: 14 JULY 1987

1. MR ISAAC ✓ ACI 14.7.

2. CHANCELLOR OF THE EXCHEQUER

TAX REFORM: INCOME TAX RATES AND UPPER EARNINGS LIMIT FOR NIC

1. This note gives the first results from our analysis of the distributional effects of the package of changes to income tax rates and national insurance contributions (NIC) which you asked us to examine. We thought you would wish to see the results at an early stage (and in advance of work on the practical and other implications of the abolition of the upper earnings limit (UEL) for NIC) since some of the first conclusions may have important implications for the overall package of changes currently under examination. We would also welcome guidance on the direction which further analysis should take.

The initial package

2. For this initial analysis we have looked at the effects of the following package (Option 1):

(i) Reduce basic rate from 27 per cent to 25 per cent;

(ii) Abolish all higher rates above 40 per cent;

MACE → CH/EX 14/7

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Miss Peirson
Miss Sinclair
Mr G P Smith
Mr Cropper
Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Calder
Mr Eason
Mr Mace
Mr Cayley
Mr R H Allen
PS/IR

(iii) Set new 40 per cent threshold at the present 45 per cent threshold (£20,400 of taxable income);

(iv) Abolish UEL for employees and the upper profits limit for the self-employed.

Objectives of the package

3. The main objectives of the package are

(i) to reduce the basic and higher rates of income tax;

(ii) by abolishing the UEL for NIC (and reducing income tax higher rates by more than you otherwise would) to:

- facilitate the integration of capital gains tax and income tax;
- eliminate the present kink in the combined schedule of marginal income tax and NIC rates;
- reduce the incentive for higher rate taxpayers to make excessive use of tax shelters.

We have not sought to incorporate within this initial package changes to NIC at the lower end of the earnings distribution. Such changes are unlikely to affect the overall conclusions about the effects of this package and are, initially at least, best analysed as a free-standing measure. (We understand that the Treasury are preparing a separate paper on this.)

Relationship with Independent Taxation

4. The interaction of the package with Independent Taxation would need further study. In general, reductions in the higher rates would tend to reduce the ultimate cost of introducing Independent Taxation. You would want, in due course, to assess the effect of this package both under the present system and under Independent Taxation. But in general Independent Taxation seems unlikely to alter the distributional effects significantly.

UEL and Upper Profits Limit Abolition

5. For the purposes of analysing the effect of abolishing the UEL and upper profits limit we have assumed that all employee earnings paid in cash (but not benefits in kind, which are not at present charged to NIC) above the 1987-88 UEL of £295 per week (£15,340 per annum) would be charged at the current Class 1 contracted-in NIC rate of 9%, irrespective of whether the employee is in fact contracted-in or contracted-out (or liable at a special NIC rate). This is the assumption normally made when considering abolition of the UEL and matches what you did when you abolished the UEL for employers. (There is no contracted-out rebate on employers' contributions above the UEL). For the self-employed we have similarly assumed that all profits above the current Class IV NIC upper profits limit of £15,340 would be charged to NIC at 9%, though the Class IV NIC rate itself is 6.3 per cent. We have also assumed that there would be no income tax relief on NIC paid on the slice of profits above £15,340. (At present the self-employed get income tax relief on half their Class IV contributions).

Are these sensible assumptions? AuK

MB ?

6. These assumptions are aimed at eliminating the present kink in the combined profile of marginal tax and NIC rates for all earners and ensuring that the combined top income tax and NIC rate is the same (at 49%) on all earnings. (Giving tax relief on half the NIC paid on profits above £15,340, for example, would reduce the effective top rate on self-employed profits to 47.2 per cent). Although the assumptions seem reasonable as a matter of principle other options are not, of course, precluded.* We have not at this stage examined the practicability of implementing the assumed NIC structure, though there seems no obvious reason for thinking that it is likely to be more difficult than other options. ?

* Charging NIC at 9% on contracted-out earnings and self-employed profits above the UEL/upper profits limit (compared with 6.85 per cent and 6.3 per cent respectively up to that level) could be controversial but is necessary if you want both to eliminate the kink completely and to have the same top marginal rate on all earnings (see, however, paragraph 39).

Costs

7. For simplicity in this initial paper we have costed the package and analysed its distributional impact on a full year basis at 1987-88 income levels. If you wished we could provide an analysis at 1988-89 income levels but the overall results are unlikely to be significantly different.

8. The full year direct revenue cost (at 1987-88 income levels) of each of the components of the package is as follows.

	£ billion
Reduce basic rate by 2 points*	2.60
Abolish higher rates above 40 per cent*	1.36
Raise 40 per cent threshold*	0.37
Total income tax	4.33
Extra 9% NIC (on earnings/profits above £15,340 per individual)	- 1.60
Net cost	2.73

* Costs of the separate tax changes assume that they are made in the order shown.

9. The estimate of £1.6 billion for the ~~cost~~ yield of abolishing the UEL and upper profits limit in 1987-88 is higher than the £1.17 billion estimate prepared by the Government Actuary's Department (GAD) and given by DHSS Ministers in answer to Parliamentary Questions. We have discussed this difference with GAD. They have been using some out of date figures and rely on the New Earnings Survey which has less comprehensive information on high salaries than the Survey of Personal Incomes on which our estimate is based. GAD have also used slightly different assumptions. We are confident that £1.6 billion is a reasonable estimate.

10. The costings are direct revenue costs only. Changes in rates of income tax and NIC of this order would be certain to induce some behavioural changes by taxpayers. For example, reliefs such as mortgage interest, BES and occupational pension contributions

would be worth substantially less for existing 60 per cent taxpayers. Investment income would be charged at a marginal rate of 9% less than earnings at all income levels, as would benefits in kind. If benefits continue to be subject to income tax but not NIC, this would significantly increase the attractiveness of payment in kind rather than in cash (though to the extent that benefits (essentially cars) are not at present charged to income tax at their full value the incentive to take remuneration in this form would be somewhat reduced by the reduction in the top rates of income tax.) In general behavioural changes seem likely to be extensive and difficult to assess.

11. The overall first year cost of the package could be significantly different from the full year cost. The first year cost of the income tax components of the package would be about £3 billion; the first year cost of the NIC component would depend crucially on the timing of the change: an April 1988 start is impossible without an announcement before the Budget and introducing the NIC changes part way through the tax year would substantially reduce the first year yield from this component. This aspect, together with the implications for the perception of the distributional changes by taxpayers, is considered in more detail in paragraphs 40-44 below.

Distributional Analysis

12. The distributional effects of the package are complex. For any individual the pattern of gain or loss would depend on a number of factors in particular

- the split of gross income between earnings and investment;
- the size of any income tax reliefs claimed against gross income (which do not, of course, run for the NIC charge).

An individual with a relatively small amount of earnings and claiming few tax reliefs could do significantly better than someone with the same gross income who had large earnings and claimed substantial relief.

13. Chart A shows the pattern of gain and loss from the package for a married man whose income is all from earnings, and who claims tax

ie £30,000 @ 10%

relief on £3,000 of mortgage interest. There are gains for those with gross incomes up to about £17,500 and for those with incomes above about £47,500 (roughly the threshold for the present 60% rate for this individual) and losses for those in the intervening band. The maximum loss is about £500 per annum (compared with a maximum gain of £170 for someone with earnings at the UEL (and unlimited gains, of course, for top incomes). (Gains and losses throughout this paper are shown in annual terms).

14. In more detail the picture for this particular example builds up as follows:

Gross Income Level	Distributional effects	Change in Marginal Rate
Tax threshold to £15,340 (UEL)	- gains from cut in basic rate	- 2
£15,340 to £17,780	- gains from cut in basic rate progressively reduced to nil by extra NIC above UEL.	+ 7
£17,780 to £24,695	- increasing loss through extra NIC above UEL.	+ 7
£24,695 to £27,195	- loss from extra NIC partly reduced by raising of higher rate threshold. (Losses about £400 - £500).	- 6
£27,195 to £32,195	- Proposed higher rate (40%) and extra 9% NIC, compared with present 45% rate, increase loss to almost £600.	+ 4
Above £32,195	- loss from extra NIC progressively reduced by cut in income tax rates from 50% and above to 40%. (Turns to gain at approx £47,500).	- 1 - 6 - 11

15. Chart A provides a very broad view of the effect of the package for a not untypical individual. Nevertheless because of the complexity of individuals' tax and NIC liabilities the Chart should be treated with caution. The picture can be significantly changed if the taxpayer has a different mixture of earnings and investment income and larger or smaller reliefs.

16. Chart B gives further examples to show how losses would be reduced and gains increased if the married man had no mortgage relief and if progressively more of his income came from pension or investments. For example, a married man with income of £45,000 of which 80% came from pension or investments (someone who had retired from his main employment at age 55, for example, on a substantial pension and who was now working part time) would be unaffected by abolition of the UEL and hence gain over £3,500. By contrast, a person earning £100,000 per annum with large tax reliefs (say from BES, pension contributions, farming losses and £30,000 mortgage) could lose substantially more than the maximum amount shown in Chart B, because he would have to pay an extra 9% NIC on about £85,000. This would not be fully offset by his lower income tax liability.

17. We have analysed the actual numbers of gainers and losers from Option 1 using data derived from the personal income tax model. Table 1 shows the number of gainers by size of total income and gain and Table 2 shows losers by size of total income and loss. Chart C is a graphical representation of the results (in which the vertical scales are not the same for gainers and losers).

Gainers

18. About 20 million of the 20.8 million tax units (counting married couples as one) would gain from the package. The basic rate cut, worth up to £358 per annum, would benefit 18.5 million tax units with incomes under £20,000, but for the great majority (17.3 million) the gain would be less than £200 (see Table 1). Only 30,000 tax units in this income range (those unaffected by abolition of the UEL) would gain more than £300.

19. The reductions in the higher rates would produce some large gains for those on high incomes and for those with little or no earnings above the UEL. Over 400,000 tax units would gain more than £500 and those with incomes over £50,000 would, on average, gain nearly £5,000 each. At somewhat lower incomes of £20,000 to £30,000, there would be 160,000 tax units gaining over £500.

20. In total nearly 1 million tax units with incomes in the range £20,000 to £40,000 would gain in excess of £200. These would typically be two-earner couples, and couples and single people (including the elderly) with a substantial part of their income from investment or pension who gain from the reduction in the basic rate and changes to the higher rates but who do not lose from the offsetting increase in NIC above the UEL.

21. On the other hand the package would produce only small gains for many tax units on high incomes. For example about 360,000 tax units with incomes over £20,000 would gain by less than £200.

22. Chart C illustrates the overall picture for gainers: the great majority are on low incomes and gain small amounts while a small number on very high incomes gain £5000 or more.

Losers

23. Although Option 1 has a full year revenue cost of £2.7 billion about 800,000 tax units would nevertheless lose from the package. They broadly fall into two groups: those on incomes between £18,000 and £25,000 who would nearly all lose under £300 each; and those on larger incomes where losses can be much higher (Table 2). The 380,000 tax units in the first group would have their gains from the basic rate reduction more than eliminated by the extra NIC charged on earnings above the UEL. At higher incomes, about 50,000 tax units with substantial earnings but large tax reliefs would lose more than £500; the reduction in their higher rate liability would be exceeded by higher NIC payments. The average loss for the 20,000 losers with incomes over £50,000 would be £600.

24. Of the total of 800,000 losers about 1/2 million would be tax units liable at the basic rate only (under the Option 1 structure) and about 300,000 would be liable at the higher rate.

25. Chart C shows the concentration of losers in the income range £15,000 - £35,000 and the large losses for very limited numbers of very high earners.

26. Most of the 800,000 losers are married couples. About 340,000 would be two-earner couples, half of them having incomes over £30,000. The 350,000 one-earner married couples who would lose have slightly lower incomes (only 70,000 above £30,000). The 100,000 losers at the lowest level of income (£18,000 - £20,000) are nearly all single people or one-earner married couples.

not enclosed: you have seen dwk

27. Some of those who would lose from the abolition of the UEL would, as is clear from Mr Cayley's note of 1 July on capital gains reform, also lose from the proposal to tax gains at income tax rates.

28. Table 3 shows how the overall net £2.7 billion full year cost is distributed at different income levels. The main groups of beneficiaries are the large number of basic rate taxpayers, who gain from the basic rate cut; and those on high incomes for whom the cut in higher rates exceeds the effect of the UEL abolition. 57 per cent of the benefit would go to the 85 per cent of tax units who have incomes below £18,000 and 23 per cent would go to the under 1 per cent of tax units with incomes over £50,000. The 15 per cent of tax units with incomes between £18,000 and £50,000 would obtain 20 per cent of the benefit, but this group contains most of the 800,000 losers.

Average Rates of Tax

29. Chart D shows average rates of income tax and NIC (for a married man whose income is all earned and who has no reliefs other than the personal allowance) in 1978-79, 1987-88 and under Option 1. The Chart shows that Option 1 removes the present kink in the combined income tax and NIC structure (which results in average rates falling over a band of income as earnings rise) but at the price of losers over a wide range of income - in this example from about 1.6 times average earnings to almost 3.5 times average earnings.

Marginal Rates of Income Tax and NIC combined

30. Changes in marginal rate at different income levels as a result of Option 1 are illustrated on Chart A. The overwhelming majority of the 25 million individuals liable to income tax (counting husbands and wives separately) would see a reduction in their combined marginal rate of income tax and NIC. For most people there would be a 2 point reduction in marginal rate as a result of the cut in the basic rate to 25 per cent. About two-thirds of all higher rate taxpayers would also have a cut in the combined marginal rate (either from 40 per cent to 34 per cent as a result of raising the first higher rate threshold or from 50 per cent or more to 49 per cent as a result of abolishing the higher rates of income tax above 40 per cent). There would be a reduction of about 320,000 in the total number of higher rate tax units (counting married couples as one) to around 850,000.

31. Two groups of taxpayers would face increased marginal rates. About 1.3 million basic rate taxpayers would see an increase in their combined marginal rate from 27 per cent to 34 per cent (25+9) as a result of the abolition of the UEL. These are the basic rate tax units currently in the kink between the UEL and the first higher rate threshold. About 340,000 or so higher rate tax units who currently pay at 45% would also face an increase in marginal rate to 49% (40+9).

Scope for reducing losers

32. In view of the substantial numbers of taxpayers who are worse off under Option 1, and the large losses for some, we have had a quick look at ways in which, within the same basic framework, modifications might be made to reduce losers. Reducing the number of losers amongst those who would pay income tax at 40 per cent under the package can be achieved straightforwardly (and at not unacceptable cost) by raising the starting point for the 40 per cent rate. But reducing the number of losers amongst basic rate taxpayers is considerably more difficult and costly.

1A worth looking at. NB (deliberate mortgages, push also means Rate offset

Eliminating losers liable at higher rates

Option 1A

33. This Option is designed to reduce the number of higher rate losers. The structure would be the same as for Option 1 except that the 40 per cent higher rate threshold would be set at £24,000 of taxable income (instead of £20,400). This would have an additional full year cost of about £320 million on top of Option 1 (taking the overall cost of Option 1A to just over £3 billion in a full year.) Option 1A would roughly halve the number of higher rate tax units (to 600,000) compared with 1987-88).

34. Option 1A gives a maximum additional benefit of £540 to 40 per cent rate taxpayers under Option 1. This is enough to reduce the number of higher rate losers from 300,000 (under Option 1) to 50,000 making the overall number of losers under Option 1A about 550,000. Because of the size of the losses for some of those on very high earnings it would not be possible to eliminate losers amongst higher rate taxpayers altogether by raising the higher rate threshold further.

Eliminating losers liable at the basic rate

35. Within the basic structure of Option 1 the scope for reducing losers liable at the basic rate at reasonable cost is limited. Increases in income tax personal allowances are not effective for this purpose because the cash gains from such changes for those with upper incomes are small. The main options are a further reduction in the basic rate of income tax or a cut in the main NIC rate. For illustration we have looked at the effect of reducing the main NIC rate. Although this is very expensive it is likely to be more cost-effective in reducing losers than an equivalent cost reduction in the basic rate because:

- all the benefit goes to those with earnings rather than investment income. (There are of course no losers amongst those whose income is exclusively from investments or pensions);

- the reduction in rate applies to the whole of gross earnings;

- reducing the NIC rate means that the extra charge on earnings above the UEL (which is the cause of the losses) is reduced.

Option 1B

36. We have considered a reduction in the NIC rate which would make the NIC component of the package broadly revenue neutral (Option 1B). (This was the approach you adopted when the UEL for employers was abolished). Revenue neutrality of the NIC component of the package can be broadly achieved by reducing all the main NIC rates (including Class IV and the new additional charge on earnings above the UEL) by 3/4 percentage point. This has, we estimate, a full year revenue cost of about £1.3 billion and the NIC component of Option IB would therefore have a net full year revenue yield of about £300 million (which might go to pay for cuts in the reduced rates of NIC). The overall full year cost of Option IB (assuming that the 40% rate threshold was set at £20,400 of taxable income as in Option 1) would be something over £4 billion. Option IB reduces the overall number of losers to about 330,000.

Option 1AB

37. Combining the two changes in Options 1A and 1B (increasing the 40% rate threshold to £24,000 of taxable income and cutting the main NIC rates by 3/4 percentage point) would reduce the number of losers further to about 220,000. This is not as much as the sum of the reduction in losers in Options 1A and 1B separately because of the overlap in the effect of the two measures. The full year revenue cost of this Option would be something over £4 1/4 billion.

38. The table below summarises the effects of Options 1A, 1B and 1AB. Chart E shows the effects for a married man paying £3,000 mortgage interest whose income is all from earnings.

Option	Losers	Additional Full Year Cost* £ million
Option 1	800,000	-
Option 1A: (Raise 40% threshold to £24,000)	550,000	320
Option 1B: (Reduce main NIC rates by 3/4%)	330,000	1,300
Option 1AB: (Combine changes in Options 1A and 1B)	220,000	1,600

* on top of Option 1.

Other options for reducing losers

39. Raising the first higher rate threshold and, particularly, cutting the basic income tax or main NIC rates are expensive ways of reducing the number of losers from Option 1 because a substantial part of the relief goes to those who already gain from Option 1 as well as to those who are losers. One possible way of acting directly to reduce the number of basic rate losers would be to reduce the NIC rate charged on earnings above the UEL. Reducing the rate below 9% would, of course, mean that the present kink in the profile of marginal rates for those contracted-in employees would be reduced but not wholly eliminated. Of the 2 million or so employees and self-employed with earnings above the UEL/upper profits limit, something over 1/2 million currently pay NIC at the Class 1 contracted-in rate. Provided the rate charged on earnings above the UEL was not reduced below the Class 1 contracted-out rate (6.85%), the kink would be eliminated for the majority of those with earnings above the UEL; a substantial number would still face a drop in marginal rate above the UEL but this would be much smaller than at present. We have not yet made

any analysis of this option since you may feel that it is in any case ruled out for various reasons (the contrast with the position for employers (liable at the full 10.45% rate on earnings above the UEL) might, for example, be difficult to present; and it might require an increase in the 40 per cent higher rate of income tax to provide an appropriate combined top rate of tax and NIC. That would have implications for the restructuring of CGT.) We could let you have a further note on the possibilities here if you think the approach worth pursuing.

Phasing

40. This note looks at the full year revenue and distributional effects of Option 1 (and variants). But the impact of the measures in practice could be considerably different if, as seems likely, the income tax and NIC changes have to be phased in over different periods.

41. Assuming an announcement in the March 1988 Budget it is likely that the earliest the NIC changes could be introduced would be October 1988. An alternative would be to make all the NIC changes from April 1989 (with an interim reduction in the top higher rate to, say, 50% during 1988-89).

42. The table below gives a very broad indication of the impact on revenue in 1988-89 and 1989-90 (and subsequent years) of these two alternatives for each of Option 1 and its variants. We have assumed in all cases that the income tax changes made for 1988-89 would, as usual, be implemented under PAYE in May 1988.* If you wish to pursue these Options we should need to do further work (in consultation with the Treasury) to refine the figures to give a more precise indication of the first and second year effects though the preliminary figures given here should be accurate to about £1/4 billion or so either way.

* In the case where the NIC changes are not made until April 1989 we have assumed that the further increase in the first higher rate threshold under Options 1A and 1AB is also held back until 1989-90.

NIC changes implemented in October 1988

	Direct revenue cost £bn (at 1987-88 income levels) 1988-89	1989-90 (et seq)
Option 1	$2^1/_4$	$2^3/_4$
Option 1A	$2^1/_2$	3
Option 1B	3	4
Option 1AB	3	$4^1/_4$

NIC changes implemented in April 1989*

	Direct revenue cost £bn (at 1987-88 income levels) 1988-89	1989-90	1990-91 (et seq)
Option 1	$2^3/_4$	$2^1/_2$	$2^3/_4$
Option 1A	$2^3/_4$	$2^1/_2$	3
Option 1B	$2^3/_4$	$3^3/_4$	4
Option 1AB	$2^3/_4$	$3^3/_4$	$4^1/_4$

* And assuming top rate of 50% maintained at present threshold for 1988-89.

43. The phasing of the change would also have a significant effect on the perception of the distributional changes by taxpayers. If the income tax changes were implemented on the usual timetable in May 1988 but the abolition of the UEL did not take effect until October 1988, taxpayers would receive the full benefit of the income tax reductions some 4 to 5 months before they suffered the increase in NIC. All 2 million individuals earning above the UEL would see a sharp drop in take home pay between, say, September 1988 and October 1988. One way of avoiding this would be to delay implementation of the income tax changes until October 1988 so that they could be synchronised with the NIC increases. This would, however, mean that large numbers of basic rate taxpayers unaffected by the NIC change would have to wait much longer than usual for their income tax reductions.

44. The lack of synchronisation between the changes would be even more acute if the abolition of the UEL did not take effect until April 1989; basic rate taxpayers, for example, would have had the benefit of a full year of the reduction in the basic rate before the additional NIC charges were imposed. The impact would, however, be mitigated if you were able to make further reductions in the basic rate below 25 per cent for 1989-90.

Conclusion and options for further work

45. This note has focussed on the cost and distributional effect of options involving reductions in income tax rates combined with abolition of the UEL. If you wish to pursue these options we (and the Treasury) will, of course, need to let you have further notes on other aspects of the change including:

- the practical implications for the Revenue, DHSS and employers of the abolition of the UEL;

- the implications for the balance of taxation between earnings (subject to NIC) and investment income, pensions and benefits in kind (not subject to NIC). In particular we are considering whether there is any practical way in which the incentive to take remuneration in kind rather than cash under these options might be reduced;

- the wider implications for the contributory principle and for entitlement to social security benefits.

46. At this stage you will, however, wish to consider the results of the distributional analysis. It would be helpful to have guidance on any further distributional work which you would like us to undertake. For example:

(a) Do you need any further analysis of Option 1?

(b) Are you attracted by any of the variants of Option 1, taking account of the costs and distributional effects? Would you like any further analysis of these Options?

(c) Would it be worth looking further at an option involving a lower rate of NIC above the UEL (substantially reducing but not eliminating the kink - see paragraph 39)?

(d) Do you wish at this stage to examine options not involving abolition of the UEL?

B A Mace

B A MACE

TABLE 1

OPTION 1: GAINERS BY SIZE OF GAIN AND INCOME

Thousands

Lower limit of total income (£'000 p.a.)	Size of gain (£ p.a.) 1-50	51-100	101-200	201-300	301-500	501+	All	Average Gain (£ p.a.)
0	3,220	70	0	0	0	0	3,280	22
5	1,630	4,020	1,970	0	0	0	7,620	76
10	610	1,580	2,650	290	0	0	5,130	115
15	90	130	1,340	890	30	0	2,490	179
20	50	40	80	320	220	30	730	262
25	20	20	40	30	90	130	320	432
30	20	20	40	30	40	80	240	520
40	8	6	12	10	8	52	100	1,008
50	1	1	2	3	7	120	130	4,810
All	5,640	5,890	6,130	1,580	400	410	20,040	144

TABLE 2

OPTION 1: LOSERS BY SIZE OF LOSS AND INCOME

Thousands

Lower limit of total income (£'000 p.a.)	Size of loss (£ p.a.) 1-50	51-100	101-200	201-300	301-500	501+	All	Average Loss (£ p.a.)
0	2	0	1	0	0	0	3	78
18	50	30	10	0	0	0	100	55
20	50	50	100	50	30	0	280	155
25	20	20	40	40	50	10	170	237
30	20	20	30	30	50	20	170	277
40	6	4	9	9	8	10	50	340
50	1	1	3	2	3	8	20	599
All	150	130	200	130	140	50	790	208

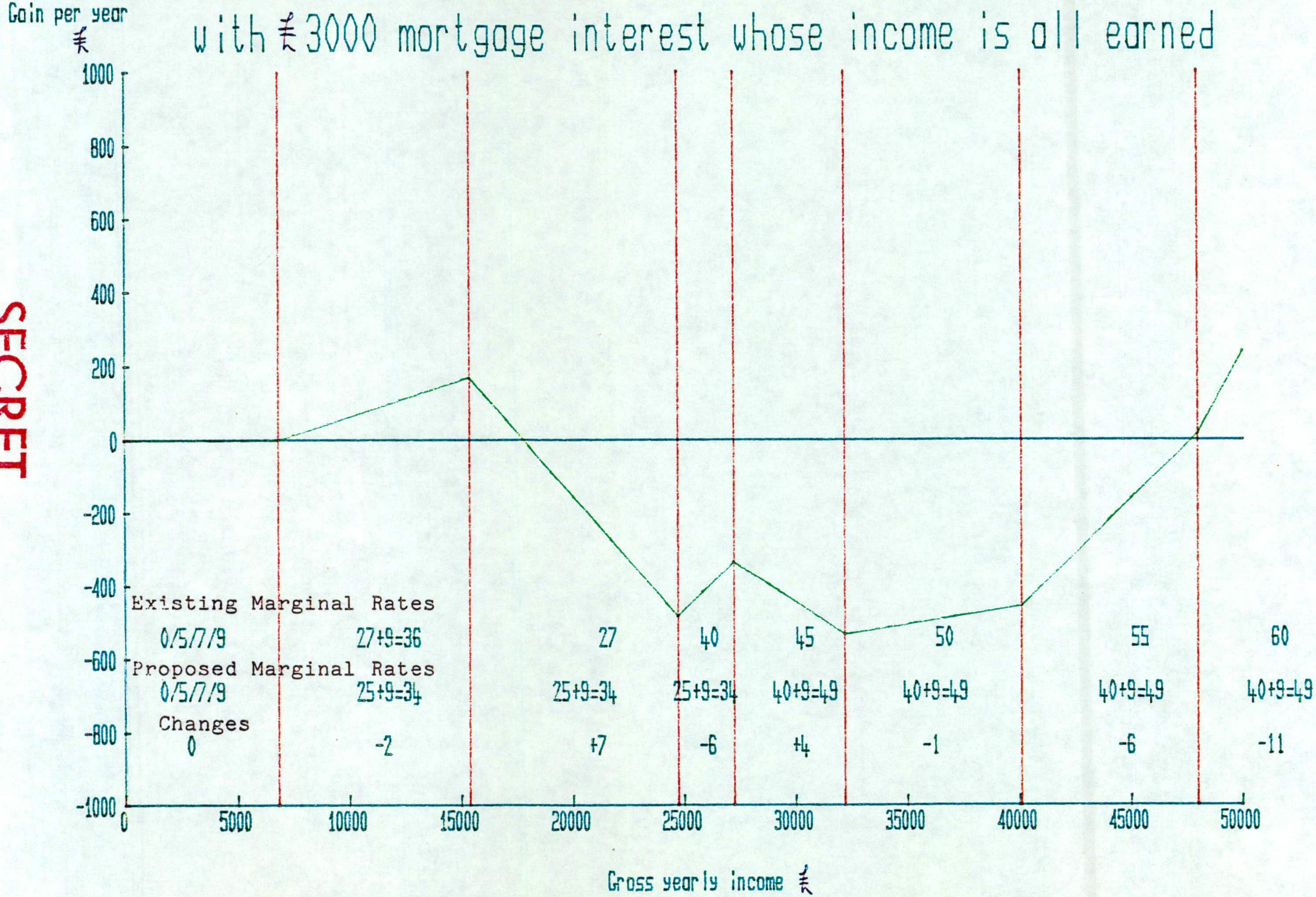
Totals may differ from the sum of the constituents due to rounding

TABLE 3

Distribution of cost of Option 1 by income

Lower limit of gross income £000	Cost £ million	(%)	No of tax units in range 000s	(%)	Average per tax unit £
0	70	(3)	3280	(16)	21
5	580	(21)	7620	(36)	76
10	480	(18)	4370	(21)	110
14	420	(15)	2560	(12)	164
18	190	(7)	1300	(6)	146
22	100	(4)	620	(3)	161
26	70	(3)	370	(2)	189
30	160	(6)	550	(3)	291
50	190	(7)	130	(0.6)	1461
75	110	(4)	25	(0.1)	4400
100	330	(12)	25	(0.1)	13200
	2,700	(100)	20,800	(100)	130

Gains from the income tax and NIC packages for a married man with £3000 mortgage interest whose income is all earned



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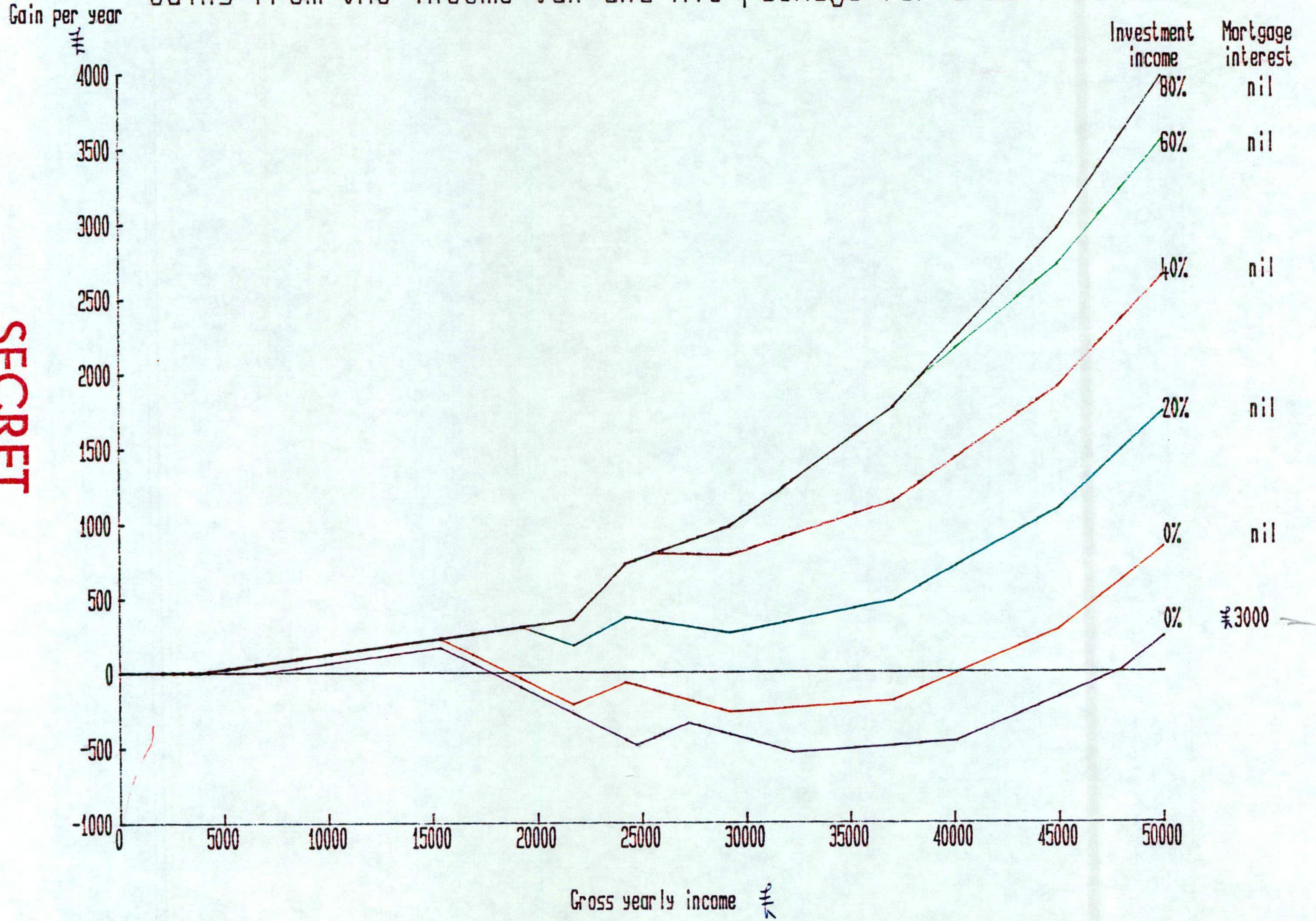
Gains from the income tax and NIC package for a married man



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Gainers and losers and their gains and losses by range of income

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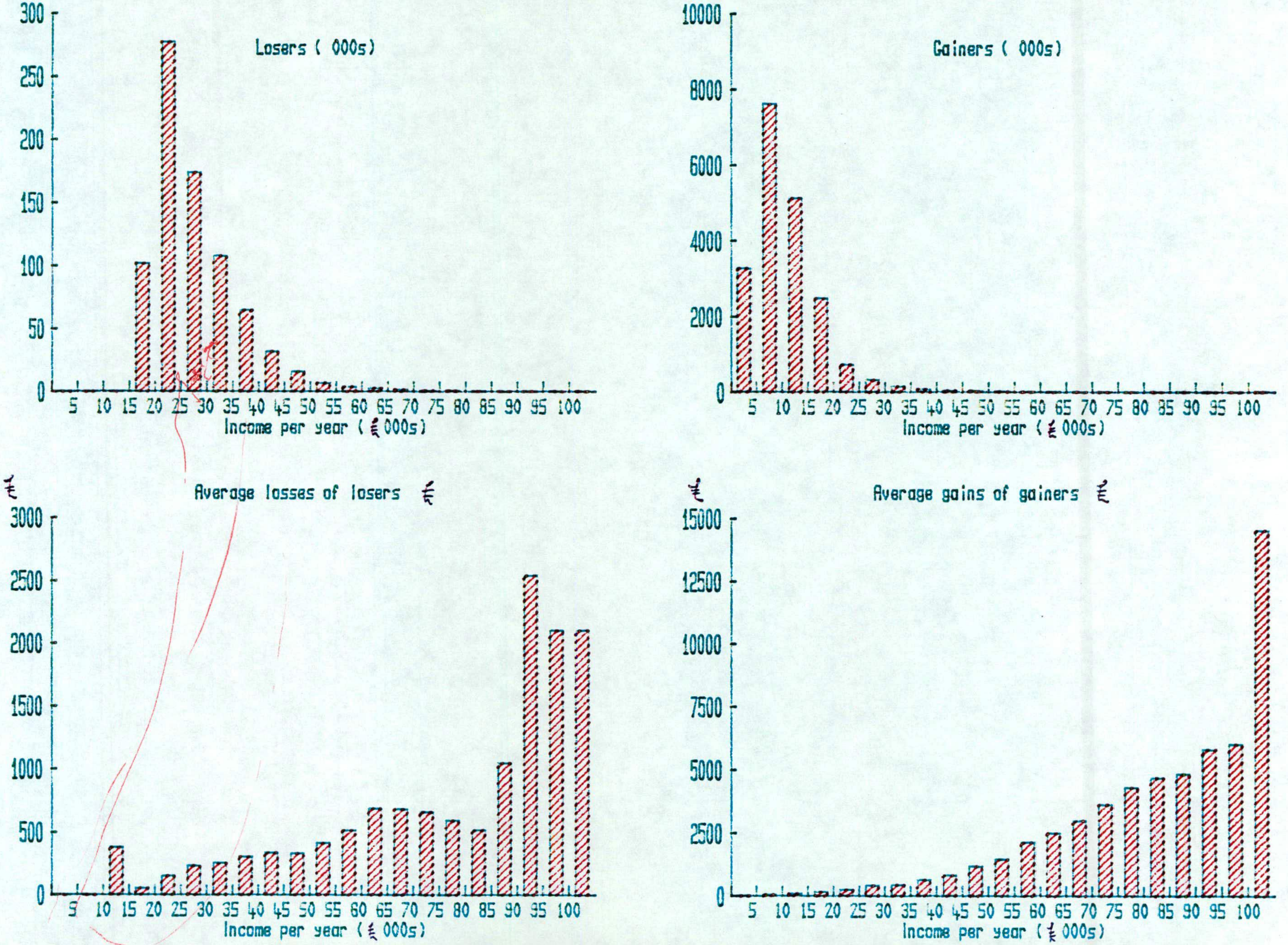

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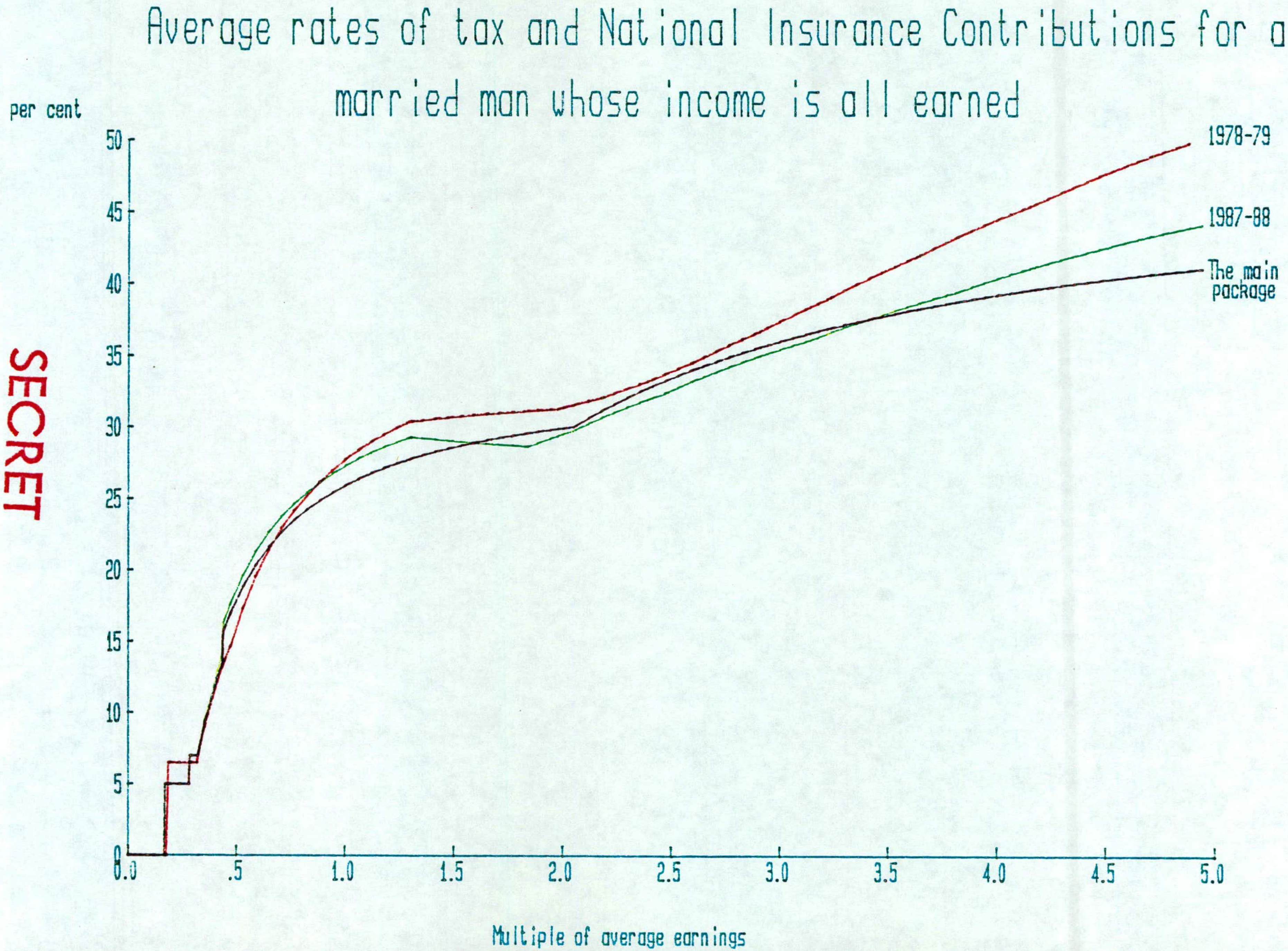

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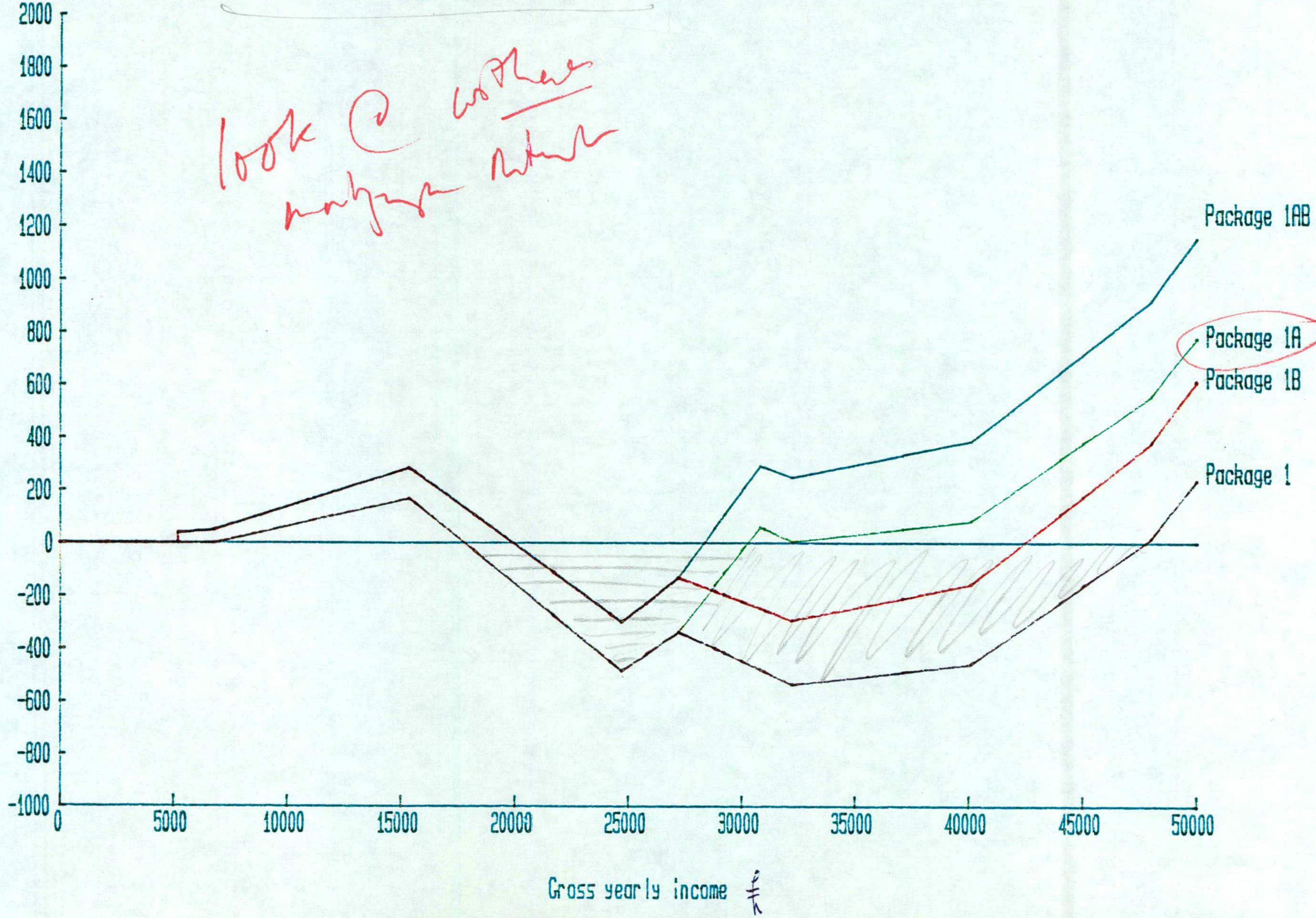
Gains from the income tax and NIC packages for a married man with £3000 mortgage interest whose income is all earned



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Many thanks.
This is an important & urgent exercise. The Annex 2 list can be reviewed after the Budget, with a view to the possibility of legislation in 1989; but the Annex 1 list (with the exception of the last item which is ruled out for the reason given in para 14 of the submission) needs to be combed thro' with a view to legislation in 1988 FB. I should be grateful if FST would take this on (making maximum use of Mr Cropper). What we are seeking is simplification & manpower savings, where these do not conflict with political imperatives.

BOARD OF INLAND REVENUE

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

FROM: A J G ISAAC
DATE: 16 JULY 1987

CHANCELLOR OF THE EXCHEQUER

TAX REFORM - REMOVING SHELTERS AND ANTI-AVOIDANCE PROVISIONS NL

1. When we discussed my note of 22 June you agreed I should let you have a more detailed assessment of the options for removing tax shelters and anti-avoidance provisions if your 1988 Budget

a) brought the top rate of tax closer to the basic rate, and

b) narrowed the gap between the rates applying to capital gains and those applying to income.

2. The attached papers take the matter further and canvass a wide range of possibilities. They involve essentially a preliminary look across the whole field with the purpose of identifying candidates at which Ministers would like to look in greater detail and those on which no further work need be done. We are not however seeking firm decisions on any of the former at this stage. I am sorry that the papers are so long, but as you will see they cover a very wide range of provisions.

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cc	Financial Secretary	Mr Battishill
	Sir Peter Middleton	Mr Isaac
	Mr Cassell	Mr Painter
	Mr Byatt	Mr Beighton
	Mr Scholar	Mr Johns
	Miss Sinclair	Mr McManus
	Mr Cropper	Mr W Carr
		PS/IR

3. Given the proposed changes there would on the one hand be less need for provisions which protect the taxpayer from the full rigours of the higher rates. This applies most directly to averaging provisions designed to ensure that lumpy receipts do not lead to very high tax bills through the operation of higher rates of tax than would have applied if the income had been more evenly spread. But lowering the top rates should also make it easier to remove tax shelters or rules which particularly favour the higher rate taxpayer even if the rules were introduced for reasons other than protecting the higher rate taxpayer. Removal of shelters broadens the tax base and generally reduces distortions. Annex 1 looks at the possibilities on this side.

4. On the other hand, reduction of top rates of tax and narrowing of the gap between capital and income also makes it less necessary to have complex rules protecting the Exchequer against manipulation either to bring income within provisions which will ensure it escapes higher rates, or to convert income into less highly taxed capital gains. Annex 2 looks at the possibilities on this side.

5. In no case does all justification for the provision disappear. Your preferred package would retain both a gap between the higher rates of income tax and the basic rate and differentiation between capital gains and income. And in the case of tax shelters there is commonly a non-tax policy behind the relief which needs to be considered. For each provision therefore, you will need to weigh up whether the remaining case for relief or protection against abuse is sufficient to outweigh the simplification (and where appropriate base broadening) which removal would offer.

6. On the reliefs side and for some of the anti-avoidance provisions what matters is the gap between the higher rates and basic rate. If your preferred package were to be introduced this would be 15% (40%-25%) compared with a maximum of 33% (60%-27%) at present and a maximum of 65% (98%-33%) when you took office. Most of the provisions were introduced when the rate differential

was near the highest figure.

7. For other anti-avoidance provisions what matters is the gap between capital gains tax rates and income tax rates. Aligning the two rates will not eliminate all difference because

- capital gains will still benefit from indexation whereas, for example, interest income will not

- there will be a higher threshold for capital gains and some special reliefs (such as retirement relief)

- capital gains tax is payable on realisations which in some cases can involve deferment of tax compared with the accrued gain.

At present gains benefit from all these advantages and a differential of up to 30% on rates as well. When you took office gains did not enjoy indexation or such a large threshold but the rate differential was up to 68%

8. Following our discussion with you, we have not looked in Annex 1 at mortgage interest relief, BES, PEP's, or Profit Related Pay as the non tax reasons for these reliefs will still retain force whatever the tax rate differential. Nor have we looked at Forestry as this is being considered separately (Mr Johns' note of 6 May). A reduction in top rates will in any event make these reliefs somewhat less attractive and may reduce the use made of some of them to some extent. We mention car benefit scales in Annex 1 as a case where rules could be tightened alongside a reduction in higher rates. However, you will need to consider the rules for benefits in kind generally in the context of the abolition of the Upper Earnings Limit for National Insurance Contributions, on which we will report separately.

[illegible]

9. The most promising candidates in this field appear to be:

a) The cluster of averaging provisions. The number of cases is too small to lead to significant savings in staff or taxpayers' compliance costs from abolition. But sweeping them all away (apart from Lloyds Special Reserve Funds and non-qualifying life policies which need to be considered separately) would remove nearly 20 pages of legislation which Inspectors and taxpayers' advisers have to learn and apply. You will, however, need to consider whether the groups affected should remain protected even against the lower penalties of extra tax on lumpy receipts: in particular, averaging can also be relevant where tax fluctuates between 0 and 25% as well as between 25% and 40%. The next stage would be for you to indicate whether there are any of these reliefs you would rule out at this stage and for us to let you have a more detailed analysis of the remaining candidates.

b) A number of major reviews, already in hand: the review of residence (which inter alia might substantially affect the liability of some people born abroad who have lived here for very many years), the review of maintenance payments and covenants and the receipts basis for Schedule E (on which we minuted the previous Financial Secretary on 10/1/86). The first two of these could significantly broaden the tax base; the second and third lead to significant staff savings. We are preparing (or have let you have) detailed papers on these subjects: at this stage you need do no more than note the connections between these reviews and the current exercise.

c) Less promising, but a possible candidate is removal of some of the special reliefs for interest on borrowing to buy shares in close companies, partnerships and cooperatives. There would be a small reduction in complexity and some base broadening. The next step is for you to decide whether you would welcome a fuller paper for decision.

10. The remaining candidates in Annex 1 could all be cut back or withdrawn if you wanted either greater simplification or general

base broadening (though in some cases you could only achieve one or the other but not both). We would not see any as strong runners, but could do more work if you were attracted by any of them. As action in this field will make taxpayers worse off, it will be difficult to remove the reliefs in later years if it is not done at the same time as the top rates are reduced. Preferably any change should be in the same Finance Bill to avoid a double debate; where that is not possible, e.g. because consultation would be desirable, the announcement of the proposal at the time of the Budget would help to tie the changes in together.

11. As for the possibility of simplifying or reducing anti-avoidance provisions to which we have given a first look in Annex 2, there is both less need to take action in 1988 (because any change will be to taxpayers benefit) and less opportunity because almost any significant changes could best be made only after consultation - indeed we should ourselves need to consult internally on a much wider basis than we have done so far - or would normally wish to do on Budget matters. So we see the possibility that you might announce that you would be consulting on the options generally. So far as we can judge, in advance of detailed study by the experts, among the specific anti-avoidance provisions which look most suitable for review are:

- Section 487 ICTA 1970 (sale of future income for capital sums)

- Section 488 ICTA 1970 (artificial transactions in land)

- Section 470 ICTA 1970 (sale or transfer of interest rights)

- Section 76 FA 1972 and Section 41 F(No 2)A 1975 (exploiting relief provisions for interest).

12. There would also appear to be a case for review of the provisions for cancelling the tax advantages from certain transactions in securities (Sections 460-468 ICTA 1970) the income tax rules relating to trusts and settlements (Sections

434-459 ICTA 1970), and the close company apportionment rules (Schedule 16 FA 1972) (though the important consideration here is the gap between the small companies rate of CT (equal to the basic rate) and the top rate of income tax where there will still be a 15% gap). In these cases many of the rules will still be required as they are in part needed to protect the Exchequer against income being manipulated to escape tax altogether but some simplification might nonetheless be possible. In the case of trusts there will anyway have to be a decision about the additional rate and we will be submitting separately on this. Finally, there is a case for review (not discussed in Annex 2) of the tax penalties on non-qualifying life policies. These, however, need to be looked at alongside the treatment of life assurance companies in the review of life assurance: one of the main considerations here will be whether the overall tax treatment of policyholders' income and gains is comparable with that on other forms of savings.

We have looked at some other areas, listed in Parts 2 and 3 of Annex 2, which look less likely to be feasible candidates for abolition but if you wanted further work on any of these we could look at them in more detail.

Priorities

13. As you yourself emphasised at our meeting, there may be a conflict of priorities. On the one hand, there might be a window of opportunity in the 1988 Budget to carry through a simplification which will not be practicable at any other foreseeable time. On the other hand, there is a limit to the amount of relief that can be withdrawn in the context of a Budget package that is likely to produce losers as well as gainers. And there are also very real constraints on resources; how much work can be done by already stretched Policy Divisions here over the next few months and by Parliamentary Counsel, and how much space can be afforded in one Finance Bill.

14. We shall also need to bear in mind the possible impact on the network of any policy change that has significant implications for the handling of large numbers of taxpayers. For example, though the 1988 tax reform might represent an ideal occasion for implementing a receipts basis for Schedule E (and its consequent long term staff savings), we have concluded that it would have to be ruled out on practical grounds for the 1988 Budget if you decide in favour of Independent Taxation with a 1990 start.

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CONCLUSIONS

15. At this stage we do not seek firm decisions from Ministers but merely to identify a short list of proposals for further analysis. On the reliefs side we will in any case be submitting papers on the major reviews. We would be grateful for a steer on whether we should:

a) do any more work on averaging reliefs and, if so, whether any of the provisions can be eliminated from further review at this stage, either because the specific reliefs are seen as necessary or because reliefs affecting the timing as opposed to the amount of relief should be excluded.

b) Do any more work on the reliefs for interest on borrowing to buy shares in close companies etc, or whether there are any other reliefs in Annex 1 which Ministers see as candidates for abolition.

On anti-avoidance provisions, we would be grateful for a steer on whether

c) Ministers are attracted by the idea of a full review after the 1988 Budget (following an announcement); or whether they wish to bring any options forward for earlier action.

(A J G Isaac)

ANNEX 1

OPTIONS FOR CURTAILING TAX RELIEFS AND SHELTERS

1. This note on possible options for curtailing tax reliefs and shelters is divided into three main sections, viz:

- top-slicing, spreading and averaging reliefs;

- tax shelters and privileged income;

- basis of assessment for Schedule E.

TOP-SLICING, SPREADING AND AVERAGING RELIEFS

2. Under this head there are eight complex provisions part if not the whole justification for which was that they alleviated the effects of a steeply progressive income tax. There would, however, remain some case for averaging, not just because of the remaining 15% differential between basic and higher rates but because averaging can also be relevant where there is fluctuation between zero tax (low income covered by allowances) and basic rate. Abolishing all these reliefs would allow some 30 pages of complicated legislation to be repealed. Staff savings would probably be negligible reflecting the infrequency of cases needing to be dealt with under much of this legislation (the exceptions are redundancy payments, Lloyds, and farmers averaging) but it would still be a worthwhile simplification because staff would not have to spend time learning (or reminding themselves) about these complex provisions. With the exception of Lloyds and farmers averaging, no figures are available for the cost of these provisions.

3. The provisions are:

(i) Redundancy Payments (S188 and Sch 8 ICTA - 8 pages of legislation). The first £25000 of a redundancy payment is exempt from tax. The remainder is subject to top-slicing which involves a complex formula to disregard a proportion of the extra tax which would be payable if the chargeable portion of the lump sum were taxed in full in the year of receipt. It would be possible to scrap the top-slicing provisions while still retaining the exemption (not necessarily at its present level).

(ii) Premiums for rent (S85 and Sch 3 ICTA - 3 pages of legislation).

These are lump sum receipts in lieu of rent. Under the top-slicing provision, tax is calculated by multiplying the number of years of the lease by the tax due at the taxpayer's marginal rate on the yearly equivalent (obtained by apportioning the lump sum over the duration of the lease).

(iii) Proceeds of certain non-qualifying life policies, annuities and capital redemption policies (S400 ICTA - 1 1/2 pages of legislation)

Gains are charged at the difference between basic and higher rates of income tax with top-slicing analogous to (ii) - gains are apportioned over the life of the policy, and total tax is the tax on the proportion of the gains attributable to one year multiplied by the number of years. There is a wider possibility, on the lines of the proposals in Annex 2 of abolishing altogether the higher rate charge on these gains which would of course subsume abolition of this relief. If the higher rate charge were retained the case for top-slicing would be less. However it would not be sensible to change the tax treatment of policy holders in advance of the review of the taxation of life companies, which will be looking for a workable and neutral system of taxing policy holders' investments more generally.

(iv) Patent Royalties (S384 ICTA - 1/2 page of legislation)

The recipient of a lump sum royalty in respect of several years use of a patent can ask for tax to be calculated as if the sum had been paid in a number of yearly instalments (up to a maximum of 6), the last when the lump sum is actually received. This has the effect that all the tax is payable when the lump sum is received but the amount depends on previous years' liabilities.

(v) Writers and Artists (S389-90 & 392 ICTA - 4 pages of legislation)

A variety of lump sum copyright payments and royalties can be spread over a number of years in computing income tax. Relief under S389 and 392 involves spreading backwards (as for lump sum patent royalties). But relief under S390 differs from all the others in allowing a lump sum payment to be spread forwards as if it were received in a number of instalments at yearly intervals, the first when the payment is actually received. So S390 relief affects not only the quantum of tax but its timing. Abolition would not only remove the benefit of top-slicing but also mean that part of the tax would become payable earlier. On the other hand, tax would still only become due after the receipt of the whole of the payment to which it related. If the distinguishing feature of S390 relief is regarded as important we could do more work on the background and balance of arguments.

(vi) Relief on Delayed Remittances (S419 ICTA - 2 pages of legislation)

Where remittance of overseas income assessable on the remittance basis is delayed owing to the operation of a foreign country's currency restrictions and arrives in a lump it may be spread back for tax purposes over the years when it would have been remitted had it not been for that country's currency restrictions.

(vii) Lloyds Special Reserve Fund (S330 & Sch 10 ICTA - 9 pages of legislation)

The special tax arrangements relating to certain payments into the Lloyds Special Reserve Fund are a form of averaging relief. The effect of these arrangements is to defer - perhaps indefinitely, as there is an exemption on death - higher rate liability on payments (up to a maximum of the lesser of £7000 or 50% of the underwriters profit for the year) into the Fund. There is still an outstanding question of whether, and if so, how the administrative arrangements for taxing Lloyds can be put onto a more sensible and efficient basis in the interests both of the Exchequer and Names. The case for continuing to give relief for payments into the Special Reserve Fund should probably be considered in that context. Last year we estimated that the short term yield from abolishing the relief would perhaps be no more than about £1m - because of Underwriting losses in recent years - and that doubling the annual limit would probably cost about £3m.

Lloyds themselves are pressing for the relief to be made more generous. Lloyds have indicated that they will seek discussions with us on a range of issues in the Autumn, including the SRF. Given the complexity and sensitivity we envisage reporting back to Ministers in the light of the first round of discussions on the scope and feasibility of 1988 legislation.

(viii) Farmers (S28 FA 1978 - 2 pages of legislation)

Where a farmer's profits fluctuate markedly in two consecutive years he is allowed to claim some averaging out between the two years in calculating tax. This relief is estimated to cost £10 million per annum.

4. There would undoubtedly be less justification for these reliefs with a less progressive income tax than when the top rate of tax was 83% (98% on investment income) or even 60%, though some people would lose from their abolition. Some of the current beneficiaries of these provisions (eg those receiving premiums in lieu of rents, patent royalties, gains on investment policies, and to some extent writers and artists) may, however, be able to rearrange their affairs for the future so that they receive a stream of income over time rather than a lump sum. They would, however, argue that this is not normal business practice. Farmers cannot influence the timing of receipts; it is not the only occupation where income is lumpy but profits are perhaps more than other activities influenced by factors beyond the farmer's control, particularly the weather. Farm incomes have been falling and there might be resistence to removal of the relief.

TAX SHELTERS AND PRIVILEGED INCOME

5. Because the UK starts with fewer tax shelters and sources of privileged income than the US did, there are not many easy or attractive options for broadening the tax base.

Relief for Pension contributions and lump sums

6. Leaving aside the relief for income and gains of pension funds and for employer contributions, the cost of relief for employee contributions and the lump sum exemption is estimated at £2.4 billion. However, in his 1985 Budget Speech the Chancellor indicated that fundmental reform in this area would need to be preceded by publication of a Green Paper. Action has already been taken in this year's (Summer) Finance Bill to cap the amount that can be received in the form of a tax free lump sum. This may be as far as Ministers would wish or feel able to go in this area without prior consultation.

National Savings

7. There are tax exemptions for the first £70 of National Savings Bank Interest (S414 ICTA) interest and terminal bonuses on National Savings Certificates up to a maximum investment of £5000 for each issue (S95-97

ICTA as amended) and contractual savings schemes (S415 ICTA), and premium bond prizes, with a total estimated annual cost in excess of £500 million. It would be possible to broaden the base by removing some or all of these exemptions for the future (but not for past issues) but this is a case where base broadening would complicate the tax system and might require an increase in Inland Revenue staff. The implications for the funding of Government borrowing would need to be considered by the Treasury and the Bank of England.

Gilts and Qualifying Corporate Bonds

8. Where securities are issued at more than a nominal discount, the discount is charged to income tax; the discount on low coupon gilts is however exempt (S27 FA 1973). Moreover, gains on gilts and qualifying corporate bonds are exempt from capital gains tax (S67 CGTA 1979). The cost of these exemptions is not known, and indeed they may well produce a net revenue yield. Before 2 July 1986 capital gains were only exempt provided disposal of the securities did not occur within 12 months of acquisition, but latterly because of the interaction with the indexation provisions the 12 month rule provided only losses for the Exchequer - securities with (indexation) losses were realised within 12 months but not securities with gains. There would be no advantage going back to the pre-July 1986 regime, and though it would be possible to consider removing the gains exemption altogether for future gilts and bond issues (the prospectuses for past gilts issues guaranteed the exemption) the 1986 arguments probably still generally apply. However, it might be appropriate to review the income tax exemption for the discount on low coupon gilts. Again the implications for Government borrowing would need to be considered by the Treasury and Bank.

Venture Capital Scheme (S37 FA 1980 - 4 pages of legislation)

9. This allows individuals to set losses on shares in unquoted trading companies against income instead of capital gains. It was introduced to encourage the provision of risk capital, but unlike BES which reduces the risk at the time of investment this relief acts as a safety net and is only relevant if there is an actual loss on an investment. We assume that Ministers would not wish to abolish a part of their support for the provision of venture capital.

Profit Sharing and Share Option Schemes

10. Given Ministers' wider objective of encouraging employee involvement as witnessed by this year's legislation on tax relief for profit related pay, we

also assume that they would not wish to restrict in any way tax relief for approved profit sharing schemes (S53-61 & Sch 9 FA 1978 as amended - 25 pages of legislation) and savings - related share option schemes (S47 & Sch 10 FA 1980 - 12 pages of legislation as amended). Although these schemes narrow the tax base, they are all employee schemes so that the majority of beneficiaries will not be higher rate taxpayers.

11. Rather different but related considerations apply to the privileged treatment of executive share option schemes (S38 & Sch 10 FA 1984 - 9 pages) which are designed to enable companies to retain and motivate a few key personnel. Under such schemes, individuals may be granted options on shares up to an acquisition value at any one time of the greater of £100,000 or four times salary and there is no charge to income tax on the gain when options are exercised, merely a capital gains tax charge when shares are eventually sold. Charging capital gains not income tax may at a guess cost the Exchequer in excess of £100 million per annum in 1987-88 (which is the earliest year options can be exercised) and in subsequent years. Again you may wish to confirm that this is consistent with Government policy.

Incentive Capital Allowances in Enterprise Zones
(S74 & Sch 13 FA 1980 - 1 1/2 pages of legislation)

12. The work done last year, when we were looking at the possibility of a minimum tax, suggested that enterprise zones provide an important shelter used by high earners. Expenditure on construction of commercial buildings in enterprise zones remains eligible for 100 per cent capital allowances provided it is incurred under a contract entered into within the first 10 years of a zone's existence. High earners can borrow money to invest in enterprise zones, get relief for interest on the borrowing against rent from the buildings (this interest cannot be carried sideways against other income) and use the 100 per cent capital allowances to shelter other income. The relief costs several tens of £millions each year and there is evidence from a recent DoE study (which will be put to Ministers very shortly) that most of the benefit is accruing to lessors not lessees in enterprise zones. Statements by Ministers and the press releases around the time the zones were set up would appear to rule out any reduction in the rate of relief. However, Ministers may feel this would not preclude restricting the benefit to particular individuals at the price of some complication in the legislation. For example it would be possible to deny altogether sideways relief for enterprise zone capital allowances (they would need instead to be set against income from letting the building to which the expenditure related or

alternatively against any income from letting buildings in enterprise zones) or putting an annual limit on the amount of sideways relief against other income.

Hobby Farming

13. Despite there being two special provisions (S170 and S180 ICTA - 3 pages of legislation) to prevent sideways relief for hobby farming losses, there is evidence that some people are still managing to get relief for what is really consumption expenditure where the farming is not genuinely carried on with the object of making profits; and certainly farming losses figured prominently among the tax shelters identified in our recent review of high earners when considering the case for a minimum tax. However, the 1984 capital allowances changes may have helped reduce the problem. There may be a case here for waiting to see how things develop before embarking on further complex legislation.

Relief for interest on borrowing to invest in a partnership or close company (para 9-12 Sch 1 FA 1974 - 2 pages of legislation)

14. Relief for interest on money borrowed to acquire a share in a partnership or shares in a close company can be carried sideways and relieved against total income for the year. This also figured among the shelters enjoyed by high earners. Arguably there would be less need for this relief with lower rates of tax. The simplest option would be to abolish relief for this interest altogether. A more complicated alternative would be to allow relief for the interest only against income from the partnership or company concerned (but it should be noted that where the interest cannot be relieved in the year in which it is paid, it cannot in general be carried forward or back for relief in another year). If any action were contemplated against relief for interest on borrowing for these purposes, consideration would also need to be given to what to do about the analogous interest reliefs for borrowing to invest in a cooperative or employee - controlled company (paras 10A-D Sch 1 FA 1974 - a further 3 1/2 pages of legislation). There are no figures available for the total cost of any of these interest reliefs.

Rules on residence and domicile: the remittance basis

15. Mr Taylor Thompson's note of 7 July reports progress on the review we are undertaking of the whole subject of residence, domicile and the remittance basis with a view to preparing a consultative document with the possibility of announcing a review at the time of the 1988 Budget. There seems to be scope for replacing the present rules with a simpler and more objective

approach and fairly substantial amounts of revenue could be involved. However, Mr Taylor Thompson also refers to the wider implications which Ministers will wish to consider.

Car Benefits

16. The benefit of having a company car is undertaxed at present and there is a clear case for increasing the scale charges so that the full value of car benefits is subject to tax (estimated yield £300 million and no increase in the Revenue staff). This would be easier if higher rates were being reduced and there would be a particularly strong case for taxing the full value of expensive company cars. The proposed abolition of the UEL, however, has a number of implications for benefits in kind (which are not charged to National Insurance Contributions) and you will need to consider the options separately. You will be receiving separate submissions.

Maintenance Payments and Payments under Covenant

17. Earlier this year Ministers agreed that an area ripe for review following the election was the tax treatment of maintenance payments and payments under covenant. The present rules are complex - whether or not the person making the payments gets tax relief on them (and whether at higher rates or basic rate only) and whether the recipient is liable to tax depends on the legal form the arrangements take. The rules produce anomolous results between married and divorced/separated couples, so there are links to the taxation of husband and wife; and some of us would say they are unfair in other ways also. The challenge is to produce a package which will make the system fairer and simpler, save staff but not produce large numbers of (unjustified) losers. We shall be sending Ministers a separate submission shortly seeking a steer on how the proposed review should be carried forward.

BASIS OF ASSESSMENT FOR SCHEDULE E

18. This item is rather different in kind to the others considered in this note, because it does not concern a relief or shelter as such. Rather it is a change in rules to a more administratively sensible basis and removal of an opportunity for abuse which would be easier to do when higher rates are being reduced. The proposal is to move from the earnings or accounts year basis of assessment to a receipts basis of Schedule E assessment. This was considered by Ministers in 1986 when it was seen as a candidate for legislation at the start of a new Parliament. A majority of employees and 80,000 directors with service contracts are already assessed on the (non-statutory)

receipts basis but about two-thirds of directors (400,000) are assessed on the non-statutory accounts year basis and the remaining 120,000 on the statutory earnings basis. The statutory earnings basis can involve long delays in assessing where it is necessary to apportion remuneration voted in two sets of accounts. The alternative non-statutory accounts basis (remuneration for the accounts year ending in the tax year is taken to be the assessable remuneration for that year) is open to abuse: the commencement and cessation provisions can be exploited so that large fees are voted in a period falling out of assessment, thereby avoiding tax.

19. Collection under PAYE is already on a receipts basis and aligning the statutory basis of assessment with this would reduce the scope for abuse and avoid a great deal of unproductive work (fewer assessments, coding adjustments, etc) in tax offices. It would be a major simplification, providing - after a 3 year transitional period - estimated additional revenue of £90m (over half from preventing abuse, the rest from no longer having to give weekly paid employees an extra 1/52nd of their allowances when there are more than 52 pay days in the year) and estimated staff savings of between 220 and 385 (there would be a staff cost of about 45 per annum during the 3 year transition). Although it would be controversial there are good reasons for introducing the change without prior publicity or consultation. To prevent avoidance for those years open before the changeover to the receipt basis, it would be necessary to deny directors on the accounts basis the right to revert to the strict earnings basis. In some circumstances the receipts basis could lead to bunching of income and move directors to a higher tax band than otherwise. Since many of the directors who would be affected by this reform stand to benefit from the rate changes it would be helpful to introduce both at the same time.

20. There are major issues here which Ministers will want to consider carefully. One important consideration is the feasibility of making this change at the same time as other changes affecting our network offices. If Ministers decide to introduce Independent Taxation with a 1990 start, for example, it would not be possible to introduce the receipts basis in Finance Bill 1988 with both changes affecting local office work at the same time. We shall provide a separate note on moving to a receipts basis for Schedule E assessment later this year.

ANNEX 2

OPTIONS FOR REVIEWING AND SIMPLIFYING CERTAIN ANTI AVOIDANCE PROVISIONS

1. This note identifies some anti-avoidance provisions that might be less necessary after the proposed tax reform. It is divided into three sections:

a) Some free standing provisions.

b) Some more complex provisions part at least of which will remain necessary which might be candidates for a later review.

c) The most important provisions which are affected by tax reform but where the case for retention seems strong.

This note has not been shown in draft to colleagues who would normally be consulted on detailed technical issues: to that extent we might need to amend our advice if the work is to be taken further.

A. FREE STANDING PROVISIONS

All of these are designed to protect the Exchequer against conversion of income into capital gains.

2. <u>Sale of future income for capital sums (section 487 ICTA 1970 - 2 pages of legislation)</u>.

This section is aimed at arrangements whereby an individual relinquishes the prospect of future income from professional activities in consideration of a receipt of a capital sum. Both parties to the transaction usually benefit. The vendor sells his income at a discount but because of the differences in income and capital gains rates receives a higher net yield. The purchaser, usually a company, makes a profit if the discount on the income exceeds the company's corporation tax rate. S487 charges the vendor to income tax instead of capital gains tax. Reform of the rate structure makes this a likely candidate for review. The tax incentive should be considerably reduced (especially since normally indexation will be of no benefit even if CGT applies). There will remain the possibility of avoiding national insurance contributions (since this is converting earned income into gains) but this is anyway possible by the use of any 'captive service company'.

3. **Artificial transactions in land (Section 488 ICTA 1970 - 3 pages of legislation).**

This section charges income tax on profits from land dealings where a gain of a capital nature is obtained usually from the development of land. The most common example is where land with planning permission is sold where the sales price is not fixed but is a percentage of the developers gains. Part of the income profit from development is converted into a capital gain but Section 488 charges it as income rather than gain. A realignment of capital gains and income tax rates may reduce the need for Section 488 but there are arguments for retaining at least some of its provisions:

i. Capital gains treatment would have a revenue cost because of different rules (indexation etc).

ii. Section 488 catches some transactions that might escape the capital gains tax net.

iii. Section 488 applies in respect of all land in the UK and catches the non resident vendor unlike the capital gains rules. (As you know, there is cause for anxiety about the use of purportedly non-resident tax shelters generally).

One possibility might be to retain Section 488 for non residents and possibly some of the cases in (ii) where otherwise payments would escape tax altogether.

4. Sale or transfer of interest rights (Section 470 1 1/2 pages)

Section 470 deals with the sale or transfer of the right to receive interest payable in respect of securities without selling or transferring the securities themselves. The vendor of the interest rights retains the right to payment of the principal whereas the buyer is an exempt institution which pays no tax on the income. The aim is to convert (highly taxed) interest to (more favourably taxed) capital and Section 470 treats the interest as being received by the vendor. Assimilation of treatment may reduce the need for this Section.

5. Exploiting relief provisions for interest (Section 76 FA 1972 and Section 41 F(No 2)A 1975 - 2 1/2 pages

These Sections combat a device much used in the late 1960's whereby a high rate taxpayer borrowed money to buy securities such as gilts standing at a discount in the market and on which a capital gain would be realised on redemption. The discrepancy between relief at the taxpayer's top marginal rate on the interest paid and the low rate of tax (or exemption in the case of gilts) of the gain on the securities enabled him to get a large profit at the Exchequer's expense. The sections deny interest relief. The scope for this has already been considerably narrowed with the abolition of most forms of interest relief for individuals: exploitation would only be feasible now through a close company. The reduction of the small companies rate to 25% would reduce the value of the interest relief, the alignment of the capital gains rate with income would mean that the device only worked for gilts or exempt bonds, and the individual shareholder faces a charge in extracting benefit through the company. We would need to do more work on the likelihood of discounts arising in the market of a sufficient size to create opportunities for abuse but if the risk is small the sections may no longer be necessary.

B. POSSIBLE CANDIDATES FOR POST 1988 BUDGET REVIEW

6. **Cancellation of tax advantages from certain transactions in securities (Sections 460-468 ICTA 1970 - 13 1/2 pages).**

These sections constitute a widely drafted framework to catch avoidance which is not caught by the more closely defined avoidance legislation elsewhere on dividend stripping and bondwashing. In some cases the mischief concerned is the conversion of income into capital gains where the reforms would reduce the need for protection. In other cases the provisions are required to stop value being taken out of a company in circumstances where not even capital gains tax would otherwise be payable. It may be possible to identify certain parts of the provisions which would no longer be necessary if capital gains and income rates of tax were aligned but even fairly small differences in effective rate due to indexation could leave the way open to exploitation. As this is a key part of the Exchequer's armoury against devices which were very popular and expensive in the 1950's - any which are also well-known in the United States - we would suggest that a more detailed analysis is needed than would be possible by next Budget of what (if anything) is still necessary and what could be dispensed with.

7. **Close company apportionment (Schedule 16 FA 1972 - 26 pages of legislation)**

The prime purpose of this complex legislation is to prevent the small private company being used as a "money box" to accumulate income taxed at corporation tax rates rather than an individual's higher rates. Where certain close companies fail to distribute their profits by way of dividends the rules provide for a distribution to be deemed to have been made and treated as income of the shareholder and taxed at higher rates. The possibility of making changes here arises not from the narrowing of the capital/income distinction but from the reduction of the differential between the rates of corporation tax (in particular the small company rate) and the higher rates of income tax. It would not be essential to have the rates identical as a small differential would not necessarily encourage avoidance as there remains a second layer of taxation on extractions of money from a company whether by way of dividend or as a capital receipt on liquidation.

This area would require careful consideration as a restructuring of rates would not eliminate all the advantages that apportionment counters e.g.

i. The medium of a company can be used to transfer income within a family to a lower rate or exempt member (e.g. children who are directors).

ii. Apportionment can also be used to prevent an individual obtaining interest relief on money borrowed to make investments. Without apportionment family investment companies can be used to obtain tax relief to fund what is in essence an individuals investment which if made directly would not qualify for interest relief on borrowings.

iii. There will still be a significant difference (15%) between the highest rate on income and the small companies corporation tax rate. Thus although the reduction of higher rates helps here, it is partly offset by the reduction in basic rate.

It would be necessary to identify whether any parts of the legislation can be separated out and retained to protect the Exchequer against (i) and (ii) while dropping other parts.

8. <u>Settlements and trusts (main legislation Sections 434-459 ICTA 1970 - 31 pages)</u>

There are many non tax reasons for setting up trusts but this block of anti-avoidance legislation is necessary to ensure that individuals cannot transfer capital into trusts paying only basic rate tax and extract the benefit of the income for their personal use thus escaping higher rate tax. The defences fall into two main groups: an additional rate of tax (currently 18%) is paid on the income of accumulation and discretionary trusts to bring the tax charge part way between basic rate and the top rate of tax; and there are rules to treat income of trusts as the income of the settlor where he, his spouse or his children are beneficiaries or able to enjoy benefits from the trust directly or indirectly.

The additional rate will inevitably have to be reviewed in the event of a reduction in higher rates. At present it is set so as to bring the combined rate of tax on the trusts affected to the second (45%) higher rate band. Initially it yields around £35m (in 1985/86) though there may be subsequent adjustments as the income is distributed to beneficiaries. Ministers will need to decide whether to align the rate on trusts with the new higher rate (40%), some intermediate figure between basic and higher rate in recognition of the fact that some beneficiaries will be higher rate taxpayers and some basic rate taxpayers, or dispense with the additional rate altogether. At present, the combined rate is 15% below the top rate of tax so this differential would not be widened in amount if the tax were abolished (although the number of beneficiaries with personal rates above the trust' rate of tax would increase). We will minute you separately on this.

The other rules are partly to prevent higher rate tax being avoided but, partly (for example, the rules to prevent transfers of income to non taxpaying minor children of the settlor) to prevent all tax being avoided. It may well not be possible to therefore to simplify or abolish any of the rules but the area is one of such widespread importance that Ministers may feel it should be reviewed.

C. PROVISIONS CONSIDERED BUT NOT RECOMMENDED FOR REVIEW

9. Stock dividends (Section 34 F(No 2)A 197 - 4 pages)

"Stock dividends" is the name given to a bonus issue of shares by a company instead of cash dividends. Certain companies also issue a special class of share which carry a continuing right to receive bonus issues of shares. Bonus issues in respect of such a special class of shares are also known as stock dividends. These cases should be distinguished from normal bonus issues where the recipient generally receives no additional value. The nominal increase in his shareholding in such cases is broadly matched by the reduction in value of the original shares after dilution by the bonus issues.

A taxpayer receiving a bonus issue of shares instead of a dividend was, prior to 1975, able to avoid an income tax charge and pay only a deferred capital gains charge when he subsequently sold the bonus issue. Since 1975 stock dividends have been chargeable to higher rates of income tax on the grossed up value. A restructuring of tax rates reducing top rates and bringing capital gains rates closer to income would reduce the impact of the section and raise the question whether it need be retained.

As long as differential tax rates remain there will be an incentive to minimise higher rate liability which could be expensive if it caught on widely. In addition, without this section there remains the possibility of deferring liability almost indefinitely which is quite unaffected by the reforms. For these reasons this does not seem a prime candidate for review.

10. Income tax on consideration for certain restrictive covenants (Section 34 ICTA 1970 - 2 pages of legislation)

This Section taxes at higher rates only sums paid to employees or former employees where they undertake to restrict their activities in connection with the holding of their employment (whether past, future or present). Under normal rules these sums are not taxable as remuneration or as capital gains. As these amounts are only taxed at higher rates a reduction in differential reduces the need for this section. As long as there remains a differential, however small, between the highest and the basic rate this section is probably still needed, if only as a deterrent.

11. Accrued Income Scheme (Sections 73-75, 77 and Schedule 23 FA 1985 - 30 pages of legislation)

This scheme changed the basis on which interest was considered to accrue for most marketable securities (including Government stock and securities). Previously a person was taxed on the interest received rather than the interest accrued. The accrued interest was treated as part of the sale or purchase price. This fuelled the practice known as "bondwashing", the buying of securities ex dividend followed by sales cum dividend the price having risen to reflect the accrued interest. This enabled profits to be taxed, if at all, at lower capital gains rates. The accrued income legislation charged tax on income on the part of the purchase price attributable to accrued interest.

Prima facie the alignment of income and capital gains taxation reduces the need for the scheme but we would recommend against changing it now:

i. On cost, individuals would be able to utilise the special capital gains reliefs to pay less on average.

ii. At present gains on Government securities and other qualifying bonds are exempt from capital gains tax. As discussed in Annex 1 there is a case for restoring a capital gains tax charge on gilts but this would be complex and difficult and the accrued income scheme or something like it would be needed so long as gains on some securities remained tax free.

iii. The accrued income scheme has only recently been introduced (with effect from February 1986) and is still in the process of bedding down. It was introduced as a more logical long term solution to a long lived area of difficulty; it looks unattractive to reverse engines at this stage.

There are also other more specific forms of bondwashing counteracted by Sections 469-475 ICTA 1970. These sections affect securities outside the accrued income scheme and are aimed at arrangements where the dividend would be received by exempt bodies such as charities. Once again, what is at stake is loss of all tax not just of the differential between income and gains so these provisions would continue to be needed.

Many thanks.

1A is certainly a possible way of dealing with the higher rate losers. But I shd be grateful if you wd let me have a note on the cost & effectiveness of doing it, alternatively, by bringing the higher rate down from 40% to 35% (& of course 9% NIC)

2. So far as the basic rate losers are concerned (the real problem) pse let me see what graph ~~[illegible]~~ 15 looks like with no mortgage interest, & let me have a table showing the numbers of losers, & the amount they lose, @ various

Income limits, in
2 cases: (a) ~~•~~ $3000
mortgage interest & (b)
no mortgage interest.

M

Capital Gains to go on ~~NI/25~~ P1A

Tax

call up papers

→ CHECK in the New year 87-88 papers separate 87 papers up this folder.

Tax Folder

1 of 19

Inland Revenue

Policy Division
Somerset House

PPS
I wd like a brief discussion with officials with Mr Scholar ASAP.

CAYLEY
→
CH/X
1 JULY

FROM: M F CAYLEY
DATE: 1 JULY 1987

1. MR HOUGHTON 1/7 Pl. see note at end.
2. MR ISAAC 2.7.
3. CHANCELLOR OF THE EXCHEQUER

[Is it possible to consider rebasing for individuals but not for companies?]

REFORM OF CAPITAL GAINS TAX

1. The attached note responds to your request for a paper on charging gains at income tax rates with a schedule of two rates - 25% and 40% - and rebasing the gains tax to 1982.

2. We shall be letting you have shortly separate papers on the possibilities of making minor simplifications of the indexation rules and of replacing Inheritance Tax with a gains charge at death.

3. In order to bring out some of the effects, we have looked at two possible schemes:-

---

cc	Financial Secretary	Mr Battishill
	Mr Scholar	Mr Isaac
	Miss Sinclair	Mr Houghton
	Mr Cropper	Mr Calder
		Mr Beighton
		Mr Cayley
		Mr Gonzalez
		Mr Hamilton
		Mr Mace
		Mr Weeden
		Mr R H Allen
		Mr Quinn
		Mr Michael
		PS/IR

i. gains as currently computed (with no rebasing) taxed at income tax rates, and

ii. rebasing to 1982, with pre-82 gains excluded from charge and the resulting taxable gains taxed at income tax rates.

4. The usual caveats about our analyses apply. In particular, our modelling of effects on hypothetical taxpayers assumes that their assets have moved in line with average changes in share and land values; and the scale of behavioural response - in terms of the effect on the volume of disposals - is extremely uncertain, and our estimates of yield and taxpayer numbers are correspondingly uncertain. Some recent American work would suggest that we may be underestimating likely behavioural reactions, and over the next month or two we shall be endeavouring to see how sensitive our estimates are to changes in the behavioural assumptions.

5. A further important point is that we have assumed no change in the general tax regime for husband and wife. If, for example, legislation were introduced next year to provide a wife's income (as opposed to earnings) election - so that couples could elect to have independent taxation of investment income - it would be necessary to review the capital gains position under which a married couple's gains qualify for only the same (currently £6,600) annual exemption as a single person.

6. For the time being, we have assumed that the annual gains exemption would remain at its present level, subject to revalorisation. We can look at alternative assumptions if you wish.

General picture

7. The general picture that emerges is as follows. Without rebasing the tax yield on an 1988/89 accruals basis might rise by around £m250 and (because behavioural responses would reduce the volume of disposals) taxpayer numbers might fall by some 10,000. On relatively small disposals of shares, liabilities would tend to decrease for basic rate taxpayers. All those above the new higher rate threshold would by definition pay more tax on gains - as generally would basic rate taxpayers on larger gains and land. Acquisitions of agricultural land in the 1980's would however, as now, often be sheltered from tax by indexation.

why?!

8. Rebasing alters the picture dramatically. Leaving aside the possibility of a short-term temporary surge in disposals (because of an unlocking effect on older assets), the CGT yield on a 1988/89 accruals basis might fall by around £m450 and taxpayer numbers might fall by perhaps a ~~third~~. There would be a further £m500 reduction in corporation tax. In practice in the short term there would probably be some increase in the volume of disposals, but the extent of this is necessarily a matter of guesswork. It would take an exceedingly substantial surge to make good the over £m900 revenue cost.

Why? - where?

9. As far as farmland is concerned, with rebasing, tax would cease to be paid at all on many disposals of farmland - and they would frequently generate capital losses available against gains on other assets. In contrast - particularly for large disposals and for higher rate taxpayers - there would often be increases in the tax paid on share disposals, though for many higher rate taxpayers these tax increases would be offset by reductions in tax on income.

10. It follows from this that the case for sweeteners for lumpy assets like land would not be strong if rebasing formed part of the package.

<u>Legislation</u>

12. The length and complexity of the legislation required would depend critically on how the charge at income rates was achieved. There are two options:-

i. CGT could be retained as a separate tax but with gains taxed at the rates that would apply if they were income. This would be much the simpler course but the appearance of integration would not be so fully achieved. Our (very) preliminary guess at the length of legislation is between ten and twenty pages.

ii. The charge could become one to income tax. This would make it a little harder to resist pressure for setting capital losses against income (which would give substantial scope for reducing tax liabilities on income and would significantly erode the income tax base). It would also - as Parliamentary Counsel emphasised in our exchanges with him last winter - add very substantially to the length of the legislation, with a likelihood of many pages of minor consequential amendments to the Taxes Acts about which the practitioners might well complain loudly.

???

13. An early decision about which route to follow would be necessary. Either way, we ought to start instructing Parliamentary Counsel in the Autumn.

Operational Implications

14. We shall also before long have to start work on the operational implications (eg. for forms, procedures and computerisation) if the option of reform on these lines is to be kept open.

Staffing

15. With the retention of indexation and with rebasing leading to more emphasis on negotiating 1982 values, there are unlikely to be significant staff savings. Indeed if there is a temporary surge of disposals of old assets our staff need might in the short term increase.

Conclusion

16. Without rebasing, we doubt the package is terribly attractive. But if rebasing is built in, it looks - in conjunction with tax cuts on income - very much more feasible but at a significant cost to the Exchequer.

Michael Cayley

M F CAYLEY

X

1. As we thought, rebasing is a key ingredient if full integration is to be a feasible proposition. So far the package looks promising but:-

a. we will need to look more closely at the interaction with income tax when the options for changes in rates and bands have taken firmer shape - particularly as regards income tax losers (who might be CGT losers as well). The treatment of the non-earned income of husband and wife could also have a significant CGT impact (thresholds might in effect be doubled);

b. we shall also need to look at the relationship of the proposal to replace IHT with CGT on death (on which a paper will follow shortly) with the changes described in this paper. If these two reforms are both to go ahead the case for rebasing may seem rather different (indeed less attractive) than when considered in the context of an integration package alone.

2. The package does not come cheap (nearly £1 billion on 1988/89 accruals and it would not be feasible to cut the cost by confining rebasing to individuals and trusts). Of this £500 million will go to landowning individuals and trusts whereas shareholders would tend to pay a little more overall. These estimates need to be taken with some caution. The CGT model on which they are based focuses on two broad groups of assets - medium term holdings of fast growing assets and long term holdings of slow growing assets. The share price index is used as a proxy for movements in the former and the agricultural land price index in the case of the latter. The former has been used in the costings in the paper as a proxy for shareholdings and the latter for land. We may moreover have underestimated the "unlocking" effects of the change. Shareholders may take the view that this is a window of opportunity which they should not miss. The behavioural and market effects are speculative and complicated and you may wish to have more guidance sought on them.

Indeed

Yes

M

B T HOUGHTON

X above is, of course essentially for political judgment. The underlying facts are that:

- integration at full income tax rates would increase the charge on substantial capital gains by up to 10 points, from 30% to 40%;

- for many taxpayers there would be offsetting benefits from the income tax bit of the package, producing a wide spectrum of losers and gainers overall;

- the most difficult area might be people at the top of the basic rate band and just above the present higher rate threshold, who could <u>both</u> lose from the wider income tax package <u>and</u> be pushed into the 40% tax bracket by the capital gain.

What have you decided what the higher rate threshold shd be.

CJ

A J G ISAAC

REFORM OF CGT

1. This paper looks at the possibility of charging gains at the rates that apply to income, and rebasing to 1982. The final section discusses some possible minor changes to indexation.

Structure of income charge

2. We have assumed two rates of income tax - a 25% basic rate and a 40% higher rate, with the latter starting at taxable income of £20,400. Variations of one or two thousand pounds in the higher rate threshold would have relatively little effect on the picture for gains.

3. For discretionary trusts, we have made a working assumption that the tax rate on income would be 40% - broadly equivalent to the basic plus additional rates now.

4. We have assumed no other changes in the structure of income tax. In particular we have worked on the basis of the present arrangements for taxing married couples.

Gains threshold

5. For working purposes we have taken the present CGT annual exemption and assumed this would be revalorised.

Rebasing

6. Rebasing would involve excluding from charge gains accruing before April 1982 (the base date for indexation). It would apply to companies as well as individuals and trusts.

7. A major policy issue is whether the rebasing should be compulsory for all taxpayers, or optional. The point here is that for some taxpayers with a capital loss, part of the loss will have accrued before 1982. So if 1982 rebasing is obligatory some taxpayers will have smaller losses for tax purposes. Logic would point to making rebasing compulsory: just as capital gains would be restricted to post-82 gains so capital losses should be restricted to post-82 losses.

clean

8. Compulsory rebasing would be equivalent to what was done when CGT was introduced in 1965: broadly capital gains or losses were computed by reference to changes in value from April 1965 (with for some assets special

A

valuation rules, for which we would need no equivalent now) and losses accrued before that date were not added to later losses.

9. On the other hand, those adversely affected would be almost certain to complain that their existing "rights" to losses accruing before 1982 were being cut off. And for indexation people have a choice between taking the 1982 value and actual original acquisition cost as the base for indexation.

10. The decision on this will turn on a political judgment as to whether people should take the rough of rebasing with the smooth, or whether alternatively the Exchequer should simultaneously give up tax on pre-82 accrued losses against post-82 gains. *

11. Whatever the decision on this, there would be circumstances where the gain or loss from 1982 was greater than the corresponding gain or loss over the total period of ownership of the asset. In 1965 this situation was met by restricting the gain or loss to the lower figure. A similar rule would be needed.

---

* You need to consider here not just those cases where people have <u>net</u> pre-82 gains or losses. There will, of course, be individual taxpayers with pre-82 gains on some individual assets and pre-82 losses on others. We are not yet clear whether it would be possible under an optional system to prevent them - even if you thought the cost quixotic - sheltering their gains and cashing their losses on each individual asset.

AJGI

Capital losses

12. As for the companies' changes this year, we have assumed that capital losses would not be generally available against income or vice versa. If they were, there would be scope for arranging to have large losses in a year of high income and a significant erosion of the income tax base.

Yield and taxpayer numbers

13. Estimates of yield and taxpayer numbers are likely to change significantly as forecasting assumptions alter over the period up to the 1988 Budget. For the moment we are using the 1987 Budget basis. They may also be highly sensitive to the assumptions about behavioural responses: the formula we have used to allow for these is the same as we employed last winter and has been agreed with the Treasury, but there can be no guarantee that the basis is well founded and, as the cover note explains, some recent American work would point to larger behavioural reactions. And some of the data on the pattern of price movements - particularly in relation to non-agricultural land disposals - before and after 1982 is far from complete: and this data is important to estimates of

the impact of rebasing. The figures that follow should be read with these caveats in mind. The figures also ignore possible sweeteners (see below).

(a) Individuals and Trusts

14. The following table shows the key figures for individuals and trusts:-

	Yield	Taxpayer numbers
a. Present CGT on 1988/89 disposals.		
- shares etc	£m1,370	200,000
- land	£m630	
- total	£m2,000	
b. Effect of reform without rebasing.		
- shares etc	+£m150	-10,000
- land	+£m120	
- total	£m270	
c. Effect of reform with rebasing.		
- shares etc	+£m50	possibly reduction of around a third.
- land	-£m500	
- total	-£m450	

The figures for (c) ignore the possibility of a temporary surge in disposals because of an "unlocking effect" on pre-82 assets. This is discussed at paragraphs 16 and 17 below.

(b) Companies

15. From this year, companies' gains will be taxed at the same rates as income. The effect of rebasing on the yield of corporation tax on 1988/89 accruals might be a reduction of around £m500.

(c) Short-term effects

16. Rebasing might well increase the volume of disposals of older assets, which in the short term would result in a higher yield than we have quoted above for the package with rebasing. The extent of this effect must be a matter of judgement. For shares, there are some technical factors limiting the likely effect: where people have blocks of shares in a company some of which were acquired before and some after 1982, under the CGT rules they are deemed to dispose of the later holdings (which generally will produce smaller gains) first, so they cannot "unlock" the pre-82 block until they have got rid of

all their post-82 holding, and they may well not want to do this. For reasons which will become apparent below, unlocking is more likely for some owners of land.

17. There would have to be a colossal unlocking effect to make good the revenue cost of rebasing. We do not think it would be realistic to anticipate unlocking on this scale. So even in the short-term rebasing is likely to involve a significant Exchequer cost.

See prev. papers wh. 51 to unlock

Staffing

18. In the package we looked at last winter, it was the removal of indexation which created the potential for large staff savings. With the retention of indexation, this potential largely disappears. Rebasing would reduce the number of actual taxpayers, especially on land disposals, but we would still need to process returns of land transactions to check there was no liability, and there would be other offsetting factors. In particular establishing an accurate 1982 value would become much more critical, as this would be important not just for indexation but also for determination of the base cost - so we could expect more

and longer negotiations with taxpayers on 1982 valuations. There would also be the possibility of an increased caseload of disposals of pre-82 assets and the extra complications from the interaction of capital gains and income in an integrated charge. Without rebasing there could be some, probably fairly small, increase in our staff need.

Would the change be a simplification?

But it is a rationalisation! AW

19. We do not think a restructured gains charge on these lines would be a simplification. In last winter's package it was again the removal of indexation which led to simplification. On the other hand the reform should not lead to any significant extra degree of complication. The greater ~~the~~ importance with rebasing of 1982 valuations might add a little to compliance costs.

but rebasing dramatically reduces the caseload!

Distributional effects

20. Annexes One and Two illustrate the distributional effects, taking hypothetical model assumptions.

21. Without rebasing, there would be likely to be a high proportion of losers. Some basic rate taxpayers would gain, particularly in relation to share disposals, but even they would often pay more tax on land and on larger

disposals. Higher rate taxpayers would see an increase in the tax rate from 30% to 40%. The effect of this would tend to be greater for shares than for land, because of the large real gains which shares have clocked up in recent years.

22. With rebasing, land that had moved in line with the average value of farmland would very largely be taken completely out of tax: generally the charge would be confined to development gains, residential property outside the private residence exemption (including second homes), commercial property and other real estate which has appreciated since 1982 in real terms.

23. The effect of rebasing on shares is rather different. Basic rate taxpayers would generally see a reduction in liability except on large disposals.

Higher rate taxpayers would often see an increase, which would be most marked in relation to post-82 acquisitions which would, of course, not benefit from rebasing. However, in many cases, particularly for top rate taxpayers, these increases would be more than offset by reductions in the tax burden on income. But there would be a group currently towards the top of the basic rate at the lower end of the higher rates who would frequently emerge worse off overall.

Market effects

24. Clearly, rebasing would be likely to have major market effects. Official Treasury and the Bank will need to look at these. Our own preliminary view is as follows.

25. The turnover in shares is likely to increase, and some insurance companies might dispose of part of some long-term shareholdings, but there is unlikely to be much effect on share prices overall. The virtual exemption of much farmland could lead to more disposals, especially by non-exempt institutions: this could lead to a (probably small) reduction in agricultural land values which are already depressed in much of the country but the effects of European Community agricultural policy will remain the dominant influence on prices. There might be some (probably limited) unlocking effect on development land which could help to hold down prices a little.

Sweeteners

2~~5~~6. Last winter, as part of the reform package then under consideration, we looked at a number of special measures to help groups particularly affected by those disposing of "lumpy" assets like land and businesses. An updated table of these sweeteners is at Annex Three.

27. Given the extent to which farmland benefits from rebasing, we do not think that there would be a strong case for special measures to help agricultural landlords and those making part disposals of farmland. Rebasing would also help others at whom the special measures would be directed. Ministers may well therefore conclude that it is not necessary, in a package with rebasing, to include special measures of this kind.

In any case, "lumpy" assets, as such, no longer give rise to the same kind of problem, when the income tax system ceases to be steeply progressive.
C.L.C.T.

Transitional

28. A decision would have to be taken on what to do where tax had been deferred on a gain under the old regime (eg. gifts relief or rollover on business assets): would any subsequent charge on the asset under the new regime be confined to the post-82 component of the gain, excluding any deferred charge on gains accrued before 1982? This would be generous, and put poeple who had opted to defer tax on gifts and on business assets in a better position than those who had paid tax at the time under the existing regime. It would also be likely to be an operational complication, since the rolled-over gain

would often have to be recomputed to exclude the pre-82 component. On the other hand people would complain that retaining a charge on the pre-82 component was inconsistent with the aim of rebasing; and they would point to the position of married couples who are treated as a single taxable unit for CGT and who, where an asset was given from one spouse to the other would pay tax only on the post-82 gain. On balance, where tax has been deferred on an earlier disposal, our recommendation would be to confine tax under the new regime to post-82 gains.

Avoidance

29. Higher rate taxpayers might seek to circumvent the higher rate charge on gains by transferring assets (with rollover relief) into an interest-in-possession trust whose gains would be chargeable only at the basic rate. This would probably become a widely publicised and used tax planning device. Thought will need to be given as to whether there should be rules to counter this and similar arrangements.

ANNEXES ONE AND TWO

1. Annexes One and Two contain illustrative graphs for a revalorised gains threshold level next year of £6,900. Annex One assumes no rebasing. Annex Two assumes that the base date is moved forward to April 1982. Both Annexes assume that the system is reformed from April 1988 and that the higher rate IT threshold is £20,400. They show, for a disposal in 1988/89 the resulting change in tax as a percentage of the unindexed gain and illustrate how the change varies according to the size of the disposal and the date the asset was acquired. They take no account of any offsetting reduction in tax on income - the extent of which will of course vary according to the level of income.

£20,400

2. Separate graphs are given for shares and for agricultural land. The value of shares is assumed to have moved in line with the FT Actuaries All Share Index, and the value of land in line with our own index for agricultural land. For assets acquired in the 1960's, the vast bulk of the disposal proceeds represents nominal capital gain. For assets acquired in the last few years, the nominal gain element in

the proceeds is very much less. The graphs thus illustrate the relative effect of the changes on people with large inflationary gains from the 1960's and 1970's.

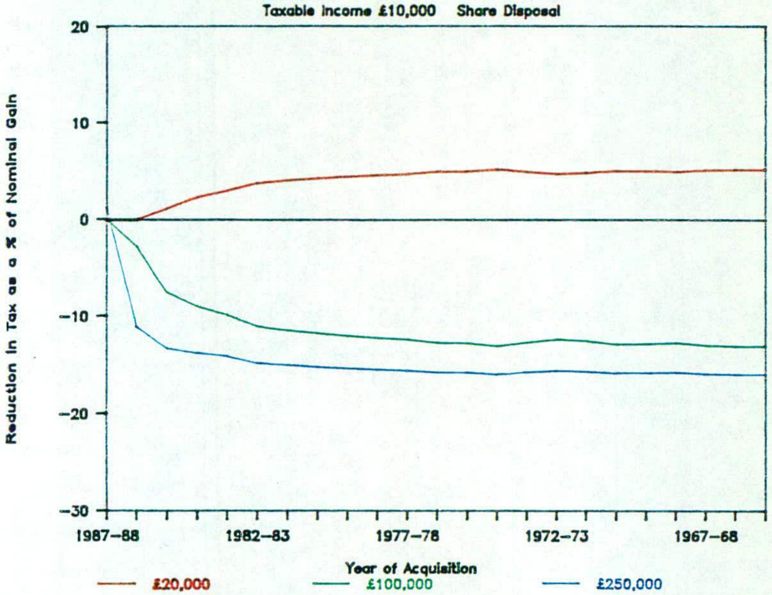
3. Three different sizes of disposal are illustrated: £20,000, £100,000 and £250,000. The taxpayer is assumed to make only the one disposal in 1988/89. Two different examples of taxpayer are taken. First, someone whose income (before adding on gains) is £10,000. Secondly, someone whose income would be taxable at 40% under the new rate structure. The graphs would be the same for anyone with a 40% marginal rate.

4. The graphs are in terms of the reduction in tax as a percentage of the nominal gain. This means that gainers appear above the zero line, and losers below.

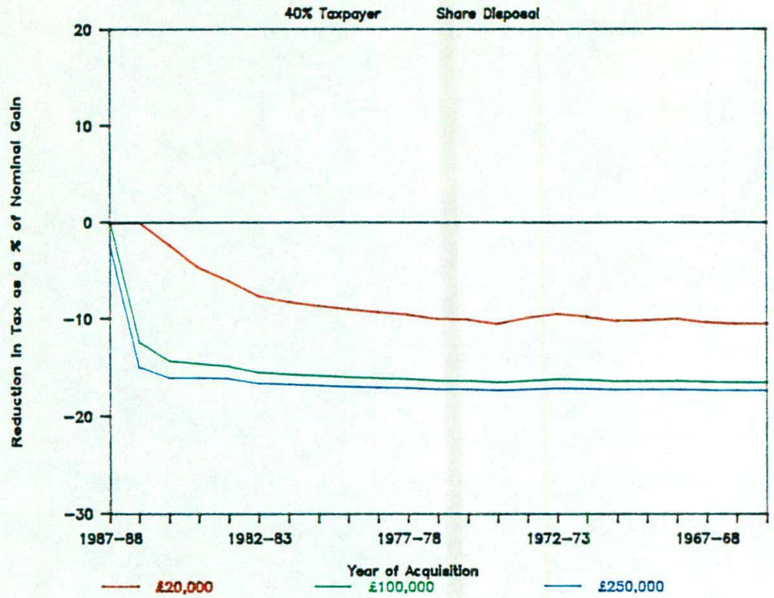
5. Although not apparent from the graphs themselves (which show changes in tax as a percentage of nominal gains as opposed to actual tax payable) a highly significant point emerges in connection with Annex Two. This is that for agricultural land which has moved in line with average prices no tax would be payable under the changes with 1982

rebasing - except on acquisitions in the last year or so. Indeed, in many cases disposals would give rise to losses which could either be set against gains elsewhere in the same year or carried forward indefinitely. Accordingly, the arguments for special measures for agricultural land as part of the package would be extremely weak.

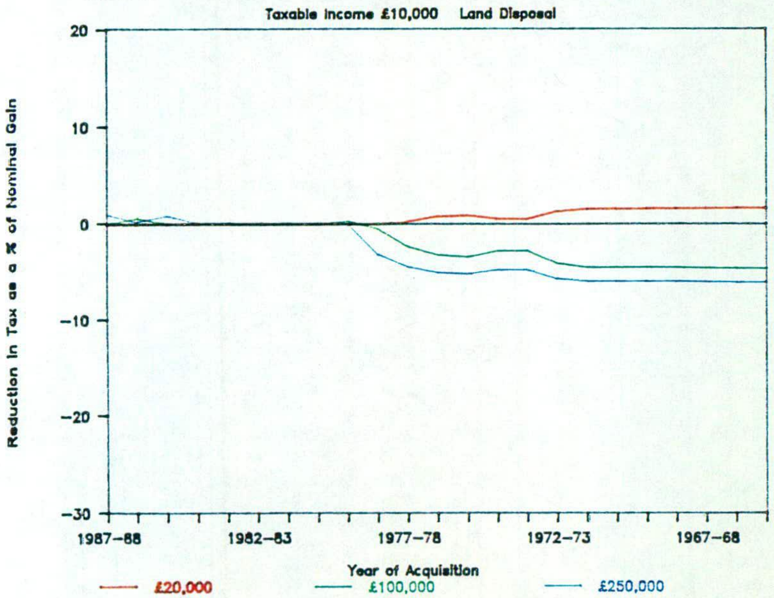
GAINS TAXED AT INCOME TAX RATES 1988-89



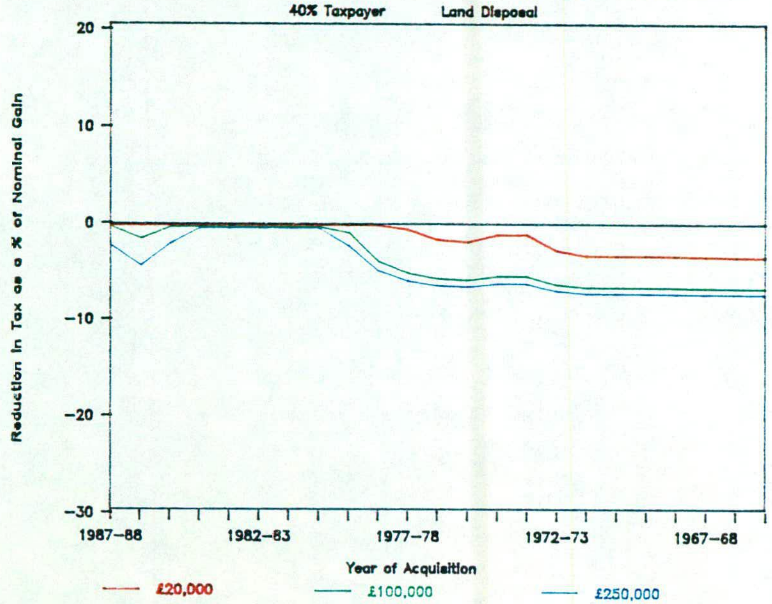
GAINS TAXED AT INCOME TAX RATES 1988-89



GAINS TAXED AT INCOME TAX RATES 1988-89



GAINS TAXED AT INCOME TAX RATES 1988-89

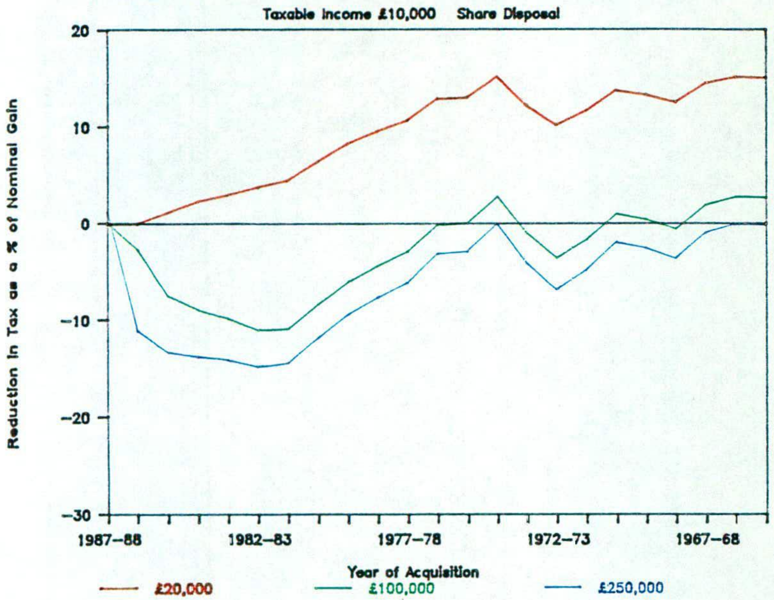


ANNEX ONE

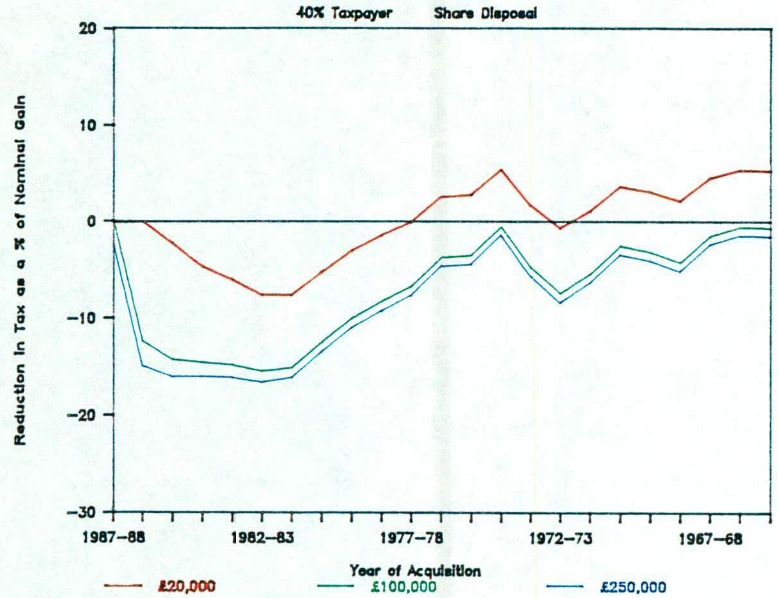
NO REBASING

ANNEX TWO
REBASING TO 1982

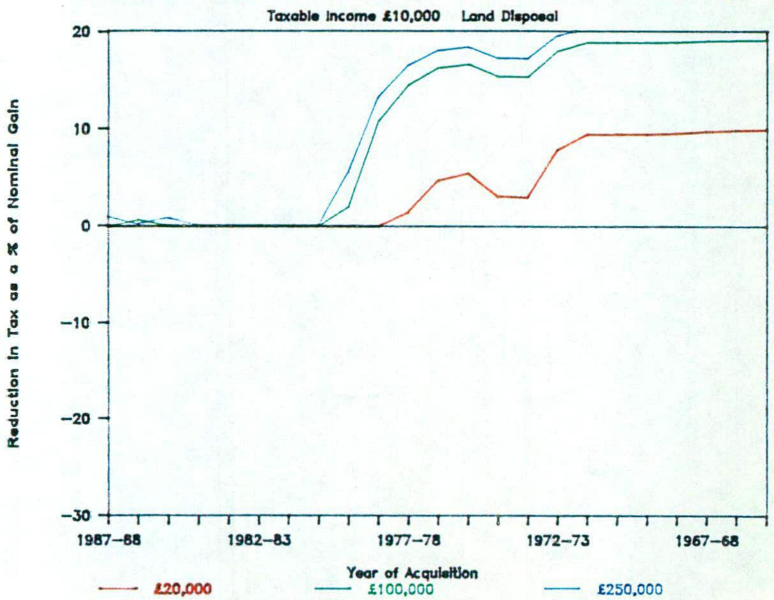
GAINS TAXED AT INCOME TAX RATES 1988-89



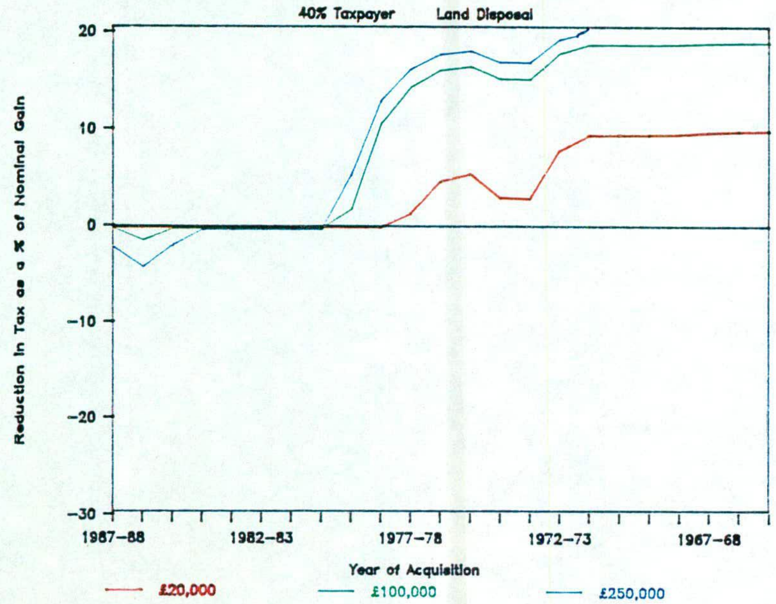
GAINS TAXED AT INCOME TAX RATES 1988-89



GAINS TAXED AT INCOME TAX RATES 1988-89



GAINS TAXED AT INCOME TAX RATES 1988-89



ANNEX THREE

CGT REFORM : SUMMARY OF SPECIAL MEASURES

	Full year cost (£m) Without Rebasing	With Rebasing
Rollover relief		
Extend to		
- Agricultural landlords, and	50	10
- (possibly) second homes	10	5
Retirement relief		
Extend to		
- Agricultural landlords	15	5
Monetary limits		
Increase retirement relief ceiling from £125,000 to £150,000.	10	5
Increase small part disposals relief from £20,000 to £25,000.	20	10
Increase partly let exemption limit from £20,000 to £25,000.	less than £m1	less than £m1

Note

Some of these estimates - particularly the "with rebasing" figures - are very tentative and may be subject to material revision.

Inland Revenue

Policy Division
Somerset House

BUDGET SECRET

From: M F Cayley
Date: 6 July 1987
Extn: 7571

1. Mr Houghton ✓ Pl see note below [initials] 6/7
2. Chancellor

CGT:MINOR SIMPLIFICATIONS OF INDEXATION

1. In my note of 1 July on CGT reform, I said that we would let you have a separate paper on the possibility of minor simplification of the indexation rules. This paper is now attached.

2. As it explains, we have looked further at the options in Mr Houghton's 7 May note. Our general conclusion is that in two cases - quarterly indexation and providing a slightly simpler way of coping with the recent RPI re-referencing - the frictional irritations of making the change would probably outweigh the marginal simplifications. The third - introducing "direct uprating" for post-1982 shares - would be useful and could be achieved and publicised by a Statement of Practice (we already accept computations on this basis, though this is not widely known). This Statement could be published on Budget Day if you wished to link this simplification with CGT reform.

---

cc Financial Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

Mr Battishill
Mr Isaac
Mr Houghton
Mr Calder
Mr Beighton
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Michael
PS/IR

3. We have also looked at the possibilities of publishing a comprehensive Revenue booklet on indexation and of revising slightly the presentation of the monthly press release which gives indexation factors. We did a good deal of initial work on a booklet last year but put it to one side because of the general CGT review. If we issued a full booklet this year and CGT reform went ahead in 1988, the booklet would need substantive revision. We therefore think that the better course would be to continue to defer further work on the booklet for the time being.

4. As regards the monthly press release, people are familiar with the present format, and again we would need to take a fresh look at it if reform went ahead next year. So here too it is probably better to leave things as they are for now.

Michael Cayley

M F CAYLEY

My note of 7 May and this note by Mr Cayley indicate how limited is the choice of changes in the CGT indexation rules which seem likely to commend themselves as simplifications of the present system.

Even the one now recommended (publicising by a Statement of Practice the use of "direct up-rating" for post-1982 shares) has a drawback in that it would allow taxpayers to cease maintaining records of actual acquisition costs, thus fixing accrued indexation irremovably in the system. This may go too far - for such a slight computational change. We can continue to accept informal calculations which are offered on this basis but without removing or weakening the statutory assumption that acquisition cost records are being maintained (many taxpayers would anyway wish to keep this information).

You may therefore see advantage in leaving the indexation arrangements as they stand and let attention concentrate on the other, far more important structural changes which are in contemplation.

R T HOUGHTON

SIMPLIFICATION OF INDEXATION

1. We have been looking at various possibilities for simplifying indexation. As we mentioned before the Election, none of the options here would make substantial inroads into the complaints which have been levelled against the indexation provisions. At most their effect would be marginal. And a further consideration which perhaps needs to be borne in mind is that neither we nor Ministers would get any thanks from practitioners for tinkering around with the legislation and making what might easily be seen as purely cosmetic changes.

2. As previously, we have identified three options:-

i. A change from a monthly to a quarterly basis for giving indexation relief.

ii. Rebasing the 1982-86 RPI figures.

iii. Simplified rules for shares acquired since 1982 (and possibly other assets generally).

These options and other possibilities (a comprehensive booklet on indexation and improving the format of our monthly press release) are fully discussed in the Annex. Broadly speaking, however, the picture which emerges is as follows.

Option (i) : Quarterly indexation

3. On balance we think that this is not worth doing. It does, of course, have some superficial attractions (for example, it would reduce the size of the table of factors) but on the other hand it would do nothing to simplify the calculations themselves. Moreover, there would be a pattern of gainers and losers. In general, these would only occur at the margin but there could be relatively large sums involved in a minority of individual cases.

Option (ii) : rebasing the 1982-1986 RPI figures

4. For assets other than post 82 shares, we regularly publish a table of factors to be used in indexation computations. For technical reasons, the indexation allowance on post-82 shares has to be calculated using actual RPI figures rather than our published factors. In order to calculate indexation on shares relief the RPI figures for the months of acquisition and disposal need to be on the same basis. Until now this has not been a problem because the RPI has always had a pre-indexation base date of 1974=100. Recently, however, the RPI has been re-referenced to make January 1987=100. Consequently, RPI movements for periods

spanning January 1987 have to be calculated using a linking formula provided by the Department of Employment. This formula has to be used for all official purposes.

5. On operational grounds there is a case for legislation to put the RPI figures since 1982 on a consistent (1987=100) basis for capital gains indexation purposes, thus removing the need to use the official linking formula for calculations for post-82 shares. However, the difficulties which re-referencing has created are likely to be of a transitional nature only and, as a matter of working practice, local offices will be able to accept computations where taxpayers have, in fact used re-worked RPI figures (published in some journals) rather than the official formula. In addition, by the time legislation appeared others will have become familiar with the linking formula and it is likely that many outside agencies will already have re-programmed their computers on this basis. And legislation on this would make some people slightly worse off: it would therefore be difficult to make the change retrospective to the start of 1987, and it would be confusing to have the linking formula serve as the official basis of calculation up to the date any legisaltion was effective, with a revised basis thereafter. A further change might not, therefore, be

welcomed. And by the time any 1988 legislation became effective the number of cases where the official linking formula causes a little extra complication will have already started to diminish. On balance we think this is a change whose marginal benefits will be outweighed by the irritation factor of the change itself.

Option (iii) : simplified rules for post-1982 shares

6. Indexation operates slightly differently for shares acquired since 1982 as compared with other assets. As a result, there is scope for applying indexation by direct uplift rather than having to compute the relief as a separate step in the calculations.

7. We think that this would be a worthwhile simplification. It could be presented as a positive response to some of the criticism which the rules for shares in particular have attracted and significantly it could be achieved by Statement of Practice. If the restructuring goes ahead next year this could be published on Budget Day as a component in CGT reform. We would not advocate a comparable change for assets other than shares: the benefits of the simplified approach would generally be virtually nil, could only be achieved by complex legislation and would probably not be worth the candle.

ANNEX

SIMPLIFICATION OF INDEXATION

1. This annex takes a rather more detailed look at the following ways of simplifying indexation:-

i. a reduction in the frequency of indexation adjustments;

ii. rebasing the 1982-1986 RPI figures; and

iii. direct uprating for post-1982 shares (and possibly other assets).

We also consider the possibilities of issuing a comprehensive booklet on indexation and improving the format of our monthly press release.

Frequency of indexation adjustments

2. At present, indexation is computed by reference to the monthly changes in the RPI. The resulting table of indexation factors is looking increasingly long and daunting.

3. It would be possible to give indexation relief by reference to RPI movements over a longer period - for instance a calendar quarter. (When the USA contemplated indexation it was to be on a quarterly basis). Someone who acquired and disposed of an asset within this period would get no relief.

4. Quarterly indexation (by reference to the RPI for the mid-month of each calendar quarter) was considered, and rejected, in 1982 for the following reasons.

i. First, in the context of a future only indexation scheme it was felt to be too restrictive.

ii. Secondly, it would produce odd results. For example, taking an extreme case, someone holding an asset for 18 months would receive only the same indexation as someone holding for 12 months and a day.

The first point would not, of course be of significance if the tax is rebased at 1982 and, in any event, quarterly adjustments would be much more tolerable with current low rates of inflation. Inevitably, the second point would give rise to all the usual complaints about anomalies but this would have to be the price for "rough and ready" indexation.

5. There would be an incentive for people wishing to dispose of an asset towards the end of the calendar period to hang on into the next period, so as to get an extra tranche of indexation - and the longer the period the greater this "lock-in" effect. But if the adjustments were done on a quarterly basis it is questionable whether, with present levels of inflation, there would be substantial market distortions.

6. There is a rule at present to counter this "hanging on" effect for monthly indexation which has the effect of denying indexation for assets acquired and disposed of within a period of 10 days overlapping the end of the month. If quarterly indexation were introduced there would be an argument for extending the straddle period to, perhaps, 30 days. The disadvantage with this system is that it requires identification of disposals with acquisitions for a larger number of transactions - a significant counterbalance to the marginal simplification achieved by the adoption of a quarterly basis.

7. A switch of this kind could be achieved by about half a page of legislation. It would not, of course, simplify the computations themselves. But it would reduce the frequency of calculations and hence the overall compliance burden on both sides. The principal beneficiaries under the change would be investors in shares (because of the velocity of disposals and acquisitions as compared with non-fungible assets such as land).

Rebasing the 1982-1986 RPI figures

8. In order to calculate the amount of indexation relief available it is necessary for the RPI for both the months of acquisition and disposal to be on the same basis. Hitherto, this has not been a problem because the RPI has always had a pre-1982 base date of 1974=100. Recently, however, the Department of Employment has re-referenced the RPI to a 1987 base. This means that whenever it is necessary to compute the RPI movement for a period spanning January 1987 a special linking formula has to be used. In this we and taxpayers are in the same position as anyone else who has for legal or contractual purposes to use movements in the RPI for whatever purpose.

9. For technical reasons, the change is more material for shares acquired since 1982, where the actual (unrounded) move in the RPI is used in computations. For all other assets (including shares acquired pre-1982) the indexation adjustment is rounded before being applied and we publish a table of indexation factors - the linking formula is not relevant to actual tax computations as people simply use our published factors.

10. Nevertheless, the formula involves an irritating extra layer of complication. It would simplify things if we could use a series of RPI figures going back to 1982 which were converted to a 1987=100 base. But this series would have no legal standing and would produce slightly different results - in some cases making taxpayers marginally better off, in others marginally worse off. So if we are to do this, we would need legislative cover. The necessary legislation should be fairly short - perhaps less than one page - and would need to be preceded by consultation with the Department of Employment.

11. However, the operational difficulties which have arisen as a result of re-referencing will work their way out of the system over time and,

significantly, we have not so far received representations on the point. Moreover, we have told local tax offices that, as a matter of practice computations submitted on re-worked RPI figures - and some outside agencies have already published tables - may be accepted. In addition, it is probable that by the time any legislation was introduced other taxpayers will have become familiar with the formula - which we suspect has already been incorporated in computer programmes. A further change might not, therefore, be greeted with enthusiasm.

Direct uprating for shares acquired since 1982 (and possibly other assets)

12. Much of the criticism which the indexation provisions have attracted has been directed at the rules for shares. If indexation is to continue some complication is inevitable. Nevertheless, there is scope for streamlining the calculations to a significant extent.

13. At present indexation applies slightly differently to shares acquired since 1982 as compared with other assets. For these other assets such as land and pre-1982 shares the rise in the RPI is first rounded to the nearest

third decimal place before being applied. From April 1985 onwards the indexation of 1982 holdings of shares (ie post 1982 acquisitions) is achieved by applying the rise in the RPI to the relevant expenditure without rounding. This slight mis-match is, in part, a by-product of the speed with which the 1985 changes had to be put together.

14. In all cases, the indexation allowance is computed as a separate element in the calculations. But with the rounding rule already abolished for post 1982 shares, the computations here could be short-cut: all calculations could be done on indexed expenditure, with no need to keep separate records for actual (nominal) expenditure. Examples comparing the existing and alternative (simplified) arrangements are attached.

15. To apply this change across the board would involve the abolition of the rounding rule for other assets (at the margin this would produce gainers and losers) and fairly complex legislation. It can however be applied in practice to the uprating of 1982 holdings of shares after 1985. Because of the way the statutory indexation rules for such shares have been drafted, if direct uprating were confined to them it could

be done without legislation. The simplified leaflet on indexation for shares issued last year does contain an oblique reference to the fact that we will accept computations on this short-cut basis. If Ministers wished to avoid complex legislation in this tricky area, it would thus be possible to confine direct uprating to post-1982 shares (where it would be of most practical benefit) without legislation. In that event we would recommend issuing a Statement of Practice on the point to give greater publicity to our willingness to accept short-cut computations. The alternative basis would, of course, be optional so that people who wished to continue on the strict statutory basis could do so.

16. There is, though, one important consideration. Doing this would only be really worthwhile if we were to tell people that they no longer needed to keep records of actual (nominal) cost. But once we do this, we rule out any possibility of abolishing indexation relief for RPI movements up to a current date: if at some point Ministers wished to abolish indexation, they would be able to do so only for <u>future</u> RPI increases: <u>accrued</u> entitlement to indexation would have to be preserved. This would also mean that the indexation

calculations would have to be continued until all assets acquired before the date of abolition were disposed of.

EXAMPLE ILLUSTRATING THE INDEXATION RULES FOR SHARES

An individual makes the following acquisitions and disposals of shares in the same company -

December	1982	-	Acquisition :	25,000	shares for	£40,000
August	1985	-	Disposal :	5,000	" "	£15,000
March	1986	-	Acquisition :	4,000	" "	£14,000
May	1986	-	Disposal :	8,000	" "	£29,000
January	1987	-	Acquisition :	3,000	" "	£12,000

The RPI is as follows -

December	1982	-	325.5
April	1985	-	373.9
August	1985	-	376.7
March	1986	-	381.6
May	1986	-	386.0
January	1987	-	394.5

STATUTORY POOLING

	Number of shares	Qualifying expenditure	Indexed Pool
STEP 1	25,000	£40,000	£40,000
Add indexation allowance for Dec. 1982 to April 1985			
£40,000 x 0.149			5,960
	25,000	£40,000	£45,960
STEP 2			
Disposal of 5,000 shares for £15,000 in August 1985.			
Add indexation allowance for April 1985 to August 1985.			
$£45,960 \times \frac{376.7-373.9}{373.9}$			£345
	25,000	£40,000	£46,305
Disposal $\frac{5,000}{25,000}$	(5,000)	(£8,000)	(£9,261)
	20,000	£32,000	£37,044

Computation

Sale proceeds	£15,000
Indexed cost	9,261
Gain	£5,739

STEP 3

Acquisition of 4,000 shares for £14,000 in March 1986.			£37,044
Add indexation allowance for August 1985 to March 1986. $£37,044 \times \frac{381.6-376.7}{376.7}$			£482
	20,000	£32,000	£37,526
Shares to enter pool	4,000	£14,000	£14,000
	24,000	£46,000	£51,526

STEP 4

Disposal of 8,000 shares for £29,000 in May 1986.			
Add indexation allowance for March 1986 to May 1986 $£51,526 \times \frac{386.0-381.6}{381.6}$			£595
	24,000	£46,000	£52,121
Disposal $\frac{8,000}{24,000}$	(8,000)	(£15,333)	(£17,374)
	16,000	£30,667	£34,747

Computation

Sale proceeds	£29,000
Indexed cost	£17,374
Gain	£11,626

STEP 5

Acquisition of 3,000 shares for £12,000 in January 1987.			£34,747
Add indexation allowance for May 1986 to Jan 1987			
$£34,747 \times \dfrac{394.5-386.0}{386.0}$			£766
	16,000	£30,667	£35,513
Shares to enter pool	3,000	£12,000	£12,000
	19,000	£42,667	£47,513

EXAMPLE ILLUSTRATING SIMPLIFIED SHARE POOLING (USING THE SAME ASSUMED FACTS AS AT IN THE PREVIOUS EXAMPLE)

	Number of shares	Indexed Pool
	25,000	£40,000
STEP 1		
Add indexation allowance for December 1982 to April 1985 0.149 x £40,000		5,960
		45,960
STEP 2		
Disposal of 5,000 shares for £15,000 in August 1985.		
Indexation of pool : £45,960 x $\frac{376.7}{373.9}$	25,000	£46,305
Indexed cost : £46,292 x $\frac{5,000}{25,000}$	(5,000)	(£9,261)

Computation	
Sale proceeds	£15,000
Indexed cost	9,261
Gain	£5,739

	Number of shares	Indexed Pool
	20,000	£37,044
STEP 2		
Acquisition of 4,000 shares for £14,000 in March 1986		
Indexation of pool : £37,044 x $\frac{381.6}{376.7}$	20,000	£37,526
Shares to enter pool :	4,000	£14,000
	24,000	£51,526

STEP 3

Disposal of 8,000 shares
for £29,000 in May 1986

Indexation of pool : $£51{,}526 \times \frac{386.0}{381.6}$	24,000	£52,121
Indexed cost : $£52{,}121 \times \frac{8{,}000}{24{,}000}$	(8,000)	(£17,374)

Computation	
Sale proceeds	£29,000
Indexed cost	17,374
Gain	£11,626

STEP 4

Acquisition of 3,000 shares
for £12,000 in January 1987

Indexation of pool : $£34{,}747 \times \frac{394.5}{386}$	16,000	£35,513
Shares to enter pool	3,000	£12,000
	19,000	£47,513

C10/50

SECRET AND PERSONAL

COPY NO 4 OF 4

b/f 22/7

FROM: A W KUCZYS
DATE: 17 JULY 1987

MR MACE - INLAND REVENUE

TAX REFORM: INCOME TAX RATES AND UPPER EARNINGS LIMIT FOR NIC

The Chancellor was most grateful for your minute of 14 July.

2. He has commented that option 1A is certainly a possible way of dealing with the higher rate losers. But he would be grateful if you could let him have a note on the cost and effectiveness of doing it, instead, by bringing the higher rate down from 40 per cent to 35 per cent (plus of course 9 per cent NIC).

3. So far as the basic rate losers are concerned (the real problem) the Chancellor would like to see what graph E would look like with <u>no</u> mortgage interest. He would also be grateful for a table showing the numbers of losers, and the amount they lose, at various income levels, analysing by reference to

- mortgage interest relief

- pension contributions

- other reliefs.

AWK

A W KUCZYS

AWK → MACE 17/7

ps3/13K

TASK FORCE

SECRET

COPY NO. 14 OF 14.

FROM: A W KUCZYS
DATE: 20 July 1987

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Mr Cassell
Mr Byatt
Mr Scholar
Miss Sinclair
Mr Cropper

Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Beighton - IR
Mr Johns - IR

TAX REFORM - REMOVING SHELTERS AND ANTI-AVOIDANCE PROVISIONS

The Chancellor was most grateful for Mr Isaac's minute of 16 July. This is an important and urgent exercise. The Annex 2 list can be reviewed after the Budget, with a view to the possibility of legislation in 1989. But the Annex 1 list (with the exception of the last item - basis of assessment for Schedule E - which is ruled out for the reason given in paragraph 14 of Mr Isaac's submission - it is incompatible with a 1990 start for Independent Taxation) needs to be combed through with a view to legislation in the 1988 Finance Bill.

2. The Chancellor would be grateful if the Financial Secretary would take this on, with maximum help from Mr Cropper. What we are seeking is simplification and manpower savings, where these do not conflict with political imperatives.

AWK

A W KUCZYS

5-35

TASK FORCE SECRET

COPY NO 1 OF 20 COPIES

FROM: M C SCHOLAR
DATE: 21 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Cassell
Mr Monck
Miss Peirson
Miss Sinclair
Mr G P Smith
Mr Macpherson
Mr Haigh
Mr Short
Mr Cropper
Mr Isaac - IR
Mr Mace - IR
PS/IR

TAX REFORM: INCOME TAX RATES AND NICs

I attach a paper by ETS and ST which meets your request for further work on employee NIC options designed to alleviate the unemployment trap. You will want to consider this in conjunction with Mr Mace's submission of 14 July.

NICs and the unemployment trap

2. Options 1 to 4 in the attached paper aim, in different ways, to alleviate the unemployment trap by reducing NIC rates at the lower end and stretching lower rate bands. Option 5 is a more radical approach based on a withdrawable allowance.

3. Options 1 and 2 have a relatively small impact on the trap (and are least expensive at £200-250 million).

4. Option 3 is worth considering if you wanted to focus relief on low income families rather than on single people. It would reduce the NIC rate from 7 per cent to 5 per cent for those earning between

~~£65 and £100~~a week; and from 9 per cent to 7 per cent for those earning £100-£150 a week; families are strongly represented in these bands. The cost would be almost £600 million.

5. In addition to providing relief for the £65-£100 a week group, Option 4 would also cut rates for those lower down (ie £39-65 a week) and would cost over £800 million.

6. The attraction of Option 5 is that it would get rid of the sudden jumps in NIC payments which are an inevitable part of a multi-rate system. This would be done by bringing in an allowance of £39 a week combined with a marginal NIC rate of 11.4 per cent for everyone earning between £39 and £185 a week. The 11.4 per cent rate and the £185 limit are the numbers required to avoid there being any cash losers. This option would cost about £700 million.

My preference – but 'big' admin?

7. By themselves any of these options look, on the basis of the tentative projections in the paper, feasible from the point of view of NIF finances. But it could be difficult to combine the more expensive options, including Option 5, with accelerated phasing out of the Treasury Supplement.

Income tax package/abolition of UEL

8. You will be looking at these options as part of a wider package involving income tax reductions and abolition of the employees' UEL. The difficulty with that package, described in Mr Mace's note, is that while some 20 million tax units would benefit from it, there would be a significant number of losers.

9. The problem about action to reduce the number of losers is that relief cannot be targetted tightly on the losers without building back into the system the sort of 'kink' that UEL abolition is meant to eliminate. This means, for example, that help for basic rate losers (500,000 out of 800,000) will also benefit the much larger number of basic rate gainers to some extent. This makes action expensive, and still leaves "middle earners" faring worse from your package than those above or below the £17,500-£47,500 band.

NB: It's the top part of the basic rate band that's the problem: £17,500 to – say – £25,000

10. As Mr Mace's minute shows, each of the options for reducing the basic rate losers is very expensive (although it might be worth pursuing a little further the option of reducing the NIC charged on earnings above the UEL: this would re-introduce a kink at the UEL, but only for the minority of high earners who are contracted in).

11. We therefore considered whether any of the options for acting at the lower end of NICs could be adapted to help with the problem of basic rate losers from abolition of the UEL. There is no direct interaction between the two sets of proposals. But reductions at the bottom end could help in the presentation of action to reduce the burden of UEL abolition. Alternatively, Option 5 in the NIC paper could be developed by setting a marginal NIC rate above the LEL lower than 11.4 per cent and raising the point on the earnings scale at which this marginal rate ran out so as to bring gains to some of those earning above the UEL as well as at the bottom.

12. Such an option would, however, be extremely expensive, particularly if it were designed so as to produce a significant reduction in the number of losers from UEL abolition: to reduce the number of losers in Mr Mace's Option 1 by a third, using the Option 5 approach, would cost a further £3 billion.

13. We have looked for other ways of helping with the problem of basic rate losers from abolition of the UEL. One option might be to make NICs deductible for basic rate tax liability. Another might be some form of earned income allowance available only against basic rate liability.

14. Both ideas would help reduce the present bias against earned as opposed to unearned income and any costs would be borne on the tax side, not on NICs (thus leaving you free to pursue the objective of abolishing the Treasury supplement). But they would both be administratively complex, and very expensive.

MCS

M C SCHOLAR

NATIONAL INSURANCE CONTRIBUTIONS AND THE UNEMPLOYMENT TRAP

Mr Scholar's submission of 24 April identified changes to the NIC system as a relatively cost effective way of alleviating the unemployment trap. At a meeting on 27 April, the Chancellor asked for further work on national insurance options to be carried out. This paper examines a number of options for changing employee NICs; these are spelled out more fully in the Annex.

The Unemployment trap

2. Around 800,000 are currently in the unemployment trap, defined as full time heads of households (tax units) with replacement ratios of over 80 per cent. Of these, 430,000 are in work and around 400,000 are unemployed. The analysis below is confined to the former. The effects on unemployed households are likely to be broadly similar in qualitative terms, but the lack of information on potential in-work earnings of such households makes it difficult to make precise estimates.

3. Of the 430,000 working heads of households in the unemployment trap, over four fifths earn between £39 and £150 a week (see Table 1). In order, therefore, to achieve higher relative in-work income within this range of earnings, the options are confined to lowering the reduced rates (Option 1), introducing an additional reduced rate band (Option 2) and a combination of both (Options 3 and 4). A radical option, involving the introduction of a withdrawable allowance, is explored in Option 5.

NIC Options

Option 1: Change lower band contribution rates from 5% and 7% to 3% and 6% respectively. Removes 9000 from the trap at a cost of £210m. (Cost per tax unit out of trap £23,300). Reduces average replacement ratio in trap by 0.4%.

Option 2: Introduce additional reduced rate band of 8% parallel to employers' £100 to £150 band. Removes 6000 from trap at cost of £250m. (Cost per tax unit out of trap £41,700). Reduces average replacement ratio in trap by 0.2%.

Option 3: Extend upper limit of 5% band to £100 and change 7% band from £65-£100 to £100-£150. Removes 24,000 from trap at cost of £590m. (Cost per tax unit out of trap £24,600). Reduces average replacement ratio in trap by 0.7%.

Option 4: Introduce additional band as in Option 2 but at 7%. Reduce lower bands to 3% and 5% respectively. Removes 33,000 from trap at cost of £810m. (Cost per tax unit out of trap £24,500). Reduces average replacement ratio in the trap by 1.0%.

Option 5: Introduce withdrawable allowance for those earning between £39 and £185 a week, with marginal NIC rate of 11.4%. For those earning over £185 a week present system would apply. Removes 25,000 from the trap at cost of £740 million. (Cost per tax unit out of trap £29,600). Reduces average replacement ratio in trap by 0.6%.

4. The relative attraction of the various options depends on whether the objective is to maximise the numbers taken out of the trap or to target certain groups within the trap, in particular married men with children. Option 1, for example, is concerned with the former. By targeting the two lower rate bands, in which there is the highest concentration of those in the trap, it is clearly cost effective. However, it is young people and women part timers who tend to benefit (see Table 2). Married men with children account for only a small proportion of those in the £39 to £65 band, and although they account for over half of those in the £65 to £100 band, they are even better represented in the potential third band of £100 to £150. Option 2 which leaves the two lower rate bands unchanged but introduces a third band of 8% is targeted almost solely at the married with children group within the trap.

5. There may be a stronger case for targeting married men with children than single people: as the Chancellor observed at the meeting in April, it might be easier to take single people out of the trap by reducing out of work benefits either in real terms or relative to earnings. Helping those married with children carries a high cost, reflecting considerable deadweight. Not only are there more employees in the £100 to £150 a week band in which they are concentrated - 4.6 million compared to 3.8 million in the £39 to £100 a week bands - but there is also a higher

proportion of people not in the trap. A given NIC rate reduction will also cost more per individual compared to those in the lower rate bands because it will be calculated on higher earnings.

6. Option 2 illustrates the cost of springing families with children from the trap, 6000 being removed at a cost of £250 million. If results of any significance are to be achieved, it will probably be necessary to spend at least £½ billion.

7. Option 3 which involves stretching the 5% band to £100 and inserting a 7% band between £100 and £150 a week, would appear to be one of the more attractive options, taking 24000 out of the trap and reducing the average replacement ratio for those in it by 0.7%. This would cost around £600 million.

The Steps and the Poverty Trap

8. Changes to the NIC system also present an opportunity to ameliorate the steps. Here, the old dilemma resurfaces. If the size of the steps is to be reduced it is necessary to introduce an additional step, but an additional step ensures that additional numbers will be affected by them. Options 1 and 3 maintain the current number of steps. The former lowers the first step by 2%, at the cost of raising the second and third steps, while the latter leaves the size of the steps unchanged, but moves the third step to £150, a more densely populated point on the earnings distribution. Options 2 and 4 also have a step at £150, but in their case it is an additional one. Option 2 has the advantage of halving the step at £100, while the step at £150 is only 1%. Option 4 has no such redeeming feature, although the initial step at £39 is reduced by 2%.

9. Only a radical approach, such as that outlined in Option 5, would dispose of the step problem altogether. With this option, an allowance of £39 and a marginal rate of 11.4% would be introduced for those earning under £185 a week. (The marginal rate and threshold at £185 are the precise numbers required to make the system work, i.e. to avoid a step at the point the allowance is withdrawn and ensure that there are no losers). The disadvantage of this option is the high marginal rate.

10. The effect of the various options on the poverty trap is generally small. In so far as the steps are reduced or abolished, those earning just below them will have their marginal tax rates substantially reduced. Equally, for those in the trap who are affected by an increase in the number or size of the steps, the effect of the trap will be exacerbated. However, for those in the trap but not close to the steps, the effect will be negligible.

Tax Burden and Distributional effects

11. The effect of the options on the tax burden is shown in Table 3. Only Option 5 benefits anyone on 75% of average earnings or above, and then only marginally. In all the options, the lower paid are the main beneficiaries. For example, Option 3 reduces the tax burden below that of 1978-79 for single people both at 25% and 50% of average earnings, and although the same is not achieved for single earner married couples there are still sizeable gains.

12. However, although individuals with low earnings are the beneficiaries, much of the gain goes to families with relatively high earnings. This is because about a quarter of those with earnings between £39 and £150 a week are married women, many of whom are married to well-paid husbands - about a quarter of them have earnings above average male full-time earnings. As a result, in all the options a third or more of the benefit goes to families who are in the top half of the income distribution for working families.

NIF finances

13. To put the options into context, it is necessary to provide an update on the state of the NIF. This is set out in the table below. GAD are currently projecting a NIF surplus of £1.8 billion in 1988-89, with the balance of the fund rising to over 30% of outgo. Without taking account of any contribution from proposals considered elsewhere to abolish the UEL, these

projections suggest there is plenty of scope for action to alleviate the unemployment trap, including the more expensive Options 4 and 5, without detriment to NIF finances.

National Insurance Fund (£billion)

	1988-89	1989-90
Projected surplus	1.8	0.9
Including Treasury supplement	1.6	1.0
(rate)	(5%)	(3%)
Balance at end year	31%	30%

14. Abolition of the Treasury Supplement (instead of the currently planned phased reduction) would, however, make it more difficult to afford Options 4 or 5, although Options 1-3 should still be affordable. Adoption of 4 or 5, along with abolition, could result in the balance of the Fund falling below 17 per cent of outgo in 1989-90, a level the Government Actuary has cited as important in the past. It should be stressed though that our costings are based on the Treasury NIF model and are therefore approximate. To gain a more accurate estimate of the cost of any option, it would be necessary to run it through the GAD model.

ETS division
21 July 1987

TABLE 1

DISTRIBUTION OF EMPLOYEES BY EARNINGS LEVEL(1)

thousands (percentage of income band total)

Earnings (£ per week)

	Under 39	39-65	65-100	100-150	150-200	200-295	Over 295	All levels
Full-time heads								
Replacement ratio:								
0-50	- (-)	230 (16.7)	855 (34.8)	2255 (49.4)	2045 (50.0)	2675 (68.1)	1750 (92.7)	9820 (48.7)
50-80	25 (1.3)	175 (12.8)	775 (31.5)	1225 (26.8)	1475 (36.0)	885 (22.6)	60 (3.2)	4620 (22.9)
Over 80								
Families with children	- (-)	15 (1.3)	60 (2.3)	140 (3.1)	45 (1.0)	10 (0.2)	- (-)	265 (1.3)
Others	15 (0.9)	60 (4.5)	40 (1.7)	35 (0.7)	5 (0.2)	- (-)	- (-)	160 (0.8)
Others (full time married women and part-timers)	1815 (97.8)	885 (64.8)	730 (29.6)	915 (20.0)	525 (12.8)	360 (9.1)	80 (4.2)	5305 (26.3)
Total	1855	1370	2465	4570	4095	3930	1890	20175

(1) Excluding pensioners and optants. Estimates based on 1985 FES uprated to 1987-88 earnings levels. Figures rounded to nearest 5 thousand but are not accurate to that degree.

TABLE 2

DISTRIBUTION OF EMPLOYEES BY EARNINGS LEVEL(1)

thousands (percentage)

Earnings (£ per week)

	Under 39	39-65	65-100	100-150	150-200	200-295	Over 295	All levels
Part time								
Men	150 (8.0)	130 (9.3)	30 (1.2)	35 (0.7)	25 (0.7)	60 (1.5)	25 (1.3)	450 (2.2)
Single women	275 (14.7)	170 (12.4)	95 (3.8)	20 (0.4)	15 (0.4)	35 (0.9)	- (-)	610 (3.0)
Married women	1370 (73.8)	545 (40.0)	280 (11.3)	70 (1.6)	50 (1.3)	50 (1.2)	5 (0.1)	2370 (11.7)
Full time								
Men under 21	15 (0.7)	195 (14.2)	480 (19.4)	410 (8.9)	70 (1.7)	45 (1.2)	5 (0.2)	1215 (6.0)
Women under 21	25 (1.3)	195 (14.2)	590 (23.9)	215 (4.7)	20 (0.5)	5 (0.1)	- (-)	1045 (5.2)
Men over 21	-	40 (3.1)	280 (11.4)	2180 (47.7)	3015 (73.6)	3220 (81.9)	1750 (92.5)	10485 (52.0)
Women over 21	25 (1.4)	95 (6.9)	715 (28.9)	1645 (36.0)	895 (21.9)	515 (13.1)	110 (5.8)	4000 (19.8)
Total	**1855**	**1370**	**2465**	**4570**	**4095**	**3930**	**1890**	**20175**

(1) Excluding pensioners and optants. Estimates based on 1985 FES uprated to 1987-88 earnings levels. Figures rounded to nearest 5 thousand but are not accurate to that degree.

TABLE 3

Income tax and NIC as Percentage earnings at multiples of adult MALE average earnings

Multiple average earnings	25%	50%	75%	100%
Single person				
1978/79	11.1	23.6	28.9	31.5
1987/88	9.8	24.9	28.6	30.5
Option 1	7.8	24.9	28.6	30.5
Option 2	9.8	23.9	28.6	30.5
Option 3	9.8	22.9	28.6	30.5
Option 4	7.8	22.9	28.6	30.5
Option 5	8.4	23.5	28.5	30.5
Married couple, no children				
1978/79	6.5	16.0	23.8	27.8
1987/88	5.0	18.7	24.4	27.3
Option 1	3.0	18.7	24.4	27.3
Option 2	5.0	17.7	24.4	27.3
Option 3	5.0	16.7	24.4	27.3
Option 4	3.0	16.7	24.4	27.3
Option 5	3.6	17.3	24.3	27.3
Married couple, 2 children under 11				
1978/79	-15.6	2.5	14.6	20.9
1987/88	-20.5	5.9	15.9	21.0
Option 1	-22.5	5.9	15.9	21.0
Option 2	-20.5	4.9	15.9	21.0
Option 3	-20.5	3.9	15.9	21.0
Option 4	-22.5	3.9	15.9	21.0
Option 5	-21.9	4.5	15.8	21.0

Annex

NIC OPTIONS

Option 1: Reduce lower employee bands to 3 per cent and 6 per cent.

Gives the following structure:

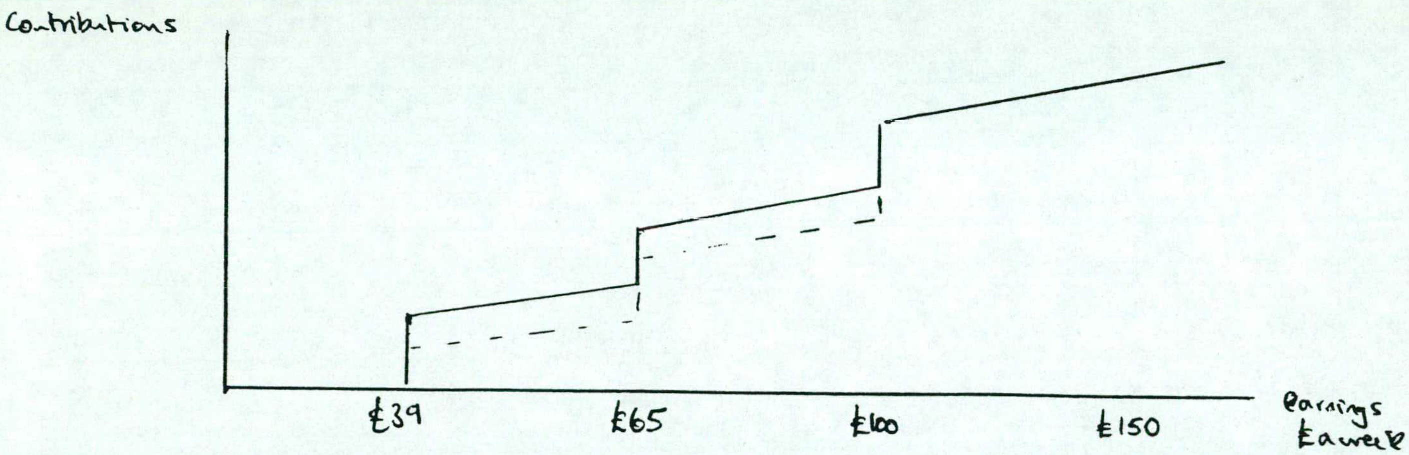
£ per week*	Employees % rate at present	Employees % rate proposed	Employers % rate - no change
39-65	5	3	5
65-100	7	6	7
100-150	9	9	9
150-295	9	9	10.45
295 and over	9% of 295	9% of 295	10.45

Approximate cost

1988-89 £170 million (£210 million if optant rate and Class 2 and 3 rates changed).

Effect on unemployment trap

9000 taken out of trap and average replacement of those in the trap reduced by 0.4%.



*For illustrative purposes, bands have been left at 1987-88 levels. Costings assume normal upratings in April 1988.

Main advantages

1. Increases take home pay of 3.7 million low paid workers earning betwee £39 and £100 per week by amounts ranging between 60p and 130p.

2. Cost effective in terms of numbers taken out of the trap.

3. Particularly well targetted at lowest paid. Initial step reduced from £1.95 to £1.17. Young full time workers also benefit.

Disadvantages

1. Steepens steps. Step at £65 rises from £1.30 (2 per cent) to £1.95 (3 per cent) and similarly at £100 from £2 to £3.

2. Fails to target married people with children in the trap, most of whom earn more than £100 per week.

3. Change to lowest rate would almost certainly mean changing Class 2 and 3 flat rates in line. This will cost around £30 million. (For summary of NIC system, see Annex).

4. Change to lowest rate may make it necessary to reduce married woman optant rate, currently 3.85%; otherwise optant earning less than £65 a week would be paying a higher rate of contribution to secure considerably less benefit. Cost of introducing a reduced rate band of 2.85% for optants earning between £39 and £65 a week could be around £10 million.

Option 2: Insert an additional reduced rate band of 8 per cent for employees parallel to the employers £100 to £150 band.

Gives the following structure:

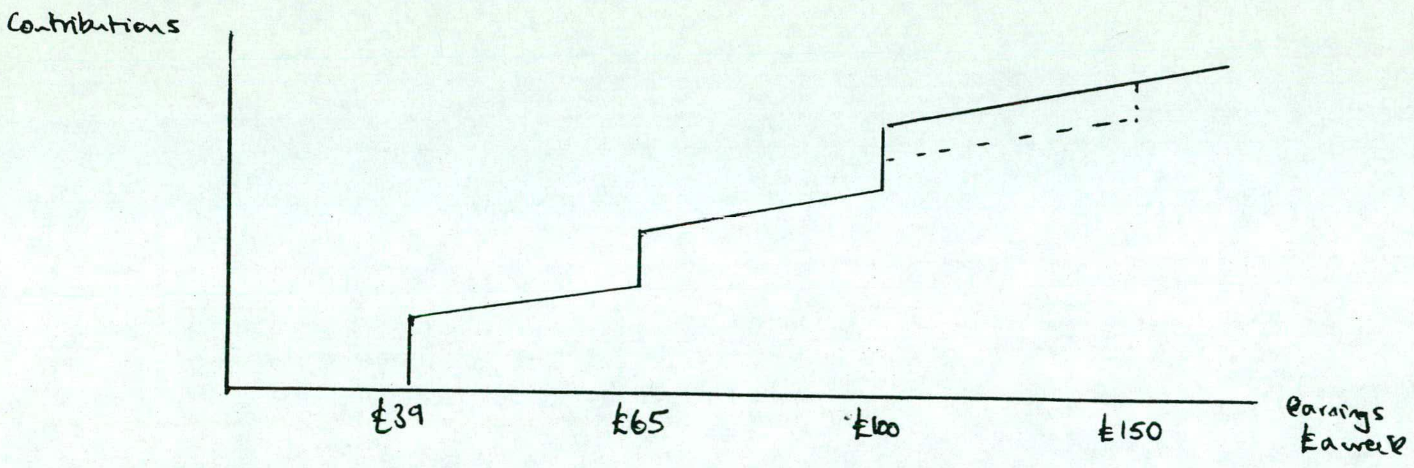
£ per week	Employees % rate at present	Employees % rate proposed	Employers % rate - no change
39-65	5	5	5
65-100	7	7	7
100-150	9	8	9
150-295	9	9	10.45
295 and over	9% of 295	9% of 295	10.45

Approximate cost

1988-89 £250 million

Effect on unemployment trap

6000 taken out of trap and average replacement of those in the trap reduced by 0.2%.



Advantages

1. Increases take home pay of over 4 million low paid workers earning between £100 and £150 per week by amounts ranging from £1

per week to £1.50. Means that almost 8 million workers would now be covered by the reduced rate structure.

2. Well targeted. Catches bottom end of full time adult male earnings distribution. Does not waste money on part timers.

3. Reduces the most troublesome of the NIC steps at £100 a week -from £2 to £1.

4. Easy to present. A small but worthwhile refinement to the structure, which does not suggest we are having second thoughts.

Disadvantages

1. In terms of taking people out of trap not cost effective.

2. Introduces another step at £150 - a fairly dense area on the earnings distribution where the disincentive effect might really matter. Would affect low earning full time adult male workers.

3. Appears to do nothing for the lowest paid including young full timers. However they benefited most from 1985 reforms.

Option 3: Extend upper limit of 5% band to £100 and change 7% band from £65 to £100 to £100 to £150.

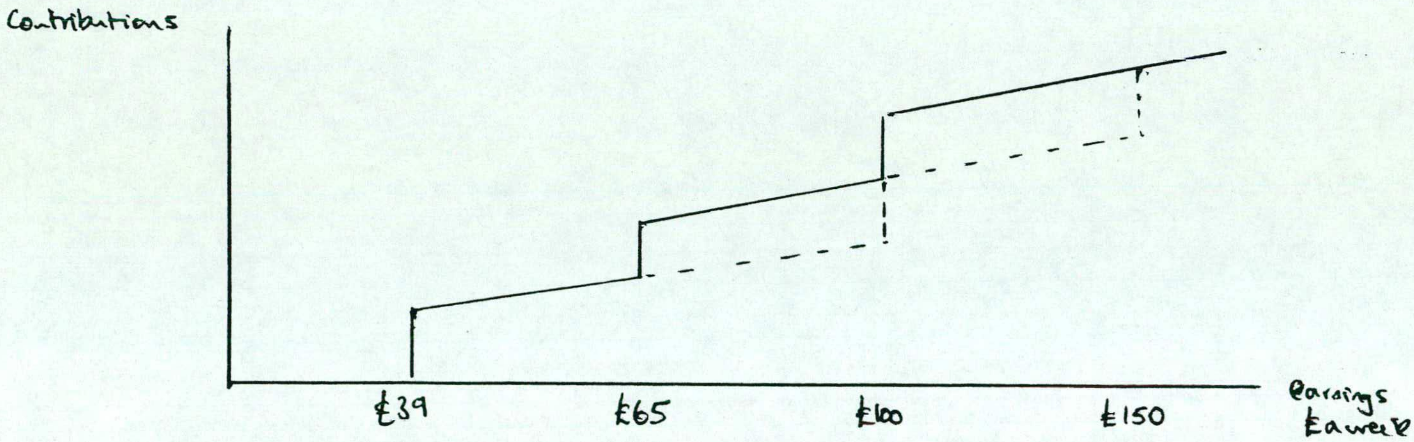
	Employees % rate		Employers % rate
£ per week	at present	proposed	- no change
39-65	5	5	5
65-100	7	5	7
100-150	9	7	9
150-295	9	9	10.45
295 and over	9% of 295	9% of 295	10.45

Approximate cost

1987-88 £590 million

Effect on unemployment trap

24000 taken out of trap and average replacement ratio reduced by 0.7%.



Advantages

1. Will increase take home pay of 6.1 million low paid workers earning between £65 and £150 per week by between £1.30 and £3.00 a week.

2. Well targeted. Three quarters of families with children in the unemployment trap earn between £65 and £150 a week. Little money wasted on part timers.

3. Unlike Options 2 and 3 does not introduce additional step.

4. Does not require changes to optant or Class 2 contribution rate.

Disadvantages

1. No attempt to reduce size of the steps. Higher step is shifted to more densely populated point in the earnings distribution, and increases from £2 to £3.

2. Not cost effective in terms of absolut numbers taken out of trap.

3. There might be pressure to stretch employer rate bands in line, abolishing the 9% employer rate. This would increase the cost by over £600 million.

Option 4: Introduce an additional reduced rate band of 7 per cent and reduce lower rates by 2 per cent.

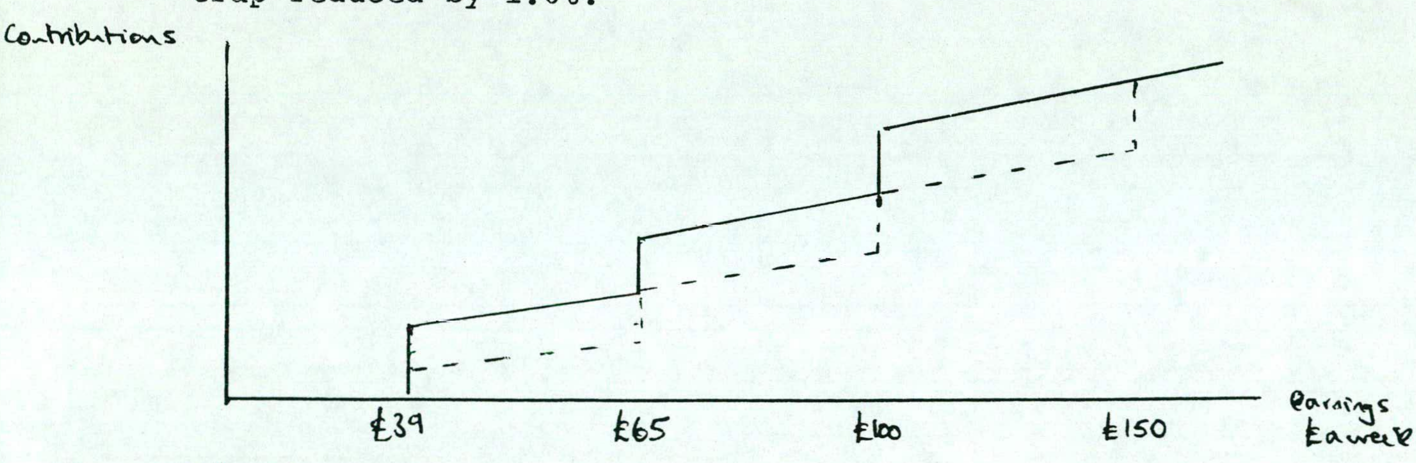
£ per week	Employees % rate at present	Employees % rate proposed	Employers % rate - no change
39-65	5	3	5
65-100	7	5	7
100-150	9	7	9
150-295	9	9	10.45
295 and over	9% of 295	9% of 295	10.45

Approximate cost

1987-88 £770 million (£810 million if optant rates and Class 2 and 3 rates changed).

Effect on unemployment trap

33,000 taken out of trap and average replacement of those in the trap reduced by 1.0%.



Advantages

1. Combines the advantages of options 1 and 2. Improves take home pay of nearly 8 million low paid workers by between 78p and £3 per week. Could be presented as a well targetted way of helping all the lower paid.

2. Significant and cost effective impact on unemployment trap.

Disadvantages

1. Does nothing to soften existing steps and introduces another one of £3 at £150 a week, a fairly densely populated point of the earnings distribution.

2. Nearly all money spent on lowest tier goes to part-timers. Doubtful use of resources.

3. Change to lowest tier would almost certainly mean changing Class 2 and 3 flat rates in line, and introducing a reduced rate optant band (see Option 1).

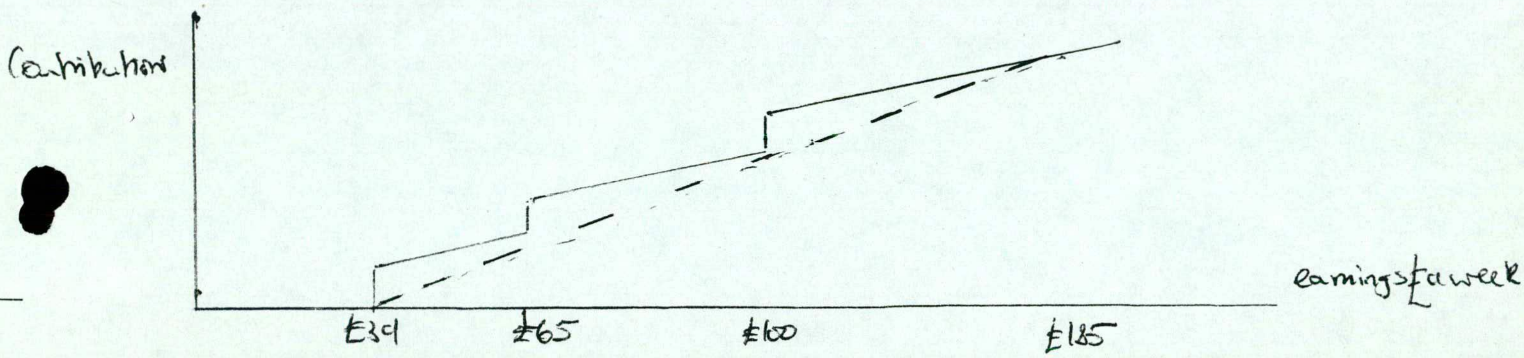
Option 5: Introduce withdrawable allowance for those earning between £39 and £185 a week, with marginal NIC rate of 11.4%. For those earning over £185 a week the present system would apply.

Approximate cost

£720 million (£740 million if withdrawable allowance introduced for optants earning between £39 and £65 a week)

Effect on unemployment trap

25,000 taken out of trap and average replacement ratio of those in the trap reduced by 0.6%.



Advantages

1. Abolishes steps for employees and with it much of poverty trap problem associated with NICs.

2. No losers. Substantial gains for those towards lower end of current bands. For example, gain of £1.95 at £39 per week, £1.59 at £65 a week and £2.05 at £100 a week.

Disadvantages

1. Represents significant break from 1985 reforms.

2. Was rejected in 1985 because of presentational problems associated with high marginal NIC rate (though average NIC rate would be lower or the same as under present system). Also undermines the contributory principle, though latter already compromised by existence of reduced rates.

3. Would create problems with optant rate. If the contracting back of low paid optants into Class 1 contributions is to be avoided, it might be necessary to introduce a withdrawable allowance. An allowance of £39 a week for those earning between £39 and £65 a week, combined with marginal rate of 9.6% (to ensure no step), would cost around £20 million.

4. There would be pressure to apply same system to employer NICs, which would double the cost. There may also be pressure to change Class 2 flat rate.

APPENDIX 1

Appendix 1

Optants, Class 2 and Class 3 contributors

Married women optants

Married women who opted out of paying class 1 contributions before April 1978 pay a flat rate 3.85% contribution. This entitles them to Industrial Injury Benefits and to claim Retirement Pension on the basis of their husband's contribution record, but not to claim unemployment benefit or a SERPs pension. A breed which will eventually die out, they currently number 1.1 million.

Class 2

The Class 2 contribution is a flat rate payment of £3.85 a week payable by all self employed people unless they have applied for the small earnings exception, currently £2125 p.a. It entitles the self employed to retirement pension, sickness and invalidity benefits and widow's benefits.

The flat rate is currently calculated by taking 10% of the LEL (representing 5% employers' contribution and 5% employees') and subtracting 5p, reflecting reduced benefit rights. Thus any reduction in the Class 1 NIC rate payable in the first reduced rate band is likely to reduce the Class 2 rate.

Class 3

The Class 3 contribution is a flat rate payment of £3.75 a week paid voluntarily to enable an individual to qualify for retirement pension and widow's benefit, if their contribution record is not otherwise sufficient.

Traditionally, the Class 3 rate has been set at 10p below the Class 2 rate, reflecting the fact that it does not entitle the contributor to sickness and invalidity benefits.

Appendix 2

Summary of National Contribution Rates and Limits 1987-88

Employer's Class 1 (contracted-in)	10.45%
Employer's Class 1 (contracted-in)	9%
Opted-out married women	3.85%
Lower Earnings Limit (Class 1)	£39
Upper Earnings Limit (Class 1)	£295
Low paid earnings brackets	£39-£65 £65-£100 £100-£150
Rates payable within low paid brackets	5% 7% 9%
Class 2 (self employed)	£3.85
Small earnings exception	£2,125
Class 3 (voluntary)	£3.75
Class 4 (self employed profit related)	6.3%
Lower profits limit (Class 4)	£4,590
Upper profits limit (Class 4)	£15,340

Note: Contracting-out rebate 4.1% for employer and 2.15% for employee in 1987-88 but falls to 3.8% for employer and 2.0% for employee in 1988-89.

Inland Revenue

Policy Division
Somerset House

Copy Number 1 of 19

TASK FORCE SECRET

FROM: M F CAYLEY
DATE: 21 JULY 1987

1. Mr Houghton
2. Mr Isaac
3. Chancellor

Thanks.

CAYLEY → CH/EX 21/7

REFORM OF CAPITAL GAINS TAX

1. The attached notes attempt to give you a quick response on four of the issues raised in Mr Kuczys' note of 10 July:-

- Annex One discusses the possibility of confining rebasing to individuals (and trusts)

- Y Annex Two covers some precedents which may be useful in dealing with complaints that CGT changes are retrospective

- X Annex Three looks at the costs and benefits of charging capital gains to income tax

- Annex Four considers the LIFO rule under which where people have blocks of shares some of which were acquired before 1982 and some after, the latter are deemed to be disposed of first.

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cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G Smith
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Beighton
Mr Houghton
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Mace
Mr Michael
PS/IR

2. We are now looking at options for husband and wife (paragraph 6 of Mr Kuczys' note) and hope to let you have a note on these fairly soon.

Michael Cayley

M F CAYLEY

ANNEX ONE

ANX 1

CONFINING 1982 REBASING TO INDIVIDUALS

1. The obvious difficulty with confining rebasing to individuals is that there would be two different regimes side by side for computing and taxing gains - one for individuals and trusts, and the other for companies. The overall tax burden on companies' gains would, without rebasing, be significantly heavier than that on gains of individuals. This would inevitably create distortions.

2. Companies would be bound to argue that, if rebasing is right for individuals, it is right for companies. It is difficult to see an effective counter-argument. It is likely to be harder to justify rebasing for individuals only having already gone ahead with integration on the corporate side this year without it - and all the more difficult if the income tax rate structure is to be brought much more into line with company rates.

Counter-arg— [illegible]

3. There would be particularly strong complaints from the small business lobby, who would say that small companies were being penalised compared with unincorporated businesses. The capital gains issue would in some cases become critical to the decision whether to conduct a business in corporate or unincorporated form. As you know we have

I think that this is probably the main point here: an additional complexity for small businesses to have to master: a tax advantage in keeping ownership of valuable assets, whilst using them in your company's business; and so forth.

[illegible]

recently issued a consultative document on disincorporation: at the moment this is likely to interest only a tiny minority of small companies. Were rebasing confined to individuals, many more might wish to consider disincorporation, and it is difficult to envisage anything other than massive pressure for substantial (and complex) easements of the tax position on disincorporation: and if easements were introduced and a lot of companies disincorporated, we could face a significant staff cost. (Up to now we have thought that tax reliefs for disincorporation would have little staff cost because few companies would wish to disincorporate. Rebasing for individuals only would change that.) There could be no question of a disincorporation package in 1988: DTI need to legislate first (on creditor protection aspects and striking-off procedures), the legislation would be long and complex - more so if rebasing was confined to individuals - and it could not be got ready in time and both we and DTI need to consult on the details.

ANNEX Two

ANX 2

CAPITAL GAINS CHANGES: RETROSPECTION

General principle

1. Inevitably, all capital gains changes, whether structural, relieving or anti-avoidance, apply to disposals after a specified date. So gains which have accrued up until that time under a previous regime will invariably be affected. Of course, this is not retrospection in the legal sense. But it does mean that some taxpayers may see a fall in their original expectations whenever there are legislative changes. A common case arises in the field of anti-avoidance provisions (some examples of which are given at the end of this annex). On the other hand it has to be recognised that the general rule does cut both ways. Accordingly, some taxpayers will receive an unexpected bonus whenever a new relief is introduced (for example, the furnished holiday lettings provisions in 1984) or whenever non-indexed monetary limits are increased (for example, retirement relief in 1984 and this year).

Exceptions

2. There have, however, been one or two significant exceptions - the most notable being the introduction of CGT in 1965 and indexation relief in 1982, both of which are confined to subsequent accruals irrespective of the earlier date of acquisition. In the event of integration

Note that 1982 indexation was confined to post-1982 acquisitions: only in 1986 was it extended to pre-1982 accruals going ahead, these could be quoted as precedents for confining a major change to future gains only.

3. The response to the first would be that people who acquired assets since 1965 did so at least in the knowledge that long-term gains were charged to tax: this was not the case for pre-1965 acquisitions. The second - indexation - was a relieving provision which by definition made nobody worse off, so different considerations were involved (the decision not to extend indexation back to 1965 was in fact taken on grounds of Exchequer Cost and practicality - difficulties with share pools etc.)

Previous restructuring

4. The capital gains regime has been restructured in the past and on some of these occasions there have been gainers as well as losers. These previous reforms would provide useful precedents to draw upon.

5. First, the abolition of the "alternative charge". Between 1965 and 1978 an individual could elect to have half his gains up to £5,000 charged to income tax as investment income rather than the full gains to CGT. In a number of cases this resulted in a significant tax reduction. The "alternative charge" was abolished in 1978.

6. Secondly, this year's reforms for the gains of companies. For large companies the rate of tax on disposals from Budget Day goes up from 30% to 35% and most of these will not benefit from the

extension of ACT set-off.

Anti-avoidance legislation

7. The main purpose of anti-avoidance legislation is to prevent for the future particular form of activity which is costing the Exchequer money rather than to tax that activity as such. However, without exception, if someone fell foul of any anti-avoidance provision introduced since 1965, the effect would be to charge gains which accrued prior to the date on which the law was changed in addition to those which had accrued subsequently. Examples include the 1981 changes in the rules relating to UK beneficiaries under foreign settlements, the withdrawal of gifts relief if a donee goes non-resident after receiving a gift within 6 years (also 1981) and last year's legislation on dual resident trusts.

? ~~[illegible]~~ complexity of having 2 different CGT rates, ~~[illegible]~~ for pre + post 1988?

ANNEX THREE

COSTS AND BENEFITS OF INTEGRATION WITH INCOME TAX

1. Whether or not capital gains are charged to income tax rather than CGT has no implications for the yield: a charge at income rates (determined broadly as if capital gains were the marginal slice of income) could be achieved within a formally separate CGT.

2. There is one obvious advantage of a charge to income tax: it would give a greater <u>appearance</u> of integration of the taxation of gains and that of income, even though it did not alter the substantive position. It would also mean that, in form, capital gains tax would be abolished - though gains would have to be subject to a special regime within income tax.

3. The extra degree of integration with income tax would be much more apparent than real, and people would soon see this. In particular:-

(i) as for companies this year, capital losses would have to be ring-fenced so that they could not be set against income, with income losses being similarly unavailable against capital gains - otherwise there would be scope for major avoidance in a year of high income. (A charge at income rates could well lead to pressure to allow capital losses against income - if the charge was <u>to</u> income tax rather than CGT, this pressure could well be greater.)

ANX 3

(ii) All the special rules for computing capital gains would remain - not least indexation relief.

(iii) A lot of income tax provisions would be inappropriate for capital gains, which would have to be taken outside the scope of the rules concerned.

(iv) Capital gains would qualify for a separate annual exemption.

(v) The scope of the capital gains charge would be different from that on income. Thus people resident and ordinarily resident outside the UK are generally totally exempt from CGT but liable on UK income. To align the CGT and IT rules would mean a major extension of the scope of the tax on capital gains, some substantial changes (eg in the trusts area) in the persons on whom liability fell, and so on - with large market effects and real risk of driving foreign investors away from the UK. We doubt you would wish to contemplate this.

What is po- in US?

??

4. Because of these big differences between capital gains and income, it would be hard to argue that capital gains tax was in substance being abolished. People would say that the income tax charge was merely CGT by another name, albeit at income rates.

5. A charge to income tax would involve very much longer legislation. Without talking in detail to Parliamentary Counsel, we cannot

put a precise figure on the length of extra legislation, but on a preliminary look it could well involve another twenty pages - and possibly very much more than this. Most of this would consist of minor consequential amendments, to amend references to capital gains tax and to preserve, within income tax, the separate regime for capital gains. Last winter we explored with Parliamentary Counsel whether we could find a way of short-cutting some of this.

6. Should he and we be unable to devise a short cut, we shall have to go through every income tax provision in the Taxes Acts, and every reference to capital gains or income, and consider what amendments are called for - a formidable task which would divert a ~~large~~ disproportionate amount of our Head Office resources from other tasks (including substantive policy work), and take up a lot of Parliamentary Counsel's time - and inevitably there would be things we would miss. The result would be page on page of technical amendment. We would hope to find a way of avoiding most of this, but even if, with Parliamentary Counsel's help, we succeed, he has warned us that a lot of extra drafting work would be involved in achieving the charge to income tax instead of CGT, with a large number of minor consequential amendments.

I do indeed hope so.
C L.

7. These minor consequential changes would irritate taxpayers and their advisers, who would say that the reform could have been achieved by much more simply by keeping CGT as a separate tax. With other important legislative changes next year, they may well allege that there is more than enough for them to take on board without

added technical consequential changes. A further point here is that legislation on husband and wife would be likely itself to necessitate a long schedule of consequential changes: to have two such schedules would not be popular. And with the possibility of a number of major tax reforms next year it is desirable to keep down as far as possible the burden of work on drafting legislation.

TASK FORCE SECRET

ANNEX FOUR

THE LIFO RULE FOR SHARE POOLS

1. Under present law, where someone has bought shares in a company both before and after April 1982, they go into two separate share pools, and disposals are deemed to be made out of the later (post-82) pool first, and, only when that is exhausted, out of the earlier pool.

2. Paragraph 10 of Mr Kuczys' note of 10 July asks if this LIFO rule is immutable. In general, the rule works to people's advantage by substantially reducing taxable gains, and would still do so with 1982 rebasing. This can be seen clearly with the following simple example, which assumes rebasing. Suppose someone buys one block of 500 shares before 1982 with a 1982 value (adjusted for indexation) of £5,000, and another block of 500 in 1987 for a cost (again indexation-adjusted) of £20,000, and then sells 500 for £22,000. Under the LIFO rule the gain is only £2,000 - he is deemed to have disposed of all the post-82 pool.

ANX 4

3. If one changes the rule, two options would be available. The first would be a FIFO rule, so that the pre-82 shares are deemed to be sold first. The gain under this would be £22,000-£5,000 or £17,000. The second would be to merge the two pools, giving a CGT base (after indexation) of £25,000 for 1,000 shares. The taxpayer would have a gain of £22,000-£12,500 or £9,500. Either way, there would be a large

increase in the amount of chargeable gain - and this would be the normal consequence of altering the present LIFO rule.

4. The effect of altering the present rule would thus generally be to <u>increase</u> tax liabilities compared with what they would otherwise be - and hence if anything to <u>increase</u> locking-in. This is so whether or not there is rebasing to 1982. What rebasing does is to reduce for most of those concerned the extent of the extra tax liability that would result from altering the LIFO rule - but there would still normally be an (often substantial) extra tax bill.