PO-CH/NL 0025 PART I

SECRET

(Circulate under cover and notify REGISTRY of movement)

PO -CH /NL/0025

PART D

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

DD's 25 years NAB3 4/01/96.

PO -CH /NL/0025
PART D

6.11.87

CLOSED

CONTINUED ON:-

PART E

CENTRE FOR POLICY STUDIES

8 Wilfred Street, London SW1E 6 PL. Tel: 01-828 1176

Norman Lamont, Esq., MP,
The Treasury,
Whitehall,
London SW1.

13 October 1987

VINSON → FST 13/10

Dear Norman —

When you were kind enough to invite me round to have a chat you asked me to expand my letter of the 17 September on a number of points.

1. Capital Allowances. The small unincorporated business was badly hit when the capital allowance regime was changed and consequently now operates under a far harsher tax burden than hitherto. I think the CBI proposal that the first £30,000 of capital expenditure in any year should be tax allowable is an admirable solution to this problem, but it should only apply to the unincorporated business as the incorporated businesses has the benefit of lower tax rates: nor would we want to see a plethora of small subsidiary companies set up to use the allowance. I can think of no other single measure that would be more beneficial to the growth of small businesses, (most of which are unincorporated) than this. Not least it enables them to expand on their own self-generated funds before paying or borrowing more. This must be desirable, at a time when we need to give every encouragement to new investment.

2. Capital Gains Tax. In attempting to abbreviate our arguments in our previous letter we perhaps did not make our stand quite clear. If capital gains tax is to be retained, somehow we have to simplify it. Indexation could only be abolished if the tax had a relatively early cut off point.

.../.

Part. D

Starts:
23-9-87
12-10-87

As CGT is an entirely arbitrary tax, the levels are equally arbitrary; we would suggest that indexation was totally abolished, that first year gains were treated as income and taxed accordingly, and that subsequent gains should be taxed at tapering rates; after seven years CGT would no longer be applicable and the taxpayer would not be required to keep any records.

One alternative we have also discussed is that there should be some form of roll-over relief where the proceeds of sales are immediately re-invested; it is absurd that we should ossify the market for the personal investor while offering full gross fund status to the institutions.

If the thought of a change along these lines is too daunting then we would like to see the indexation arrangements within the existing framework progressively backdated. It is monstruously unfair that the inflationary gains of the seventies are still taxed as they were real: the fact that CGT impacts on such a small proportion of the electorate should not restrain us from eliminating this iniquity.

X 3. Shares to Employees. I think the Government should do more to encourage employee shareholding through profit sharing schemes approved under the provisions of the 1978 Finance Act. This, rather than share option schemes, is more likely to lead to widespread and long term employee shareholding because all employees with a relatively short qualifying period of service (maximum five years, usually two or three) must be included, and there is a strong incentive to retain each annual allocation of shares for at least five years.

I hope that the 1988 Finance Act will increase the maximum value of shares that may be appropriated to individual employees in any one year. The present limits are £1,250 (set by the Finance Act 1982) or if greater 10% of salary up to an overall maximum of £5,000 (Finance Act 1983). Inflation since July 1982 is around 20%, so because it is not desirable to alter the provisions too frequently, I would suggest that the amounts be increased by at least 25%. If the new limits were £1,600 and £6,400 respectively, this would represent a 28% increase producing round figures that could probably stand unchanged for another three or four years.

Many proprietors of small businesses wish to give incentives to their senior and other staff by way of shares. An outright gift from themselves to the employees concerned. Currently, above the gifts 'inter vivos' minima, such transactions rate for capital transfer tax. Thus the proprietor of a business in effect penalises his own family when giving shares to his employees. Bona fide gifts of shares to employees from a proprietor (other than to members of his own family) should not rank for CTT. I have met numerous instances of employers who would wish to give shares away but are inhibited by the present regulations.

.../.

4. Credit Card Transaction Tax. In the past I have put up the suggestion that credit card transactions should carry a tax, say, of 10p/20p per entry. Credit card operators could very easily add this figure to each transaction and show the necessary debit in favour of the Inland Revenue on the customer's monthly statement. The cost of collection would be minimal for both them and the Inland Revenue as only a handful of banks or authorised operators are involved. I estimate that this simple tax would raise some £100 million per year - a very useful offset to some of the other suggestions we have made to you. Not least it would mark up the Government's concern that there is too much personal credit about. It would be an avoidable tax if people wished to pay cash.

We shall be delighted to clarify these points with you and hope you will find some of the suggestions helpful.

LORD VINSON

PHILLIP CHAPPELL

and others of the Wider Ownership Group,
Centre for Policy Studies

Provided by FP.

CEILING ON TAX RELIEF FOR PENSION CONTRIBUTIONS

The average contribution to pension schemes is at present around 15% of the employee's salary. But the costs of providing maximum benefits for a very high earner can be considerably more than this, particularly where the period of accrual is short: in some cases it can be much greater than the example used by Lord Vinson.

Placing a ceiling on tax relieved contributions would be a major change and would significantly erode the concept of a final salary scheme. It might well, therefore, be regarded as a Green Paper issue following the Chancellor's assurances in 1985. This is certainly how it was seen when a series of options for the anti-exploitation package were considered earlier this year. At that stage, the suggestion was felt to be too radical, and action was confined to capping the lump sum. But the suggestion is relevant to the paper on personal pensions and final salary schemes that the Chancellor has recently commissioned from Treasury and Revenue officials.

SELF EMPLOYMENT

The CPS Wider Ownership group suggest that employed people should be taxed on the same basis as self-employed people - ie everyone should individually be assessed and not subject to deduction of tax at source under PAYE. This idea has been floated in other quarters, for example in the Institute of Directors' proposals for "optional selfemployment". Ministers' response has been that they think it important that the tax system should continue to encourage people to be entrepreneurial. Self-employed tax treatment gives a person considerable advantages, but only if he is genuinely in business on his own account. Extending self-employed tax treatment to everybody would remove these advantages and leave no incentive to set up in business. So there are important arguments of principle (leaving aside any exchequer administrative implications) against the CPS suggestion.

1783.17

Provided by FP

FROM: P H BROOK

DATE: 2 October 1987

MR SPARKES - 93/1

CENTRE FOR POLICY STUDIES

You asked for a contribution on point 6 of the Lard Vinson's letter to the Chancellor. We suggest the following:-

> "Since 1981, when the first index-linked gilt was issued, we have offered to the market substantial amounts of this kind of instrument at a wide range of maturities. There is at present just under £12 billion nominal index-linked gilts outstanding, and the longest maturity is 2024. We do not give undertakings about the specific sorts of gilt edged stock that will contribute to our future funding programme, and prices are of course set by the market. I can assure you however that our decisions on gilt issues will continue to take full account of market demand".

P Brook

P H BROOK

CAPITAL GAINS TAX

Proposals - in order of priority

(i) Abolish indexation, charge gains in first year as income and thereafter at tapering rates with a 7 year cut-off,

or

(ii) general roll-over relief where proceeds of sales immediately re-invested,

or

(iii) progressive backdating of indexation.

Comment

The Chancellor will be very familiar with the arguments here and will want to say very little. Very briefly, the main ones are as follows:

On (i)

- Tapering not simpler than indexation (could not continue share pooling: would need separate identification rules of the 1982/85 era)

- Expensive: would cost most of the yield (estimated at over £bn2 for the current year)

- ?behavioural/market responses: there would be considerable implications here: advantages in converting taxable investment income into (eventually) exempt gains: distortion of investment patterns.

On (ii)

- Effect would be to convert CGT into an expenditure tax. (What happens to the Income Tax ?)

- Would be expensive.

- People paying tax under this regime would be those who needed the cash and unable to reinvest eg pensioners and businessmen repaying borrowings.

- ? implications for markets/behavioural responses as at (i) above.

On (iii)

- Not possible to backdate indexation for shares (because of pre-1982 share pools).

3974/44

TASK FORCE SECRET

Raise the LEL apart, I agree with para 1; & X so but on; but I await Mr Scholar's comments on the other pts.

Copy no: 1 of 8

FROM: P J CROPPER
DATE: 13 October 1987

CHANCELLOR

cc Financial Secretary
Mr Isaac
Mr Scholar
Mr Tyrie
Mr Call

NICs

Tentative personal conclusions after yesterday's meeting:

1. **Employers' contributions**. It is probably right that we cannot raise any of the employers' rates this year, having so recently cut them, but I would concentrate all concessions this year on employees.

2. **Employees' contributions**. The combined starting rate of income tax and NIC still seems to me grossly excessive at anywhere below average earnings, and it is not at all certain whether/when we will be able to get the basic rate of Income Tax below 25 per cent. Neither is a reduced rate band looking promising. We should therefore do all we can to reduce the NIC rates at all income levels up to £150 or even £200. That is where our tax system is really wrong - levying 35% or so on half the income of people like that.

3. **Threshold for NICs**. The proposal to raise the starting point from £41 to £70 is very attractive. But:

(i) are we quite sure that we would not be disentitling some of the wrong people for benefits? Myself I have always hankered X after a simple residence (or citizenship) qualification for the OAP. It seems to me more dignified than the present arrangement of a partial contribution-based benefit topped up by supplementary benefit. In any case there is no justification for disentitling genuine people - better to maintain a nominal 1% or 2% employees contribution for them.

(ii) are we sure this is the best use of money? To the extent that these are part-time women and juveniles they can probably afford to pay NICs. Might it not be better to try and aim our reliefs primarily at the really hard pressed - for example, married men trying to bring up families on £100 or £150 a week?

4. **Burdens on Business.** It would be useful to know which sort of business would be most relieved by the lifting of the NIC threshold. And in what way. Would people below £70 simply be paid cash without the need for any sort of records at all beyond those required for normal accountancy purposes? How big is the prize, to set against the possibility of disentitling worthy people?

P J CROPPER

SECRET

FROM: J P MCINTYRE
DATE: 14 October 1987

CHIEF SECRETARY

cc Chancellor
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Miss Peirson
Mr Scholar
Mr Turnbull
Mr Gibson
Mr Cropper

* Re X, it is essential that the review does not cover CTAs. This affects the whole structure of the tax system, & is out of [illegible]. I do not want the review covering the taxation of CB, however. [illegible]

CHILD BENEFIT: REVIEW

You agreed with Mr Moore during the bilaterals that officials should carry out further work on the reform of child benefit. DHSS officials have now given us a draft of the terms of reference for the review, which they plan to put to their Ministers at the weekend. They have asked if we have any comments, stressing that it is very much a first shot and without prejudice to their Ministers' views. It would be helpful if you could let us know tomorrow (Thursday) whether you agree with what we propose to say.

2. We have the following comments on the draft (for ease of reference, I attach a marked-up copy of the draft as well as the original version).

Preamble

3. The reference to targeting as an objective should be deleted if we want the review to cover the possibility of a lower rate (eg for 2nd and subsequent children or for all children). This would not of course target assistance on those who need it most. But I think we ought to keep the option open: it would be more easily reconciled with pre-election pledges and would be administratively simpler (thus enabling savings to be made earlier).

MACINTYRE TO CST 14OCT

Para 3

4. This raises the question of whether we allow the review to consider taxation of child benefit and restoration of child tax allowances (CTAs). DHSS officials tell us that Mr Moore is convinced that the PM would be hostile to other reform measures, including means testing, unless she were convinced that CTAs had also been properly considered. On the other hand, the 1984-85 review of benefits for children and young people came down against the idea of giving people a choice between child benefit (to help non-taxpayers) and tax allowances on the grounds that it would:

(i) benefit higher rate taxpayers;

(ii) involve heavy staff costs;

(iii) add to the PSBR (1984-85 estimate: £100 million)

(iv) go to fathers rather than mothers in the case of many CTAs.

Treasury Ministers endorsed this conclusion.

X 5. On balance, I would try to persuade DHSS to omit CTAs from the scope of the review. Although they would produce public expenditure savings they would probably be small in relation to the total cost of child benefit (£4$^{3}/_{4}$ billion this year), because only higher rate tax payers would have an incentive to switch to CTAs. Moreover, they would add to the PSBR and have the other disadvantages listed above. And if the PM or other colleagues ask about them, we can refer back to the 1984-85 work. Their omission would also help to sharpen the focus of the review on the measures we are really interested in.

6. The 1984-85 review also rejected taxation of child benefit. As taxation would also have the disadvantage of producing no public expenditure savings, you may agree that we should continue to take the line that it should be ruled out.

7. Instead of taxation and CTAs, paragraph 3 of the draft needs to refer to differential rates, as the alternative to means testing.

Para 4

8. We need to complete the review of APA ahead of the other work, so that a decision on conversion into benefit could be announced in the next Budget, assuming that is what Ministers choose to do. DHSS officials agree that, if necessary, an interim report on APA could be produced.

Para 7

9. A report to Ministers by end-February would fit with Mr Moore's proposal, in his letter to you of 25 September that the work be ready "before the next Survey". I do not think we need dissent from the end-February date. But we will need to watch the handling of the issue after that. On the one hand, early completion of the review would be good in so far it would enable earlier decisions, earlier implementation and earlier savings. But on the other, there could be advantage in putting the conclusions of the review to the PM and other colleagues during the Survey in the context of the large and growing expenditure on social security generally. This might point to some delay before approaching colleagues, until the summer for example, when we will know the size of Mr Moore's bids.

General

10. The draft makes no reference to the possibility of abolition, with some compensating action being taken to increase family credit (to help low income families in work) and the children's allowances and family premia in Income Support (for those out of work). I think there is a good case for this being considered in the review.

11. It could of course involve a large reduction in the number of families receiving child support: around 1.8 million families are

expected to receive income-related benefits next year, compared with 6.8 million families receiving child benefit. However, it this were thought too great a reduction, the rules for family credit (currently expected to go to about 450,000 working families next year) could be changed so as to enable more families to become entitled to it.

12. Abolition would have administrative advantages, compared with means testing child benefit, because we would be building on existing means testing machinery rather than creating a new system. This might enable us to go ahead earlier. A more generous family credit would also alleviate the poverty trap for many working families on low incomes.

13. We would welcome your views on this option and whether you would like us to suggest to DHSS now that it be included within the terms of the review. If you want a little longer to think about it, we would simply give DHSS the other comments on their draft and say that Treasury Ministers may have further comments when Mr Moore writes.

Conclusions

14. If you agree, we will go back to DHSS officials with the comments shown on the draft attached. We would also be grateful to know whether you would like us at this stage to propose that the possibility of abolition be considered in the review, with compensating action for those on income-related benefits.

15. Mr Moore is likely to write to you shortly, proposing the terms of reference.

J P MCINTYRE

Having regard to Ministers' objectives of achieving public expenditure savings and of removing support from well off families and targetting it on the poorest,

1. to devise and cost a system or systems for means-testing child benefit, including access to tax information, at a number of different income levels

2. to identify and make costed proposals for dealing with the consequences for other benefits (eg one-parent benefit, child dependency additions, income-related benefits)

3. to identify and cost other possible options including taxation and tax allowances for better targetting of child maintenance

4. to review the options for abolishing, adapting or replacing the additional personal allowance

5. to assess the operational consequences, including the use of information technology

6. to consider the costs and benefits of the options including their implications for incentives/dependency and family incomes and consequences for other benefits and operational considerations

7. to report to Ministers by the end of February 1988

Having regard to Ministers' objectives of achieving public expenditure savings to offset the continuing increase in benefit expenditure ~~and of removing support from well off families and targetting it on the poorest~~,

1. to devise and cost a system or systems for means-testing child benefit, including access to tax information, at a number of different income levels

2. to identify and make costed proposals for dealing with the consequences for other benefits (eg one-parent benefit, child dependency additions, income-related benefits)

3. to identify and cost ~~other possible~~ options for different rates of child benefit, payable in respect of different numbers of children ~~including taxation and tax allowances for better targetting of child maintenance~~

4. to review the options for abolishing, adapting or replacing the additional personal allowance; an interim report on this issue to be produced by end-November.

5. to assess the operational consequences, including the use of information technology

6. to consider the costs and benefits of the options including their implications for incentives/dependency and family incomes and consequences for other benefits and operational considerations

7. to report to Ministers by the end of February 1988

JT 14/10

ps3/45T

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 14 October 1987

MR SCHOLAR

cc Sir P Middleton
Mr Cassell
Mr McIntyre
Mr Macpherson
Mr Cropper

Mr Isaac - IR
PS/IR

JMGT to Scholar 14 OCT

NICs AT THE LOWER END

The Chancellor would be grateful if you could look at a further variant. This would involve: a zero rate up to £70 a week; employers' rates as at present (except zero up to £70 pw); the 5 per cent employees' rate band to be extended upwards as far as can be afforded, if possible to above ½ average earnings; then a small band at 7 per cent, perhaps £10 wide; all within the same cash envelope of £700 million or so.

2. I should be grateful for advice in due course.

JT

J M G TAYLOR

MR MOORE-NIF
14/10

CONFIDENTIAL

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CH/EXCHEQUER
REC. 14 OCT 1987
ACTION Mr McIntyre
COPIES TO CST FST
Sir P. Middleton
Sir T. Burns
Mr Cassell Mr Monck
Miss Peirson Mr Scholar
Miss Sinclair Mr Gibson
Mr Cropper Mr Tyrie
Mr Mace I/R PS/IR

papers
PX

DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

14 October 1987

Ch
Will speak to David [illegible] PS/Moore
AA

Dear Nigel.

NATIONAL INSURANCE CONTRIBUTIONS RERATING 1988/9

I have now received the Government Actuary's projections on which I have to decide what changes to make to national insurance contributions (NICs) for 1988/9.

The Government Actuary's projections show that the Fund is accumulating a considerable surplus. I would like to consider with you in the longer term how this can be tackled strategically. However, in the interim, I do not propose to alter any of the rates of NIC for 1988/9. The main changes which have to be made are to the earnings limits for Class 1, and the earnings brackets for lower earners paying the reduced rate of NIC; the small earnings exception for the flat-rate self-employed Class 2 contribution; and the profits limits for Class 4. My proposals are accordingly as follows:

* a **2 per cent reduction in the Treasury Supplement, from 7 per cent of gross contribution income to 5 per cent.** This is the maximum reduction possible within subordinate legislation and will help shift more of the balance of contributory benefit spending from general taxation to contributions.

* a **zero employment protection allocation.** This takes up the point in Norman Fowler's letter to me of 30 June and avoids adding to the surplus in the Redundancy Fund.

* a **lower earnings limit of £41 and an upper earnings limit of £305 a week for Class 1 NICs.** These limits are tied by statute to the rate of the basic pension, and the increase is therefore virtually automatic (the present lower and upper limits are £39.00 and £295 respectively).

* a **£5 increase in the ceiling of each earnings bracket where reduced rate NICs are payable.** These ceilings should rise with the earnings limits, and to put them up by less than £5 would complicate employers' tasks unnecessarily.

* **for self-employed people, increase the small earnings exception for Class 2 to £2,250 a year and raise the lower and upper profits limits for Class 4 NICs to £4,750 and £15,860 a year respectively.** The upper profits limit movement is automatic, as it equals the annual upper earnings limit for Class 1 NICs. The other two figures follow it.

I hope that you will agree to these minimal changes, which will on the Government Actuary's assumptions give us a surplus in the NI Fund of £2.4 billion for 1988/9. If you are content, I suggest that we follow the practice of the last few years, with you announcing the main changes in your Autumn Statement and me filling in the details in reply to an inspired Question the same day. If the timing is right, it will probably make sense to debate the rerating and the benefit uprating Orders together, as we did last year. A number of minor consequentials following from these main decisions will need to be finalised, most of them affecting the special classes of contributors. I suggest that we leave the details to be agreed between our officials, with Michael Portillo keeping an eye on them here.

I am sending copies of this letter to Prime Minister, Norman Fowler and Tom King, and to Sir Robert Armstrong.

Yours ever
John

JOHN MOORE

ps3/35T

TASK FORCE SECRET

COPY NO. 8 OF 8 .

FROM: J M G TAYLOR
DATE: 14 October 1987

MR CROPPER

cc Financial Secretary
Mr Scholar
Mr Tyrie
Mr Call
Mr Isaac - IR

JMGT TO CROPPER 14OCT

NICs

The Chancellor has seen your minute of 13 October.

2. He has commented that, raising the LEL apart, he agrees that we should concentrate all concessions this year on employees (your paragraph 1). A simple residence (or citizenship) qualification for the OAP (your paragraph 3(i)) is <u>not</u> on. He awaits Mr Scholar's comments on the other points.

JT

J M G TAYLOR

ps3/36T

TASK FORCE SECRET

JNINT TO CAYLEY 14 OCT

COPY NO. 14 OF 15.

FROM: J M G TAYLOR
DATE: 14 October 1987

MR CAYLEY - Inland Revenue

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Jenkins - Parly Counsel
Mr Battishill - IR
Mr Isaac - IR
PS/IR

REFORM OF CAPITAL GAINS TAX

The Chancellor has seen your minute of 12 October. He is content to keep only the "alternative" option in play, ie to retain CGT as a separate tax and charge at the rates that would apply if gains were the marginal slice of income.

J M G TAYLOR

TASK FORCE SECRET

COPY NO. 1 OF 21

FROM: MISS C EVANS
DATE: 16 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Miss Sinclair o/r
Mr Riley
Mr Battishill)
Mr Isaac) IR
Mr Mace)
PS/IR
Mr Calder IR
Mr Cropper
Mr Tyrie
Mr Call

Many thanks. Most helpful. One or two points @ foot of page: –

TAX REFORM: 'SCORECARD' COSTINGS

You may find helpful for your meeting on Tuesday the attached update of the tax reform package which aims to reflect the latest state of play. Table 1 shows the total cost of the main proposals and Table 2 lists the alternative proposals which are still in play.

2. Except for a correctionto the CGT numbers the estimates for the CGT, income tax and NIC proposals are the same as those in Carolyn Sinclair's submission of 18 September.

3. As usual, the costings assume that the changes are introduced in the order shown.

CE

MISS C EVANS

1. I sh'd prefer order of costings to show (3) before (2).
2. No. 11 sh'd show tax ~~[illegible]~~ offset only
3. Add new proposal: ~~£30,000~~ lower limit for liability ~~[illegible]~~ of real estate to stamp duty to be converted to £30,000 threshold.
4. Amend option 2 (b) to read 37% in 1988-89, 36% in 1989-90 and 35% in 1990-91, with cap gains added to income & taxed @ income tax rate in each case.

PS. You sh'd be aware that I have also asked the IR for a note on a further CGT ~~proposal~~ which sh'd produce a yield. Viz, when an asset is transferred to a new owner (ie a gift) there is a CGT liability on the accrued gain, & the base price for the donee thus becomes the price/value @ transfer. N.

TASK FORCE SECRET

TABLE 1

COST OF TASK FORCE PACKAGE AS AT 16 OCTOBER

All figures highly provisional

Proposal Number	Proposal	Cost(-) or Yield(+) in £ billion 1988-89	1989-90	1990-91
1	Reduce basic rate of IT to 25p	-2.4	-2.8	-2.8
2	Abolish higher rates of IT above 35p	-1.3	-2.3	-2.3
3	Increase higher rate IT threshold to £25,000	-0.3	-0.6	-0.6
4	Independent taxation from 1990-91	Nil	Nil	-0.5
5	Reduce small companies CT rate to 25p	Neg.	-0.1	-0.1
6	Exempt first £6,600 gains from CGT, add remaining gains to income and tax at IT rates (25%/35%)	Nil	+0.1	+0.1
7	Rebase CGT to 1982 (cost includes rebasing CT on companies' gains)	Nil	-0.5	-1.0
8	In October 1988 abolish employees' UEL, set rate above it at 7% until April 1989, 8% to April 1990, then 9%	+0.5	+1.3	+1.5
9	Changes to NICs at lower end	*	*	*
10	Restrict MIR to residence basis from 1.8.88 and raise ceiling to £35,000 (cost ignores behavioural effects)	-0.2	-0.2	-0.2
11	Exempt forestry from tax and raise grants (assumed revenue-neutral)	Nil	Nil	Nil
12	Abolish tax relief on new covenants between individuals	Neg.	+0.1	+0.2
13	Tax employers instead of employees on main benefits in kind	*	*	*
14	Raise IHT threshold to £100,000 or £105,000 and single rate of 40%	-0.1	-0.2	-0.3
	TOTAL OF 1-14	-3.8	-5.2	-6.0

* Cost depends on option to be chosen

TASK FORCE SECRET

TABLE 2

ALTERNATIVE PROPOSALS

All figures highly provisional

Proposal Number	Alternative Proposal	Cost(-) or Yield(+) in £ billion 1988-89	1989-90	1990-91
2a	Abolish higher rates of IT above 40p	-0.8	-1.6	-1.6
2b	Abolish higher rates above 40p in 1988-89 reduce to 37½p in 1989-90 and to 35p in 1990-91	-0.8	-1.8	-2.2
6a	FST's proposal of 6 October as amended by PS/Chancellor's minute of 12 October		to be costed	
10a	MIR on present basis with £20,000 ceiling for singles and £40,000 for couples (cost ignores behavioural effects)	-0.2	-0.2	-0.3

COPY NO. 1 OF 20

FROM: M C SCHOLAR
DATE: 16 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Riley
Miss Sinclair o/r
Miss Evans
Mr Battishill)
Mr Isaac) IR
Mr Mace)
PS/IR
Mr Call
Mr Cropper
Mr Tyrie

Ch/ The pps. at 'X', and the backing papers, are on this folder. 'Y' papers are on the folder below. 19/10

TAX REFORM: MEETING ON 20 OCTOBER

You asked for an annotated agenda for this meeting.

2. You will wish first to take stock of the package as a whole. The principal papers are:

X
(i) Miss Evans' proto-scorecard of 16 October;
(ii) My minute of 16 October, covering a paper by the Task Force on the rationale and effects of the package as a whole;
(iii) Mr Mace on the distributional effects of the tax and UEL proposals (29 September); (& see Mace of 19/10 on "Income Tax + NIC" - not seen before)
(iv) Mr McIntyre's minute of 30 September on the self-employed - whether and how to soften the package for them;
(v) a paper by Mr Mace, on the distributional effects of the tax and UPL proposal for the self employed; (also not seen before, and also dated 19/10)
(vi) Mr Macpherson's paper of 16 October on NICs at the lower end. AND = a paper by Mr M. on implementation below this one).

3. There are also a clutch of papers on capital gains tax which have not yet been discussed. It would be best to postpone a substantive discussion of them until later, when we have revised CGT costings, on a stated range of assumptions, and based on the evidence of the new survey. These papers are:

(i) Mr Cayley of 10 September, on the 35 per cent top rate option;
(ii) ditto of 17 September on the option for a lesser degree of integration between income and capital gains tax (no cumulation);
(iii) The Financial Secretary's suggestion (6 October) - see Mr Cayley of 30 September, and Mr Taylor of 12 October;
(iv) practical arguments for not statutorily integrating capital gains tax and income tax (Mr Cayley of 12 October; see now your decision of 14 October).

4. This leaves a number of things for later:

(i) new paper on mortgage interest relief on a residence basis, with the £20,000 per person alternative;
(ii) paper promised by ST on the contributory principle;
(iii) paper by FP/FIM/Bank on the market implications of the capital gains tax proposal;
(iv) matrix of all the distributional effects (by Task Force: cannot be done yet);
(v) further papers on maintenance payments and divorce;
(vi) ditto on benefits in kind (for meeting on 26 October);
(vii) paper by FP (commissioned on Monday) on effect of package on small businesses and the self-employed.

5. I hesitate to add to the volume of paper by suggesting a list of questions you might consider. I will let you have, as you requested, an annotated agenda on capital gains tax for the meeting which will be specifically devoted to that. Meanwhile the scorecard (or our economic rationale paper) might serve as an agenda for Tuesday's discussion.

MCS

M C SCHOLAR

ps2/42R

SECRET

FROM: CATHY RYDING
DATE: 16 October 1987

PS/CHIEF SECRETARY

cc Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Miss Peirson
Mr Scholar
Mr Turnbull
Mr McIntyre
Mr Gibson
Mr Cropper

CHILD BENEFIT: REVIEW

The Chancellor has seen Mr McIntyre's minute to the Chief Secretary of 14 October.

2. The Chancellor has noted in paragraph 5 Mr McIntyre's comment that on balance, he would try to persuade DHSS to omit CTAs from the scope of the Review. The Chancellor has commented that it is essential that the Review does not cover CTAs. This affects the whole structure of the personal tax system, and is out of bounds. He does not, however, mind the Review covering the taxation of child benefits.

CR

CATHY RYDING

Copy 1 out of 22

MJS 16/10

FROM: N I MACPHERSON
DATE: 16 OCTOBER 1987

MACPHERSON TO CHEX 16 OCT

1. MR SCHOLAR

2. CHANCELLOR OF THE EXCHEQUER

These are v. helpful. But are getting warmer. Pls now let me see further options, ~~with employers' rates unchanged but for employees~~ as below:
(i) Employees 41-130 5, 130-155 7, 155-305 9 while employers remain unchanged.
(ii) Employees as above, but employers 41-130 5, 130-155 7, 155-305 10.45.
(iii) As (i) but setting reducing rates for 18 months.
(iv) As (ii), but setting reduced rates for 18 months.
NL.

cc. Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr A Wilson
Miss Peirson
Mr McIntyre
Mr Riley
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
PS/IR

NICS AT THE LOWER END

At last Monday's meeting, you asked for further work on NIC options. The attached paper examines a number of options involving raising the LEL, and looks in greater detail at the implications for the pensions system. It also includes some fall back options.

2. Time has not permitted a costing of the exact option contained in Mr Taylor's minute of 14 October. However, Option C which involves raising the 5 per cent band to over half of average earnings and reducing the spread of the 7 per cent band to £25 comes fairly close to it.

behind

N I Macpherson

N I MACPHERSON

NICS AT THE LOWER END

This paper looks at further NIC options involving raising the LEL and examines in greater detail the implications for the pensions and benefit system. It also puts forward some fall back options.

Raising the Lower Earnings Limit

Option A

2. At the meeting on 12 October, the Chancellor suggested the following Option:

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	0	5	0
70-105	7	5	7	7
105-155	9	7	9	9
155-305	9	9	10.45	10.45

3. If introduced in October 1988, this would cost:

1988-89	£160 million
1989-90	£460 million

The advantage of this option is that employees retain the gains of the 12 October options - 2.1 million taken out of NICs, 4.1 million employees earning between £70 and £155 a week gaining by between £1.40 and £3.10 a week (less 58p if contracted out) and 40,000 tax units taken out of the trap - but at a much reduced cost. The option meets most of the criteria set out in Mr Cropper's minute of 13 October. Concessions above the LEL are
behind
targeted exclusively on employees, while gainers earn as much as 65 per cent of average earnings. Of those gaining between £105 and £155 a week, nearly half would be full time men. However, the cost of extending the reduced rate structure further up the earnings distribution, as suggested in Mr Cropper's minute, would be

high; for example, extending the upper limit to £165 would add £100 million to the cost in 1988-89 and £250 million in 1989-90.

4. A more cost effective alternative might be to extend the upper limit of the £70-105 band to £115, slightly under half of average earnings. This would add £60 million to the cost of Option A in the first year and £170 million in the second, implying an aggregate cost of £220 million in 1988-89 and £630 million in 1989-90. This variant would mean a 4 per cent NIC rate reduction for those earning between £105 and £115 a week. The maximum gainer from the low end package would now be someone on £115 a week, who would pay £4.60 less contributions. This variant would target full time workers, though clearly not as many married men with children as raising the £155 limit, hence the lower cost.

5. Despite taking 2.1 employees out of NICs, Option A would not take many out of the tax system. This is because only 5 to 10 per cent of the 2.1 million are adult males, the only group likely to qualify for a married man's allowance. Women, and the bulk of men under 21, will have only a single person's allowance, equivalent to £48.55 a week in 1988-89, and will therefore continue to pay income tax. Although some of these low earners may qualify for some tax relief, it is extremely unlikely that it will be sufficent to push the point at which they begin to pay tax above £70 a week. If people are to be taken out of the tax system in any numbers, it will be necessary to increase tax allowances as well as the LEL.

Option B

6. This involves explicitly tieing the LEL to the married man's allowance, which, on the assumption that the present allowance is increased by 4.2%, will be equivalent to £76 a week in 1988-89, and extending the first band along the lines of the variant described in paragraph 4. It gives the following structure:

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	0	5	0
70-76	7	0	7	0
76-105	7	5	7	7
105-115	9	5	9	7
115-155	9	7	9	9
155-305	9	9	10.45	10.45

7. If introduced in October 1988, this would cost:

1988-89	£210 million
1989-90	£610 million

The advantage of tieing the LEL to the married man's allowance is mainly presentational, since as argued above it unlikely to take many people out of the tax system. It would simplify the tax system creating a single starting point for married men at £76. The step will of course be high at £4.05, but anything short of an allowance system along the lines of the old Option 5 (where the starting point for NICs was turned into a threshold not a lower earnings limit: ie employees paid NICs on the amount above the threshold, not on their whole earnings once they reached the limit) will result in steps somewhere on the earnings distribution.

8. The higher LEL than in Option A would take a further 300,000 employees out of NICs, someone on £75 a week gaining £5.25 in reduced contributions. Since the higher LEL saves money, the cost of the option is slightly less than the variant in paragraph

4. Were the first band extended further to £120, about half of average earnings, the cost would rise to £250 million in 1988-89 and £710 million.

9. The disadvantage of this option is that tieing the LEL to the married man's allowance will reduce the room for manoeuvre on either in the future. The higher LEL also means a lower contracted out rebate. The 7 million contracted out earning over £155 a week will have to pay 70p a week more in contributions (compared to 58p a week in Option A), while their employers will have to pay £1.33 a week more (£1.10 in Option A). This will result in a marginal increase in the losers from the overall tax package.

Option C

10. This involves not uprating the bands in April 1989. They would therefore stand for eighteen months rather than six. The resulting savings are used to extend the £70-105 band. This would give the following structure:

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	0	5	0
70-105	7	5	7	7
105-130	9	5	9	7
130-155	9	7	9	9
155-305	9	9	10.45	10.45

11. If introduced in October 1988, this would cost*:

1988-89	£340 million
1989-90	£590 million

*Costings assume UEL abolition. Otherwise, cost would be higher.

The advantage of this option is the breadth of the 5 per cent band for employees, the upper limit being pushed up to 53 per cent of average earnings in 1988-89. Around 3/4 million adult men earning between £105 and £130 a week would benefit from a 4 per cent NIC rate cut, with a contracted in employee on £130 a week gaining £5.20 a week in lower contributions. A more expensive variant would involve pushing the limit up to £135 a week; this would cost £400 million in 1988-89 and £700 million in 1989-90.

12. The main disadvantage of this option is the lack of an uprating in the bands in April 1989. As a result employees may find themselves floating into the higher bands during the course of 1989-90. However, this will happen even when the bands are uprated every twelve months. It can be argued that not uprating the bands is administratively simple for employers. There will have been an uprating in April 1988, while these proposals imply further changes in October 1988; to uprate the limits in April 1989 would be the third change in twelve months.

Implications for the pensions and benefit system

13. The above options have a number of implications beyond their immediate impact on take home pay.

a) Basic retirement pension

14. The 2.1 million people taken out of NICs will no longer be building up entitlement to retirement pension (or other contributory benefits). Of these 400,000 are married women optants, who will already have chosen to forego retirement pension in their own right. Of the other 1.7 million, around 30 per cent are under 21; they will have time to build up an adequate contribution record as their earnings rise over the life cycle. They may not however get the full pension; for this, a complete contribution record is required for around 90 per cent of their

working life*. Around half are married women; these are less likely to experience career progression. Assuming they remained married, they would now only be entitled to the married couple's addition, which is 60 per cent of the husband's retirement pension. If they were divorced or widowed, and remained so, they would be entitled to their husband's full pension. That leaves around 20 per cent, 400,000 employees, who are either adult men or adult single women. These are the people likely to lose the most in terms of entitlement and may well end up relying exclusively on means tested benefit. All these effects will take time to work through, since those currently working between £41 and £70 a week will already have built up some entitlement.

15. Most employees taken out of NICs will no doubt doubt see this as more than adequate compensation for losing benefit entitlement. However, at a time when independent taxation of husband and wife is being introduced, making a large number of women dependent on their husbands for benefit purposes may be seen as somewhat contradictory. Those who are unhappy will of course have the option of paying Class 3 contributions, though given this is likely to be £4 a week in 1988-89 it will involve paying more NICs for less benefit (Class 3 carries no SERPS entitlement).

16. Breaking the link between the basic retirement pension and the LEL should not present too many problems. In actuarial terms the link has always been arbitrary, and although primary legislation will be required this will already be necessary for abolishing the UEL.

<u>b) SERPS</u>

17. Unlike the basic retirement pension, entitlement to the additional component (AC) cannot be obtained through the husband's contributions (except after he dies when the widow is

---

*Working life is 49 years for a man and 44 years for a woman. Years spent on 'home responsibilities',eg looking after children, are deducted.

entitled to half her husband's AC). Given the lack of career progression most low earning women experience, it is likely that many of those taken out of NICs will receive no, or a much reduced AC. However, the effect of losing all AC entitlement is considerably less than losing 40 per cent of the basic pension. The most in terms of additional pension someone earning £70 a week for their whole working life would have been entitled to is £5.80 a week.

18. But it will not just be those who are taken out of NICs whose SERPS entitlement will be reduced. Everybody whose earnings are consistently over £70 a week will lose £5.80 a week in AC. This will hit low earners proportionately more. For example, a low paid full time adult man on £130 a week through his whole working life would experience a reduction of a third in his AC entitlement from £17.80 to £12 a week. The regressive nature of the policy might be hard to justify in social security terms.

19. Again all these reductions in entitlement would take a long time to work through the system. Only those retiring in the third decade of the next century will experience the full £5.80 reduction, and then only if the LEL is consistently uprated in line with earnings. Public expenditure in the long run would of course be much reduced.

<u>c) Contracted out rebate</u>

20. Since GMP entitlement will be reduced in line with the Additional Component, the pensions' industry should have little reason to complain about the lower rebate. Only a very small number of contracted out employees will have been taken out of NICs, though actuaries may argue that, since these are predominantly young people, the rebate will have to be recalculated. They will be on weak ground since there is a 14 per cent subsidy implicit in the rebate.

d) Personal Pensions

21. The effect on personal pensions (and contracted out money purchase occupational schemes) will be much the same as that on the GMP. The rebate, the 'minimum required contributions', will only be available from £70 a week, as will the 2 per cent bonus. Those earning under £70 a week will now be disenfranchised from personal pensions, though they could still take out a retirement annuity. However, personal pensions were never designed to have much appeal for married women or part- timers. They were ~~however~~ though expected to appeal to employees, often on low earnings, in industries without occupational pension schemes.

22. The Annex contains a scheme designed for agricultural workers. On the third page, is an example of a plan for someone earning £6000 a year. The table below shows expected contributions on different LEL assumptions. The £70 LEL results in contributions being cut by 25 per cent. If the plan holder had no employers' contributions, they would have been cut by 40 per cent.

Contributions to pension plan on total earnings of £6000 per year

	£41 lel	£70 lel
From employer at £4 a week	208	208
DHSS rebate, including tax relief	253	154
Special incentive, for 6 yrs at most	77	47
Total for year	538	409

23. In that SERPs would also be cut back, the relative merits of personal pensions might be little changed. However, personal pension providers might feel justifiably aggrieved. Here, the problem is one of timing. DHSS have already changed the introduction date of personal pensions twice, the current start date being June 1988. Numerous plans like that in the Annex will be being marketed by next Spring. All, as required by law, will contain illustrative examples of expected benefits, based on a

LEL of around £40, the figure implied by numerous consultative documents produced by DHSS. A Budget announcement of a LEL of £70, which will render all these illustrative examples out of date, is likely therefore to be unpopular. Nor is it likely to get the much heralded departure in pensions policy off to a flying start.

Fallback Options

24. The problems identified in the last section could be avoided if the dual LEL structure, referred to in previous papers, was introduced. This would involve a LEL of £41 for benefit and rebate purposes and a LEL of £70 for NIC payment purposes. The difficulty with this would be that most of the advantages of Options A to C would go in the process. Since firms would still have to report earnings of those earning over £41 a week even if they did not pay NICs, there would be no administrative savings, while, since there would be no savings on the rebate, cuts in employee NICs in the £70 to £150 bands could not be afforded.

25. The two fallback options (D and E) therefore envisage a LEL of £41 being maintained. They are based on the suggestions in paragraph 3 of Mr Cropper's minute. Option D involves the minimum necessary NIC rates in the £41 to £70 band, while Option E involves all resources being targeted on the £105 to £155 band.

Option D

	Employees % rate		Employers % rate
£ per week	now	proposed	unchanged
41-70	5	2	5
70-105	7	5	7
105-155	9	8	9
155-305	9	9	10.45

26. If introduced in October 1988, this would cost:

1988-89	£230 million
1989-90	£660 million

This option would result in nearly 8 million low paid employees gaining by between £1.05 and £2.10 a week. The lowest paid would gain proportionately the most; for example, someone on £41 a week would pay £1.23 a week less in contributions. The 100 000 contracted out employees earning between £41 and £70 a week would cease to pay NICs, though their earnings would still have to be reported for benefit entitlement purposes. (This might cause problems since it is NIC payments not earnings which determine entitlement). Around 30 000 tax units would be taken out of the unemployment trap.

27. The disadvantage of this option is that most of the gains go to married part-time women. It would also be necessary to introduce reduced rates for optants to avoid widespread contracting back into Class 1 contributions. This might add around £25 million to the full year cost. The steps at £70 and £105 are higher than at present.

Option E

	Employees % rate		Employers % rate
£ per week	now	proposed	unchanged
41-70	5	5	5
70-105	7	7	7
105-155	9	7	9
155-305	9	9	10.45

28. If introduced in October 1988, this would cost:

1988-89	£210 million
1989-90	£620 million

The advantage of this option is its targeting. All the gains, which will range from £2.10 to £3.10 a week, will go to those earning between 43 per cent and 63 per cent of average earnings. Nearly all the 4.1 million Class 1 contributors in this group are full time employees and around half are adult men. Over 10000 tax units would be taken out of the unemployment trap.

29. The disadvantages of this option are that few are affected by the cut in NIC rates, a step of £3.10 would appear at £155, a well populated point in the distribution, and that employers may complain about the dealignment of NIC rates between £105 and £155. These criticisms would appear weak.

30. An attractive variant would involve setting the reduced rates for eighteen months in the same way as in Option C. The LEL would have to be raised in line with the pension to £43 in 1988-89, though the UEL which would now only apply for rebate purposes could be frozen, thus cutting the cost of the rebate. This would allow the £155 limit to be raised to £170, 70 per cent of average earnings. This would ensure that around 1½ million additional employees would be brought into the reduced rate structure, though they would of course float out over the course of the next eighteen months. The cost of this variant is £360 million in 1988-89 and £650 million in 1989-90. (If it proved necessary to raise the UEL in April 1989, the second year cost rises to £710 million).

ETS division
16 October 1987

Consulting Actuaries

ANNEX

HM TREASURY – MCU
18 JUN 1987
McGuckin STI
24/2
FOR INFO
20387/87

Mg 19/6

Bacon & Woodrow
6 South Charlotte Street
Edinburgh
EH2 4ED

Resident Partner
R Brereton

Telephone 031-225 4040

and at London Bristol Epsom
Leeds Southend and Guernsey

Associated Firms:
Dublin Brussels Trinidad

16th June 1987

John Moore Esq
Social Services Secretary
House of Commons
LONDON

Dear Mr Moore

First major use of Personal Pensions proposed by T&GWU!

Here is some good publicity for you! My reason for wanting to help is that I was the last Tory Leader of Edinburgh District Council.

Despite Labour and Union opposition to Personal Pensions (which Norman Fowler launched) it looks as if agricultural workers may be among the first to benefit from this Tory innovation.

Why don't you make a press statement along the lines of "....welcomes the T&GWU initiative in recognising the suitability for the agricultural industry of Personal Pensions as introduced by the last Tory Government, and believes that thousands more people will come to realise their usefulness."

With best wishes for your success.

Yours sincerely

Ralph Brereton.

RALPH BRERETON

Enc

cc Malcolm Rifkind, Secretary of State for Scotland
Norman Fowler, Employment Secretary
Nigel Lawson, Chancellor of the Exchequer

BACON B&W WOODROW

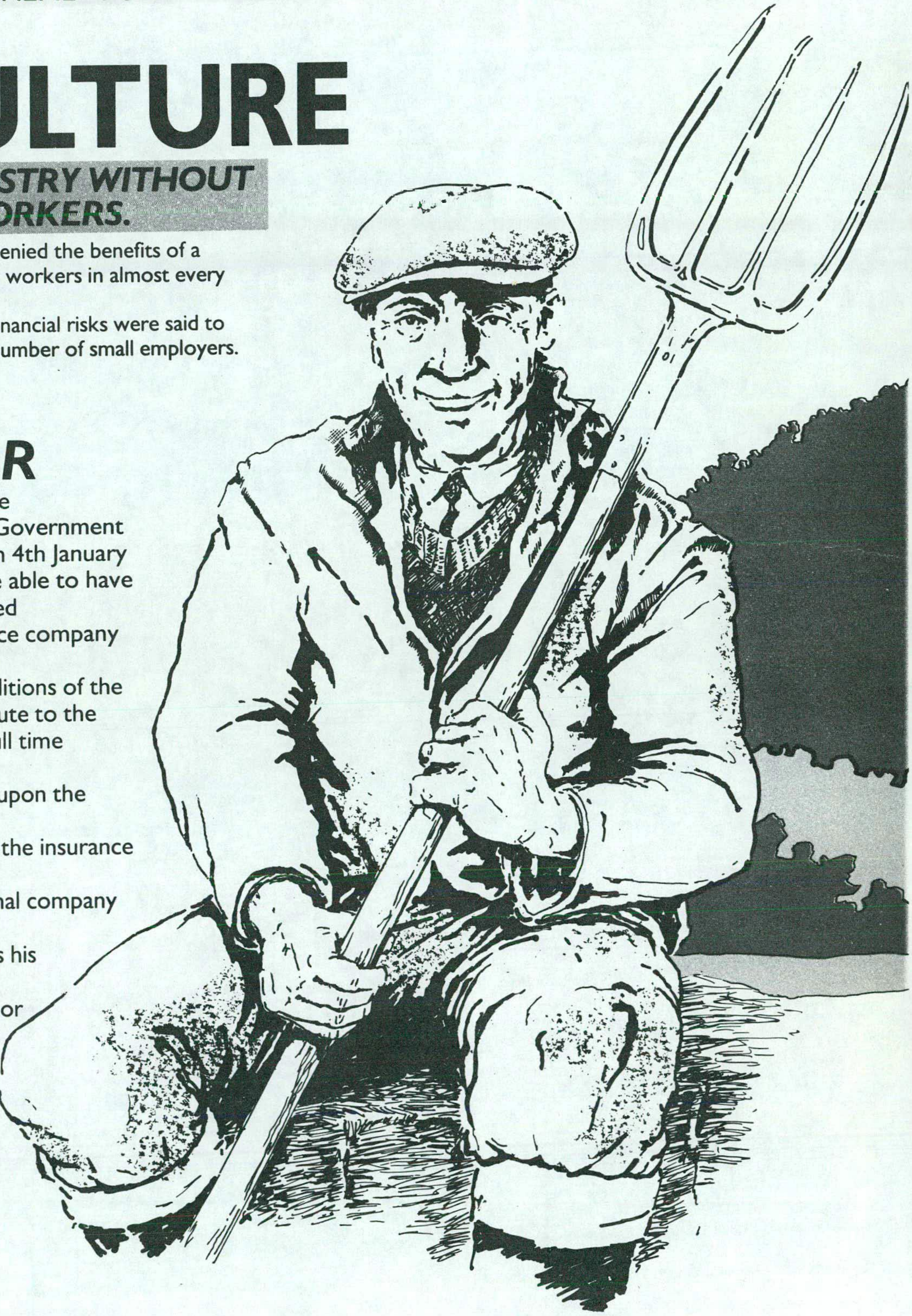
FARMSAVE

THE · PENSION · SCHEME · FOR · AGRICULTURAL · AND · ALLIED · WORKERS

AGRICULTURE

THE LAST MAJOR INDUSTRY WITHOUT PENSIONS FOR THE WORKERS.

For years agricultural workes have been denied the benefits of a "company pension scheme" as enjoyed by workers in almost every other industry.
The red tape, the complications and the financial risks were said to be too great for an industry with a large number of small employers.



FARMSAVE IS THE ANSWER

To meet the pension problems of the agricultural industry and others, the Government has created a new opportunity. From 4th January 1988 each agricultural worker will be able to have his own personal pension policy, called "Farmsave", from the leading insurance company Standard Life.

- ★ As part of the basic terms and conditions of the industry the employers will contribute to the personal pension policies of their full time workers.
- ★ Thereafter no financial risk will fall upon the employers.
- ★ The administration will be done by the insurance company.
- ★ All the tax advantages of a traditional company pension scheme will apply.
- ★ If the worker changes jobs he takes his personal pension policy with him.
- ★ Individual workers can contract in, or out, of part of the State pension scheme as they wish but the employers' book-keeping is not affected.
- ★ Finally, for many workers, the Government will pay a special incentive to encourage them to use this opportunity rather than rely upon the State.

DESIGNED · AT · THE · REQUEST · OF · THE · TRANSPORT · & · GENERAL · WORKERS' · UNION

THE FIRST STEP

In June 1987, the Transport & General Workers' Union will ask the Scottish Agricultural Wages Board to make an order that every employer must pay £4 per week into a Personal Pension policy held by each of his employees.
The Wages Board will also be asked to recommend that workers in the industry use the Personal Pension policy, called Farmsave, which Standard Life will make available on attractive terms specially for the agricultural industry.
In this way a pension from one of the leading insurance companies will become part of the basic working conditions of the industry.

STARTING DATE

It is suggested that the industry should make the first pension contributions in the week commencing Monday, 4th January 1988. This is the date when the Government intends that Personal Pensions should be first available. It is possible that the 1987 General Election may delay this. In any event contributions should start before 5th April 1988.

LIFE ASSURANCE

In the unfortunate event that a member of Farmsave should die before retirement, life assurance is automatically provided at not less than the following amounts.

Age on joining Farmsave	Cash Paid on death
35 and under	**£10,000**
36 to 40	**8,000**
41 to 45	**5,000**
46 to 50	**3,000**
51 and over	**2,000**

BENEFITS AT RETIREMENT

The savings which each worker will have accumulated within his Farmsave policy by retirement date obviously depend on two things:

★ the number of years contributions which have been paid at £4 per week

★ the success of the insurance company's investments.

It is impossible to predict investment results with any certainty, so the table below shows what the accumulated savings would be if the investment results averaged either 11% each year or 13% each year.

Age at entry to Farmsave Contributions of £4 per week	Men Fund at 65 **11% growth**	 **13% growth**	Women Fund at 60 **11% growth**	 **13% growth**
	£	£	£	£
25	101,992	179,244	59,968	96,773
30	59,304	95,898	34,766	51,709
35	33,566	50,119	19,653	27,059
40	18,857	26,024	10,859	13,880
45	10,691	13,638	5,849	6,954
50	5,805	6,886	2,855	3,178
55	2,804	3,119	1,053	1,105
60	944	990		

However, it is not sufficient to look only at investment results. Inflation must also be taken into account. The table below shows the effect on Farmsave if the investment results exceed inflation by an average of 2% each year or 4% each year.

Age at entry to Farmsave Contributions of £4 per week	Purchasing power, in today's terms, of the monies in the Personal Pension policy at retirement, if investment growth exceeds inflation each year by: Men Fund at 65 **2%**	 **4%**	 Women Fund at 60 **2%**	 **4%**
	£	£	£	£
25	3,264	5,736	2,938	4,742
30	2,906	4,699	2,607	3,878
35	2,517	3,759	2,280	3,139
40	2,187	3,019	1,933	2,471
45	1,903	2,428	1,608	1,912
50	1,596	1,894	1,205	1,341
55	1,183	1,316	684	718
60	614	643		

CASH OR PENSION

On retirement the worker may uplift at most one quarter of his accumulated savings entirely free from tax. The rest will be used to provide a pension for life, and a reduced pension for any surviving spouse.

KEEPING UP WITH INFLATION

It is recommended that the Wages Board should increase the £4 contribution each year in line with any increase in the industry basic wage.

EFFECT OF FARMSAVE ON THE STATE PENSION

The Farmsave pension, provided by the £4 per week contribution, will be in addition to the State pension which is itself in two parts:

★ the basic "old-age" pension which is £39.50 per week for a single person or £63.25 per week for a married couple

★ plus a further amount which depends on earnings and is called the State Earnings Related Pension Scheme.

THE GOVERNMENT IS WORRIED

The long term finances of the State Earnings Related Pension Scheme have been questioned. The problem is that people are retiring earlier and living longer. Since all State pensions are paid from taxes on workers, and an increase in the ratio of pensioners to workers is forecast, it follows that taxes may have to rise. The situation is made worse because pensioners, not unreasonably, expect an ever improving standard of living. This particularly affects the earnings related part of the State Scheme. The danger is that some future generation of workers may refuse to pay the taxes needed to keep an older generation of pensioners in the style to which they feel entitled.

THE GOVERNMENT'S SOLUTION

The Government would prefer people to provide their earnings related pension by saving up for it rather than depending on future generations. Accordingly, anyone who has a Personal Pension policy, like Farmsave, may ask the DHSS to release part of the National Insurance contributions which are paid on their behalf. The DHSS will pay this rebate, once a year, into a Personal Pension policy. In this way people will become less dependent on future generations of workers.

SPECIAL INCENTIVE PAYMENT

To encourage people to make this change towards providing for their own pension, the Government will pay an extra amount into Personal Pension policies for the next six years for those people who decide to "contract-out" of the State Earnings Related Pension Scheme.

WHO SHOULD CONTRACT-OUT OF THE STATE EARNINGS RELATED PENSION SCHEME?

Most men under age 50, and women under 40, will be well advised to choose to contract-out and, instead, to have the DHSS rebate, and the Special Incentive, paid into their Farmsave policy. Older people should probably continue as they are. Each worker must make his own decision. His employer is not affected.

TOTAL CONTRIBUTIONS TO FARMSAVE IF CONTRACTED-OUT

The rebate from DHSS, and the Government's Special Incentive payment, are both based upon total earnings in a year, which, of course, includes basic pay plus overtime plus any other payments. The total monies going into Farmsave each year will be as follows:

On total earnings of £6,000 per year	**£**
From the employer, at £4 per week	208
DHSS rebate, including tax relief	259
Special Incentive, for six years at most	79
Total for year	£546

On total earnings of £8,000 per year	
From the employer, at £4 per week	208
DHSS rebate, including tax relief	390
Special Incentive, for six years at most	119
Total for year	£717

These higher contributions will increase proportionately the pension which may be expected from Farmsave in lieu of pension from the State Earnings Related Pension Scheme.
In addition to all of the above, there may be further contributions from the employer and/or the employee subject to the limits described elsewhere.

FURTHER CONTRIBUTIONS

The employer may make higher contributions than £4 per week to reward a particularly valued or long serving employee. The employee may make further contributions to increase his own pension. The maximum contribution which may be paid in total, from the employer and employee combined, depends upon the employee's age, and is shown in the following table.

Age	Maximum contribution as a percentage of pay
Under 50	17½
51 to 55	20
56 to 60	22
61 and over	27½

Any DHSS rebate and Special Incentive payment is in addition to the above.

RETIREMENT AGE

This may be anytime between age 50 and age 75, or earlier than age 50 if retirement is on grounds of ill health.

JOB CHANGING

When an employee changes his job he takes his Farmsave policy with him. If he moves within the agricultural industry his new employer will contribute to it. If he leaves the industry his new employer may contribute if he chooses. People joining the agricultural industry who already have a Personal Pension policy other than Farmsave may continue with it.

CALDER 16.10.87

CONFIDENTIAL

CALDER TO CH.EX 16-10-87

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

FROM: J R CALDER
DATE: 16 October 1987

1. ~~MR ISAAC~~ seen in draft.
2. CHANCELLOR OF THE EXCHEQUER

Thanks – in particular 1 note that 37% of CGT payers have income below £10,000 and 57% below £20,000. 2. How is the work to cost more accurately the rebasing option getting on? (i.e. making a proper calculation of the unlocking effect)

CAPITAL GAINS TAX DATA

1. This note is a brief report of the first analysis of the new sample of CGT data. Mr Gonzalez minuted you on this on 29 July. The sample covers assessments made on disposals of assets in 1985-86 by individuals and trusts. Details have been collected from the taxpayers' computations which show the make-up of the gain and of the taxpayers' taxable income. Analyses are presented in terms of taxpayers and individual disposals.

2. Two notes of caution are needed. These are the first analyses of data which have just become available from a moderate sized sample. Capital transactions are by their nature lumpy and CGT is an extremely skewed tax: a small [illegible]
proportion of taxpayers accounts for a high proportion of

cc. Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Mr Scotter
Mr Cropper
Chairman
Mr Isaac
Mr Cayley
Mr Mace
Mr Gonzalez
Mr Weeden
Mr Quinn
Mr Calder
PS/IR

the yield. Sampling variation may therefore be quite large. Second, not all the 1985-86 assessments have been made and not all the sampled returns are in yet. More complex gains cases take longer to agree and later returns may well differ in some respects from earlier cases. The data yet to come may alter the details presented here - but not, we think, the broad picture. The data update and extend the analysis of the incomes of a sample of 1983-84 gains taxpayers which Mr Gonzalez sent you on 8 January 1987.

General

3. In 1985-86 we have estimated that there were about 750,000 disposals by about 125,000 individuals and 25,000 trusts. Total indexed gains were about £4,500 million giving a tax liability of about £1,100 million. Figures for taxpayer numbers are under review. Individuals account for some four-fifths of the indexed gains, trusts for one-fifth.

Analysis by taxpayer - individuals

4. About 4 per cent of individual gains taxpayers (ie about 5,000 in number) made indexed gains of over £100,000 and these amounted to half the total indexed gains made by individuals. After allowing for other reliefs and the annual exempt amount, we estimate that these taxpayers contributed about 60% of the CGT yield from individuals for 1985-86. A quarter of individual gains taxpayers had taxable incomes (ie after subtracting reliefs and allowances) of over £30,000 in 1985-86 and their indexed gains amounted to some 55% of the total.

5. On the other hand, 37% of gains taxpayers had taxable incomes below £10,000 and their indexed gains accounted for a quarter of the total. The sample thus confirms the picture in last winter's survey of a sizeable proportion of CGT payers having income liable at no more than the basic rate.

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6. Tables 1 and 2 show more detail of the percentage distribution of gains taxpayer numbers and amounts of gain.

Elderly

7. 45% of gains taxpayers were elderly (aged 65+) and they accounted for one-third of indexed gains. A slightly higher proportion (65%) of the elderly gains taxpayers had taxable incomes below £20,000 compared with the non-elderly (57%). The elderly with taxable incomes below £20,000 accounted for half of the total elderly gains; the corresponding proportion for the non-elderly was one-third. The sample also suggests that very large gains (£250,000+) are concentrated among those under 65.

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TABLE 1:

Percentage distribution of numbers of individual gains taxpayers by
- size of gain and taxable income

(Per cent)

size of indexed gain (£ thous)

Taxable income (£ thous)	below 10	10-25	25-100	100-500	500+	Total
below 10	16	15	5	1	-	37
10-20	10	9	5	-	-	24
20-30	7	5	3	-	-	15
30-100	7	6	5	1	½	20
100+	½	1	1	½	½	4
Total	41	37	18	3	1	100

TABLE 2:

Percentage distribution of individuals' total indexed gain by:
- size of gain and taxable income

(Per cent)

size of indexed gain (£ thous)

Taxable income (£ thous)	below 10	10-15	25-100	100-500	500+	Total
below 10	4	7	7	5	1	24
10-20	2	4	5	2	1	14
20-30	1	2	4	1	½	9
30-100	2	3	6	8	9	27
100+	-	½	2	3	20	26
Total	9	16	24	19	31	100

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Married Couples

8. About two-thirds of gains taxpayers were married couples accounting for three-quarters of the indexed gain. 55% of the married couples and 70% of the unmarried had taxable incomes below £20,000.

Trusts

9. 18% of gains taxpayers were trusts. One-half of these were ordinary trusts, one-third discretionary and the classification of the remaining one-sixth is not yet known. 18% of the total indexed gains were also made by trusts. The percentage distribution of the trusts' gain by size is shown in table 3. Two-thirds of the total trusts' gain was accounted for by gains of over £100,000, compared with one-half for individuals (table 2).

TABLE 3:

Trusts: size of indexed gain (£ thous)

(Per cent)

below 10	10-25	25-100	100-500	500+	Total
9	9	14	27	40	100

Disposals (individuals and trusts)

10. Table 4 shows how the total indexed gain of about £4,500 million and the 750,000 disposals were distributed across various categories of disposal. Figures are in percentages; those for numbers of disposals are shown in brackets.

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TABLE 4

Percentage distribution of net indexed gain (numbers of disposals) by:
- type of asset, date of acquisition and size of disposal

Per cent

	up to £¼ million	above £¼ million	TOTAL
pre April 1982			
shares	22	26	48 (30)
land and real property	22	5	27 (8)
other(1)	1	1	1 (-)
TOTAL pre 82	44	32	76 (38)
post April 1982			
shares	12	6	18 (59)
land and real property	3	3	5 (2)
other(1)	-	-	1 (1)
TOTAL post 82	15	9	24 (62)
TOTAL	59(99.6)	41(0.4)	100 (100)
by asset type:			
shares	34	32	66 (89)
land and real property	25	8	33 (1)
other(1)	1	1	1 (1)

(1) other consists mainly of works of art, antiques and jewellery.

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- three-quarters of the indexed gain arose from the 38% of disposals of assets acquired before April 1982;

- two-fifths of the gain arose from the 3,000 or so (0.4 per cent) disposals of over £½ million;

- two-thirds of the gain arose from shares which accounted for almost 90% of the disposals;

- one quarter of the indexed gain on shares arose on shares acquired since April 1982 and one sixth of the gain on land and real property.

11 Table 5 shows the percentage distribution of gains on land and real property. One-fifth of the gain arose from agricultural land and buildings and more than two-fifths from residential property.

TABLE 5:

Percentage distribution of net indexed gain land and real property

	Acquired pre April 1982	Acquired post April 1982	Total
residential property	41	3	44
agricultural land and buildings	13	7	20
industrial/commercial and other(1)	30	6	36
TOTAL	84	16	100

(1) includes shops with living accommodation, boarding houses, goodwill etc.

Conclusion

12. In conjunction with the Treasury, we are continuing to examine the data and to consider its implications for the various assumptions on the amounts and distribution of gains and individual behaviour we have made so far in costing the reform packages. When this work is complete, we shall present you with revised costings and distributional analyses.

J R CALDER

RATIONALE + EFFECTS OF TAX REFORM PROPOSALS

COPY NO. 1 OF 23

FROM: M C SCHOLAR
DATE: 16 OCTOBER 1987

1. SIR P MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

For discussion @ Tuesday's meeting

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir T Burns
Mr Byatt
Mr Cassell
Mr A Wilson
Mr Riley
Miss Sinclair o/r
Mr Battishill) Inland
Mr Isaac) Revenue
PS/IR
Mr Cropper
Mr Tyrie
Mr Call

THE RATIONALE AND EFFECTS OF TAX REFORM PROPOSALS

Some time ago you asked for a paper setting out the economic rationale for your current proposals for tax reform; and for a paper analysing the effects of the package.

but more analysis than rationale

2. I attach a paper by the Treasury Task Force which is a first shot at meeting both these requests. The paper has been discussed with the Inland Revenue and has benefitted greatly from comments which they have given us, but in the time available we have not tried to agree every proposition in the paper with them.

3. There are many things which this paper is not. It is not - at this stage - an attempt to sell the present package; or to suggest how the proposals might best be presented; or to suggest alternative options which you might want to consider. It is, rather, an appraisal and analysis of your proposals, which tries to provide a map of the landscape within which your proposals - and those of others, eg Mervyn King - may be placed. This means that it raises a rather wider range of possibilities (this is particularly true of the discussion in Annex B) than many of our papers customarily do; but that these are introduced not as possible options for action (many of them are wholly impractical) but as

benchmarks of, for example, what one species of neutrality in the tax system might be.

4. Our paper thus differs rather from Professor King's recent paper, which both analyses and sells his proposals for reform. The next stage for us, when we have revised and improved the present paper and when the general shape of the package has further settled down, will be to work up ideas for advocating and presenting the proposals on Budget day and afterwards.

MCS

M C SCHOLAR

RATIONALE AND EFFECTS OF THE TAX REFORM PACKAGE

Introduction

1. This paper analyses the rationale for the tax reforms currently under consideration, and their microeconomic effects. It examines them in the context of the Government's overall approach to taxation and the reforms implemented in previous budgets. The purpose of the paper is both to contribute to the process of decision, and to provide material which may be useful for public presentation.

2. The first section of the paper sets out the underlying aims of the Government's tax policy and the criteria against which the proposed reforms should be assessed. The next section sets the current proposals in the context of the general programme of tax reform undertaken by this Government. Then the paper examines the package as a whole in detail and assesses it against the criteria set out earlier in the paper. The final section considers the likely microeconomic effects.

Aims and Criteria

3. The Government's microeconomic policies are essentially designed to encourage the market system to work more efficiently, encouraging enterprise and freedom of choice. Tax policy has an important role to play in this, though that is not its only role. While bringing taxes down is important, they must be set so as to avoid excessive levels of government borrowing given the priorities for public spending. And the levying of taxes must pay regard to considerations of fairness, equity and administration.

4. Against this general background, the underlying aims of the Government's tax policy are as follows:

(i) **Tax burden and marginal rates.** A central objective of policy to improve the supply side is to bring down the overall burden of tax so that markets, rather than tax considerations, can exert the primary influence on economic decisions. Within this the aim is to broaden the tax base, by eliminating special reliefs wherever possible, in order to reduce marginal tax rates as far as possible.

(ii) **Neutrality**. A related aim is to avoid discriminatory taxation wherever possible. Discrimination distorts the choices faced by taxpayers, and should be confined to cases where there are clear arguments on wider social and economic grounds (eg to promote home ownership or to help small businesses) or where it is desirable to alleviate the effects of imperfections in particular markets. In the latter case there is a presumption that the discrimination should be temporary, in place only until the market can be induced to function more efficiently. Generally the objective should be to produce a "level playing field" for economic agents.

(iii) **Markets**. Taxes which impede the functioning of markets should be reduced or eliminated, while with poorly functioning markets there may be a case for providing incentives - probably temporary - to improve them*.

(iv) **Simplicity**. A more comprehensible, less costly, cumbersome and burdensome tax system is of advantage to both taxpayers and the tax authorities.

(v) **Fairness and Equity**. A variety of criteria are relevant under this heading, including relating taxes to ability to pay and/or to benefits received; ensuring equal treatment of otherwise similar tax units and limiting the scope for artificial avoidance schemes and evasion.

The programme of tax reform and the proposed 1988 measures

5. The measures to be announced in the 1988 Budget will be a continuation of the programme of tax reform undertaken by this Government. A major step was taken in 1984 when Corporation Tax was

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* A distinction must be drawn between alleviation of the effects of market imperfections, as in (ii), and reducing imperfections, in (iii).

radically reformed, but a large number of other tax measures have been taken since 1979. The main ones are summarised in annex A. It will be an important element in the presentation of the 1988 Budget to show how the new reforms carry forward - and are not inconsistent with - the main themes in taxation policy since 1979.

6. At this stage the 1988 reform package is still very fluid, with many options in play or likely to be considered. For the present, however, we focus on the main changes in option B of Miss Sinclair's note of 18 September and the proposed change in the taxation of benefits in kind. The paper does not deal with recent decisions or proposals on convenants and IHT, or with the issue of phasing. The changes considered are as follows:

see separate "scorecard" string.

(i) **Income tax.**

Basic rate reduced by 2p
Abolish higher rates above 35p
Extend basic rate band to £25,000
MIR put on a residence basis at say £40,000 (or £20,000 a person)
Independent taxation of husband and wife from 1990-91

(ii) **NICs**

Abolish employees' UEL
Reduce overall burden of NICs at lower end, particularly for employees

(iii) **CGT**

Charge at new income tax rates, retaining separate threshold (£6600)
Rebase to 1982
Separate threshold for husband and wife from 1990-91

(iv) **Benefits in kind**

Exempt employees from tax on benefits
Impose flat rate tax on value of certain benefits paid by employers

7. The main objectives of the package are to:

- bring down marginal tax rates throughout the range, so improving incentives and reducing distortions.

- simplify the tax structure, removing kinks in the schedule of marginal rates and reducing the number of rates.

- put income and capital gains on a more equal footing.

- provide independence and privacy for married women in tax matters and reduce the tax penalties on marriage.

- counteract the incentive to pay benefits rather than cash by taxing the former more effectively (and efficiently) in the hands of employers.

Assessment

8. The following sections assess the package against the aims and criteria set out earlier.

(i) Tax burden and marginal rates

9. A major objective of the package is to bring down the tax burden and reduce marginal rates. The cuts in basic and higher rates, and the extension of the basic rate band clearly make a major contribution. The NIC changes reduce marginal rates at the lower end. The vast majority of tax payers see a reduction in the combined rate of income tax and NICs they face.

10. The move to independent taxation in 1990 will also help to bring down marginal tax rates. The beneficiaries are couples who are paying higher rates of tax but for whom wife's earnings election is not possible or worthwhile*. At present there is a kink in the marginal tax schedule facing the family, with higher rates charged when joint income reaches a certain level but a move back to the basic rate at somewhat higher incomes. This kink will be removed, with marginal rates on average lower.

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* In practice this means families with total income in excess of about £25 thousand where the wife has only investment income or earns less than around £7 thousand.

11. There are some elements of the package, however, which work the other way. Abolition of the UEL for employees and withdrawal of the married allowance for those liable to higher rate tax will raise marginal rates over the relevant ranges. But only those between the UEL and the present higher rate threshold, and a small number of higher rate taxpayers - in all about 1.3 million tax payers out a total of over 21 million - will actually experience an increase in the combined marginal rate of tax and NIC. The details are summarised in table 1.

Table 1: Combined marginal rates of tax and NIC

Approximate range of Gross annual income (£thousand)*

Tax rates	**0-7**	**7-16**	**16-25**	**25-28**	**28-32**	**32-40**	**40-48**	**48 upwards**
Present	0/5/7/9	36	27	40/45	45	50	55	60
Proposed	**	34	34	34	44	44	44	44
Change		-2	+7	-6/-11	-1	-6	-11	-16
Numbers involved								
Thousands	18,550		1,300	650	50		550	
Percent	88		6	3	-		3	

* Ranges are for a married man with £3000 mortgage interest whose income is all earned. For other taxpayers the ranges corresponding to particular marginal rates may be slightly different.

** Lower rate NICs depend on option chosen.

12. The changes to CGT work in both directions. For basic rate taxpayers, who in 1983-84 (the latest year for which information exists) constituted over half the individuals liable to CGT, the marginal rate will fall from 30% to 25% unless gains are large enough, when added to income, to take them above the higher rate threshold. However for higher rate taxpayers, around two-fifths of individuals liable, the marginal rate of CGT will rise to 35%. The main purpose of the CGT changes is to bring tax on real gains

broadly into line with tax on income - see the section below on neutrality - not to reduce CGT rates.

13. The implications of the proposed employer tax on benefits depend on the coverage of benefits and the rate set. As noted below, there are strong arguments for bringing benefits more effectively into tax by correcting the undervaluation of certain benefits at present, and setting the tax at a high flat rate. Insofar as the total yield of tax on benefits is increased, this in principle permits marginal tax rates generally to be somewhat lower than they otherwise would be.

<u>(ii) Neutrality</u>

14. Various concepts of neutrality are of concern. Subject to the exceptions noted in paragraph 4 - wider social and economic objectives, market imperfections - the aim should be to avoid as far as possible discriminating between:

- different form of income/gain
- different forms of company finance
- consumption and saving

15. Lower tax rates in themselves reduce both the value of tax breaks and special reliefs, and the general disincentives at the margin to work and save inherent in an income tax system. The reductions in income tax which form a major part of the package will thus help considerably to produce a more neutral tax system. Also the way in which marginal rates have been reduced at the top end - by a sharp reduction in higher income tax rates offset by higher NICs above the UEL - will further limit the value of tax breaks because the latter generally run against income tax but not against NICs.

16. The present system implies a clear non-neutrality between **<u>different forms of income/gain</u>**. Income and gains are now taxed at different rates, and the effective taxation of gains is considerably lighter than that of income. The high threshold for capital gains tax, the fact that only real gains since 1982 are subject to tax,

and the deferral of tax until gains are realised all give gains an advantage in tax terms over income. Even if the rates of tax on gains and income were aligned, with gains being added to income for tax purposes, complete neutrality would not be achieved because of these other differences.

17. Alignment of CGT and IT rates will do something to reduce the non-neutrality, however. For basic rate taxpayers whose gains do not take them over the higher rate threshold, CGT will be charged at their marginal rate of income tax; under the present system gains are charged at above the income tax rate. Although deferral of the tax until realisation means that the implicit rate of tax on accrued gains is significantly below the CGT rate when assets are held for long periods, and only small numbers may be involved, this is arguably a slight improvement.

18. Much more important is the greater neutrality achieved by the package for higher rate tax payers. At present there is for them a strong bias in favour of gains: top rate taxpayers currently pay 60% on incomes and only 30% on gains, whereas under the proposed reform both will be taxable at 35%. Even allowing for the implicit rate on accruals generally being lower, this is clearly an improvement.

19. None of the measures considered in this paper deal with the problem of **indexation for inflation**. Alignment of CGT and income tax rates could be achieved with or without indexation. If it were combined with abolition of indexation for CGT purposes, greater neutrality would be achieved in the treatment of interest and gains. But this would make the system <u>less</u> neutral as between different inflation rates. And politically the abolition of CGT indexation would be very difficult, not least because the taxation of gains as income, subject only to the high threshold, would increase the rate of tax faced by many capital gains taxpayers. The alternative approach of indexing other forms of investment income raises much wider issues, which are beyond the scope of this paper.

20. If indexation of capital gains is retained, there is an argument for extending it back to 1965 so that only real gains are taxed, regardless of when the assets were acquired. This would complete the reform begun in 1982. But indexation back to 1965 is not a practical proposition (because of the difficulty with share pools etc). The only practical way of achieving a similar result is to rebase all assets to 1982. This is of course more generous than the mere extension of indexation. Rebasing would thus tend to widen the gap between the taxation of gains and income in the short to medium term, though in the longer run it would become less significant as the proportion of assets acquired before 1982 became less and less significant. By definition people could not acquire assets in order to benefit from rebasing. Overall, a package involving the taxation of gains at income tax rates (with gains added to income), even with rebasing, would ultimately be closer to neutrality than the present regime and would be a definite improvement.

This pressure also applies to businessmen

21. The analysis of CGT and IT rates in the preceding paragraphs applies unambiguously only to gains on assets other than shares, and for windfall gains on shares. It has to be modified to the extent that gains on shares reflect retention of profits on which corporation tax has already been paid. Of course gains don't always reflect post-tax retentions. But where they do, the combined rate of tax - corporation tax <u>and</u> CGT - may exceed the rate of income tax. The changes in the package - reducing the higher rates of income tax and raising the CGT rate for higher rate taxpayers - may produce a bias in favour of income <u>against</u> this form of capital gain for those on higher rates <u>except</u> insofar as CGT is not in fact paid. But while this may be a problem the caveat is important, given the scope - particularly great with shares - for ensuring that total realised gains remain below the CGT threshold.

discuss

22. This leads us naturally to consider the tax treatment of **<u>different forms of company finance</u>**. In this context it is natural also to consider how the reforms in the package relate to those proposed by Mervyn King, since he is primarily concerned with this issue.

23. The present package has not been designed primarily with the issue of company finance in mind, and there is little hard evidence on the effects of the current tax treatment. But inevitably the radical changes being proposed do affect the balance of advantage enjoyed by different forms of finance. Analysis in this area is complex, and a fuller discussion is attached as annex B. But briefly, the package will:

- leave the relative position of interest and dividends broadly unchanged, though widening the gap between the basic rate and the CT rate slightly favours interest.

- diminish somewhat the relative attractiveness of retentions, by bringing down income tax rates on interest and dividends while raising the CGT rate for higher rate taxpayers and those whose gains take them into the higher rate bracket.*

Insofar as individuals can often avoid CGT by keeping realisations below the annual threshold, the reforms produce a clear improvement by reducing top rates of income tax on interest and dividends to broadly the same rate - the CT rate - charged on retentions.

24. The distinctive features of the King proposal, which has the same income tax and NIC rates as in the present package, are:

- taxation of all investment income at a flat rate of 25%
- taxation of investment income (but not gains) of pension funds, also at 25%.

This produces distortions of broadly the same order as the present package, and in both cases a clear improvement on the present position insofar as CGT is often not paid by individuals. The main advantage of the King proposal is that it deals with - or at least aims to deal with - the pension funds, bringing taxation of their income into line with that of other investors. The main disadvantage, however, is that it introduces differential income

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* This may tend to reduce the number of leveraged bids for cash rich companies or companies with readily realisable assets.

taxation of investment and earned income for higher rate taxpayers; investment income is already favoured by abolition of the UEL, and King's flat rate treatment would add to this.

25. In any event neither the King proposals nor the present package achieve full neutrality between different forms of finance. Other - generally impractical - changes would be needed to achieve that, as discussed in annex B. One possibility would be to build on the King proposals, charging his flat rate on investment income at the same rate as CT,and abolishing CGT on shares - he assumes gains are already effectively untaxed. Another possibility would be to retain CGT, charged at income tax rates and with a minimal threshold, remove the exemptions for interest and dividends against CT and bring down the CT rate sharply. These two possibilities are in effect limiting cases which illustrate what full neutrality would mean: as such they provide a useful benchmark against which to judge more practical possibilities.

Jowess

26. If the aim were to reduce distortions further without necessarily achieving full neutrality, this might involve some of the following:

- reducing the CT rate to 25%, so bringing the tax treatment of interest and dividends into line for all taxpayers;

- leaving the CT rate unchanged, but limiting interest deductibility for companies to 25p - ie the basic rate - so as to bring the treatment of interest and dividends into line. Raising the imputation rate to 35% would be a possible alternative;

- reducing or abolishing CGT on shares, so limiting the possible double taxation of retentions;

- abolishing ACT refunds to pension funds.

Jowess

Annex B provides further analysis of some of these possible measures, but clearly all have their difficulties. Nevertheless some might be considered as possible longer term objectives - eg reducing the CT rate to 25% - even though they are not runners at present.

27. The present **tax treatment of saving** is complex. Income tax, CGT and CT provide a disincentive to saving, relative to consumption, for many assets (most liquid assets, gilts, shares). On the other hand some forms of saving are positively encouraged by the tax system - eg housing (MIR, exemption from CGT), pensions, (tax free lump sum), BES (investment deductible, gains exempt). PEPs are effectively free of tax, ensuring equality of pre- and post-tax returns.

28. The package has not been designed primarily with the implications for saving in mind - the effects are largely incidental. With the exception of the new higher rate of CGT, which may increase slightly the disincentive for higher rate tax payers to invest in shares for example, the general effect of the package is to reduce the positive encouragement given to privileged forms of saving and reduce the disincentive to hold non-favoured assets. The average effect on saving incentives is unclear, and is arguably less important than the relative treatment of different forms of saving. By narrowing the range of incentives and disincentives the package will make the tax system more neutral, and so cause less distortion to the pattern of saving. Many commentators will welcome this, though there may be some comment that the Government is now content to grant relatively less favourable treatment to housing and BES than hitherto.

29. A related issue is the relative treatment of investment and earned income. At present they are taxed equally at the margin in the hands of employees, above the UEL. But below the UEL, earned income is taxed at a higher rate, and abolition of the UEL will extend this treatment throughout the income distribution. The defence of this change is that investment income can be seen as deferred income which has already been subject to tax: taxing both saving and the returns on it implies discrimination in favour of consumption against saving. The proposed treatment is some way short of the full expenditure tax treatment favoured by some.

30. Finally the proposed employer tax on benefits in kind alters the relative treatment of cash and benefits. In principle both are currently taxed at marginal income tax rates. But in practice undervaluation of certain benefits means they receive more favourable treatment, as also does the exemption of benefits from NICs. The new tax offers scope for redressing the balance, depending on the precise rate chosen. But the fact that the tax would be charged at a flat rate means that the balance of advantage would vary with income, discouraging benefits less at the higher incomes than at low incomes, and thus introducing a new form of non-neutrality.

(iii) Markets

31. There are no measures in the package designed specifically to improve the functioning of markets - as, for example, with the reductions in stamp duty in 1984 and 1986, and the tax concession to PRP in 1987. But by reducing tax rates the package in effect means that economic decisions will tend to be based more on market signals and less on the tax system.

(iv) Simplicity

32. Moving to a two rate income tax structure - three rates when the married allowance is withdrawn above the higher rate threshold - gives a significantly simpler structure of tax rates, though the administrative savings are relatively slight. Similarly, abolition of the UEL for employees is a simplification, bringing the basis of employer and employee contributions closer into line and ensuring that the marginal rate of NICs is constant above £155 per week. The overall effect of the changes is to eliminate the kink in the combined income tax/NIC schedule between the UEL and the higher rate threshold, significantly smoothing out the profile of marginal rates and hence the pattern of incentives.

(but may have hump!)

33. The new employer tax on benefits in kind may also be a move in the direction of simplification; it will clearly be simpler for employees, and should be easier for Inland Revenue to collect than the present tax on employees, but it is not yet clear whether it will represent a significant extra burden for employers. The move to independent taxation of husband and wife, however, will undoubtedly make the system more complicated, both for the Revenue (who will require large numbers of extra staff) and for those married women who previously had no dealings with the Revenue.

34. The introduction of two separate CGT rates, plus rebasing, is also a move to greater complication. However it should not result in significantly greater administrative complexity. Bringing tax rates on gains and income closer into line has its own advantages in terms of simplicity and comparability.

35. The main advantage of the package is that the tax system should become easier to understand, and the pattern of incentives more clear. But whether they make compliance more or less difficult on balance is uncertain. Different categories of taxpayer - persons, companies, wives, etc - will be affected differently. As far as administration is concerned it is certainly not obvious that there will be any net gain. Further work on these two issues is needed.

(v) Fairness and equity

36. The present tax system relates tax liability very clearly to the ability to pay: a proportionate tax system would do this, but a graduated system with rising marginal rates (from zero at the bottom end to 60p at present) makes the relationship stronger. The problem is to choose a degree of graduation - or progressivity - which is fair, in the sense of ensuring a sufficiently strong relationship between tax and ability to pay, while minimising the disincentive effects resulting from high marginal rates.

how defined?

37. We retain a graduated system, as other countries do, but the incentive argument points to the need for reductions in the higher

marginal rates. The top rate in the UK at present is well above that in the US, and in many other successful countries (Japan, France and Italy, for example) higher rates are generally below ours except right at the top of the income distribution. The success of these economies - and especially the US and Japan - may well owe a good deal to low rates of tax at the upper end. The package therefore brings the top UK rate down to broadly the US level, while at the same time extending graduation to CGT.

not quite!

38. Another major objective of the proposed reforms is to give married women a fair deal in tax matters and to remove or alleviate the tax penalties on marriage. The move to independent taxation in 1990 should contribute to both these objectives. It will give married women greater privacy and independence in tax matters and ensure that their tax status, including the marginal rate they face, reflects their own circumstances rather than their husband's.

39. Putting MIR onto a residence basis would remove the privileged treatment currently available to unmarried couples and those in house sharing arrangements, and thus alleviate a tax penalty on marriage. Phasing out the married allowance above the higher rate threshold is a natural accompaniment to independent taxation: high earners are the main beneficiaries of the latter, and the married man's allowance is somewhat anomalous in a system of full independence.

40. The abolition of the employees' UEL and the changes at the lower end alter the relation between NIC contributions and benefits, and so have implications for the contributory principle. The essential principle remains intact: a record of contributions is required in order to establish entitlement to benefits. But it will now, for the first time, be possible for employees to pay additional NICS without increasing their entitlement to benefits. However the relationship between the size of contributions and benefits for different individuals has already evolved over time. The proposed changes continue this process, with the higher paid paying more and the lower paid paying less, and the NI fund running a surplus at present to reflect the demographic and other factors tending to raise benefits relative to contributions in the longer term.

impt: discuss

41. Finally, the new employer tax on benefits in kind should promote a more equal tax treatment of benefits and cash. But it may nevertheless give rise to complaints about lack of fairness. Employers may regard it as unfair since they have to pay the tax; and employees not receiving "tax free" benefits may also regard the new regime as unfair. However in the longer term the formal incidence of the tax may not matter too much, because levels of gross remuneration will tend to adjust. Complaints about fairness of the new tax, if they arise, will thus largely reflect problems of perception.

Microeconomic effects

42. This section discusses in broad terms the microeconomic effects of the proposed package. The main areas covered are:

i) work incentives
ii) distribution of earnings and benefits
iii) saving
iv) other effects.

43. But before discussing the effects in particular areas it is important to note the overall impact of the package. The main point is that lower taxes, and in particular lower marginal rates, will reduce distortions generally throughout the economy. Incentives to tax avoidance, and the creation of special schemes to exploit loopholes and tax breaks, will be reduced. The allocation of resources and finance will reflect underlying market considerations more closely. The economy will thus benefit from increased efficiency, so improving supply performance and economic welfare.

(i) Work incentives

44. The reduction in taxes as a result of the package should produce favourable effects on work incentives and enterprise in the longer term. The main benefits are likely to arise from a

strengthening of the enterprise culture in the economy, perhaps taking the form of changes in career choice, and increased investment in knowledge and skills. These benefits may take a good deal of time to come through fully, and partly as a consequence there is little direct empirical evidence on their likely scale. But cross country comparisons - for example the relative economic success of the US and Japan - suggest that they may have a powerful and pervasive effect.

45. Changes in incentives in the short term will reflect both income and substitution effects, and hence the changes in both marginal and average tax/NIC rates - illustrated in Chart 1. The reduction in marginal rates will have beneficial substitution effects, increasing the attractiveness of work at the margin and thus raising hours worked and participation rates. But any package of tax cuts will have income effects which work in the opposite direction: to the extent that incomes are increased - ie average tax rates reduced - the incentive to work may be diminished to some degree (although it may be that, in the longer run at any rate, people have a propensity to enjoy unlimited increases in income).

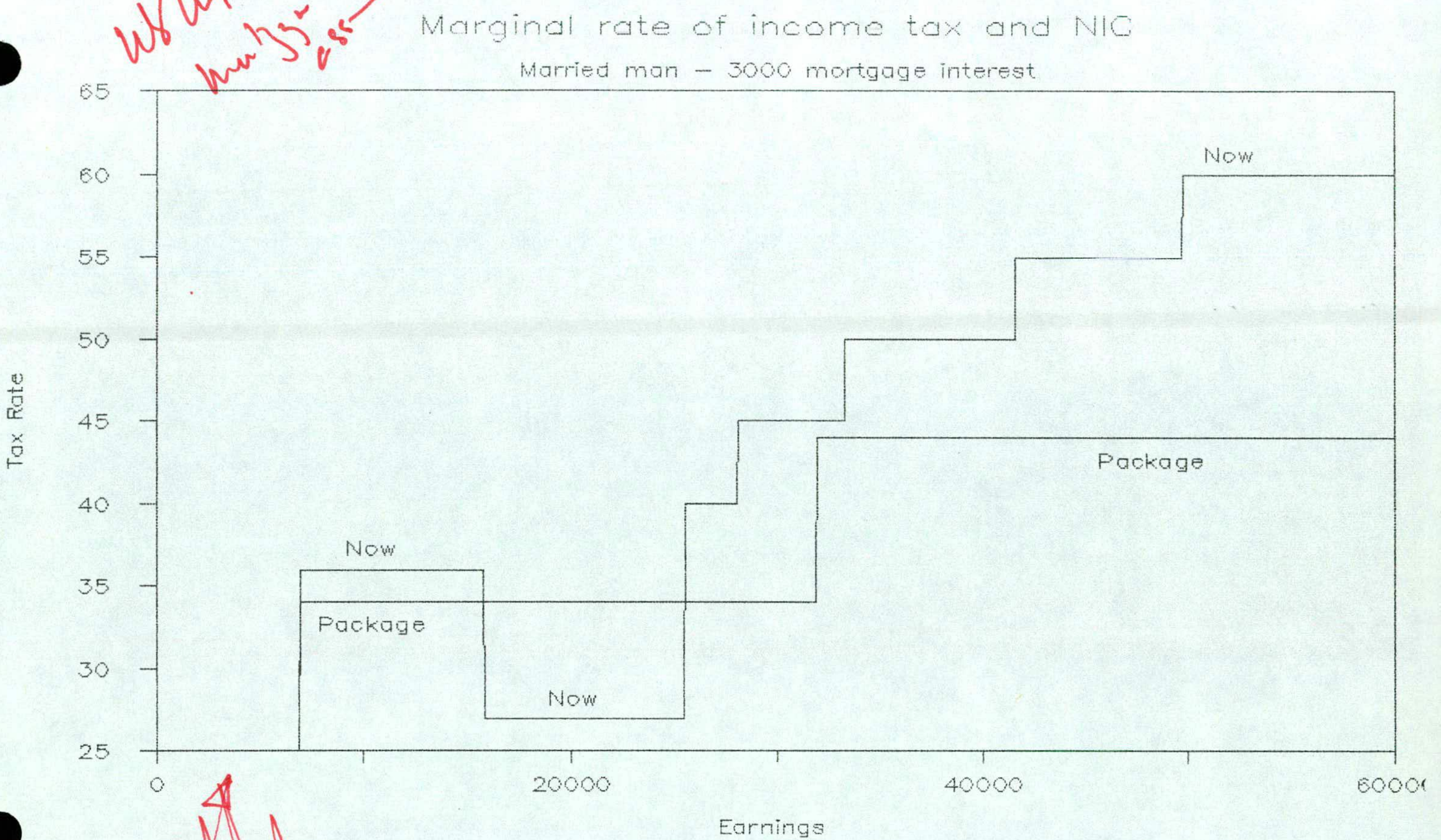
Prof Brown!

[illegible]

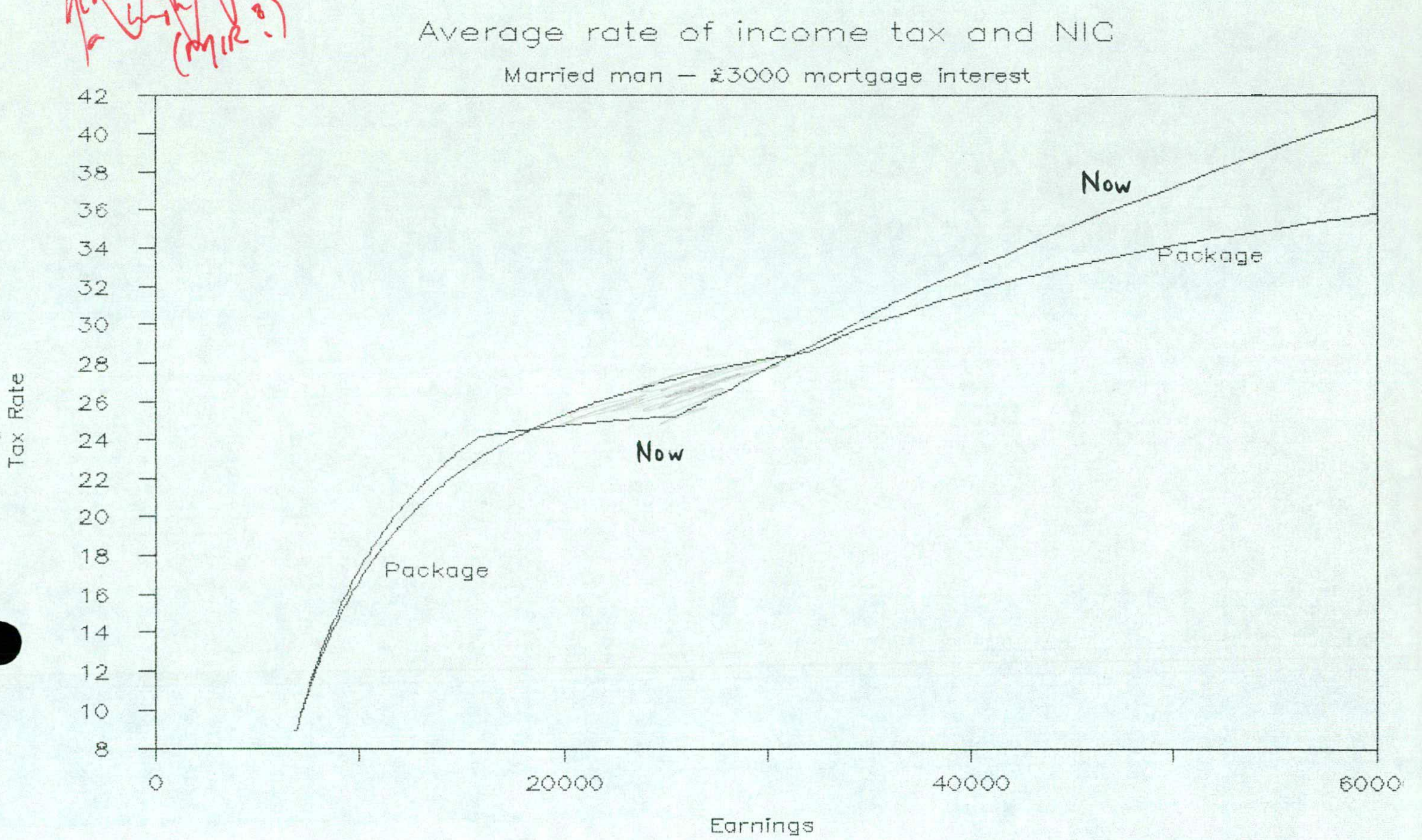
46. The available research evidence suggests that tax changes may have little short term effect on hours worked in existing jobs by male breadwinners; in the case of tax cuts, adverse income effects are sufficient broadly to offset the beneficial substitution effects. But there is evidence of rather greater short term effects on the hours and participation of married women, with tax cuts leading to significant increases.

47. There may be significant effects on relative incentives to work at different points of the income distribution. The main effects are likely to arise where average and marginal tax rates change in opposite directions, because in this case both income and substitution effects will work in the same direction. Where a cut in marginal rates is accompanied by higher average rates there is likely to be a more significant positive effect on work incentives, and conversely for higher marginal rates. The income ranges

CHART 1



Marginal rate of income tax and NIC
Married man — 3000 mortgage interest
Tax Rate
65
60
55
50
45
40
35
30
25
0
20000
40000
60000
Earnings
Now
Package
Now
Now
Package



Average rate of income tax and NIC
Married man — £3000 mortgage interest
Tax Rate
42
40
38
36
34
32
30
28
26
24
22
20
18
16
14
12
10
8
0
20000
40000
60000
Earnings
Now
Package
Now
Package

affected can be seen from the chart. On the basis of the current package there are some 920 thousand taxpayers affected in this way:

- those losers with incomes above the current higher rate threshold whose marginal tax rate falls substantially. This group will experience a relatively strong positive effect on incentives; about 190 thousand taxpayers are involved.

- some people in the NIC kink whose marginal rate is raised by 7 points because of UEL abolition but who are net gainers because of the cut in the basic rate (ie those earning up to about £20 thousand, depending on their allowances).* The effect on incentives for this group is likely to be significantly adverse, and roughly 730 thousand taxpayers are affected.

48. For most people, however, both average and marginal tax rates will fall and, as already noted, the net effect on work incentives for them in the short term may be relatively small. We are not in a position to quantify the overall effects with any confidence: the models that we have suggest that in aggregate the income and substitution effects will broadly cancel each other out. But in the longer term we would expect to see the wider benefits predominating.

49. One important point worth noting is that tax cuts which take the form of lower marginal rates can be expected to have better effects on incentives than cuts of the same average size which leave marginal rates unchanged - apart, that is, from the effects on the traps (see below). Thus the concentration in the present package on reducing marginal rates should produce relatively favourable effects.

---

* There will also be some in the kink who face both higher marginal rates and higher average rates, and the net effect on their incentives is likely to be muted.

50. The package will reduce the number of families in the poverty and unemployment traps. The numbers in the <u>unemployment trap</u> (those with replacement ratios of 80% or more) will fall by around 60 thousand , made up of 25-30 thousand as a result of the NIC changes, and a similar number as a result of the cut in the basic rate. The number in the <u>poverty trap</u> (those with marginal rates of 70% or more) will fall by around 50 thousand, mainly reflecting the cut in the basic rate. But the social security reforms coming into effect in April will themselves <u>raise</u> the number in the poverty trap by over 200 thousand. So even after the present tax package there will be more families with high marginal rates than at present.

but slope of traps less steep

51. The move to independent taxation in 1990 will affect work incentives for some wives - ie those whose income is at present (or would be) subject to higher rates of tax but for whom wife's earnings election is not worthwhile (see paragraph 11). About 300 thousand wives currently working will be affected, and both hours of work and participation rate can be expected to increase for the class of married women affected. However we have no way of quantifying the scale of the effects.

<u>(ii) Distribution of earnings and benefits</u>

52. There has been a good deal of analysis of the likely impact on post-tax incomes of the various measures making up the package - see, for example, Mr Mace's note of 29 September on the income tax and NIC changes. These generally assume that pre-tax incomes are unchanged, but in the longer term this is unlikely to be a valid assumption. The distribution of earnings (and hence also of employment) will tend to change, mirroring the incentive effects discussed in the previous section. However these effects on relative earnings are likely to be pretty small; a potentially much greater shift is likely to occur between payment of income and benefits in kind for different groups of employees.

53. Abolition of the UEL on employee contributions will strengthen the incentive (for both employers and employees) to provide remuneration in the form of benefits rather than cash. But insofar as benefits can be taxed more effectively through the employer than in the hands of the employee, an employer tax will provide an incentive to switch out of benefits in kind into cash. However both the overall effect and the pattern of effects will depend crucially on the tax rate to be set on benefits.

54. The effect of any given tax regime depends on whether benefits in kind are an economically efficient, as distinct from merely tax efficient, form of remuneration - eg because the employer can provide benefits in kind relatively cheaply because of economies of scale. But other things being equal, the higher the new tax rate the less the incentive to give benefits. In any event, a flat rate of tax will make benefits <u>relatively</u> less attractive at lower incomes than at high incomes.

55. If the tax rate is set relatively high, there will be a tendency for pay to rise relative to benefits for those on low incomes. Conversely if the rate is set fairly low, there will be a strong incentive for high earners to take income in the form of benefits rather than cash. The overall responses will depend on the relative bargaining strengths of employers and employees in the sectors concerned.*

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* Assessment of the incentive to pay benefits rather than cash for different categories of taxpayer is complicated. It is necessary to compare the new rate of employer tax, allowing for any CT offset, with the total of income tax, employee NICs, and employer NICs (net of CT) payable on cash remuneration. Calculations have been done on the assumption that payments of the new tax are <u>not</u> deductible against CT, and the rate of tax is expressed as a percent of net benefits in the hands of employees. They suggest that a rate of about 65% would be necessary to make the system neutral as between benefits and cash for higher rate (35p) taxpayers, while discriminating against benefits for basic rate taxpayers. A rate of 45% would be neutral for basic rate taxpayers, but would strongly encourage benefits in kind for higher rate taxpayers.

Politically tricky: discuss (one of two, or three Ans/w2)

56. Finally, the relative attractiveness of payment in the form of share options will be diminished as a consequence of the package. One of the main attractions of share options, particularly for higher rate taxpayers, is that capital gains are taxed less than cash income. The alignment of CGT and income tax rates will reduce this attraction to some degree, perhaps reducing the use of share options in the longer term. But to the extent that the tax advantage remains (eg for those who do not pay CGT) and there are other attractions, this effect is likely to be small.

(iii) Saving

57. Table 2 gives some (stylised) illustrations of how tax wedges between gross and net returns vary with tax rates for a number of the main savings media. As already noted, the main effect of the package is to reduce the absolute size of tax wedges for different forms of saving, and so narrow significantly the range of incentives and disincentives. The relativeness attractiveness of different forms of saving will therefore change, though by how much will depend on how pre-tax yields change as the market adjusts to the new tax regime. There is a presumption that the narrowing of tax incentives will be partially offset by movements in gross yields.

58. It is not possible to say much about the likely effect on the pattern of saving. The tax cuts imply some switching out of - or less switching into - privileged assets, such as BES, pensions and owner occupied housing, because taxed assets become relatively less unattractive. But we have insufficient evidence to assess the scale of the shifts that are likely to occur.

59. There are some important links with policy action in other areas:

i) Forestry. If this were to be exempt from tax, and support given via grants so as to maintain net returns at present levels, then this form of privileged investment would become more attractive relative to others currently enjoying substantial tax breaks (eg BES).

?

True, whether, whatever, than @ present, but more attractive?

TASK FORCE SECRET

TABLE 2

TAX WEDGES ASSUMING 10 PER CENT NOMINAL RETURN AND 5 PER CENT INFLATION

(35% higher rate)

	Tax Rates 25	27	35	60
Building Society	2.13	2.29	3.13	5.59
Gilts issued at par	2.50	2.70	3.50	6.00
Low coupon gilts (1)	1.00	1.08	1.40	2.41
Indexed Gilts (2)	0.75	0.81	1.05	1.80
Life Policy (income)	3.50	3.50	3.50	3.50
Life Policy (C.G.)	1.75	1.75	1.75	1.75
Shares (for income)	2.50	2.70	3.50	6.00
Shares (Current CGT)	0.00	0.00	1.50	1.50
Shares (New CGT) (3)	0.00		1.75	
PEP	0.00	0.00	0.00	0.00
Housing,30% Mortgage, rates 1% of capital value	0.36	0.27	-0.07	-1.14
Housing,30% Mortgage,no rates	-1.07	-1.16	-1.50	-2.57
Pension - 40 years	-0.22	-0.24	-0.35	-0.88
Pension - 10 years	-0.88	-0.98	-1.40	-3.56
Pension - 10 years (4) (pensioners pay basic rate)			-2.48	-7.86
BES	-6.51	-7.15	-9.90	-22.12

(1) assuming a 3% coupon on a five year gilt
(2) assuming 3% of the real return comes as income and 2% as capital gain
(3) CGT at income tax rates
(4) assuming people pay the higher rate tax whilst working and the basic rate once retired

All figures neglect trading costs and stamp duty and assume that only higher rate tax payers are liable for CGT.

Pension calculations assume a tax-free lump sum of 25%

BES and PEP calculations assume that the investment is held for the relevant qualifying period.

ii) Housing. In broad terms, the reduction in income tax rates will mean increased housing costs for owner occupiers except those who benefit from an increase in the mortgage ceiling. This may put downward pressure on house prices. The reduction in income tax rates will increase the net return to renting, but the returns on alternative investments may also rise. So no great increase in the supply of houses to rent can be expected. Overall the market for rented housing is unlikely to be much affected on either the supply or demand side.

60. The effect on aggregate saving is difficult to judge. Abolition of the UEL extends the tax advantage enjoyed by investment income higher up the income distribution, which could encourage increased saving. However, the overall incentive to save is also affected by the changes in income tax rates and CGT, but the different tax treatment of different savings media, (illustrated in table 2), means that the net effect on aggregate saving is unclear. On balance, in the absence of particular measures to encourage or discourage saving, it seems best to assume that aggregate saving will be little affected.

(iv) Other effects

61. Effects of the package are likely to be felt in a number of other areas:

i) Capital gains. CGT changes will have wide ranging effects, which depend considerably on whether there is rebasing. Some - the effects on saving, the relative attractiveness of gains and income - have already been touched upon. But an important side-effect of the changes is to alter the attractiveness of realising existing gains. The effective rates of tax on those gains under the new regime depend on the type of asset, the date of purchase, the size of disposal, and the income tax position of the holder. But while it is not possible to generalise, the net effect with rebasing is likely to be some short term increase in realisations, and hence some implications for CGT revenue. In addition there is likely to be some long term effect on holding periods and the rate of realisations. And in the very short run, immediately after the announcement, there is likely to be forestalling.

The issues here are very complex, and the scale of revenue and other effects extremely uncertain. They depend also on the precise regime chosen. A separate paper, which will take into account the data now becoming available, is in preparation for submission in November.

ii) Profit related pay. The tax incentive granted to PRP in the 1987 Budget will be worth less after the reduction in marginal income tax rates. And at the same time fluctuations in after-tax pay in PRP schemes will be greater; not all PRP is tax exempt, and so net pay will vary more for any given change in gross pay. If anything this will tend to hold back the spread of PRP very slightly, though the tax incentive is still substantial.

iii) Company finance. The reduction in the relative attractiveness of retentions (see paragraph 23) will probably lead to some increase in dividend payments, and possibly some increase in debt financing. It is very difficult to put figures on the scale of these effects.

iv) Small companies. A number of influences are relevant here. A reduction in the small companies CT rate, accompanying the basic rate reduction, will clearly be of benefit. But the somewhat reduced attractiveness of BES may result in some reduction in the supply of capital to small firms. The net effect is difficult to discern.

Surely CT rate much more important?

v) Charities. There are offsetting influences once again. Higher net incomes may mean an increase in charitable giving, but the tax relief on donations will be worth less. The net effect is unclear.

Conclusion

62. No package of tax changes can in practice score well against all the criteria of desirable tax reform. It is a question of weighing clear benefits in some areas against possible costs in others.

63. The present package yields a number of important benefits:

- Marginal rates of tax and NIC are brought down for the vast majority of taxpayers, and particularly at the top end. This will be good for incentives and reduce distortions in the labour and savings markets.

- Alignment of CGT and income tax rates will reduce (but not eliminate) the tax advantage enjoyed by capital gains, particularly for higher rate taxpayers.

- The structure of tax and NICs is simplified considerably, with the number of different rates reduced and the 'kinks' in the present schedule largely eliminated.

- The reforms will result in greater neutrality between different forms of company finance as long as individuals do not pay CGT (but 200,000 (individuals and trusts) do pay CGT).

- Independent taxation will give married women independence and privacy in tax matters. Both this and changes in MIR will reduce the tax penalties on marriage.

- Benefits are brought more effectively into tax, and the artificial incentive to switch from income to benefits is reduced.

64. But there are also some disadvantages:

- Marginal tax rates are raised for some taxpayers, for example between the UEL and the present higher rate threshold.

- Abolition of the UEL for employees arguably strains the credibility of the contributory principle for National insurance.

- Independent taxation imposes additional compliance and administrative costs.

65. Inevitably the package does not solve all the problems of the tax system:

- It does nothing to alleviate the present asymmetric treatment of inflation, with gains indexed but interest unindexed. Significant differences remain in the tax treatment of income and gains.

- Dividends, interest and retentions are still treated somewhat unequally for tax purposes; the treatment of company finance thus remains some way from full neutrality.

- The flat rate of employer tax on benefits means that benefits still receive a relatively more favourable treatment at high incomes.

66. The main microeconomic effects of the package are:

- an improvement in the efficiency of the economy, with better allocation of resources and finance

- an improvement in work incentives, especially in the longer term. The effects are likely to be greater than for a package of similar size which left marginal tax rates unchanged

- some slight change in the relative pattern of incentives, and some offsetting changes in relative pay

- changes in the extent and pattern of payments of benefits in kind, the precise effects depending on the tax rate set on benefits

- some switching between savings media, particularly by higher rate taxpayers, but probably little effect on aggregate saving. Some consequential changes in relative rates of return.

- some reduction in the tendency for higher rate tax payers to invest for capital gains rather than income

- a reduction in retained earnings, increased dividend payments and perhaps some increase in debt financing.

ANNEX A: MAIN TAX CHANGES SINCE 1979

1979 Basic rate of income tax reduced by 3p, top rate reduced from 83p to 60p, higher rate threshold increased in real terms and higher rate bands widened, all to improve incentives.

VAT rates raised from 8 and 12½ per cent to 15 percent to finance income tax cuts. Switch from direct to indirect also to give individuals greater freedom of choice.

Personal allowances raised in real terms to help alleviate disincentives to work at the lower end of the income scale - the poverty and unemployment traps.

Threshold for investment income surcharge raised to reduce discrimination against saving.

1980 Lower rate band of income tax abolished, simplifying the income tax system.

All-employee savings related share option schemes introduced to encourage wider share ownership and employee participation.

1981 Business Start-up Scheme introduced to help make financing more readily available to small firms - to fill the 'equity gap'.

1982 Capital gains tax. Indexation of post-March 1982 capital gains in order to limit taxation to real gains and exempt inflationary gains, to help encourage share ownership.

MIRAS scheme announced, simplifying the income tax treatment of mortgage interest relief.

National Insurance Surcharge reduced from 3½ to 2½ percent. First step in abolition of 'tax on jobs'.

1983 Personal allowances raised in real terms to help traps.

Business Start-up Scheme replaced by Business Expansion Scheme.

1984 Personal allowances raised significantly in real terms to help traps.

Reform of corporation tax. Initial investment allowances replaced by writing down allowances, and the main rate of CT reduced in annual stages from 52% to 35%. Stock relief and NIS abolished. The main objectives of the reforms were to reduce the discrimination against labour and between different forms of investment and finance inherent in the pre-1984 system and, by increasing post-tax profitability, to stimulate potential output via the supply side.

Stamp duty halved, in order to reduce the cost of transactions in equities and houses.

Life assurance premium relief abolished in order to limit the privileged treatment of institutional investment.

ANNEX A: MAIN TAX CHANGES SINCE 1979

Investment income surcharge abolished, to reduce discrimination against saving.

Composite rate tax on banks, introduced in order to ensure fairer competition with building societies.

VAT base extended to include hot take-away food and drink and building alterations.

1985 Personal allowances raised significantly in real terms.

Restructuring of NICs. Lower contribution rates at the lower end combined with abolition of the upper earnings limit for employers. The changes were designed to help employment at the lower end.

Development land tax abolished. The tax acted as a disincentive to bringing forward of land for development.

Indexation of Capital Gains on assets acquired before 1982 taken from March 1982 value.

1986 Basic rate of income tax reduced by 1p to improve incentives.

Capital transfer tax abolished on lifetime gifts in order to eliminate the 'locking in' of assets, particularly family businesses, which acted to the detriment of business efficiency.

Pension fund surpluses. Measures taken to limit the surpluses of pension funds in order to prevent companies exploiting for their own purposes the tax privileges accorded to pensions.

Stamp duty halved on share transactions.

Personal equity plans introduced. This scheme exempts returns on shares from tax, up to a limit, so reducing the general bias of the tax system against saving and encouraging wider share ownership.

1987 Basic rate of income tax reduced by 2p.

Profit related pay. Half of PRP payments under qualifying schemes, up to a limit, exempted from income tax. The aim is to improve the functioning of the labour market by encouraging a closer relationship between pay and market conditions.

VAT on small businesses. Simplification of collection procedures and raising of exemption limits.

Pensions. Tax measures to encourage greater flexibility of pensions in order to enhance pension portability and so improve labour mobility.

Companies; capital gains taxed at same rates as income instead of 30%.

SCF p6, (c) & (d)

ANNEX B: NEUTRALITY BETWEEN DIFFERENT SOURCES OF COMPANY FINANCE

1. The present tax treatment of alternative forms of company financing - interest, dividends and retained earnings - is set out in summary form below. For simplicity investment, depreciation and inflation are ignored, and CGT is treated as a tax on accruals.

Interest

Income tax (IT) paid by recipient (basic and higher rates)

Fully deductible against CT.

Total equivalent to tax at recipient's marginal IT rate.

Dividends

CT paid by company (ACT offset against MCT)

Recipient pays (or receives) difference between marginal IT rate and the imputation (ACT) rate on the grossed up dividend

Total equivalent to tax at CT rate plus the difference between marginal IT rate and ACT rate grossed slightly down*

Retentions

CT paid by company

CGT paid by recipients on the net (of CT) retention**

Total equivalent to tax at CT rate plus the grossed up CGT rate.

2. It is evident that at present the tax system does not treat the different sources of finance equally:

ANNEX B: COMPANY FINANCE

- dividends are more highly taxed than interest because the CT rate (35%) exceeds the imputation ACT rate (25%), though both are subject to higher rate IT;

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* The higher rate margin is grossed down slightly because the dividend is paid after deducting CT and grossed up at a lower rate - the imputation rate.

** Throughout this note it is assumed that retentions are reflected one-for-one in share prices, though in practice the relationship may be less than one-for-one.

- tax on retentions differs from that on dividends insofar as the effective rate of CGT paid differs from the gap between marginal rates and the basic rate.

3. Total tax rates for different categories of investor and finance are summarised below on the basis of both present tax rates and the current proposals (with a 35p higher rate).

	Basic rate tax payers	Higher rate tax payers	Exempt tax payers
Present tax rates			
Interest	27p	up to 60p	-
Dividends	35p	up to 64p	11p
Retentions*	55p(35p)	55p(35p)	35p
Current proposals			
Interest	25p	35p	-
Dividends	35p	44p	13p
Retentions*	51p(35p)	58p(35p)	35p

* Figure in brackets is the rate applicable below the CGT threshold

4. The current proposals do not lead unambiguously towards greater neutrality:

i) The reduction in higher rates in principle gives rise to a bias against retained earnings, insofar as they face a combined CT/CGT rate broadly in line with present (higher) tax rates

ii) Reduction in the basic rate slightly increases the bias against dividends, because the differential against the CT rate widens.

iii) The introduction of a higher CGT rate increases the bias against retentions for those subject to the higher rate.

but

iv) The introduction of a lower CGT rate reduces the potential bias against retentions for those paying the basic rate..

v) Where CGT is not paid in practice, because of the high threshold, the reduction in higher rates reduces the bias in favour of retained earnings.

5. Insofar as CGT is not actually paid, the package leads to a clear improvement, though some distortions would still remain. There are essentially two ways to produce full neutrality:

option A

- Charge a flat rate of income tax on all investment income, at the same rate as CT (whatever that may be)
- Abolish CGT on shares

option B

- Make interest non-deductible against CT
- Disallow ACT as an offset to MCT
- Charge CGT at marginal IT rates

6. Option A ensures that all forms of finance are taxed at a flat rate equal to the CT rate. Option B ensures neutrality by charging all forms of finance to both CT and income/gains tax. The total tax rates for different categories of investor under these options are set out below.

	Basic rate tax payers	Higher rate tax payers	Exempt tax payers
Option A*	25p(30p)	25p(30p)	-
Option B**	51p(33p)	58p(42p)	35p(10p)

* Figures assume both the CT rate and the flat rate of tax on investment income set at 25p (30p)

** Figures in brackets assume that CT is charged at 10%.

7. Option A is close to that proposed by Mervyn King. (He assumes that the rate of CGT is effectively zero for many taxpayers because of its separate threshold, but his flat rate on investment income is not equal to the CT rate.) While it ensures neutrality between different forms of company finance, it introduces discrimination in income tax between investment and earned income. How expensive this option would be depends on where the common CT/investment income tax rate was set: at 25p there would be a significant loss of CT and IT; at 30p (say) the cost would be less, with lower revenue from CT and higher rate taxpayers but higher revenue from basic rate taxpayers.

8. Option B gives neutrality in principle only if CGT is actually paid, and this suggests it would be necessary to reduce sharply or abolish the separate CGT threshold. To achieve complete neutrality it would also be necessary to charge CGT on accruals rather than, as now, on realisations, and abolish indexation. On these grounds it may be ruled out as a practical possibility. But it retains a degree of progression in the tax treatment of investment income, and avoids the discrimination between investment and earned income in option A. It would also cost less/yield more than option A.

9. The cost/yield of option B depends crucially on the rate at which CT is set: loss of revenue due to lower rates would be partially offset by the non-deductibility of interest and dividends against MCT, and reduction/abolition of the CGT threshold. Marginal tax rates would remain high unless the CT rate was brought down very sharply: a CT rate of 10p would yield roughly the same marginal rates for all forms of finance as the current proposals yield for dividends.

10. Option B imposes a penalty on incorporation, since corporate returns would be taxed more heavily (via CT) than returns to unincorporated businesses. The logic of this option, taken on its own, would thus point to the ultimate abolition of CT, though this is not necessary to achieve neutrality between different forms of finance. If CT were not abolished it would be desirable to

reintroduce 100% initial investment allowances in order to offset the impact of removing deductibility on the cost of capital.

11. Neither option A nor B may be considered feasible or desirable in practice. It is therefore helpful to consider less radical options which would produce greater, if not perfect, neutrality. There are a number of possibilities in principle, each with its own advantages and disadvantages:

(i) abolish CGT on shares.* This would reduce the potential bias against retentions.

(ii) reduce the main CT rate to 25%. This would eliminate the bias against dividends and, if CGT were also abolished, retentions.

(iii) limit interest deductibility to the basic rate (25p), with the CT rate remaining at 35%. This would bring the tax treatment of dividends and interest into line.

(iv) raise the imputation rate to 35%. If ACT were not refunded to basic rate taxpayers this would amount to a flat rate tax of 35p on dividends.

The total tax rates under these options are shown in the table below.

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* And CT on company gains on shares.

	Basic rate tax payers	Higher rate tax payers	Exempt tax payers
Abolish CGT on shares			
Interest	25p	35p	-
Dividends	35p	44p	13p
Retentions	35p	35p	35p
Reduce CT rate to 25%			
Interest	25p	35p	-
Dividends	25p	35p	-
Retentions	44p(25p)	51p(25p)	25p
Limit interest deductibility to the basic rate			
Interest	35p	44p	-
Dividends	35p	44p	13p
Retentions	51p(35p)	58p(35p)	35p
Raise the imputation rate to 35%			
Interest	25p	35p	-
Dividends	35p	35p	-
Retentions	51p(35p)	58p(35p)	35p

C

D

12. The main disadvantage of abolishing CGT on shares, apart from the loss of revenue, is that capital gains due to factors other than retentions - such as improved trading conditions or better management - would be untaxed. Windfall gains and loss would accrue fully to shareholders, thus increasing their exposure to changing conditions. Avoidance could well be a problem, since there would be a strong incentive to securitise assets to get the CGT exemption.

13. The main problem with reducing the CT rate to 25p is that it would be very costly. The 1984 reforms will themselves tend to reduce CT revenue in the longer term, setting aside their supply-side effects, as writing down allowances build up again at the new (lower) CT rate: a further reduction in the rate would be less costly than if it were implemented now, but the baseline would be lower.

CH REPLY 19/10

psl/27A

CONFIDENTIAL

PWP

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

19 October 1987

The Rt Hon John Moore PC MP
Secretary of State for Social Services
Department of Health and Social Security
Alexander Fleming House
Elephant and Castle
LONDON SE1 7RE

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Kemp
Mr Monck
Miss Peirson
Mr Scholar
Mr Turnbull
Mr McIntyre
Mr Mowl
Mr Gibson
Mr Macpherson
Mr Cropper
Mr Mace - IR

Dear John

NATIONAL INSURANCE CONTRIBUTIONS: 1988-89

Thank you for your letter of 14 October.

I am content with your proposals. I would, however, like to suggest one further measure we might take. This would be to increase the NHS allocation by the maximum amount permitted under current legislation. This would not of course affect the contribution rates nor the total amount of money to be spent on Health. But it would result in a helpful reduction in the projected surplus in the National Insurance Fund of the order of £350 million, which would more than offset the effect of the zero Employment Protection Allocation which Norman Fowler is seeking. You may recall that we did this last year, and it did not give rise to any comment.

I also agree with your proposals for the handling of the announcement, namely that the main changes should as usual form part of my Autumn Statement and that you should make a more detailed statement in a Written Answer on the same day.

I am sending copies of this letter to the Prime Minister, Norman Fowler and Tom King and also to Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

35/1 5106/045/ejb

PS/CHX
12/2
(for information)

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

John Maples Esq MP
House of Commons
LONDON
SW1A 0AA

October 1987

Thank you for your letter of 22 September to Nigel Lawson expressing your views on tax reform.

I have read your comments with great interest and I can assure you that they will be carefully considered in the run-up to the Budget. However, I hope you will understand that I cannot comment further at this stage.

NORMAN LAMONT

John Maples M.P.

HOUSE OF COMMONS
LONDON SW1A 0AA

285

HM TREASURY – MCU
REC'D 25 SEP 1987
ACTION
capall
LR

PSJ
25/10/87

22nd September 1987

Rt.Hon. Nigel Lawson, M.P.,
The Chancellor of the Exchequer,
H.M.Treasury,
Treasury Chambers,
Parliament Street,
London, SW1P 3AG

Dear Nigel.

You asked for any thoughts we might have on tax reform for the budget.

1. The gradient of the higher rates is now far too steep and with a 25p basic rate will go straight from 25% to 40%.

2. If the maximum rate of tax is to be reduced during this parliament, it should be done sooner rather than later.

3. I understand that very few "overfunded" pension schemes are actually making 'repayments' to the employers concerned. Actuaries are usually able to justify the excess and coupled with the 40% applicable tax on the refunds, which cannot be set off against losses, it is not surprising if few companies make them.

Might it be worthwhile allowing capital investment in plant and machinery against such refunds as a way of encouraging them? This could be a one-off measure so as not to interfere with the general system of capital allowances.

As much of the pension overfunding is in the manufacturing sector this would have the doubly beneficial effects of taking money out of the stock market and investing it in manufacturing plant and equipment.

4. The amendment to the BES made in the last Finance Bill to allow £5,000 to be thrown back to the previous year will not solve the problem of "bunching". It is very difficult to raise BES money until late in the tax year

and this gives very little time for the money to be invested. It mitigates against investment in the expansion of real businesses and in favour of specially constructed and often artificial public issues. Could BES funds not be given say until September 30th of the next tax year (i.e., six months) to invest money raised? I am sure that this would make it easier for BES Funds to raise more money and encourage a more appropriate use of that money. It could even be coupled with further investment restrictions.

5. My experience as a director of a BES Fund is that the Revenue are inordinately slow in issuing tax certificates and that this discourages investors from investing again in BES. They often have to wait six to nine months for the certificates which allow them to claim tax relief. For PAYE investors this is a very serious drawback.

Best wishes.

Yours ever,

John

JOHN MAPLES M.P.

ps3/66T

BF 23/10

TASK FORCE SECRET

COPY NO. 8 OF 8 .

FROM: J M G TAYLOR
DATE: 19 October 1987

PS/INLAND REVENUE

cc PS/Financial Secretary
PS/Sir P Middleton
Mr Scholar
Miss Evans

Mr Isaac - IR

TAX PROPOSALS

Inheritance tax

The Chancellor has asked for a note showing the comparative incidence of IHT in the UK and other major countries on a businessman leaving property to his son. I should be most grateful if you could arrange for this to be done. The Chancellor would like two examples to be worked through. In the first example, the donor passes on a business worth £1 million, and other net assets of £100,000; in the second example, these amounts are doubled.

Capital Gains Tax

2. I passed on to you by telephone a further CGT option. Under this option, CGT would be payable on gifts at the point of transfer, and the base price for the donees' future CGT liability would be the price/value at transfer. I should be grateful for advice in due course.

Stamp Duty

3. You may also have seen (my minute of today to Miss Evans) that the Chancellor has suggested another starter. Under this, the £30,000 lower limit for liability of real estate to stamp duty is to be converted to a £30,000 threshold. I should be grateful for advice on this also.

J M G TAYLOR

MACE PAPER 19|10
TAXREF: SELF EMP

MACE TO CH/EX 19 OCT

TASK FORCE SECRET COPY 1 OF 24

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE
DATE: 19 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

TAX REFORM: SELF-EMPLOYED

1. This note answers your recent requests for further information about the effects of the tax reform package on the self-employed. (Mr Taylor's minutes to me of 5 October and to Mr McIntyre of 5 and 7 October). I am also sending you separately (today) a note about the operational implications for 1988-89 of the reform package for the self-employed. — below.

These notes are above.

Self Employed NIC: assumptions

2. Mr Taylor's minute of 5 October to me asked about the assumption in paragraph 6(iv) of my submission of 29 September that there would be no tax relief on Class IV NIC charged on profits above the upper profits limit (UPL). As in my submission of 14 July this assumption is aimed at ensuring that the combined top income tax and NIC rate is the same (at 49 per cent under Option A) on all earnings, employed

Notes are above.

---

cc Financial Secretary	Chairman
Sir P Middleton	Mr Isaac
Sir T Burns	Mr Painter
Mr Byatt	Mr Beighton
Mr Cassell	Mr Lewis
Miss Peirson	Mr Calder
Mr Scholar	Mr Cayley
Miss Sinclair	Mr Eason
Mr Macpherson	Mr Yard
Mr McIntyre	PS/IR
Mr G P Smith	Mr Mace
Mr Cropper	
Mr Tyrie	

and self-employed. Giving tax relief on half the Class IV NIC on profits above the UPL would reduce the combined top rate on self-employed profits to 47.2 per cent. The cost of giving this additional relief in a full year would be about £85 million. Mr Taylor's note of 5 October to PS/Financial Secretary indicated that you might be interested in a package for the self-employed which restricted the NIC rate above the UPL to 6.3 per cent with tax relief on half the contributions above (as well as below) the limit. (This option was discussed in paragraph 15 of Mr Macpherson's paper attached to Mr McIntyre's note of 30 September.) A 6.3 per cent rate above the UPL with tax relief on half the contributions would imply an effective combined top marginal rate on self-employed profits of slightly over 45 per cent.

3. If the top rate of income tax were 35 per cent the effective combined top marginal rate on self-employed profits would be just under 42 1/2 per cent with a 9 per cent NIC rate above the UPL (with tax relief) and about 40.2 per cent with a 6.3 per cent rate (and tax relief). These figures compare with a combined rate of 44 per cent for employees.

Self-Employed: Distributional effects

4. Mr Taylor's note of 7 October to PS/Financial Secretary asked Mr McIntyre to provide some illustrative tables and costings for the options for reform for the self-employed. We agreed with Treasury ST Division that we would take on this task as the necessary analysis has to be obtained from our computer model based on the Survey of Personal Incomes (SPI). (We have not had time to show the results to ST before submitting this note.)

5. Our estimates are based on projections of incomes reported in the 1984-85 SPI and will therefore differ to some extent from those which are included in (or which can be inferred from) the paper by Mr Macpherson. These are based on a simplified version of the model used by the Government Actuary's Department incorporating some data from earlier SPIs. We have discussed the reasons for the variations in the figures with the Treasury and believe that our estimates are better for incomes above the tax threshold but not at the lower end of the income range.

Option A

6. Table 1 attached shows the full year effects of imposing a full 9 per cent NIC charge (without tax relief) on self-employed profits (Schedule D Case I and II) above the UPL at 1988-89 income levels. This is effectively Option A of my submission of 29 September. Thus of the total of nearly 1 3/4 million self-employed individuals whose profits are liable to NIC just over 350,000 have profits above the UPL and would pay around £480 million in additional contributions in a full year with 9 per cent NIC on those profits (out of the total of £1.88 billion payable as a result of abolishing the UEL/UPL.) The table also shows that the total cost of giving tax relief on half those additional contributions would be around £85 million in a full year (see paragraph 2 above).

above

7. Table 2 is similar to Table 1 but shows the effect of a 6.3 per cent charge above the UPL and the cost of giving relief on half the additional contributions. On this basis the additional contribution income is reduced to just under £340 million in a full year and the cost of giving tax relief on this sum to around £60 million. The net result is that, overall, a 6.3 per cent NIC charge above the UPL, with tax relief would yield about £120 million less in a full year than a full 9 per cent NIC charge without relief.

OK

(c 75,000 fewer with losers)

8. Table 3 shows details of the losers from the reform package amongst the self-employed on a number of different assumptions and compared with indexation in 1988-89. Thus of the total of just under 800,000 losers compared with indexation under Option A (paragraph 12 of my submission of 29 September) about 135,000 are self-employed. Giving tax relief on half the NIC charge above the UPL would reduce the number of losers to around 75,000. A 6.3 per cent NIC charge above the UPL (without tax relief) combined with the other components of Option A would involve about 75,000 self-employed losers. This would be reduced to 44,000 if tax relief were given.

17% (1 in 6)

9. Table 4 gives similar information to Table 3 but the comparison is in cash terms with 1987-88. With the full 9 per cent NIC charge

(and no tax relief) just under 100,000 of the 560,000 * cash losers are self employed. With a 6.3 per cent NIC charge and tax relief on half the extra contributions the number of self-employed losers in cash terms falls to around 24,000 in total.

10. Both Tables 3 and 4 give unrounded estimates taken directly from the computer analysis. Differences in totals betweeen the analysis by total income and by size of loss are due to rounding and are therefore not significant.

Other options for the self-employed

11. Paragraph 14 of Mr Macpherson's paper looked at other options for reducing the burden of NIC on the self-employed namely

(i) lowering the Class II rate
(ii) increasing the LPL
(iii) cutting the Class IV rate below the UPL

All the options were designed to have the same first and second year costs, £25 million and £60 million respectively.

11. We have not looked in detail at the effect of these options on self-employed losers from the reform. But in round terms it appears that, combined with Option A (including full 9 per cent NIC charge above the UPL and no tax relief), Options (i) and (ii) might reduce the total numbers of losers by around 20,000 (compared with either indexation or 1987-88) and Option (iii) might reduce the number by about 40,000. If tax relief were given on the 9 per cent charge (or if the NIC charge above the UPL were reduced to 6.3 per cent) Options (i) and (ii) might reduce the residual losers by a further 10,000 or so and Option (iii) by around 20,000.

* Paragraph 15 of my submission of 29 September.

B A Mace

B A MACE

TAX REFORM: SELF EMPLOYED

Table 1

9 per cent NIC above UPL (Option A)

Total Income (lower limit) £000	No. of self-employed* 000s	No. with profits above UPL 000s	Yield of NIC £m	Cost of tax relief £m
0	1163	32	2	0.2
18	68	22	4	0.5
20	126	64	25	3
25	76	51	37	5
30	93	77	77	13
40	49	42	69	13
50	71	67	267	52
Total	1646	355	481	87

Table 2

6.3 per cent NIC above UPL

Total Income (lower limit) £000	No. of self-employed* 000s	No. with profits above UPL 000s	Yield of NIC £m	Cost of tax relief £m
0	1163	32	1	-
18	68	22	3	-
20	126	64	17	2
25	76	51	26	3
30	93	77	54	9
40	49	42	48	10
50	71	67	187	37
Total	1646	355	336	61

* Liable to NIC

TABLE 2

TAX REFORM: SELF EMPLOYED

Comparison with indexation

	Option A (9 per cent NIC)				Option A (6.3 per cent NIC)			
	Without Class IV NIC relief		With Class IV NIC relief		Without Class IV NIC relief		With Class IV NIC relief	
Total income (lower limit) £000	No. losers (000)	Amt. loss (£m)	No. losers. (000)	Amt. loss (£m)	No. losers (000)	Amt. loss (£m)	No. losers (000)	Amt. loss (£m)
0	0	0	0	0	0	0	0	0
18	8	0.4	2	0.1	3	0.1	2	0.1
20	53	8	28	4	32	3	12	2
25	33	11	27	6	25	5	18	3
30	24	7	14	4	12	3	9	2
40	11	3	3	1	3	0.8	2	0.5
50	7	3	1	0.6	1	0.4	0.5	0.2
Total *	136	32	75	16	76	12	44	8
Amount of loss (lower limit) £								
1	22	0.6	14	0.3	18	0.4	11	0.3
50	20	1	13	0.1	16	1	8	0.6
100	29	4	18	3	20	3	12	2
200	23	6	13	3	14	4	6	2
300	24	9	13	5	6	2	3	1
500	17	12	5	3	4	2	3	2
Total *	135	33	76	15	78	12	43	8

* Totals not identicial due to rounding

TABLE 4

TAX REFORM: SELF EMPLOYED

Comparison with 1987-88

	Option A (9 per cent NIC)				Option A (6.3 per cent NIC)			
	Without Class IV NIC relief		With Class IV NIC relief		Without Class IV NIC relief		With Class IV NIC relief	
Total income (lower limit) £000	No. losers (000)	Amt. loss (£m)	No. losers. (000)	Amt. loss (£m)	No. losers (000)	Amt. loss (£m)	No. losers (000)	Amt. loss (£m)
0	0	0	0	0	0	0	0	0
18	4	0.1	0	0	1	-	0	0
20	44	6	20	2	21	2	10	1
25	27	8	19	4	19	3	9	2
30	13	4	8	2	6	1	4	0.8
40	6	2	1	0.6	1	0.4	1	0.3
50	3	1	0.7	0.3	0.5	0.2	0.3	0.1
Total *	97	21	49	9	48	7	24	4
Amount of loss (lower limit) £								
1	21	0.5	10	0.3	12	0.3	6	0.1
50	14	1	6	0.4	7	0.5	4	0.3
100	21	3	14	2	16	2	6	1
200	17	4	12	3	7	2	4	1
300	18	7	6	2	5	2	3	1
500	7	5	2	2	1	1	1	0.5
Total *	98	20	50	10	48	8	24	4

* Totals not identicial due to rounding

Scorecard Costings

p.../...

TASK FORCE SECRET

JMGT to Evans 19 Oct

COPY NO. 21 OF 22.

FROM: J M G TAYLOR
DATE: 19 October 1987

MISS C EVANS

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Mace - IR
Mr Calder - IR
PS/IR

TAX REFORM: 'SCORECARD' COSTINGS

The Chancellor was most grateful for your minute and enclosure of 16 October. The Scorecard is most helpful.

2. He has one or two detailed comments:

(i) he should prefer the order of costings to show proposal No.3 before proposal No.2;

(ii) the costing for proposal No.11 should show the tax effect only;

(iii) a new proposal should be added: the £30,000 lower limit for liability of real estate to Stamp Duty to be converted to a £30,000 threshold;

(iv) amend option 2(b) to read: 37 per cent in 1988-89, 36 per cent in 1989-90 and 35 per cent in 1990-91, with capital gains added to income and taxed at income tax rates in each case.

3. You should be aware that he has also asked the Revenue for a note on a further CGT proposal which should produce a yield. Under this proposal, CGT would be payable on receipt of a gift, and the base price for future CGT would be the price/value at transfer to the donee. (I passed this on separately to PS/IR).

J M G TAYLOR

NICS AT THE LOWER END

ps3/63T

TASK FORCE SECRET

Copy 22 of

FROM: J M G TAYLOR

DATE: 19 October 1987

MR MACPHERSON

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr A Wilson
Mr Scholar
Miss Peirson
Mr McIntyre
Mr Riley
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
PS/IR

NICs AT THE LOWER END

The Chancellor has seen your note of 16 October, which he thought very helpful. He has commented that we are getting warmer. He would be most grateful if you could cost these further options:

(i) employees' rates: £41-130 at 5 per cent, £130-155 at 7 per cent, £155-305 at 9 per cent; employers' rates unchanged;

(ii) employees as above, but employers: £41-130 at 5 per cent, £130-155 at 7 per cent, £155-305 at 10.45 per cent;

(iii) as (i), but setting reduced rates for 18 months;

(iv) as (ii), but setting reduced rates for 18 months.

J M G TAYLOR

CAPITAL GAINS TAX DATA

JMGT 19.10.87

JMGT TO CALDER 19.10.87

RJ4.2

CONFIDENTIAL

Note

FROM: J M G TAYLOR

DATE: 19 October 1987

MR CALDER - INLAND REVENUE

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Mr Scotter
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
PS/IR

CAPITAL GAINS TAX DATA

The Chancellor was grateful for your minute of 16 October.

2. He has noted, in particular, that 37 per cent of CGT payers had incomes below £10,000, and 57 per cent below £20,000.

J M G TAYLOR

COPY 1 of 24

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE

DATE: 19 OCTOBER 1987

MACE TO CH.EX 19OCT

1. MR ISAAC

Seen in draft BAM 19/10

2. CHANCELLOR OF THE EXCHEQUER

Discuss. Start for S-E'n over 16?

TAX REFORM: SELF-EMPLOYED NIC: IMPLEMENTATION

Self-employed NIC: Implementation

1. Paragraph 19 of Mr Macpherson's paper of 30 September mentioned our preliminary view that it would be difficult to implement the proposal to charge 9 per cent NIC without tax relief on self-employed profits above the UPL in 1988-89. We have subsequently been examining further the operational implications of the change and this note reports the outcome of that work.

Abolition of the UEL/upper profits limit

2. The present working assumption is that abolition of the UEL for employees would take effect from October 1988. This means that broadly half an employee's total earnings above the UEL in 1988-89

---

cc Financial Secretary	Chairman
Sir P Middleton	Mr Isaac
Sir T Burns	Mr Painter
Mr Byatt	Mr Rogers
Mr Cassell	Mr Beighton
Miss Peirson	Mr Lewis
Mr Scholar	Mr Calder
Miss Sinclair	Mr Cayley
Mr Macpherson	Mr Eason
Mr McIntyre	Mr Yard
Mr G P Smith	PS/IR
Mr Cropper	Mr Mace
Mr Tyrie	

would be charged to NIC. Because Class IV NIC is assessed on an annual basis (like income tax) the closest way of matching the change for employees would be to charge self-employed profits above the UPL assessed for 1988-89 at half the rate which would otherwise be imposed ($4^{1}/2$ per cent, for example, if the NIC rate above the UEL/UPL were 9 per cent, 3.15 per cent if the rate were 6.3 per cent). This arrangement would not produce exact parity of treatment between the employed and self-employed (for example where a business starts or finishes during 1988-89 compared with someone starting or finishing employment) but would give a reasonably close match for the majority.

Operational Considerations

3. Abolishing the UPL for the self-employed requires significant changes to the infrastructure of the computerised Schedule D assessing (CODA) system which is at present running as a pilot in two of our Regions prior to national implementation in Spring 1988. We are currently about half-way through the pilot and although it has been reasonably successful so far we may come across further teething problems over the next few months. Even on the assumption that the pilot continues to go well there are dangers in making changes to the system at the same time as it is introduced nationally. And because of the scope of the NIC changes there are particular reasons why attempting to make them in time for implementation in 1988-89 would carry fairly severe risks.

Computer Implications

4. Making the NIC changes in time for a 1988-89 start will add to the burden of work on our trained computer staff, who, as you know, are already very heavily stretched at present. The time for implementation of the changes will in practice be very short. In order to avoid continual disruption to the computer system we normally make programming and other software changes in batches at six monthly intervals. The next batch of changes is due to be made in April 1988 and work on them is now in progress. We think it would be too risky and disruptive to try to incorporate the changes

needed for abolition of the UPL for NIC in the batch for implementation in April. The changes would therefore have to be made as a separate item and we think that, as a result, they could not be put into place until June 1988. This has important implications for the work on the Schedule D assessing programme in tax offices (see paragraph 6 below).

5. It will take about 11-12 weeks to make the software changes needed for UPL abolition. So with a June 1988 start the work would need to begin at the latest in March 1988. There is very little that can be cut out of our present development plans to make way for this additional work and we therefore think that we would have to rely on overtime to carry out the task (for which funding would be required). (There is a contingent risk that the work would be vulnerable if an overtime ban was called by the Unions in the early part of 1988, during the negotiations on next year's pay settlement. We are considering whether it would be possible to minimise this risk by bringing some of the work forward. But the scope for this may be limited and it would, of course, mean widening the circle of those aware of the changes at a much earlier stage.)

Implications for tax offices

6. In the normal way work on the Schedule D assessing programme begins in tax offices in April each year and builds up over the succeeding months. However, as the computer changes needed for UPL abolition cannot be in place before June 1988 the start of the assessing programme in tax offices would be delayed next year, compressing the work which has to be done into the subsequent period. The delayed start would also mean a clash with the programme for introducing CODA into tax offices next year. Because the computer changes for UPL abolition would not be in place until June tax office staff would have to be trained to use the new computer system on the basis of the old NIC arrangements. But once they begin live working they would then have to familiarise themselves with the new scheme. This would be an unwelcome complication to the already difficult task of ensuring a smooth transition from the present manual Schedule D system to CODA.

Conclusion

7. To sum up, attempting to implement UPL abolition in 1988-89 carries fairly severe risks, both on the computer side and for the work of local tax offices. Successful implementation would depend on everything going right. Although we could not say at this stage that a 1988-89 start has to be absolutely ruled out on operational grounds, our very strong preference would be to postpone implementation for the self-employed until 1989-90.

8. You will wish to discuss the implications of this for the reform package as a whole at your meeting on 20 October. If you find the operational risks of 1988-89 implementation for the self-employed unacceptable there are, perhaps, two possible options:

(i) To delay implementation of the UEL/UPL changes for both employees and the self-employed until April 1989. (This might in any case prove necessary if DHSS were to take the view that they cannot manage an October 1988 start for employees).

(ii) To keep the October 1988 start for employees but to postpone the start for the self-employed until April 1989. This might help with the presentation of the package to the self-employed and might be defended on the grounds that there are significant differences between NIC on self-employed profits and employment earnings (for example the annual nature and previous year basis of assessment for Class IV NIC compared with the weekly/monthly current basis for employees NIC) as well as operational constraints which justified a different approach.

B A Mace

B A MACE

FROM: J M G TAYLOR

DATE: 19 October 1987

MR MACPHERSON

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr A Wilson
Mr Scholar
Miss Peirson
Mr McIntyre
Mr Riley
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
PS/IR

NICs AT THE LOWER END

The Chancellor has seen your note of 16 October, which he thought very helpful. He has commented that we are getting warmer. He would be most grateful if you could cost these further options:

(i) employees' rates: £41-130 at 5 per cent, £130-155 at 7 per cent, £155-305 at 9 per cent; employers' rates unchanged;

(ii) employees as above, but employers: £41-130 at 5 per cent, £130-155 at 7 per cent, £155-305 at 10.45 per cent;

(iii) as (i), but setting reduced rates for 18 months;

(iv) as (ii), but setting reduced rates for 18 months.

J M G TAYLOR

CAYLEY
19.10.87

Copy 1 of 18

TASK FORCE SECRET

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY
DATE: 19 OCTOBER 1987

CHANCELLOR

CGT: ABOLISHING TAX DEFERRAL ON GIFTS

1. You enquired about the effects on tax yield if CGT was payable immediately on a gift instead of being deferred (subject to an election by the parties involved) and payable by the donee when he or she disposes of the asset.

2. The precise increase in yield would obviously depend on what package of CGT reform goes ahead (though the different permutations on the table would not affect the magnitude of the figure). The more substantive - and imponderable - factor is the behavioural reaction. We might well see a substantial reduction in the volume of gifts, but it must be entirely a matter of guesswork how much. The figures that follow therefore give a range. They assume that equivalent reliefs for gifts into and out of trusts would also be abolished.

---

c Financial Secretary
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Pitts
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Michael
Mr Quinn
Mr Lester
PS/IR
Mr Beighton

3. The full year yield might be £m30 to £m60. In terms of tax receipts, the effect for the next three years might be:-

88/89	89/90	90/91
Nil	+£m10 to 25	+£m20 to 40

Our information on gifts is incomplete, and all these figures just quoted should be treated with caution.

ns prior to indep. taxation

4. General tax deferral on gifts was introduced in 1980. Prior to that, it was available for business assets only. There would be strong pressure to continue to allow it for business assets. This would not substantially affect the figures.

OK

5. Married couples get - and have always had - tax deferral, but by another mechanism: the "no gain/no loss" transfer. Under this, where one spouse gives an asset to the other, the donee takes on the donor's CGT base cost. With independent taxation, it would seem inappropriate to continue to give married couples tax deferral if deferral on gifts generally is abolished. Under the present system, we get no information on the extent of CGT deferral on gifts between spouses. There is however no CGT advantage at present in such gifts. There would be with independent taxation, because each spouse would have a separate exemption. Abolishing tax deferral on gifts between husband and wife might add, at a guess, perhaps £m10 to the yield - and could reduce by, say, £m20 the cost (£m90 or so) of independent taxation of married couples' gains. But it must be stressed that the figures are no more than guesses.

right?

[illegible]

Michael Cayley

M F CAYLEY

CLASSIFICATION: CONF

SECURE FAX NO: IR 1

OUTGOING SECURE FAX

FROM INLAND REVENUE (PRIVATE OFFICE)

(Fax No. 2541 7681) Operation (2541 6315)

TO C. Rydning Department HMT

Date 20-10-87 Time 1.30 PM

No of pages following 2+R

Copy will also be sent by post Yes [✓] No [ ]

RECEIPT OF THIS TRANSMISSION MUST BE SENT

This material must be handled in accordance with the security instructions applicable to the classification.

CLASSIFICATION: CONF

Cathy

Can't get an answer to you on Stamp Duty (Jonathan's note of yesterday) still trying for the others.

Ben

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON
DATE: 20 OCTOBER 1987

CHANCELLOR

INHERITANCE TAX - RATES

1. You asked what would be the cost (as compared with indexation) of raising the IHT threshold to either £100,000 or £105,000 and having a single rate of 40 per cent thereafter (Mr Taylor's note of 13 October).

2. For the £100,000 threshold the full year cost would be £205m (£68m in the first and £105 in the second year).

3. For the £105,000 threshold the full year cost would be £225m (£86m in the first and £190m in the second year).

4. These thresholds are estimated to produce 28,000 and 25,000 taxpaying estates respectively, compared with 31,000 taxpaying estates on the indexed scale.

---

cc PS/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 Pitts
Mr Gonzalez
Mr Jaundoo
Mr Pape
Mrs Evans
PS/IR

CONFIDENTIAL

5. Since the present IHT rates begin at 30 per cent there will be losers from a scale starting at 40 per cent. These losers will be in the smaller taxpaying estates. We estimate that on a threshold of £100,000 some 15,000 estates (in the range £118,000-£255,000) will pay more tax than under indexation. On a £105,000 threshold some 10,000 estates (in the range £138,000-£235,000) will pay more. (We can do more work to illustrate the extent of these losses if your wish).

6. You also asked what would be the cost of abolishing the 60 per cent rate. If the change were to take effect from 1988/89 the cost in that year is estimated at £35m and in 1989.90 at £75m, building up over 5 years to a full year cost of £100m.

B T HOUGHTON

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2. For the £100,000 threshold the full year cost would be £205m (£68m in the first and £195 in the second year).

3. For the £105,000 threshold the full year cost would be £225m (£86m in the first and £190m in the second year).

4. These thresholds are estimated to produce 28,000 and 25,000 taxpaying estates respectively, compared with 31,000 taxpaying estates on the indexed scale.

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Sir P Middleton
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Mr Battishill
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Mrs Evans
PS/IR

CONFIDENTIAL

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6. You also asked what would be the cost of abolishing the 60 per cent rate. If the change were to take effect from 1988/89 the cost in that year is estimated at £35m and in 1989.90 at £75m, building up over 5 years to a full year cost of £100m.

B T HOUGHTON

SECRET.

CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	TAX REFORM DISTRIBUTION & COSTINGS.
DATE AND TIME	TUESDAY 20 OCTOBER 3.00pm (TWO HRS)
VENUE	Chancellor's Room, Treasury/~~No.11/Conference Room/House of Commons~~
PAPERS	Annotated agenda to follow from Mr Scholar.
THOSE ATTENDING	CST. FST. PMG EST. Sir P Middleton Sir T. Burns Mr Byatt Mr Cassell Mr Scholar Mr Cropper Mr Tyrie Mr Call Mr Battishill IR. Mr Isaac IR. Mr Mace IR Mr Cayley IR Mr Gonzalez IR cc Mr ACS Allan Mr Taylor.

SECRET.

(20/10)

SECRET

CHANCELLOR OF THE EXCHEQUER

CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	TAX REFORM: DISTRIBUTION & COSTINGS
DATE AND TIME	TUESDAY 20 OCTOBER 3.00 PM (TWO HOURS)
VENUE	Chancellor's Room, Treasury/~~No.11~~/~~Conference Room/House of Commons~~
PAPERS	
THOSE ATTENDING	FST SIR P. MIDDLETON SIR T. BURNS MR BYATT MR CASSELL MR SCHOLAR MR CROPPER MR BATTISHILL I.R. MR ISAAC I.R MR MACE I.R MR CAYLEY I.R MR GONZALEZ I.R. cc. MR ALLAN MR TAYLOR

SECRET

CHANCELLORS MEETING

1 SUBJECT Tax Reform Distribution + Costings 2hrs.

2. LOCATION. HMT.

CONF. 20/10 3pm

CAST LIST	'PHONE NO'	15/10. 3.00.	16/10. 10.15.	19/10. 3-5.00	20/10. 3-5.00.	21/10. 10.
FST. BP		BP Launch	✓	✓	✓ ✓	
Perm		✓		✓	✓ ✓	
Sir TB.	5202	✓		✓	✓ ✓	
~~Byatt~~ ESRC Council	5135	✓		? ✓	✓ ✓	
Cassell.	5181	✓		✓	✓ ✓	
Scholar	5264.	✓			✓ ✓	
Cropper.	5027 4359	✓		✓	✓ ✓	
TR - Battishill	2541 6615 6386	Manchester.		✓	✓ ✓	
6604 Isaac* 6444	2541 6604/6678	✓			✓ ✓	
Mace.	2541 6546	✓			✓ ✓	
Cayley.	7427	✓			✓ ✓	
Mr Gonzalez.	6463	✓			✓ ✓	

to be.
*invited to bring a Statistician.

PAPERS

MTG NOTICE SENT :

012/2981

SECRET AND PERSONAL

FROM: JILL RUTTER
DATE: 20 October 1987

MR McINTYRE

cc:
PS/Chancellor (Ms Ryding)
Financial Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Anson
Miss Peirson
Mr Scholar
Mr Turnbull
Mr Gibson
Mr Cropper

CHILD BENEFIT: REVIEW

The Chief Secretary has seen your minute of 14 October. I am sorry it was not possible to respond in time to meet your deadline.

2 The Chief Secretary is content with the deletion of the reference to targetting. He believes that it would be wrong to consider child tax allowances. He also took the view that taxation of Child Benefit was a matter for the Chancellor. On this you will have seen Cathy Ryding's minute of 16 October.+

3 The Chief Secretary is content with the idea of a report back by end February. He believes that we should leave open handling thereafter.

4 The Chief Secretary does not think it worth raising the possibility of abolishing Child Benefit - he does not believe that this is a live possibility.

Jill Rutter

JILL RUTTER

Private Secretary

+ I have discussed with the CST. He does not want taxation of CB to be considered since he regards this review as looking at ways of reducing public expenditure

RUTTER TO MACINTYRE 20 OCT

PTB

NOTE OF MTG 20/10

NOTE OF A MEETING HELD AT 3.00PM ON
TUESDAY 20 OCTOBER IN HM TREASURY

Present: Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Mace - IR
Mr Cayley - IR
Mr Gonzalez - IR
Mr Calder - IR

TAX REFORM: DISTRIBUTION AND COSTINGS

Papers: Mr Scholar's annotated agenda of 16 October, and related papers.

Tax reform: "Scorecard" costings (Miss Evans' minute of 20 October)

The Chancellor, opening the discussion, thanked officials for the comprehensive set of papers prepared for the meeting. He preferred the revised scorecard in its changed format. It produced an interesting and attractive package, of the right order of magnitude, which produced a good basis for further work. One or two elements would need adjustment: the figures for independent taxation did not take full account of proposals for the MCA, and the CGT figures were also currently under review. He suggested that the meeting discuss the individual elements in the scorecard seriatim.

2. Reducing the basic rate of IT to 25p (proposal number 1) was simple, expensive, and inescapable. It might be necessary to look further at the precise amount by which the higher rate IT threshold should be increased. But the current proposal to increase it to £25,000 (proposal number 2) should remain the base assumption for the time being. The same applied to the proposal to abolish higher rates of IT above 35p (proposal number 3).

3. A separate meeting might be required on the details of introducing independent taxation from 1990 to 1991 (proposal number 4). The Chancellor was anxious to do something here, but there were considerable complications. These would need to be settled satisfactorily before going ahead. The Revenue confirmed that the full year cost would be around £½ billion. The small companies' CT rate should be reduced to 25p (proposal number 5).

4. The Chancellor would hold a separate meeting on CGT (proposals 6 and 7). The Chancellor commented that, in the present circumstances, he was uncomfortable with a change which increased the CGT take, as this proposal would if rebasing were not included in it. He also wished to consider returning to the former basis for the tax treatment of gifts. When the gifts' concession had been made, a separate gift tax had existed and CGT indexation had not been introduced. Mr Isaac noted that rebasing would require some 20 pages of additional legislation. It would be necessary to reach a decision on this before long, to allow time for drafting.

5. On the proposal to abolish employees' UEL, and set the rate above it at 7 per cent till April 1989, 8 per cent to April 1990, and 9 per cent thereafter (proposal number 8), the Chancellor noted that it was an advantage of this proposal that it dramatically

reduced the number of losers. But should there be an offsetting phasing in the reductions in the higher rate of income tax?

6. On the proposal itself, Sir T Burns said that it might be that many of the losers would not, in fact, lose very much. If so it might not be worthwhile to introduce the complexity of the phasing arrangement simply to convert small losses into small gains. Mr Scholar said that the offsetting phasing of the higher rate might excite unfavourable attention from basic rate taxpayers who would see their national insurance contribution rate rising each year uncushioned by any reduction in income tax. The Chancellor invited Mr Mace to prepare a table showing the size of the losses on the phasing option.

7. The Chancellor noted that there were now two main choices on mortgage interest relief. First (proposal 10), the relief should be restricted to the residence basis from 1988 and the ceiling raised to £35,000. Second (proposal 10a), the relief would continue on the present basis, with a £20,000 ceiling for singles and a £40,000 ceiling for couples. Proposal 10 hit single people who wished to share; proposal 10a hit single people on their own. The effects on single people, and especially on the disadvantaged in this category (eg. widows) would need to be considered carefully. He noted that the package as a whole hit single people. Mr Cassell noted that proposal 10 had already been canvassed and had received a favourable reception. The Chancellor said that, for this reason, there should be a disposition towards proposal 10, though the issue would need to be examined further. The Revenue said that further papers on these proposals would be coming forward shortly (they would, inter alia, give an estimate of the proportion of new mortgages going to single people).

8. It was noted that exempting forestry from tax (proposal number 11) would give rise to additional revenue (around £5 million per year). Further work was under way on the proposal to abolish

tax relief on new covenants between individuals (proposal number 12).

9. On taxing employers instead of employees on benefits in kind (proposal number 13), Mr Isaac said the Revenue saw some scope for a tax which focussed on a limited number of high yielding benefits. A note was on its way to the Chancellor.

10. The Chancellor said something must be done about inheritance tax. He was not attracted by a relief to businesses; the relief should be general in nature. The proposal to consolidate at a rate of 40 per cent (proposal number 14) would assist businessmen, and also took people out of the tax net altogether.

11. The Chancellor said that converting the £30,000 lower limit on stamp duty into a threshold seemed the most optional proposal in the package. If it were necessary to drop a proposal in order to reduce the revenue cost of the package as a whole, this proposal should fall.

Tax reform: self employed

12. The Chancellor commended Mr Mace's paper of 19 October. He was increasingly convinced that fixing a NIC rate above the Upper Earnings Limit for the self employed of 9 per cent would be damaging to the package as a whole, and would stretch the contributory principle too far. He would prefer simply to abolish the UPL. The self employed would then have a lower top rate of tax/NIC combined than employees, but this was a "necessary evil" to secure acceptance of the package. A proposal on these lines would maintain the integrity of the NIC system, and appeared also to help losers (Mr Mace undertook to provide further figures on this).

13. Mr Isaac suggested that the Chancellor would want to look horizontally at the position of the self employed vis a vis employees. A proposal along these lines would put pressure on high

earning employees to "become" self employed. Mr Scholar suggested that, by analogy with the NIC proposals for employees at the bottom end, some assistance might need to be given to the lower paid self employed. Lowering the class 2 rate seemed the least complicated option. The Chancellor agreed this option should be pursued.

14. The Financial Secretary noted that the self employed would still complain if the UPL were merely abolished, without further adjustment. The Chancellor said further consideration should be given to allowing tax relief on half the contributions on profits above the UPL, although he was unenthusiastic about this aspect. There should also be further examination of the package in the context of the proposed changes to employees' contributions.

15. Mr Isaac noted that the only safe option for implementing changes to NICs for the self employed was April 1989. The Chancellor strongly preferred October 1988. He invited Mr Isaac to look further at the possibilities, and provide advice.

NICs at the lower end

16. The Chancellor said he would like to keep in play Option C (Mr Macpherson's minute of 16 October) and Option F (Mr Macpherson's minute of 20 October). Further analysis of these options should be carried out. Mr Calder said Option C would be included in the gainers and losers analysis (because of its effect on the "contracted out").

Economic rationale

17. In a brief discussion, the Chancellor suggested a number of amendments to the paper and invited those present to give further comments in writing to Mr Scholar. Sir P Middleton said further work on the paper was envisaged.

Circulation

Those present
Mr McIntyre) paragraphs 12-16 only
Mr Macpherson)

J M G TAYLOR

21 October 1987

SECRET

pty

CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	TAX REFORM: DISTRIBUTION & COSTINGS.
DATE AND TIME	TUESDAY 20 OCTOBER 3.00 PM (TWO HOURS)
VENUE	Chancellor's Room, Treasury/~~No.11~~/~~Conference~~ Room/~~House of Commons~~
PAPERS	
THOSE ATTENDING	FST SIR P. MIDDLETON SIR T. BURNS MR BYATT MR CASSELL MR SCHOLAR MR CROPPER MR BATTISHILL I.R. MR ISAAC I.R MR MACE I.R MR CAYLEY I.R MR GONZALEZ I.R. cc. MR ALLAN – MR TAYLOR.

SECRET

CE.2

TASK FORCE SECRET

COPY NO 1 of 21 COPIES

FROM: MISS C EVANS
DATE: 20 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Cassell
Mr Scholar
Miss Sinclair or
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Mace - IR
PS/IR
Mr Calder - IR

TAX REFORM: 'SCORECARD' COSTINGS

As requested I attach a revised Scorecard which takes account of the comments in Mr Taylor's minute of yesterday.

pp MISS C EVANS

EVANS → CH/EX 20/10

TASK FORCE SECRET

TABLE 1

COST OF TASK FORCE PACKAGE AS AT 20 OCTOBER

All figures highly provisional. Costs at 1988-89 levels of income etc

Proposal Number	Proposal	Cost(-) or Yield(+) in £ billion 1988-89	1989-90	1990-91
1	Reduce basic rate of IT to 25p	-2.4	-2.8	-2.8
2	Increase higher rate IT threshold to £25,000	-0.8	-1.3	-1.3
3	Abolish higher rates of IT above 35p	-0.8 (-0.7)	-1.6 (-1.5)	-1.6
4	Independent taxation from 1990-91	Nil	Nil	-0.5 (?)
5	Reduce small companies' CT rate to 25p	Neg	-0.1	-0.1
6	Exempt first £6,600 gains from CGT, add remaining gains to income and tax at IT rates (25%/35%)	Nil	+0.1	+0.1
7	Rebase CGT to 1982 (cost includes rebasing CT on companies' gains)	Nil	-0.5	-1.0
8	In October 1988 abolish employees' UEL, set rate above it at 7% until April 1989, 8% to April 1990, then 9%	+0.5	+1.3	+1.5
9	Changes to NICs at lower end	*	*	*
10	Restrict MIR to residence basis from 1.8.88 and raise ceiling to £35,000 (cost ignores behavioural effects)	-0.2	-0.2	-0.2 (-0.3)
11	Exempt forestry from tax	Nil	Neg	Neg
12	Abolish tax relief on new covenants between individuals	Neg	+0.1	+0.2
13	Tax employers instead of employees on main benefits in kind (possibly some yield)	*	*	*
14	Raise IHT threshold to £100,000 or £105,000 and single rate of 40%	-0.1	-0.2	-0.3
15	Convert stamp duty £30,000 lower limit for real estate into threshold	-0.5	-0.6	-0.7
	TOTAL**	-4.3	-5.8	-6.7

**Total does not include any costings for items 9 or 13
*Cost/yield depends on option to be chosen

TABLE 2

ALTERNATIVE PROPOSALS

All figures highly provisional. Costs at 1988-89 levels of income etc

Proposal Number	Alternative Proposal	Cost(-) or Yield(+) in £ billion 1988-89	1989-90	1990-91
3a	Abolish higher rates of IT above 40p	-0.3	-0.9	-0.9
3b	Abolish higher rates above 37p in 1988-89 reduce to 36p in 1989-90 and to 35p in 1990-91 with gains added to income and taxed at IT rates*	-0.7	-1.5	-1.6
6a	FST's proposal of 6 October as amended by PS/Chancellor's minute of 12 October		to be costed	
6b	Abolish CGT deferral on gifts	Nil	Neg	Neg
10a	MIR on present basis with £20,000 ceiling for singles and £40,000 for couples (cost ignores behavioural effects)	-0.2	-0.2	-0.3

*costing represents income tax effect only: effect on capital gains is the same as for proposal 6.

TASK FORCE SECRET Copy 1 out of 21

FROM: N I MACPHERSON
DATE: 20 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc. Chief Secretary
Financial Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr A Wilson
Miss Peirson
Mr Scholar
Mr McIntyre
Mr Riley
Miss Sinclair
Mr Cropper
Mr Tyric
Mr Call

Mr Battishill - IR
Mr Isaac - IR
PS/IR

NICs AT THE LOWER END

Mr Taylor's minute of 19 October requested costings of further options.

2. Option (i) which I will call Option F gives the following structure. (I have assumed that leaving employers' rates unchanged also means ~~implies~~ leaving employers' bands unchanged.)

Option F

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	5	5	5
70-105	7	5	7	7
105-130	9	5	9	9
130-155	9	7	9	9
155-305	9	9	10.45	10.45

If introduced in October 1988, this would cost:

1988-89 £370 million
1989-90 £1050 million

TASK FORCE SECRET

This Option is similar to the old Option 3, except that the 2 million employees earning between £105 and £130 a week will be getting a 4 per cent cut instead of a 2 per cent cut in their NIC rate. Hence, the higher cost.

3. You asked for a costing of the above without an uprating of the reduced rate bands in April 1989 (Option F1). This would cost:

1988-89 £370 million
1989-90 ~~£880~~ £730 million

This number is an error. It is likely to be revised downwards by around £100 million. New figure will be given as soon as possible. N.P.M. 1.40pm

Not uprating the UEL, which would now only be applying for rebate purposes, would reduce the second year cost by £60 million. This option would clearly be affordable.

4. Option ii which I will call Option G gives the following structure:

Option G

£ per week	Employees % rate now	Employees % rate proposed	Employers % rate now	Employers % rate proposed
41-70	5	5	5	5
70-105	7	5	7	5
105-130	9	5	9	5
130-155	9	7	9	7
155-305	9	9	10.45	10.45

If introduced in October 1988, this would cost:

1988-89 £770 million
1989-90 £2150 million

This would appear prohibitively expensive.

5. Option G1, involving no uprating of the reduced rate bands in April 1989, would reduce the second year cost to £1700 million

(less £60 million if UEL not uprated), but again cost would appear to rule it out.

N I MACPHERSON

TASK FORCE SECRET

COPY 1 OF 28

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE

DATE: 20 OCTOBER 1987

PS/CHANCELLOR

TAX REFORM: INCOME TAX AND NIC

I am afraid that there is an error in Table 1 of my submission of 19 October on this subject. The figure of 100 which appears in the first line of the table should, of course, appear under the column headed "Gain less than £200" rather than "Loss less than £200". I am sorry about this mistake and I attach a corrected version of the table.

B A Mace.

B A MACE

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Miss Peirson
Mr Scholar
Miss Sinclair
Mr MacPherson
Mr McIntyre
Mr G P Smith
Mr Cropper
Mr Tyrie

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Calder
Mr Mace
Mr Cayley
Mr Eason
Mr Allen
PS/IR

TABLE 1

Option A: Percentage Distribution of Losers and Gainers by Income

Comparison with 1987-88

Lower limit of total income £'000	Loss (£) Over 400	200-400	less than 200	Gain £ less than 200	200-400	over 400	Tax Units (thousands)
0				100			10,200*
10	-	-	1	57	42	-	8,300
20	2	7	15	14	42	20	1,900
30	1	3	4	10	18	64	530
40	1	1	2	3	5	88	390
All	1/4	3/4	2	72	20	5	21,400*

* An additional 300,000 tax units are included in this distribution compared with the table on page 5 of the submission of 29 September. These are units taken out of tax by indexation of the personal allowances.

Copy 2 of 18

TASK FORCE SECRET

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

Ch/ To be aware at this stage. I have spared you the back pps. at this stage. You may, however, [illegible]
JT 23/10

FROM : L J H BEIGHTON
DATE : 23 October 1987

I take it this is for judgement as a starter for 1988.

FINANCIAL SECRETARY

TAX REFORM : REMOVING SHELTERS : STARTER 454

The Chancellor has made it clear that he regards it as both important and urgent that we should examine all the tax shelters to see which might reasonably be reduced or removed as part of a tax reform package which is likely to include reductions in the top rates of income tax. He is looking in particular for measures which would simplify the system and produce manpower savings where these do not conflict with political imperatives.

You will recall that he asked you (Mr Kuczys' note of 22 July) to take this on with help from Mr Cropper. At your meeting on 31 July you came to a number of preliminary conclusions on which the Chancellor commented on 5 August. Between you you decided that a number of the possibilities which we had put on a shopping list, such as farmers' averaging, should not be considered further. The purpose of this minute is to consider the treatment of the smaller items which remain on the list but it may be convenient to start by listing where we have got to on the major topics.

---

cc Chancellor of the Exchequer
Sir Peter Middleton
Mr Cassell
Mr Byatt
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Jenkins
Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Cleave
Mr Marshall
Mr McManus
Mr W Carr
PS/IR

Forestry. The Prime Minister is due to hold a meeting today.

Benefits in Kind. Mr Isaac responded on 20 October to the Chancellor's request (Mr Taylor's minute of 5 October) for further work on the possibility of transferring the liability arising on many benefits from employee to employer.

Maintenance and covenants. You and the Chancellor discussed this with us on 12 October.

Residence. Following your minute of 28 July we are working further on a possible consultative document on changes to the rules of residence and on the abolition of the remittance basis.

Enterprise zones. Mr Painter and Mr Driscoll put forward on 20 and 21 October notes on the implications of restricting the relief available to lessors.

Receipts basis for Schedule E. Mr Lewis will be minuting you shortly to explain why, following the decision to introduce independent taxation in 1990, we consider that this topic will need to be held over. We now see it as a major starter for the 1989 Bill.

These are all significant items and, if action is taken in respect of most of them, it will make a major impact on the scale of the shelters available. As I have said, however, there are a few remaining issues on the list and they are examined in the attached papers. They are all relatively minor. They concern the abolition of a number of averaging or spreading reliefs and of some of the special interest relief provisions. Separate notes are attached on:

i. redundancy payments (by Miss Rhodes);

ii. writers and artists copyright, patent royalties and premiums for rent (by Mr Elliott); and

iii. interest relief (by Mr O'Connor).

The question which arises in each of these cases is whether the abolition of the shelter would have sufficient advantage to justify the likely fuss from those concerned, especially the writers and artists. Their abolition would simplify the tax code by removing anything up to 20 pages of statute, and the special rules have to be covered in training courses and learned by our staff and practitioners alike; but they are not provisions which in practice give rise to a great deal of work either for us or for taxpayers and any staff savings would therefore be negligible. The Revenue yield from their abolition is hard to quantify but would be small: indeed, if in order to reduce the impact of the possible changes on redundancy payments it was thought necessary to raise the £25,000 exemption limit, there could well be a net cost to the Exchequer. The strongest case for tackling these provisions is probably that, in so far as they owe their original justification to high marginal rates of income tax, there may never be a better time to remove them: if they are retained now we may have to live with them for many years.

The question in each case is whether the game would be worth the candle. If they were the only simplifications to be made, the answer might well be not. The question is whether they are more attractive as part of a wider package in which Ministers are likely to include at least some of the major items covered in paragraph 2 above and perhaps some other smaller items as well, such as restricting the tax relief for foreign entertainment.

X

LJHB

L J H BEIGHTON

REDUNDANCY AND OTHER LUMP SUM PAYMENTS FROM EMPLOYMENT

1. There are spreading provisions for redundancy (and certain other lump sum payments) over £25,000. The present rules were introduced in 1981 (with modifications in 1982 and 1986) replacing more complicated rules which had existed since 1960. They are designed to reduce the high rates of tax which could otherwise be due when a large lump sum is paid for exceptional reasons.

2. Under the present rules

- the first £25,000 is exempt

- the next £25,000 of the payment (ie between £25,001 and £50,000) is charged at half the rate or rates that would otherwise apply

- the third £25,000 of the payment (ie between £50,001 and £75,000) is charged at three-quarters of the rate or rates that would otherwise apply

- the excess over £75,000 is charged at the normal rates.

3. In calculating these reliefs the payment is treated as the "top slice" of the taxpayers income - ie it is the last part of his income to be taken into account for tax, so that the reliefs are calculated at his highest marginal rate. A simple example illustrates this:

> A taxpayer receives a termination payment of £30,000. His other taxable income (after allowances etc) is £50,000. His marginal rate of tax is 60%. The first £25,000 of the termination payment is exempt. The following £5,000 is charged at half the rate which would normally apply (60%) = £5,000 x 30% = £1,500.

4. These rules apply to the payment of a variety of lump sums but in practice the commonest are payments made in connection with the termination of the holding of an office or an employment. Many of these are redundancy payments but it can also include a payment to an employee on retirement or resignation in mid-career.

5. A brief word about the treatment of redundancy pay for NIC purposes may be helpful. The Social Security regulations provide for redundancy payments to be disregarded for NIC. It is not beyond doubt whether only statutory redundancy payments ought to be disregarded for NIC but in practice we suspect all redundancy payments are disregarded. The position would need to be put beyond doubt if the UEL were abolished but in the calculations which follow we assume all redundancy payments are disregarded for NIC purposes.

Numbers involved

6. We do not have firm estimates of the number and amount of payments over £25,000 which qualify for this relief. However information is available about payments over £50,000 and, by extrapolating from this date we estimate that there could be around 1500 payments in excess of £25,000 made each year and that the cost of the spreading reliefs on these payments is of the order £5m.

7. These figures are fairly tentative. Nevertheless it is clear that only a small number of people benefit from these reliefs. The justification for special reliefs which benefit very few is self-evident when tax rates are high. But with low rates of tax the need for a tax shelter is in principle much less obvious. And, these reliefs are complex to operate.

<u>Case for removing the reliefs</u>

8. The main arguments for getting rid of the special reliefs for redundancy payments can be summarised as follows:

- The rules were designed to protect payments from high rates of tax.

- Most payments are under £25,000. Only a few people - probably less than 1 per cent receiving redundancy payments - benefit from these rules and they stand to gain most from the reduction in rates.

- Removing the reliefs would represent a considerable simplification;

Case against removing the reliefs

9. The arguments against making any change are:

- most recipients would be net losers* from this change. Only for people receiving payments in excess of £80,000 will the reduction in the rates (to a maximum rate of 35%) more than outweigh the loss of these reliefs (though people at the lower end of the scale would pay relatively little extra tax)

- an increase in the threshold to eliminate losers is likely to encourage an increase in the size of awards resulting in a revenue cost.

Options for change

10. Clearly if anything is to be done about these reliefs it needs to coincide with a reduction in the rates of tax. The options are considered below. They are based on the assumption of the current main option for the new tax rates (ie basic rate 25% higher rate 35%). If this changes the yields and costs given for the options set out below will require revision.

11. One possibility would be to sweep away all the reliefs including the £25,000 threshold. (This would also bring statutory redundancy payments - maximum amount payable less than £5,000 - into tax. These payments are at present exempt under

* They would be losers only in the sense that they would pay more tax than they would have done had they been made redundant before the change

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the special rules. However the exemption for statutory payments could be continued by a small amendment to S412 ICTA, which deals with other tax aspects of statutory redundancy pay.) All other payments would be charged at the recipients marginal rate of tax. This would end the exploitation of these rules by some highly successful employees (eg professional footballers) who are able to command sizeable termination payments when moving from one lucrative job to another. Nevertheless those hardest hit would be people receiving relatively modest payments on being made redundant who would at present be exempt. Many of them will be basic rate taxpayers. There would be obvious presentational difficulties. The change would no doubt be represented as making those facing unemployment pay for the tax cuts of the rich and we assume Ministers will not wish to consider this as an option.

12. The options considered below assume the retention of the threshold as its current or a higher level.

Option A - Retain £25,000 threshold, abolish special reliefs

13. This option involves leaving the first £25,000 of a lump sum payment exempt from tax, and charging tax on the excess at the recipients marginal rate. There would be gainers and losers from this option. The gainers are those with very high redundancy payments (over £80,000 in general) for whom the cuts in rates would more than outweigh the loss of the special reliefs. At lower levels of redundancy payments, however, the reduction in rates would not completely offset the loss of the special reliefs. The amount of extra tax due would depend on the level of the recipients other income and the size of the payment. The worst case we have been able to identify is extra tax of £2,300 which would be due from someone with no other income and who received a lump sum of £50,000 (Graph 1 attached). Though such cases might not occur often, some will inevitably arise. For recipients with other income, the number of losers and the extra tax would be less (Graph 2 attached).

14. In general the amounts of extra tax payable are likely to be up to £1,000. The main losers are those in the middle of the

range - ie receiving payments of around £40,000 to £60,000. People at the lower end ie £25,000 - £35,000 would pay only small amounts of additional tax. It is perhaps worth pointing out that in the context of this option (and options B and C below) the concept of gainers and losers is a little unusual in that the people concerned generally have no expectation of a redundancy or lump sum payment. So - in contrast with tax changes generally - if changes were made there is no particular body of individuals who could immediately identify themselves as gainers or losers.

15. The yield from this option - measured as the difference between tax payable on option A with new tax rates and the tax payable with new tax rates but no change to the spreading reliefs - is estimated to be about £3m.

Option B - Increase threshold to £30,000, abolish spreading reliefs

16. The number of losers under this option is much smaller than under option A. The biggest loser we have identified under this option is again the person with no other income receiving a lump sum of around £50,000 for whom the extra bill is about £1,050.

17. It is difficult to estimate the cost of this option. If there were no behavioural changes, this change would, when the effect of the rate changes are taken into account, lead to a small yield of just over £1m. When the threshold was last increased from £10,000 to £25,000 in 1981, many lump sum payments - particularly in the less deserving cases like directors of small family companies whose lump sum on retirement is generally set at the exemption level - were increased to the new exemption level. In the absence of any firm estimates of the number of payments which are currently at or just below £25,000, it is difficult to predict the number of payments which would be increased if the exemption level were raised. As an illustration of the possible effect: if 10,000 employees were to receive an additional £5,000 lump sum as a result of this option, the behavioural effects could cost up to £9m.

Option C - Increase the threshold to £35,000; abolish spreading reliefs

18. With a threshold of £35,000 there would be no losers from the abolition of spreading reliefs. The biggest gainers would be those with the highest lump sums for example the saving for a person with other income of £25,000 and a lump sum of £100,000 would be over £10,000.

19. The behavioural effects of this option are again difficult to predict but are likely to be similar to those described for option B in paragraph 16. Using similar assumptions - if 10,000 employees were to receive an extra £10,000 the cost could be up to £18m.

Staff Effects

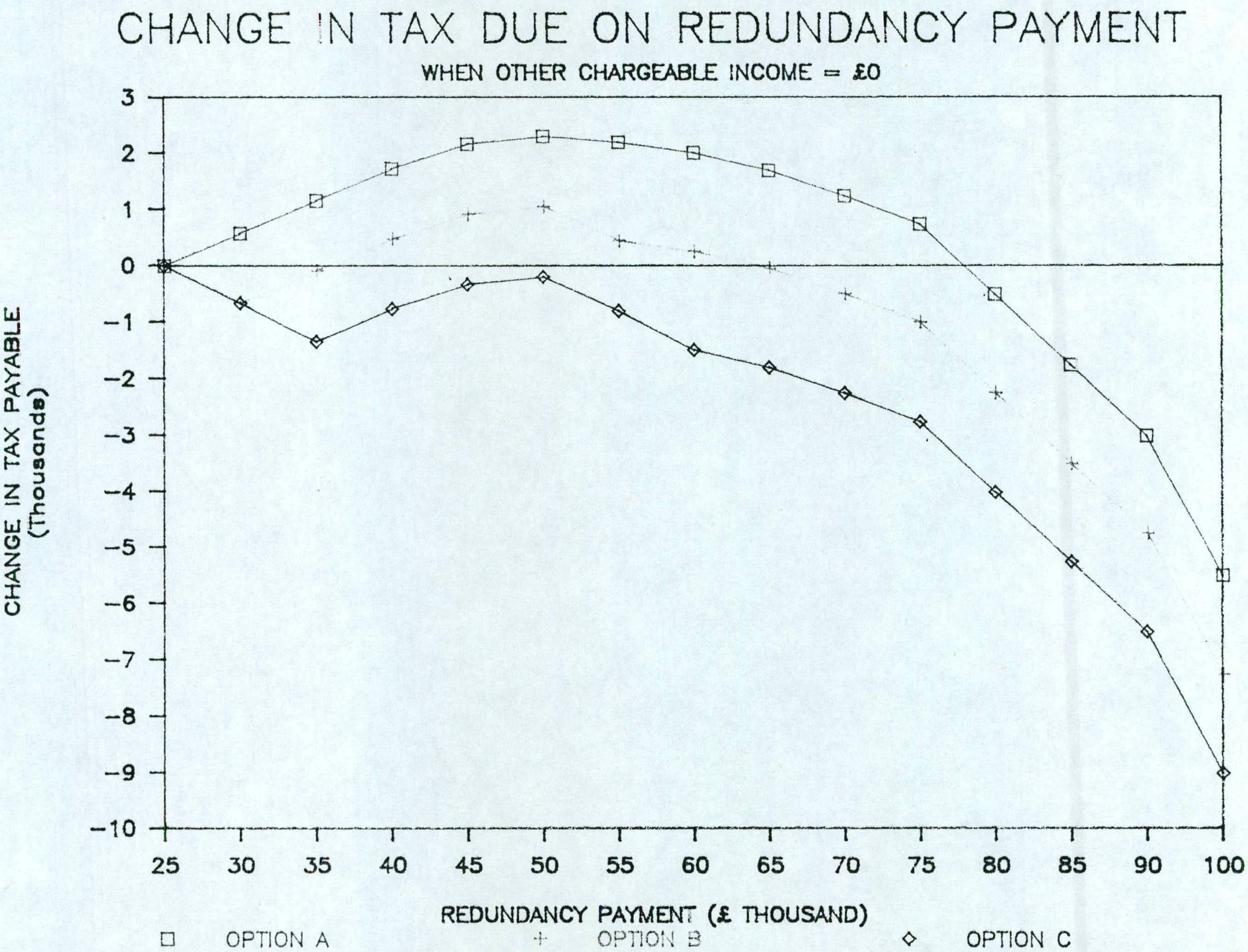
20. There are no large staff savings in abolishing these reliefs. The rules are complex and elaborate, but there are only relatively few cases; the savings would probably amount to no more than a handful of staff. The main advantage is the simplification of the tax system. It would remove some 8 pages from the statute book. But more than this it gets rid of a "nuisance value" attached to such provisions. All our staff need to know about them even though they handle few cases. So full instructions and training are necessary and booklets have to refer to the provisions. There are similar costs for practitioners.

Conclusion

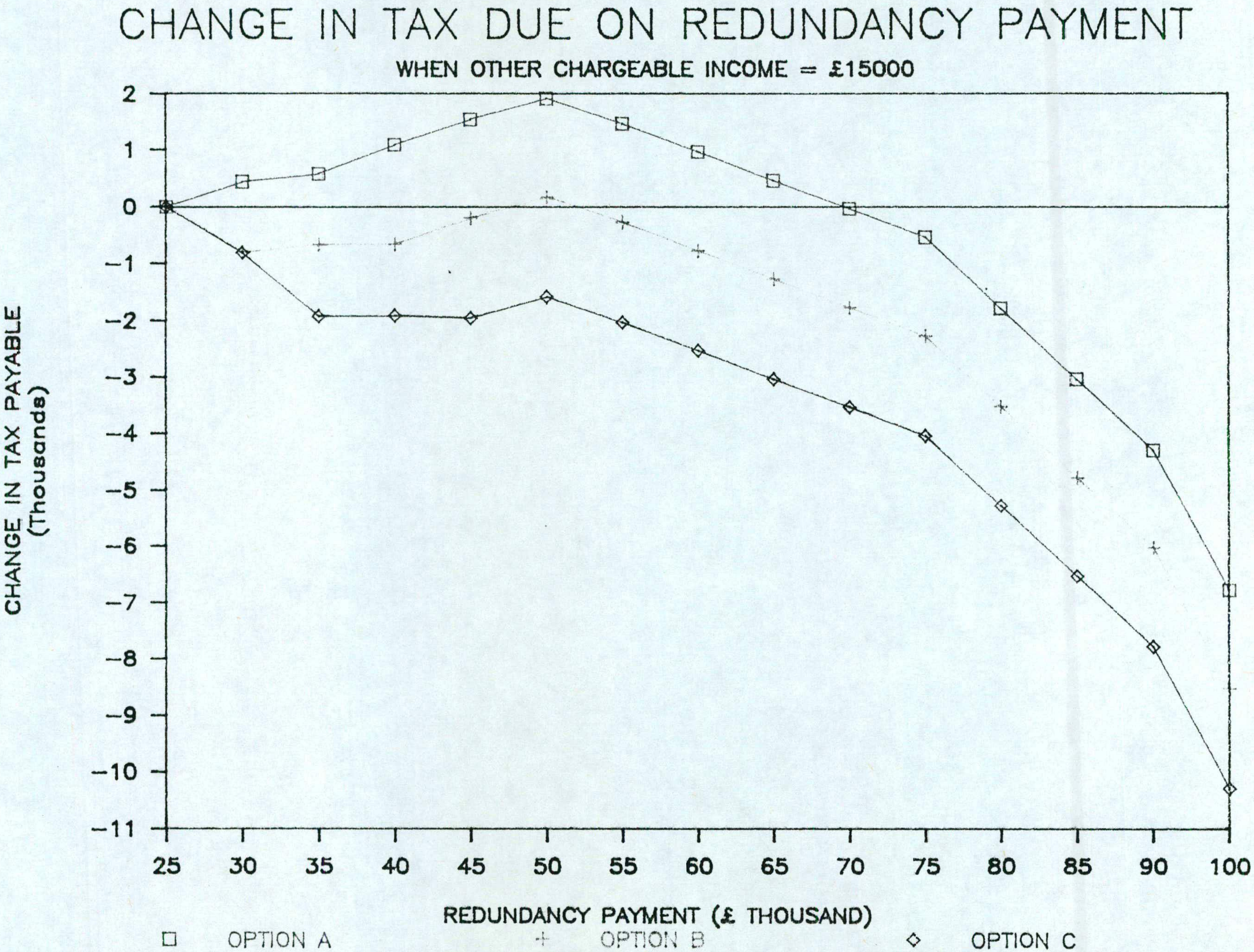
21. With reductions in the rates, the need for special reliefs for lump sum payments very largely disappears. Abolishing the spreading reliefs and leaving the threshold unchanged would result in losers. Although the amounts of extra tax would not generally be very high, it could in some cases be over £2,000 and would mainly be in the middle of the scale. An increase in the threshold to £30,000 would reduce the number of losers

considerably (and the amounts lost) and an increase to £35,000 would eliminate losers completely. Both are likely to result in an uplift in the size of lump sum payments (mainly to people who are able to "command their own terms") and could result in a revenue cost.

Graph 1


CHANGE IN TAX DUE ON REDUNDANCY PAYMENT
WHEN OTHER CHARGEABLE INCOME = £0
CHANGE IN TAX PAYABLE (Thousands)
3
2
1
0
−1
−2
−3
−4
−5
−6
−7
−8
−9
−10
25
30
35
40
45
50
55
60
65
70
75
80
85
90
100
REDUNDANCY PAYMENT (£ THOUSAND)
OPTION A
OPTION B
OPTION C

Graph 2



CHANGE IN TAX DUE ON REDUNDANCY PAYMENT
WHEN OTHER CHARGEABLE INCOME = £15000
CHANGE IN TAX PAYABLE (Thousands)
2
1
0
−1
−2
−3
−4
−5
−6
−7
−8
−9
−10
−11
25
30
35
40
45
50
55
60
65
70
75
80
85
90
100
REDUNDANCY PAYMENT (£ THOUSAND)
OPTION A
OPTION B
OPTION C

Income from copyrights, patents, and works of art: and premiums for leases

1. A number of provisions in the tax code allow for the spreading of receipts arising from the sale of (broadly), patents, copyrights, and actual works of art. There is also a provision which gives a form of top-slicing relief in relation to a special tax charge on premiums for leases and certain comparable payments.

2. These provisions are described in a little detail in Annex X, which also explains the history of the various copyrights etc provisions, which have been written into the law piecemeal over the last forty years or so.

3. Briefly, the relevant provisions are as follows -

Sections 389 and 392 of ICTA allow the proceeds from the sale of copyrights in a literary or artistic work, or of an actual work of art, which took over a year to produce to be spread backwards for tax purposes over two years, or over three years if the work took longer than two years to produce. This provision also applies to royalties in certain circumstances.

Section 384 of ICTA provides a form of top slicing relief for lump sums paid by way of compensation for the use of a patent. The tax for the year of receipt is reduced to the amount that would have been paid if the sum had been spread over the six preceding years.

Sections 380 and 390 of ICTA allow lump sum receipts from the sale of patent rights, and from the sale of copyright in a work published ten years before the sale, to be spread forward six years for tax purposes.

Schedule 3 to ICTA also gives a form of "top-slicing" relief on the tax payable, under special anti-avoidance provisions, on premiums for short leases and certain other payments made in connection with short leases.

Length of the legislation

4. This legislation runs in total to some 9.5 pages of the Taxes Acts.

Yield and staffing effects from abolition

5. We have not got sufficient information available to quantify either the number of taxpayers affected by these provisions, or the revenue yield from abolishing them. Any staff saving could only be negligible though there would be some small benefit from reducing the amount of legislation that Inspectors, taxpayers and their advisors have to learn and apply. The backward spreading reliefs if claimed may mean that fresh assessments have to be made for past years.

Comment

6. As long as there remains more than one rate of tax the arguments that led to the introduction of averaging remain. It might be difficult to justify removing an existing privilege if similar provisions (eg farmers averaging) were not removed at the same time. There would no doubt be opposition, from the small but vociferous arts lobby, to the removal of any of the copyright etc provisions; that opposition might be strongest in relation to Sections 380 and 390, because those two provisions not only reduce the rate of tax on the payment in question, they also allow the tax to be paid, at whatever rate, by instalments over six years. In July the Financial Secretary's initial conclusion was to retain these forward spreading reliefs. We would agree that any simplification gains are unlikely to outweigh the political difficulties.

7. As regards the backward spreading reliefs, Section 389 and Section 392, the arguments for abolition are perhaps stronger. The advantage of spreading income into previous years is

reduced if the tax rates were higher in the earlier years over which the income is to be spread. Both these reliefs were brought in to alleviate the effects of surtax where the fruits of several years work was received by writers or artists in one year. Reduction in higher income rates will have reduced both the value and the number likely to benefit. Because relief can be spread over only a maximum of two years preceding the year of receipt these reliefs are less valuable than the longer forward spreading provisions.

You will wish to balance the relatively limited benefits of simplification against any political difficulty of withdrawing a relief from a potentially vocal minority.

8. Similar arguments apply to the form of top-slicing relief for payments for the use of patents. Declining rates of tax and increases in the higher rate thresholds have reduced the benefit of the relief. We have no reason to suppose that it is often claimed. Abolition is perhaps only worthwhile as part of a wider package: on its own it might be used as a basis for suggestions that the charge should be moved from income tax to capital gains tax, but such a change would be doubtful in principle and complex in practice.

9. The rules for top slicing relief on taxable premiums on leases were designed to protect payments of this kind from high rates of tax. Any reduction in higher rates would reduce the need for a relieving provision. So far as we are aware there are very few of these cases. Nevertheless the odd case that arises can be very complicated particularly if the relief interacts with other top slicing reliefs in the same year (eg Life Assurance Policy Surrenders). On the other hand, abolition would only be a minor simplification and we would only be removing one element of a relatively complicated set of rules for taxing lease premiums.

Comment

This note by Mr Elliott is primarily factual as he is not privy to Task Force documents. The case for abolition of the top-slicing relief for lease premiums may be somewhat stronger than he suggests when it is considered in conjunction with the proposed capital gains tax changes. Premiums are akin in some respects to capital receipts and if capital gains were to be taxed at marginal income tax rates, retaining a provision to smoothe receipts only for lease premiums and not for capital receipts generally may look odd.

L J H BEIGHTON

ANNEX X

PART I : SPREADING AND AVERAGING PROVISIONS FOR COPYRIGHT, PATENTS AND ARTISTS' RECEIPTS

Payments received for the assignment etc of copyright: Section 389 Income and Corporation Taxes Act 1970.

1. Section 389 was the first of these provisions to be introduced, in 1944. Originally it applied only to payments for the assignment of copyright; but in 1953 it was extended to include copyright royalties receivable up to two years after publication. It allows recipients who spent more than a year producing the work protected by the copyright to elect to spread the receipts for tax purposes backwards over two years, or three if the work took longer than two years to produce. As with all the spreading provisions with which this note deals, the yearly instalments are equal in amount.

2. This measure was introduced in response to representations (including a letter to "The Times" from Bernard Shaw) that authors, whose income tends to fluctuate, were penalised because they might receive a relatively large sum in one year which related to several years' work, but because it would fall to be taxed in one year they might become liable to surtax in that year, even though their average annual income might in fact be below the surtax limit. It was further pointed out, in a PQ, that in the United States receipts from the sale of literary and similar works could be spread over the period of production for tax purposes.

3. It was thought to be necessary to put a limit on the period over which income could be spread, in order to avoid having to reopen agreed assessments for numerous past years. Three years was felt to be a reasonable period to allow.

4. The reason why the relief was not extended to royalties received more than two years after publication was that by

that time the large bulk of royalty receipts will in most cases already have been received. Also, an election to spread back the early royalties would commit the author to backwards spreading of the later royalties too, if these were included, and this could have the effect of actually increasing his liability in the early years after publication.

5. The Royal Commission in the Taxation of Profits and Income (1951-55) doubted the strength of the case for this relief. They argued that the cause of the authors' problems was their fluctuating profits; this was mainly due not to the fact that their work might take a long time to complete (indeed many other classes of taxpayers might argue that their income was the product of years of experience), but that the success of their work was often highly variable: that is, publication of a bestseller might bring in a lot of income in one year even though it might not have taken more than a year to write. Similarly, the artist might hold a successful exhibition in which no one work had taken more than a year (this point was picked up in 1969 when the relief was extended to artists - see note on Section 392 below). They recommended that the relief be dropped - but only if their proposal for an alternative way of relieving fluctuating incomes (for all classes of taxpayer) could be adopted; namely that income should be averaged over two years if the income in the second year fell to half of that in the first. This was never accepted by Governments except for farmers, who have since 1978 been able to average their profits over two years if there is more than 30% difference between them.

Sale of patent rights: Section 380 Income and Corporation Taxes Act 1970

6. This provision was enacted in 1945. Its main purpose was to bring into charge for the first time lump sum receipts from the sale of patent rights, but at the same time it provided for them to be spread forward over six years. This spread is automatic unless the recipient elects to have the whole sum taxed in the year of receipt.

7. The charge on lump sums received for the sale of patent rights was brought in as a corollary to the granting (in the same year) of writing-down allowances for the buyer (then over seventeen years, the life of a patent, but since replaced by the 25% annual writing down allowance).

8. A six-year period was chosen because it was said that most patents produce most of their income early in their life, and have an effective life of only about ten years. Thus the six-year spread gives a reasonable approximation of how the income would accrue if it were taken as a royalty instead of a lump sum. But there is also an analogy with the six-year period used for Section 384 (see below), which was enacted at the same time.

9. Part of the reason for allowing a spread may have been to defuse opposition in the House to the idea of bringing these payments into tax at all. Opponents argued that the payment was really of a capital nature and therefore should not be charged at all; that taxing would be a disincentive to inventors; and that the Exchequer would make a profit by allowing write-off of the payment over seventeen years while taxing the receipt at once (an argument which was only weakened by taxing it over six years instead).

Lump sum payments for use of patents: Section 384 ICTA

10. This provision, also introduced in 1945, allows a form of top slicing relief for a lump sum covering part use of a patent. The tax for the year of receipt can be reduced to that which would have been paid if the amount had been spread over the preceding years. The spread is over up to 6 years, depending on the length of the period of past use. The principal target was the payments which were at that time about to be awarded by a Royal Commission to patent-holders in respect of use by the Government during the war of patented inventions. This perhaps throws some light on the choice of a six-year period for the spread.

Sale of copyrights: Section 390 ICTA

11. This was introduced in 1967. It is available to authors and artists who sell copyrights in their works for a lump sum at least ten years after first publication. Instead of spreading the receipts backwards over up to three years, the recipient may elect under Section 390 to have it spread forwards over up to six years, depending on the length of the period for which it is assigned. The copyright sold must run for at least two years.

12. The intention of this provision was to help older people, and authors past their peak, who wished to sell their residual copyrights. It was introduced in response to pressure from, among others, Lord Goodman for the Arts Council and the Society of Authors. Their original proposal had been to exempt authors over 50 years of age from all liability on lump sums for the sale of copyright in works over ten years old ie to treat them as if they were capital receipts. The Government was unable to accept this proposal: apart from objections of principle to exempting an income receipt from tax, and to singling out authors from other classes of taxpayers with fluctuating incomes for specially favourable treatment, it would have given a disproportionate benefit to successful authors, the residual value of whose copyright could still be considerable even after ten years. These were not the people at whom relief was aimed. Accordingly, the Government instead brought in the present provision. it was modelled on the provision for spreading forward lump sums from the sale of patent rights: what is now Section 380 (see above).

13. The six year spread (as with patents provisions) mimics the tax treatment which would have applied had the author chosen to keep the copyright and take his income in the form of royalties instead of a lump sum.

Sale of works of art: Section 392 ICTA

14. This measure, which was introduced in 1969, extends the backward spread allowed under Section 389 to authors who sell their copyright, to painters, sculptors and other artists. That is, if a work of art is sold, and it took more than a year to make, the artist may elect to have the receipt spread for tax purposes over two years, or three if the work took over two years to make. This applies also to receipts from the sale of any work from an exhibition, the works at which, taken together, took longer than a year to produce even though any individual work sold may not have.

15. The reason for this provision was that the backwards spreading provision for copyright lump sums (Section 389) did little to help painters and sculptors, most of whose income arises not from selling the right to reproduce their work, but from the sale of the actual physical work itself. There had been stories in the newspapers of artists who were contemplating giving up their profession or going abroad because of heavy surtax liabilities.

16. This kind of problem only arises, of course, for artists who produce, say, one major work every few years: the provision does not therefore apply to those whose work (which may be less complex) is completed in less than a year, even though they may sell it for just as much.

PART II : PREMIUMS FOR LEASES : TOP SLICING

Schedule 3 to the Income and Corporation Taxes Act 1970

17. The old Schedule A tax on the annual value of land was abolished in 1963, and a charge to income tax was introduced on income from property, including rent. The charge was supplemented by special provisions which taxed landlords on premiums for leases for periods not exceeding 50 years. Without provisions of this kind, landlords and tenants could

simply enter into leases providing for the payment of non-taxed premium rather than taxable rent.

18. The provisions therefore treat a premium paid for the grant of a lease not exceeding 50 years as being, wholly or partly, rent to which the landlord becomes entitled when the lease is granted. A premium is treated wholly as rent, and so taxable in full at the time the lease is less than two years; if the lease runs for two years or more the tax liability is imposed on a sliding scale - the amount chargeable is reduced by 2 per cent for each full year of the lease after the first.

19. Similar provisions impose a charge to tax on a number of other lump sum payments made in connection with the right to possession of property. The charging provisions are the same as for premiums.

20. All these provisions have the effect of charging premiums or other payments (or some part of them) to tax in one go at the time the lease is granted. But in recognition of the fact that the provisions treat the taxable part of the premium as if it were rent, and consequently tax what is in effect more than one year's income (i.e. a string of notional rental payments) in one year, a "top-slicing" relief was introduced as well. This relief enables a taxpayer to claim that the tax on the premium is to be calculated at the rate or rates of tax which would have applied if he had received only one year's part of the premium in the year when the lease was granted.

CONFIDENTIAL

INTEREST RELIEF FOR INDIVIDUALS

BACKGROUND

1. Relief for interest paid other than business interest and mortgage interest was abolished in 1969, restored in 1972 and again abolished in 1974. The 1974 legislation retained relief in a few special cases. The present Government made minor extensions to these special cases in 1980 and 1981 (see below) but has not altered the basic position. The question now is whether, as part of the programme of reducing tax rates and removing unnecessary reliefs, these special reliefs should be removed and interest relief should be restricted solely to mortgage interest and business interest.

RELIEF FOR INTEREST ON LOANS TO CLOSE COMPANIES PARAGRAPHS 9 AND 10 OF SCHEDULE 1 FINANCE ACT 1974

2. The 1974 legislation retained relief for the interest on loans for the purchase of shares in a close company other than an investment company, or on loans to such a company for use in its business. The borrower had to work for the greater part of his time in the management of the business and own more than 5% of the ordinary share capital (ie a material interest). The 1980 Finance (No.2) Act abolished the work rule except as an alternative for those investors who did not hold a material interest in the company and also where the close company's business consisted of holding investments or property in circumstances where the borrower uses a property held by the company as a residence.

3. The 1980 relaxation was designed to provide incentive for outside investment in small firms and improve the tax environment in which small businesses operate. Many small companies allege it is difficult or, at least, expensive to obtain finance whereas it is often easier for an individual whether it be the proprietor or an outside investor, to borrow funds on the security of say a private residence and then on lend to the close company.

LOANS TO ACQUIRE A SHARE IN A PARTNERSHIP PARAGRAPHS 11 AND 12 SCHEDULE 1 FINANCE ACT 1974

4. The 1974 legislation provided relief on the interest on loans to acquire a share in a partnership. It required the borrower to have personally acted in the conduct of the business. This excluded sleeping partners and followed the close companies work rule. In 1981 this condition was relaxed so that any partners, other than a limited partner, could qualify for relief. The intention was to follow broadly the widening of the close company relief.

LOANS TO ACQUIRE AN INTEREST IN A COOPERATIVE PARAGRAPH 10A SCHEDULE 1 FINANCE ACT 1974

5. Legislation was introduced in 1981 to provide relief similar to that for investors in close companies with the added condition that the individual claimant must be a full-time working member of the cooperative or a subsidiary of a cooperative. The relief was introduced following representations that existing relief provisions discriminated against members of cooperatives. It was claimed that an individual entrepreneur who wished to expand beyond a sole trader status is faced with a choice of three forms of organisations ie. partnership, close company or industrial cooperative. Incentives given to invest in the first two should also be available for the third.

6. The three reliefs described above are the most important of the non-housing, non-business reliefs. They serve related purposes and can conveniently be considered together.

CASE FOR ABOLITION

7. Substantial reductions in both corporate and personal tax rates reduce the value of these reliefs and arguably render them less necessary. They can be argued to be not well targeted. Although intended to help small businesses these reliefs are also available to large close companies and partnerships. And there is evidence of leakage into non-qualifying purposes. Partners and shareholders/directors pay off loans which are used for non-qualifying purposes. The funds are then replaced by qualifying loans on which relief is allowed. In effect the individuals are getting relief for non-qualifying purposes and there is no introduction of new investment which the reliefs were designed to encourage. Moreover recent legislation eg. BES has targeted relief on small businesses in a way which did not exist when these interest reliefs were introduced. Even if these reliefs are abolished businesses requiring further funds for expansion could still usually obtain interest relief provided the loans were taken out by the business rather than by directors/partners.

8. The high earners survey last year (see Mr Johns' note of 17 October 1986 on a minimum tax) identified that interest relief generally was one of the main ways in which high earners reduced their tax bills and though it was not clear from the survey which interest reliefs were involved, these seem the most likely.

9. Abolition would remove some two pages of legislation and would be a small contribution to simplification. These advantages would only accrue gradually if, as would seem right to protect existing commitments, abolition just applied to interest on new loans.

CASE FOR RETAINING RELIEFS

10. The reliefs are intended to provide an incentive for investment in generally small businesses and to provide assistance to less wealthy individuals who wish so to invest. They provide some compensation for the higher costs of finance incurred by small businesses and encourage higher risk investment. Lower tax rates across the board will help small businesses but there is still an argument for positive discrimination.

11. Ministers have presented and defended the reliefs as extensions of business interest relief. They are almost invariably so described. Representations seek always to extend the reliefs and abolition can be expected to give rise to some controversy. This may come from the Opposition, who have supported the relief for cooperatives, as well as Government supporters, although their main concern is for parity of treatment between cooperatives and small companies and partnerships, rather than for the relief itself.

OTHER INTEREST RELIEFS

12. There are three other non-housing interest reliefs available to individuals which involve different considerations from those described above.

a. relief for interest on loans to acquire an interest in employee-controlled companies

Unlike the other interest reliefs covered in this note this was introduced by the Conservative Government in 1983. It provides relief for interest on loans used to purchase shares by employees within twelve months of an employee buy-out. The provision has been presented in the context of the Government's policy of wider share ownership and encouragement to employees to participate in the profits of their companies. Representations to extend the relief have been made and new clauses with this aim were debated and rejected during the 1985 and 1986 Finance Bill. Although there are differences of detail the general principle of the relief has been widely supported. Abolition is therefore likely to be controversial but might be more acceptable if all the reliefs discussed above were abolished at the same time. Very few companies have in fact become employee-controlled and there has been little take-up of this relief.

b. relief for interest on loans to purchase plant and machinery for use in a partnership or employment

c. relief for interest on loans to pay inheritance tax

Each of these two reliefs is fairly minor affecting few taxpayers. Abolition would be tidy but with negligible yield.

13. If you wish to consider these three other interest reliefs further we shall provide a detailed note.

YIELD, MANPOWER AND COMPLIANCE COSTS

14. We have no reliable figures on which to base an estimate of the cost of these reliefs. Our information includes them with various other minor deductions. The yield from abolition will not be substantial and would be small over the first year or two if applied only to new loans. As the reliefs only affect a few people no significant costs would be saved in the Revenue nor would taxpayers' compliance costs be much reduced by the simplification. There would be no identifiable staff savings.

CONCLUSIONS

15. If you were devising a simple, low rate, broad base tax from scratch, there is little doubt that you would not include these reliefs. Getting rid of them - over time - from the tax system would be consistent with the thrust of the Government's reforms. And unless opportunities are taken when they arise to remove minor complications of this sort the tax system goes on getting more complicated for marginal cases. But we cannot say that abolishing these reliefs would produce great simplification or any measurable saving in resources. Nor is the yield significant in a Budgetary context. You will no doubt want to weigh up the relatively limited benefits against the political difficulties of withdrawing reliefs for small businesses which your predecessors defended and extended in 1980-81.

COMMENT

If the Chancellor is contemplating some restrictions in mortgage interest relief, you might see it as something of an opportunity to review the minor interest reliefs discussed by Mr O'Connor.

L J H BEIGHTON

3975/3

TASK FORCE SECRET

Copy No. 1 of 9 Copies

FROM: P J CROPPER
DATE: 23 October 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Tyrie
Mr Call

[illegible]

I wd like [illegible] Self-emp @ progress

TAX REFORM: RUMINATIONS

Fundamental disagreement among the special advisers may help to clarify the presentational snags.

2. Andrew Tyrie argues that the people in the kink (£15,000 - £25,000) have enjoyed the benefit of an anomaly in the past and that they should not complain if that benefit is now taken away. I disagree.

3. The present argument illustrates how far we have already moved from subscribing to the contributory principle. The purpose behind the UEL is to limit an individual's contribution for the services of health and social security, to an amount broadly in line with the value of service he might be expected to consume. At present that limit is 9% of about £15,000 - i.e. £1,350 or so. The individual with an income above that level pays no more.

4. The fact that the kink has an upper cliff-face at around £25,000 is due to something quite unconnected with social security - i.e. the incidence of higher rates of tax. We are not dealing with an anomaly: we are ourselves in the middle of a fundamental change in the way we look at things.

5. We are considering whether to relate the citizen's health and social security contribution linearly to his income. All the way up. That means abandoning the concept that no

individual should have to contribute more than a certain fixed amount.

6. Most of the people who at present pay the higher rates of income tax will gain more from higher rate tax cuts than they will lose from abolition of UEL. The problem is with those people in the kink who will be hit by the abolition of UEL but who will derive no benefit from reduction of higher rates.

7. Myself, I find great difficulty in seeing how we can sell to those in the £15,000 - £25,000 bracket the fact that they will lose while everyone else gains. Indeed I would see almost as much difficulty in telling them they will gain only a little bit while others will gain a great deal. If we were planning our tax system from scratch there is no way we would be singling out this group of people for relative disadvantage. They are being caught by an entirely accidental side wind.

8. Meanwhile, I fully agree with the proposal itself and see all the elegance of the pension fund/mortgage interest relief effects. I believe we must renew our search for a measure which would ensure that the people in the kink are also invited to the forthcoming feast. I have failed so far to come up with one.

9. My colleagues and I are equally divided on the self-employed. I cannot see any justification for charging them less than we are proposing to charge employed people on incomes above the UEL/UPL. Or for extending tax relief on NI contributions above the UEL/UPL.

10. This tax relief was introduced as compensation for the fact that the self-employed were not eligible for unemployment benefit. There is no reason why that compensation should suddenly be increased in amount, extending right up the self-employed income scale.

11. Yes, there is a case for lower national insurance contributions for the self-employed at the lower levels. They do not get all the benefits. But the people in the kink would find it difficult to understand why a self-employed barrister or accountant on £150,000 a year should pay a reduced NI rate and even get tax relief on half of that. Indeed, highly paid people on Schedule E would feel just as irate. It would be impossible to contain Lord Vinson and the IOD any longer if self-employment became as attractive as that!

12. Would it be quite out of the question, between now and March, to get colleagues to agree that the contributory principle is dead, and to integrate NI and Income Tax completely? I know that this would deprive us of the putative advantage of the partial disallowance of tax relief for pension fund contribution and mortgage interest. But that would be a lesser evil than to be lumbered with all these interpersonal comparison problems. We would then be able to consider a graduated scale for combined Income Tax and NI along such lines as:

Taxable Income	Rate		Rate		Rate
0 - 15,000	30		25		25 or 30
15 -40,000	40	or	35	or	40
40 - upwards	50		45		40

I have asked for them to be costed.

P J CROPPER

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE
DATE: 26 OCTOBER 1987

1. MR ISAAC [illegible] 26.10

Subject to any points the FST may wish to make, this seems right: ie. answer to some [illegible] in para 10 wd be "yes"! N.

2. CHANCELLOR OF THE EXCHEQUER

INDEPENDENT TAXATION: VARIANTS OF THE MARRIED MAN'S ALLOWANCE

1. Mr Taylor's minute of 7 October recorded that you had ruled out the options for a married couple's allowance described as Schemes B and C in Miss Dyall's note of 28 September but at your meeting on 12 October you decided to go ahead with the "cosmetic" option, Scheme A.

2. I mentioned in my note of 28 September (and at your meeting) that a decision to introduce a married couple's allowance (MCA) could affect our approach on a number of issues, including the treatment of the elderly and breadwinner wives. This note explains briefly the changes which we think would be necessary in the proposals which you and the Financial Secretary have already approved. It also looks at the wider implications of opting for the Scheme A approach.

---

cc Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Jenkins (Parliamentary Counsel)

Mr Battishill
Mr Isaac
Mr Lewis
Mr Beighton
Mr Cleave
Mr Mace
Mr J C Jones
Mr A O'Brien
Mr Bousher
Mr Boyce
Miss Dyall
PS/IR

MACE TO CH/EX 26 OCT

Scheme A

3. Under Scheme A the part of the married man's allowance in excess of the single person's allowance (£1,370 for 1987-88) would be split off and made into a separate allowance, the MCA. (There would be no increase in the ongoing clerical staff cost of Independent Taxation as compared with retaining the married man's allowance but there would be a small increase in the computer systems development work from about 36 to 39 man years.) The MCA would always be allocated to the husband in a married couple if he had sufficient income to absorb it. If he could use part of it, but not the whole amount, it would be set first against his income, and the balance against his wife's. If he was unable to use any of it the whole allowance could be set against the wife's income. The husband would have to consent to the allocation of part or all of the MCA against his wife's income as the transfer of the allowance would breach his privacy.

N.B.

Breadwinner Wives

4. An MCA allocated according to these rules would subsume Option A in Miss Dyall's note of 16 September about breadwinner wives. The transitional provisions (TP) for existing breadwinner wives who had more than the MCA element of their husband's married man's allowance set against their income in the year before the introduction of Independent Taxation would remain unchanged.

The Elderly

5. Adapting the proposals in Miss Dyall's note of 16 September, elderly couples where both partners are aged 65-79 would have an MCA equal to married age allowance less single age allowance (£1,715 for 1987-88). The equivalent allowance for those aged 80 and over would be £1,775. A question arises, however, in relation to couples where the partners are in different age groups, so that one would be entitled to MCA of, say £1,370, and the other to MCA of £1,715. We think it would be difficult to make the amount of MCA dependent on the age of the partner to whom it was allocated, particularly as the taxpayers have no choice in the allocation. It would also be

awkward to determine the appropriate amount of the allowance where it had to be split between the partners. Accordingly we suggest that the solution should be to relate the level of MCA which an elderly couple could claim to the age of the older partner. This would mean that if either were over 65 (or over 80) they could claim MCA of £1,715 (or £1,775) regardless of whether MCA was set against the income of the older or younger partner. This is slightly more generous than the proposals in the notes of 16 September on the elderly and breadwinner wives which were based on a husband and wife qualifying for allowances on the basis of their own age and not that of their spouse. There would be an additional revenue cost of £10m.

Suppose this must be right, though it sits oddly with independent taxation.

6. If the elderly's entitlement to MCA was determined as suggested above there would be a consequential change in the transitional provisions we have proposed for elderly losers on the change to Independent Taxation (men married to older wives who qualify for married age allowance or higher married age allowance at present on the basis of their wife's rather than their own age). Once MCA at the rate appropriate to the wife's age was split off they would be left with single age allowance or higher single age allowance. This would then be frozen until overtaken by increases in the single person's allowance appropriate to the husband's age, either through indexation or otherwise. Assuming, for the purposes of illustration, indexation in line with an annual rate of inflation of 4 per cent this would take about 5 years. (Under the previous proposals the husband's married age allowance would have been frozen until the basic married man's allowance floated up to meet it).

Wider Implications of the MCA: Legislation

7. The note of the meeting on 12 October suggests that the choice of an MCA in preference to retaining the existing married man's allowance could be aborted at a late stage. I am afraid, however, that we do not think this would be possible. Although the change to an MCA along the lines of Scheme A would have only a cosmetic effect on the total allowances for which individuals qualify it will mean a rather different approach to the way the allowances are structured in legislative terms. The structure of allowances for married people

will be at the core of a number of provisions in the legislation especially those for the elderly and breadwinner wives, but it will also affect the form of the legislation in other areas, for example on the year of bereavement (see Mr Kent's note of 8 October). The legislation on the transitional provisions for the elderly and breadwinner wives in particular is likely to be some of the most complex of all that required for Independent Taxation. We need to make an early start on instructions to Counsel on all these aspects, based on firm decisions.

8. As you know the timetable for considering the policy issues involved in Independent Taxation and working up the necessary legislation is very tight. There will not be time to go back at a later stage to restructure the legislation on a different basis. We need to know that your decision to opt for a cosmetic MCA is a firm one which will not be subject to change.

9. The cosmetic MCA would, as you know, be a very limited change. It would not tackle the sex discrimination inherent in the married man's allowance, nor the distributional problem between one and two-earner couples. It would get rid of the "married man's allowance" label from official (though perhaps not popular) vocabulary and could be of some help in the presentation of the provisions for the elderly breadwinner wives. But the MCA could not be presented as a significant change to the structure of allowances. The rules for the allocation of the allowance will have to be spelt out in the legislation, and this will make it clear that the MCA retains essentially the same characteristics as the present married man's allowance. As was discussed at your meeting you would have to resist pressure from those who would like to make its allocation more flexible, along the lines of Schemes B or C.

Yes, though a less objectionable variant of something we're stuck with.

Questions for decisions

10. (i) Are you content for us to instruct Parliamentary Counsel on the basis that your decision to opt for a married couple's allowance is a firm one, not subject to change?

(ii) If so, are you content for the rules for the elderly under Independent Taxation to be amended as described in pargraphs 5 and 6 above?

B A Mace

B A MACE

COPY NO 13 OF 14

FROM: J M G TAYLOR
DATE: 26 October 1987

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Mr Cassell
Mr Byatt
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Jenkins
Mr Battishill - IR
Mr Isaac - IR
Mr Beighton - IR
PS/IR

TAX REFORM: REMOVING SHELTERS: STARTER 454

The Chancellor has seen Mr Beighton's minute of 23 October. He takes it that restricting the tax relief for foreign entertainment (mentioned at the end of Mr Beighton's cover note) is firmly in hand as a starter for 1988.

J M G TAYLOR

FROM: J J HEYWOOD
DATE: 27 October 1987

PS/CHANCELLOR

cc Sir P Middleton
Mr Cassell
Mr Byatt
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Jenkins
Mr Battishill IR
Mr Isaac IR
Mr Beighton IR
PS/IR

Ch/ Do you agree with FST's concls (i.e. that we act as he proposes on redundancy payments + premiums for leases, but take no action on the rest)?
JS 28/10

TAX REFORM: REMOVING SHELTERS: STARTER 454

1. The Financial Secretary has read Mr Beighton's submission of 23 October and your minute of 26 October.

2. The Chancellor asked about the proposal to restrict the tax relief for foreign entertainment. This is a Budget Starter (No. 211) and a submission will come forth in due course.

3. As far as the tax shelters listed in Mr Beighton's submission are concerned, the Financial Secretary is not very attracted to abolishing these reliefs. He thinks that several general points need to be made:

(i) The Finance Bill is already looking long, complicated and quite controversial. He thinks we should only add to the Bill where there are clear advantages in any new measures. The Financial Secretary is not convinced that action on the minor shelters listed in Mr Beighton's paper do offer significant advantages, since;

(ii) The minor shelters offer nothing in the way of manpower savings or revenue and would not even *in toto* amount to much of a simplification;

(iii) At the same time, minor though these issues undoubtedly are, they would all definitely be highly controversial with the groups affected. They would in fact be resisted with a force quite disproportionate to their significance within the tax reform package; and

(iv) We will already be able to point to a number of more substantive areas where shelters are being removed or simplifications are being made (eg. Forestry, maintenance and covenants, benefits-in-kind and possibly enterprise zones and residence).

4. The Financial Secretary, with these preliminary thoughts in mind, would put the following recommendations to the Chancellor:

Redundancy Payments: The Financial Secretary thinks that there is a case for action here. The present arrangements are largely a product of the very high marginal rates of income tax seen in the past. Nevertheless one could argue that they retain relevance even if rates are reduced - since companies should not be discouraged from making redundancies, where this is commercially necessary. The Financial Secretary thinks that some relief is useful for taking the sting out of redundancy for middle income groups. However, we do not need such generous relief for higher income groups who will gain in other ways from the package. The Financial Secretary's preference, therefore, would be for Option B - abolition of the spreading reliefs but an increase in the threshold to £30,000. (Mr Cropper and Mr Tyrie would ideally favour out-right abolition of the present arrangements (ie. the exemption and the spreading reliefs). The Financial Secretary thinks that would arouse needless controversy).

Premiums for Leases: The Financial Secretary thinks that this can be considered separately from the other shelters in Annex X of Mr Beighton's paper. He favours abolishing top-slicing relief.

Copyrights, Patents and Works of Art: The Financial Secretary does not think that abolishing these spreading reliefs would be attractive at all, not least because the Chancellor has already ruled out removing the farmers' averaging provisions. He thinks that action on these reliefs would bring about a fierce reaction from the arts lobby and that the row would just not be worth it.

Interest Relief: All these reliefs have a "small business" or "enterprise" flavour, and all have been extended or relaxed in some way since 1980. Although there is some evidence of abuse or leakage to non-qualifying purposes, the Financial Secretary again thinks that these measures would not be very significant. There would be no real manpower savings and we would face opposition from the unquoted companies and others. The Financial Secretary is, therefore, against abolition.

CONCLUSION

5. The Financial Secretary realises that his conclusions may appear rather pusillanimous. But his strong view is that the benefits in terms of simplification are very minor and would be outweighed by the potential disadvantages and the opportunity for the Opposition in the Committee Stage of the Bill. He thinks these measures would be a distraction from the main package.

9.ᴊ

JEREMY HEYWOOD
Private Secretary

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

From: M A HILL

Date: 27 October 1987

1. MR JOHNS MAJ 27/10
2. ECONOMIC SECRETARY

BS 353: CAPITAL GAINS AND FARM OUTS

1. Following an adverse legal decision which put at risk some £m150 of tax in respect of past transactions, legislation was introduced last summer to make it clear that capital gains rollover relief was not available for gains on the disposal of interests in oil licences. That legislation - now section 80 Finance (No.2) Act 1987 - came in for a fair amount of criticism. In large part this was because of its retrospective nature. But in addition the oil industry felt it might inhibit the sort of farm out arrangements early in field life which work to the full and speedy exploration of licensed acreage.

2. This latter criticism was considered to have some force. Accordingly, during the Committee Stage debates on section 80, you announced the Government's intention to "discuss further with the industry .... the possibility of introducing some form of rollover relief for gains, past and present, on work programme farm outs at the exploration phase where no cash profit is

---

cc Chancellor of the Exchequer
Financial Secretary
Mr Cassell
Mr Scholar
Mr M Williams
Miss Sinclair
Mr Wilson
Mr Jenkins - Parlia. Counsel
Mr Painter
Mr Pollard
Mr Beighton
Mr Johns
Mr Cleave
Mr Ridd
Mr Elliss
Mr Beauchamp
Mr Cayley
Mrs Hubbard
Miss Hill
Mr Kuczys
Dr Parker (Stats)
PS/IR

realised." You went on to make it clear that any legislation emerging from these discussions would be a matter for the 1988 Finance Bill (Hansard 16 July 1987 col. 1320).

3. The purpose of this note, therefore, is to report on the discussions which have now taken place with the industry, and to make recommendations on the form that any CG relief for certain farm outs might take.

Discussions with the industry

4. A meeting to discuss the farm out issue was held on 26 August, with UKOOA, UKOITC and Brindex all separately represented. This meeting enabled the industry to put forward their own suggestions for relief and for us to point out to them some of the consequences of what they were suggesting. The representative bodies were then able to consider the issue further in the light of the points made in the discussion, and both Brindex and UKOOA (who on this occasion speak for UKOITC as well) have now written expressing a firm preference. Notwithstanding the possible divergence of interests between the farmer out (usually one of the smaller companies) and the farmer in (typically a larger company), the industry seems remarkably unanimous on this issue. What the industry would like is exemption, rather than rollover - ideally for all farm outs at the exploration stage.

5. These discussions seem to point fairly clearly towards providing relief of some sort in the forthcoming Finance Bill. There is undoubtedly a class of farm outs which are desirable in terms of overall development of our oil and gas resources. In some of these cases it is certainly possible that an immediate CG charge could act as an inhibiting factor. In addition the industry's own expectations have been raised by what was said during the debates on section 80 F.(No 2)A 1987 (see paragraph 2). Were nothing to emerge now they would be sorely disappointed.

6. From the Government's point of view, it seems that a relief here need not be too costly - though the cheaper it is, the less it would match up to the industry's ideal. Equally, though this is a matter for Parliamentary Counsel, it would appear that such a relief could be achieved by relatively short - and we would hope uncontentious - legislation.

7. The remainder of this note goes on to examine the details of such a CG relief, focussing in turn on three aspects of this issue: the period in field life for which any relief should apply; which particular farm out arrangements should qualify; and the form any relief should take.

Costs

8. In order to set the technical consideration of these three aspects in context, it is perhaps helpful to focus first on the costs involved. The first aspect - the particular cut off point taken - would have a fairly major impact on the revenue effects of any relief. This is because, whereas gains made at the exploration stage are typically small, some quite large gains have been made at the appraisal stage. We know of two cases - both pre Annex B - which would alone account for some £35 million tax.

9. Precisely which sort of farm outs qualify for relief could also be crucial in cost terms. Farm out arrangements come in a wide variety of forms, but for this purpose we can perhaps focus on three different types of consideration - an agreement to perform specified works; a swap for another licence interest and cash. Work programmes do not usually produce large gains, particularly when valued on the basis now proposed by the Oil Taxation Office. Indeed we reckon that the 200 or so past work programme cases outstanding at present will amount to no more than £2m - £3m tax. So a relief limited to work programme cases would have a cost which is negligible in FSBR terms.

10. Though difficult to put an exact figure to, we believe adding licence swaps to the qualifying category could substantially increase this revenue cost. (This is because, whilst few in number, some of the licence swaps we have seen have involved blocks in which oil or gas has already been discovered.) But the really large gains - including the two mentioned above - are almost invariably cash disposals. At the extreme therefore, a relief for all licence gains up to the point Annex B approval is given would cost £m70 in respect of past disposals, with a likely continuing annual cost of at least £m10.

11. As to the form of the relief, the immediate revenue effects of rollover and exemption would be the same in all cases where a taxable gain would otherwise arise. (With disposals which produce a loss, exemption - depending on the form it took - could rule out the possibility of immediate loss relief.) But in the case of rollover, the CG charge is simply deferred, not eliminated altogether - though the tax would probably not become payable until well into the future. Equally the different treatment of the farmer in under rollover and exemption would eventually feed through to the Exchequer, when the farmer in himself disposed of the licence interest he had acquired. To the extent that the farmer in got a smaller CG deduction under exemption than under rollover, more tax would accrue to the Exchequer on his subsequent disposal of the licence interest.

Technical details

i. Timing of any relief

12. On the question of timing, your undertaking was of course in terms of farm outs "at the exploration phase". The industry readily accept that farm outs in mature fields (eg the 1983 Forties deal) should not qualify, and have given considerable thought to what would be an appropriate cut off point. Their conclusion is that, though arguably over-generous in extending to the appraisal stage as well as pure exploration, the only

sensible dividing line would be Annex B approval. Anything which tried to focus the relief more narrowly - eg a set time before Annex B consent, date of PRT field determination or when a certain number of wells had been drilled - would in their view be arbitrary and capricious in its results.

13. Having racked both our own brains and those of the Department of Energy, reluctantly we have to agree with the industry's conclusion that there is no workable alternative to an Annex B cut off. Under such a rule relief would be available if, at the time of the disposal of the licensed interest, development consent had not been given in respect of the licensed area. This unfortunately means going beyond the exploration phase itself to embrace farm outs at the appraisal stage, where there are some large gains to be made. We think it should be possible to exclude these large appraisal stage gains - if that is thought appropriate - by restricting the sort of farm out arrangement which qualifies for relief (see below). But such a restriction would of course mean that not <u>all</u> exploration phase farm outs are able to get relief.

ii. <u>Which farm outs should qualify?</u>

14. As noted above, ideally the industry would like any relief to extend to <u>all</u> disposals of licence interests - past as well as future - taking place before Annex B approval. In other words they would like to include those farm outs where the consideration is cash just as much as those where, instead of cash changing hands, the farmer in undertakes to carry out a programme of work on the licensed area. In arguing for a relief along these lines, they point out that, whatever the nature of the consideration, all these early farm outs can be said to work towards the full and timely development of our oil and gas resources.

15. But the industry do seem to consider the work programme case as particularly deserving of protection from an immediate CG charge. If any relief were to be limited to particular

arrangements, some industry representatives would press for licence swaps also to be covered. This did not, however, seem to be an issue which was of widespread concern.

16. On the basis that the cut off point has to be Annex B, a relief which extended to all farm outs, regardless of the nature of the consideration, would be extremely expensive - around £m70. The obvious way of limiting this cost, if that were thought desirable, would be to restrict the relief to specific categories of farm outs. In any case there is, in our view, a genuine distinction to be made here between farm outs where actual cash changes hands and those where the consideration takes the form of an undertaking to carry out a programme of work on the licensed area. In the latter case there are obvious benefits to North Sea exploration and development generally, but the farmer out does not have any cash out of which he can pay an immediate CG bill.

17. Though not particularly common, there are certainly some farm outs which are for part work programme and part cash. If a basic distinction is to be drawn between cash and work programmes, it would seem harsh if these hybrid cases were left out altogether - though arguably the relief should extend only to the work programme element.

18. Less clear cut is the case of the licence swap. Here too, the farmer out receives no cash out of which he can meet an immediate tax bill. But there is nothing analogous to the work programme and these farm outs, where they do happen, typically involve a few larger companies shuffling their interests among themselves. Going by past experience, the gains arising as licence swaps can be quite sizeable and hence the Exchequer cost of providing relief quite large. Also asset swaps happen in other areas and would normally attract either an immediate or deferred CG charge. On balance therefore our recommendation would not be to try to include licence swaps in any relief.

19. On a rather different point we would agree that any new relief should apply to past disposals as well as any qualifying disposals made in the future. Because of the earlier uncertainty over the legal position, there are now some 200 past work programme farm out cases awaiting valuation. To leave all these to be dealt with on the basis that no relief is available would be extremely unpopular with the industry. Moreover, as section 80 itself applies for the past as well as the future, it would leave the Government open to the criticisms of inconsistency and inequity. Admittedly retrospective legislation would be required to enable past cases to qualify; but in this instance the retrospection would generally be in the taxpayer's favour. Overall, therefore, there seems little danger of reviving the sort of "constitutional" arguments which were provoked last summer by the introduction of section 80 and section 62 (foreign partnerships).

iii. <u>Form of any relief</u>

20. Finally on the form of the relief, the industry still want - notwithstanding the discouragement given in your 19 August letter to Brindex - to go for exemption rather than rollover. In making this suggestion they clearly put a high premium on avoiding the need to value the gain/loss in work programme cases. Accordingly they are prepared to accept that the farmer in should lose any CG deduction for the value to the farmer out of the work programme.

21. Brindex themselves have floated the idea of an exemption for the farmer out, coupled with a corresponding reduction in the farmer in's acquisition cost (ie on a subsequent disposal he would be treated as having acquired that particular licence interest at nil cost). And at a recent meeting with UKOITC an idea which we ourselves put forward - providing exemption indirectly by deeming the right to have a work programme carried out to have nil value for CG purposes - seemed to meet with general approval, though the industry will be thinking more about it and coming back to us.

22. Your original undertaking (see paragraph 2) was to consider the possibility of providing rollover relief for certain farm out gains, rather than exemption. You will recall that, before the July undertaking, some thought was given to what rollover relief for work programme farm outs would mean in legislative terms. The conclusion then was that, whereas it should be possible to draft such a relief, it would necessarily have some rough edges. In particular there could be difficulties over tying in with the general rollover relief rules about reinvestment in replacement assets. Further consideration has reinforced those original doubts. In particular it has led us to conclude that, without some pretty heroic deeming provisions, the extreme case of a farmer out so strapped for cash that he simply has nothing which he can reinvest may still be left facing an immediate CG bill.

23. Following Brindex's 11 August letter to you, some preliminary consideration was also given to the exemption route. Our feeling then (my note of 18 August) was that exemption might be more difficult to square with the rules applying to other tax payers and that, in the oil context, there could be difficulties over the position of the farmer in. Taking this latter issue first, the industry have been surprisingly ready to accept that the price to be paid for an exemption for the farmer out is a corresponding loss of a CG deduction for there farmer in. So these particular difficulties may be more apparent than real.

24. On the other hand, it remains the case that to grant exemption might be seen as treating the oil sector more generously than other tax payers. This might provoke criticism on grounds of inconsistency and inequity, and could well lead to pressure to extend parallel treatment to other areas. However it may be that any problems on this score could be reduced to a minimum by the particular route whereby exemption is given. Moreover a work programme is a fairly unusual type of consideration in that any value to the disposer is in large part contingent on the work done actually finding oil, and it might be felt to justify special treatment.

25. Turning to the various possibilities for providing exemption, Brindex's suggestion of a straight exemption for the farmer out coupled with a corresponding restriction on the farmer in's acquisition costs would certainly avoid the need for work programmes to be valued. But by operating on the farmer in's acquisition cost it would run more obviously and directly counter to the rules applying to other classes of CG payers than some other exemption possibilities.

26. Rather more promising is the route which we suggested to UKOITC - ie providing an exemption indirectly by deeming a work programme itself to have nil value for CG purposes. By focussing on the work programme itself, this should minimise the possibility of invidious comparisons being drawn with other CG payers. In the vast majority of cases, such an option would again remove the need for the value of the work programme to be established. And it would deal automatically with the hybrid - ie part cash, part work programme - case, by charging only that part of the gain due to the cash element.

Conclusion

27. In your July statement you said you were sympathetic to the idea of rollover relief for work programme farm outs at the exploration stage. We would suggest that the relief should, as you foreshadowed, be restricted to the work programme element of farm outs. But we would recommend that it extend to the appraisal as well as exploration stage by using Annex B as the cut-off, and take the form of exemption (through the mechanism of treating work programmes as having zero value).

28. The costs of a relief on these lines would be some £2m - £3m in respect of past gains and a correspondingly negligible cost for future years. At this stage it is not possible to make any firm predictions about how much Finance Bill space would be needed, but we would hope that the legislation to provide such a relief would not amount to more than a couple of pages.

MAH

M A HILL

29.10.87

TASK FORCE SECRET

f 31

Inland Revenue

Policy Division
Somerset House

CAYLEY TO CH 29.10.87

Grateful for views of FST on this.

FROM: M F CAYLEY
DATE: 29 OCTOBER 1987

1. MR ISAAC

2. CHANCELLOR OF THE EXCHEQUER

CGT : DEFERRED CHARGES AND REBASING

1. There is one major subsidiary issue on CGT rebasing on which we thought it could be helpful to let you have a note in advance of your meeting on CGT. This is the interaction with the rules for deferred charges. Briefly, the issue is the extent to which tax charges deferred on occasions before 6 April 1988 should benefit from rebasing.

The issues addressed are not affected by the possibility of abolishing general gifts relief, since they relate to occasions when tax has already been deferred, or will have been before April next year.

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cc		
cc	Chief Secretary	Mr Battishill
	Financial Secretary	Mr Isaac
	Paymaster General	Mr Beighton
	Economic Secretary	Mr Calder
	Sir P Middleton	Mr Pitts
	Sir T Burns	Mr Cayley
	Mr Cassell	Mr Gonzalez
	Mr Byatt	Mr Hamilton
	Mr Scholar	Mr R H Allen
	Miss Sinclair	Mr Glassberg
	Mr Cropper	Mr Yard
	Mr Tyrie	Mr Boyce
	Mr Jenkins	Mr Michael
	(Parliamentary C.)	Mr Quinn
		Mr Heggs
		Mr C Lester
		PS/IR

Types of deferral provisions

2. The CGT provisions under which tax on a disposal can be deferred to a later occasion fall into two broad types:-

i. "no gain/no loss" transfers. Under these an asset changes hands, but the person acquiring it is treated as stepping into the shoes of the original owner, and takes on the original owner's acquisition cost. The main examples are gifts between spouses; and the transfer of an asset from one member of a company group to another company in the same group.

ii. rollover/holdover. The gain is quantified at the time of the disposal but not charged until a later occasion. The main examples are the general relief for gifts and the business rollover relief allowing tax deferral when a replacement asset is acquired. The deferred gain reduces the acquisition cost on the final taxable disposal.

"No gain/no loss" transfers

3. Where someone has received an asset via a "no gain/no loss" transfer and the asset was originally acquired before 1982, they will have the full benefit of rebasing. This will follow from the general principle that the recipient is treated under the legislation as stepping into the shoes of the original owner. And the equivalent happens now for indexation: an election to have indexation relief computed by reference to 1982 values can normally be made only where someone owned the asset at 1982 - but the person who received it via a "no gain/no loss" transfer after 1982 is treated as having owned it at that date if the transferor did so.

Rollover/Holdover

4. Where tax was deferred on an occasion before 1982, the full benefit of rebasing will again normally be available. This follows from the fact that

a. business rollover - the replacement asset will have been acquired before 1982.

b. gifts holdover - the donee will have owned the asset since before 1982.

And again too the equivalent is so now for indexation: the taxpayer can elect for a 1982 valuation.

5. No difficulty arises where tax has been deferred on the disposal of an asset acquired after 1982, because by definition rebasing, and an election for a 1982 valuation for indexation, do not come into the picture.

6. The complications arise where someone acquired an asset before 1982, made a disposal after 1982, and claimed rollover or holdover. Here indexation relief is computed by reference to:-

a. business rollover - the value of the replacement asset or assets as reduced by the deferred gain.

b. gifts holdover - the value of the asset at the time of the gift, as reduced by the deferred gain.

In both cases, the adjustment for the deferred gain can reduce the CGT base cost below what would have been the 1982 value.

7. In these cases, it will frequently not be possible to identify how much of the deferred gain arose before 1982 and how much after. For example, when a valuable business asset is

sold, and rollover relief is claimed, there may be a large number of replacement assets. Within groups of companies, the gain on the old asset may have been rolled into replacement assets owned by several group companies. Some of these replacement assets may since have been sold, with part of the deferred gain being charged, or further rollover claimed; some may have since been transferred to another company in the same group. If they were owned by an individual, they may have since been given to someone else with gifts holdover relief. If the donor has died, the donee may well not be able to show whether the asset was acquired by the donor before or after 1982, and we are unlikely to be able to help him. And so on. It would not be possible to unscramble all this in order to identify how much of a deferred gain brought into charge after 6 April 1988 was attributable to the period up to 1982. And it follows that - even were it desirable to do so - it would not be possible to exclude from the charge the pre-82 component of the deferred gain.

8. Accordingly, as things stand, where an asset was acquired before 1982, and rollover/holdover was claimed on an occasion after 1982, the taxpayer will not see any benefit from rebasing.

What form might a concession take?

9. Before considering the arguments for and against doing anything about this, it may be helpful to discuss what form a concession might take.

10. We shall not be able to identify all cases within the category concerned, for example in some complex group cases and in the case of gifts holdover where the donor has died. It will be necessary therefore to put the onus on the taxpayer to make and substantiate a claim. Even then, in the case of holdover where the donor has died, the taxpayer may be unable to substantiate a claim. If the taxpayer can show that the deferred gain accrued at least in part before 1982, the only practicable solution we have found would be simply to exclude

from charge an arbitrary proportion of the deferred gain - say 50%. In complex group cases there would still need to be quite complicated calculations to work out the amount of the deferred gain to which the 50% reduction would be applied and the detailed procedures for this have yet to be determined.

11. In some cases (eg. where the original asset was acquired just before 1982) 50% relief on these lines will be exceedingly generous. In others, taxpayers will argue that, if it were possible to compute the pre-82 element, it would have been much more than 50%. By definition, the option would give rough justice, and it would have to be presented as a pragmatic solution in circumstances where the exact answer will often be unobtainable. I refer to this as the "50% option".

Arguments for and against a concession

12. Those arguing for rebasing or a proxy for rebasing would point out that, unless a concession like this was made, there would be some circumstances where pre-82 gains were still taxable. And they would contrast the position where tax was deferred just before 1982 (where rebasing would apply - see paragraph 4) with that where an asset had been acquired before 1982 and tax was deferred just after 1982, when rebasing would give no benefit. At the extreme, the difference in the time of deferral might be a matter of days - the difference between say 28 March 1982 and 8 April 1982.

13. In the case of gifts, people could also draw a comparison with married couples: as explained, rebasing would always apply to a gift from one spouse to another of an asset acquired before 1982. The answer to this would have to be that this reflects the consequences of a tax system treating married couples as one: independent taxation will correct this for the future, but cannot rewrite the past, and we have to live with the consequences of how the tax system has operated up to now.

possibly.
HG

14. There is a more general argument for doing nothing. This is that rebasing consists of excluding from charge pre-82 gains on assets owned at 1982; that all such gains should be excluded where someone disposes of an asset they owned, or are treated under no gain/no loss provisions as owning, at 1982; and that this is so even if rollover or holdover has been given on an occasion before 1982. But things are different where an asset was acquired before 1982 but rollover or holdover was given on an occasion after 1982. Here to give the 50% option would place those who chose to defer payment of tax at an unjustified advantage over the person who paid the tax at the time. The theoretical line would thus drawn between those who dispose on or after 6 April 1988 of an asset they owned (or are treated as owning) at 1982, and those who dispose of an asset they acquired later. In the latter case, any deferred charge would be preserved in full; in the former any deferral before 1982 would be left out of account.

CTT and IHT precedents

15. There are in fact some CTT and IHT precedents for preserving deferred charges:-

i. people with reversionary interests - that is, broadly, a right to a share of the assets of a trust when it comes to an end. Transfers of such interest were liable to Estate Duty but tax could be deferred until the property actually passed out of the trust. They are exempt from CTT and IHT, but deferred Estate Duty charges were preserved.

ii. Under CTT and IHT tax on the value of timber can be deferred until the timber is felled; while deferred charges can also arise on heritage property where the conditions for the heritage exemptions cease to apply. Where tax had been deferred, or conditional exemption given, on a lifetime gift under CTT, the contingent charge has been preserved under IHT even though there is no general IHT liability on lifetime gifts.

Conclusion

16. If nothing is done for this category of deferred charges, it is virtually certain that there will be considerable pressure for a concession. And those affected will not be readily convinced by theoretical arguments for doing nothing. However, the only practicable concession we have been able to devise is to exempt an arbitrary proportion of the deferred gain where an asset was acquired before 1982 and the tax was deferred under the rollover/holdover provisions on a disposal between 1982 and 1988. People will say this gives too little help in some cases and too much in others; and even this option would involve considerable practical difficulty in some cases.

17. We would be grateful for Ministers' guidance on whether they would wish to introduce a concession of this kind.

Michael Cayley

M F CAYLEY

TAX POSITION

★ All contributions, by the employer or the employee, are paid from earnings before tax. Thus, an employee who earns £10 will usually pay tax of £2.70 and take home £7.30. Instead he could contribute £10 towards his savings in Farmsave, pay no tax on it, and his take-home pay would be reduced by £7.30. So the full £10 is in his savings at a cost to him of only £7.30.
★ Within Farmsave all the monies increase by investment income entirely free from Capital Gains Tax and Income Tax.
★ At retirement, at most one quarter of the accumulated savings may be uplifted entirely free from tax.
★ The remaining monies are used to buy a pension for life which is then taxed under PAYE in the usual way.

In total, there is no more tax advantageous way to save for retirement than through a properly organised pension arrangement like Farmsave.

WHY CHOOSE STANDARD LIFE?

Eight leading insurance companies were invited to consider a pension scheme for the agricultural industry. From the discussions and research which followed, Standard Life emerged as the most suitable for the following principal reasons:

1. Most farmworkers will probably choose a "with-profits" Personal Pension policy. "The Economist" magazine regularly reviews the performance of with-profit policies from forty insurance companies. This review has been conducted eighteen times since 1950. Only in 1975 was Standard Life not among the top three. In that year it was fourth. This is an outstanding record of consistently good performance.
2. Standard Life is big enough to handle the large number of potential members and the administration problems of the widely dispersed farming industry.
3. In return for being the recommended pension provider to the industry Standard Life will supply its Farmsave policy direct to farmworkers on "non-commission" terms. This could save the industry over one million pounds of commission in the first year which would otherwise be paid as each farmworker consulted his local insurance broker. The financial benefits to the farmworker from Farmsave will be that much greater.
4. Finally, Standard Life was enthusiastic and helpful in its approach.

By recommending Standard Life, the Wages Board will ensure that most farmworkers commence their pension provision with a top quality product from a leading insurance company. Without such a recommendation, individual farmworkers would be left at the mercy of high pressure salesmanship on a subject with which they are probably unfamiliar.

None of this will prevent an individual farmworker from choosing a Personal Pension policy from a different insurance company if he so wishes. As Personal Pensions become widely accepted in the years after 1988, there will be incomers to the agricultural industry who already have such a policy and their £4 per week can be directed to it. Some farmworkers may have particular reasons for choosing another insurer. The choice of Standard Life is not mandatory, it is a recommendation designed to ensure that pensions for the agricultural industry are given the best possible start.

WHO CAN JOIN FARMSAVE?

All full time workers employed in agriculture in Scotland and covered by Wages Orders of the Scottish Agricultural Wages Board will be able to take out a Farmsave policy,

★ except those employees who are already members of an occupational pension scheme operated by their employer to which the employer contributes at least £4 per week,
★ and except those employees who choose to have a Personal Pension policy from another financial institution to which their employer contributes at least £4 per week,
★ and except those employees who choose not to have any pension provision and for whom there shall be no obligation on their employer to pay, in wages, the pension contribution foregone.

Any other employed person in the agricultural and allied industries may choose to participate in Farmsave, provided that he or she or their employer contributes at least £4 per week. This facility is open to farm managers, relatives of a farmer and anyone in the industry provided that they have earned in excess of about £1,350 per year, and provided that pension contributions have not already been paid in respect of these earnings, and provided that the individual is not self-employed for tax purposes.

ADVISERS TO THE TRANSPORT & GENERAL WORKERS' UNION

When the T&GWU wanted advice about pensions for the agricultural industry they turned to Bacon & Woodrow, one of the largest firms of Consulting Actuaries in the United Kingdom. Bacon & Woodrow provides advice on all aspects of pensions to hundreds of companies and organisations including Boots, House of Fraser, Ford and others; in total about £23,000m of pension funds. In addition, Bacon & Woodrow advises several major UK life assurance companies. It was Bacon & Woodrow who recommended that the simplest way for the agricultural industry to provide pensions would be an industry-wide agreement to adopt the Government's new concept of Personal Pensions.

CONTACT NUMBERS

For further information, contact:
Transport & General Workers' Union, Agricultural & Allied Workers' Trade Group (Scotland), (Hugh Wilson) 0387 54514.
Bacon & Woodrow (Ralph Brereton) 031-220 1240.
Standard Life (Fraser Stuart) 031-245 7040.

3976/14

TASK FORCE SECRET

Copy No 1....of..5..Copies

FROM: P J CROPPER
DATE: 30 October 1987

CHANCELLOR

Ch/ You saw this in the context of employee benefits. There are action points 'removing shelters' - see FST's minute, behind.

cc Financial Secretary
Mr Tyrie

TAX REFORM: REMOVING SHELTERS: EMPLOYEE BENEFITS

On shelters, I am content to go along with the FST's "strong view". On employee benefits, see discussion @ para ...

Removing Shelters

The Financial Secretary has reported (Mr Heywood's minute to PS/Chancellor 27 October) on the discussions he has been holding on various tax averaging and tax relieving measures applicable to redundancy payments, premiums for leases, copyrights, works of art etc, and small business and partnership interest relief. He makes a number of modest recommendations, which he says "may appear rather pusillanimous".

2. The recommendation of bold and courageous proposals by special advisers is always open to the riposte: "Yes, OK, but you won't have to carry them through the Standing Committee." I know that. But I do hope we will cling to the fact that the major cuts in mainstream income tax rates, which we hope to introduce in 1988, provide the opportunity of a lifetime for eliminating special interest group concessions.

3. Many if not most of these shelters were introduced in response to income tax rates of 60, 83, 98 per cent. Some of them were cynically introduced by the Socialists, as breathing holes in a smothering blanket of entrepreneurial discouragement. But they would never have been introduced in the first place with tax rates of the sort we are now toying with.

4. These shelters may not be too costly in revenue or resources, because each one only affects a limited number

of people. But they all add up, they are a hunting ground for the tax avoidance advisers, and they are rife with opportunities for abuse.

5. Is it not a case of being as well hung for a sheep as a lamb? If we abolish a whole raft of these artificial shelters, do we not stand a better chance of having the '88 Budget seen as a "radical clean sweep of excessive personal tax rates and of their parasitical barnacles"? Once we start being selective among the special reliefs (because, perhaps, the farmers are a more effective lobby than the artists, or the accountancy partners than the redundant shipwrights) we will get separated from the light of principle, and become bogged down in argument and log-rolling.

6. I know this is starry-eyed stuff, but it is, after all, what we have all been working for since 1975.

Employer Tax v Employee Tax

7. It is clear from discussions that the switch to an employer based benefit tax would involve a very considerable upheaval. Not only in compliance terms, but in real economic terms - the transfer of a substantial tax bill from employees to employers. This being so, the onus is on those who would change the system to justify their proposal. The big doubts seem to me to be:

1. **Simplification**? It would be a great gain, to get rid of the P11D and all its works. But it does not look as if we would get completely rid of it. The major benefits, primarily cars, would be switched to the new system. Most of the minor benefits would remain to be covered by a variant of P11D. Two systems in place of one.

2. **Economic Effect**. A sizeable tax burden would be switched from employees to employers. In theory, employers would compensate themselves by holding pay down in the next round. I doubt very much if that would happen. Employees would simply find themselves relieved of a nasty tax bill, and employers would find their profits slightly diminished.

3. **Perceived Equity**, as between those in jobs that carry cars, and those whose jobs do not. There is a strong probability that, after a year or two, employees will cease to remember that their employers are paying benefit tax on their behalf. Those without cars will jealously observe that "those with cars are getting a tax free benefit". Equity will not be seen to prevail.

On the other side of the equation, it is undoubtedly true that it would be easier to jack up the car scales to a "proper" level under the employer based tax, and that the occasion of the switch would provide a smokescreen behind which to do it.

8. For myself, I remain doubtful on balance about the wisdom of changing the system in this way. But I do think that we should use the next Budget as an occasion for raising the car scales, very substantially. The problem is that we would be hitting a lot of people who are already in or around the kink. For people on higher rates, the advantage of income tax cuts will far outweigh the extra cost of paying a "proper" level of car benefit.

9. As to systems, it seems to me that we are stuck with the PllD. We must try to simplify the system, maybe by defining in those benefits which are in future to be taxed (cars, health insurance, education, holidays, accommodation). I do not think we will achieve an equitable system (as between one person and another on the same income level) by raising the £8,500. We may have to go the other way and abolish the limit. Or maybe we have to define out the smaller items of benefit.

P J CROPPER

TASK FORCE SECRET

COPY NO. 10 OF 11 .

FROM: A C S ALLAN
DATE: 2 November 1987

MR SCHOLAR

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr McIntyre
Mr Macpherson

PS/IR
Mr Isaac - IR

ACSA → SCHOLAR 2/11

SELF-EMPLOYED NICs

The Chancellor would be grateful for information on the following additional option to deal with the issue of self-employed NICs. This would be to abolish the 50 per cent deductibility of NICs against income tax, and to use the resulting yield to cut (or eliminate) Class II contributions. He would be particularly interested in an analysis of the distributional effects of this.

ACSA

A C S ALLAN

COPY NO 10 OF 11

FROM: A C S ALLAN

DATE: 2 November 1987

MR MACE - INLAND REVENUE

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Cropper
PS/IR
Mr Isaac - IR

ACSA → MACE 2/11

TAX PACKAGE

The Chancellor would be grateful for information about the costs and distributional consequences of the following options:

(i) Bringing the basic rate down to 24p instead of 25p.

(ii) Cutting employees NICs to 8 per cent, starting at the point where the existing 9 per cent rate starts.

(iii) Raising thresholds by amounts which would cost the same as either (i) or (ii) above - ie two different options.

2. He would be grateful in particular for a comparison of how these various options affect the basic rate losers under the existing package.

ACSA

A C S ALLAN

Inland Revenue

Policy Division
Somerset House

CAYLEY TO CH 3.11.87

Ch/ You may like to see this before the 12/11 meeting. 9/11

Para 7 is crucial, & unpersuasive.

FROM: M F CAYLEY
DATE: 3 November 1987

Seen in draft

1. MR ISAAC
2. CHANCELLOR OF THE EXCHEQUER

REFORM OF CGT :
ABOLISHING TAX DEFERRAL ON GIFTS

1. In my previous note of 19 October ~~we~~ I commented on the possible yield effects from abolishing gifts relief. This paper, which we felt you might find helpful to have before your next meeting on 12 November, is concerned with the broader policy issues arising out of the proposal.

BACKGROUND

Present position

2. Gifts between husband and wife have always been treated as taking place at "no gain/no loss" and, hitherto, this approach has been consistent

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cc	Chief Secretary	Mr Battishill
	Financial Secretary	Mr Isaac
	Paymaster General	Mr Pitts
	Economic Secretary	Mr Beighton
	Sir P Middleton	Mr Cayley
	Sir T Burns	Mr Mace
	Mr Byatt	Mr Gonzalez
	Mr Cassell	Mr Hamilton
	Mr Scholar	Mr Michael
	Miss Sinclair	Mr Quinn
	Mr Cropper	Mr C Lester
	Mr Tyrie	PS/IR
	Mr Jenkins (Parliamentary C.)	

with the idea of regarding a married couple as a single entity for capital gains purposes.

3. Other lifetime transfers qualify for gifts holdover relief (subject to an election by the parties involved). This relief defers payment of CGT through the mechanism of reducing the donee's base cost by the amount of the gain which accrued in the donor's hands up to the date of the gift. Tax on the holdover gain then comes back into charge only on a further disposal by the donee. Following independent taxation the end result in terms of tax liability will be the same as for no gain/no loss transfers between spouses.

Gifts relief

4. Prior to 1980 there was no relief for gifts outside the husband and wife context. (There was a specific relief for gifts of business assets - now largely superceded by the general gifts relief - which only survives in a truncated form for gifts to companies).

5. The absence of gifts relief meant that following the introduction of CTT in 1974, lifetime transfers were subject to both CTT and CGT. This immediate double charge, on an occasion when nothing was actually realised, gave rise to much criticism. Gifts relief was, therefore, introduced in 1980 largely as a solution to the problem. In its original form the relief was confined to gifts between individuals. It was subsequently extended to gifts into and out of trust in 1981 and 1982 respectively.

Abolition of gifts relief

6. Irrespective of arguments of fiscal logic (which we deal with in paragraph 7 below) there can be no doubt that the abolition of gifts relief would be controversial and very much a matter for Ministers' judgement. Some outsiders, particularly the small business lobby, would argue that it was

contrary to the Government's desire to encourage the lifetime transmission of wealth from one generation to another and it might also be perceived as a surreptious attempt at clawing back the 1986 and 1987 CTT/IHT reforms.

7. However, it has to be recognised that with the abolition of the CTT lifetime charges for individuals and interest in possession trusts the case for gifts relief is less strong. Moreover, our impression in recent years has been one of increasing use of the relief as a tax planning device (the most common situation being where the sale of an asset or block of shares is preceded by gifts of the shares to children so as to get the benefit of several annual exemptions). Abolition of the relief would put a swift end to this sort of activity and it is for this reason that my previous note anticipated a reduction in the level of gifts.

8. Of course, to the extent that lifetime IHT charges still remain (for example, for transfers into and out of discretionary trusts) the original justification for the corresponding CGT relief remains intact. But, in practice, we suspect that the preservation of the CGT relief here would lead to strong pressure for the continuance of relief elsewhere. So if general gifts relief is to be abolished, we would recommend abolition even for transfers where an IHT charge can arise. Any CGT payable would, under present law normally be a deduction in computing what was chargeable to IHT: we might need some minor technical changes to make sure that this was so in every circumstance.

<u>Other matters</u>

9. If Ministers decide to abolish gifts relief either wholly or in part there are a number of other matters to consider. The most significant of these is the treatment of married couples.

Husband and wife

10. There is an argument for saying that, once independent taxation is in force from 1990, the "no gain/no loss" rule for gifts between spouses should not be retained if general gifts relief is abolished. And retention would give substantial added scope for tax planning - by exploiting one's spouse's annual exemption as well as one's own. If it were removed, married couples would then fall within the same rules for gifts as anyone else. We doubt, however, whether such a change could be made ahead of independent taxation - up to 1990 we shall still be aggregating a married couple's gains, taxing them on the husband and giving only one annual exemption. So if "no gain/no loss" treatment is to cease, the preferable course of action might be to announce the change next year, include the legislation in the 1988 Bill as part of independent taxation, and make it effective from 6 April 1990. In the nature of things this would mean some forestalling but the effects are probably liveable with.

11. On the other hand, retaining no gain/no loss treatment could be seen as consistent with a general approach to independent taxation under which the tax system gives married couples independence but continues to recognise their special relationship - see Miss Dyall's note of 2 November on recognition of marriage. It would be consistent with the decision to retain IHT exemption for inter-spouse transfers. Moreover, the "no gain/no loss" rule constitutes a significant tax advantage for married couples and, as we said earlier (paragraph 2), has been with us now since 1965. Abolition of this provision could well be more controversial than removing general gifts relief. In addition, our experience from the days of Estate Duty (when inter-spouse transfers were exempt only up to £15,000) was that there are practical difficulties in establishing whether - and if so, when - ownership has passed from one spouse to the other. This extends not just to things like chattels, jewellery, works of art etc but also to the matrimonial home in those cases where it is not totally exempt from CGT and to jointly-owned assets. These problems

would probably only arise in a minority of cases but there would be an additional (small) staff cost.

CGT Retirement relief

12. For most purposes of the relief a husband and wife are already treated separately. However, in determining the amount of relief available following the earlier retirement by one spouse, the two spouses consecutive periods of ownership may be aggregated. There would be an argument for getting rid of this provision if the "no gain/no loss" rule goes. But given the purpose of the relief, and the fact that both spouses will usually have taken an active part in the business, we would recommend no change.

BES and Purchase of own shares (POS) relief

13. Married couples also enjoy advantages over other taxpayers for the purposes of the BES and purchase of own shares (POS) relief. In the case of BES a transfer of shares between spouses does not result in the withdrawal of income tax relief and the CGT exemption on the disposal of new BES shares remains available on a subsequent disposal to a third party. For POS relief spouses may aggregate periods of ownership following an inter-spouse transfer in order to satisfy the 5 year minimum period of ownership requirement.

14. If married couples continue to get "no gain/no loss" treatment there is no reason to alter these BES and POS rules. But if the "no gain/no loss" provision for married couples is abolished it would be necessary to consider whether, as a corollary, these special rules should go as well. For BES we would see no good reason for continuing the existing treatment, which was intended to provide a relief broadly similar to the CGT provision. So if that is abolished the special BES relief should also go.

15. Turning to the aggregation of periods of ownership for the purposes of POS relief, there would be an argument

for getting rid of it, so treating married couples in the same way as everyone else. But since the purpose of the requirement for a 5 year minimum period of ownership is to discourage the acquisition of shares with the intention of getting POS relief on a subsequent sale to the company it does not really matter if the shares have passed between a husband and wife in this period. So there would be no harm in leaving this provision alone. The argument here is much the same as for retirement relief (paragraph 12 above).

16. If either or both of these provisions is to go, we presume that Ministers would nevertheless want to preserve the existing position for transfers before 1990.

Maintenance Funds

17. Originally, transfers of assets to maintenance funds for historic buildings were deemed to take place at "no gain/no loss". In 1984 this provision was repealed at the request of the heritage lobby who, for various technical reasons, wanted general gifts relief instead. If this is repealed Ministers will need to decide whether to preserve relief for gifts to these funds. The pressure for doing so would be considerable, and the precedent of conditional IHT exemption for such transfers is a strong one.

Business assets

18. We presume that Ministers, would want to reinstate the pre-1980 position for gifts of business assets (paragraph 4 above), so that these would continue to qualify for CGT deferral.

Matters for decision

19. If Ministers wish in principle to abolish the general gifts relief the following matters will need to be decided:-

i. Should the relief only be withdrawn to the extent that there are no corresponding IHT lifetime charges or should it go completely (paragraphs 6, 7 and 8)?

ii. Is the "no gain/no loss" rule for married couples to be retained? If it is to be repealed, is it agreed that this be done from 1990 (paragraphs 10 and 11)?

iii. If the "no gain/no loss" provision for married couples goes should the aggregation rule for CGT retirement relief be retained (paragraph 12)?

iv. If married couples are to be treated like anyone else for gifts purposes should the special provisions for BES relief also be abolished but preserving the position for POS relief (paragraphs 13 to 16)?

v. Should gifts relief be retained for transfers to heritage maintenance funds (paragraph 17)?

vi. Should the pre-1980 relief for gifts of business assets be restored (paragraph 18)?

Michael Cayley

M F CAYLEY

TASK FORCE SECRET

Copy No 1 of 15

FROM: J P MCINTYRE
DATE: 6 November 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Scholar
Miss Peirson
Mr Gibson
Mr Macpherson
Mr Cropper
Mr Tyrie
Mr Call
Mr Mace (IR)

Thanks. I agree with X (on paper). SERPS entitlement is difficult: there is a case for changing the rules so that it depends on total NICs paid, & not those between LEL & UEL (the latter being both ~~automatically~~ relevant for this purpose).

On the other hand, keeping SERPS entitlement rules as they are, while employees NICs are no longer bounded by the UEL, would presumably ...

NATIONAL INSURANCE CONTRIBUTIONS, CONTRIBUTORY PRINCIPLE AND NIF SURPLUS

I attach two papers which you may find helpful background to the current discussions on tax reform and changes to the NICs regime.

2. The first paper reviews the contributory principle and examines how far it can be reconciled with the Budget measures you have in mind. The paper concludes that, as far as abolition of the Upper Earnings Limit (UEL) is concerned, much depends on how the principle is interpreted. UEL abolition could not be reconciled with the "strong" version of the principle, namely that all contributions must produce some return in the form of benefits. Those paying contributions on earnings above the UEL will not, of course, receive any additional benefits in return.

3. However, as the paper points out, the 1985 reforms moved in this direction; those on low earnings are paying reduced contributions without having their benefit entitlements reduced. Moreover, the "weak" version of the contributory principle would not be breached by UEL abolition, in that entitlement to certain benefits would continue to be available only to those with a contribution record.

4. The paper concludes that a substantial increase in the Lower Earnings Limit (LEL) could be more easily defended in terms of the contributory principle than UEL abolition, in that those on low

incomes who were no longer paying any NICs would not be given entitlement to benefits. The disadvantage, from the point of view of the contributory principle, would be that the contribution system would cover a smaller proportion of the working population than hitherto.

5. Finally, the paper concludes that abolition of the Treasury Supplement would strengthen the principle, in so far as expenditure on contributory benefits would then be financed entirely by NICs.

NIF surplus

6. The second paper sets out our latest projections for the NIF surplus, taking account of your Budget measures. It shows that, in 1988-89 and possibly in 1989-90, your measures would have the effect of reducing the NIF surplus below what it would otherwise be. However, by 1990-91, this effect would be reversed as the impact of UEL abolition begins to outweigh the effect of reduced contribution rates at the lower end and abolition of the Treasury Supplement.

7. Because the initial effect of your measures would be to reduce the surplus, it may be that no further action to reduce it would be needed in the short term. However, as the paper shows, the balance in the NIF is expected to go on increasing, and this may of course result in pressure to cut contribution rates and increase benefits.

8. The paper concludes that the most promising way of reducing the surplus may be to increase the NHS allocation. The extent to which we can do this at present is strictly limited under current legislation, and we should consider whether to use the opportunity of next year's Social Security Bill to give ourselves more room for manoeuvre on this front.

JPM

J P MCINTYRE

NATIONAL INSURANCE CONTRIBUTIONS - CONTRIBUTORY PRINCIPLE

The purpose of this paper is to examine the implications for the Contributory Principle of three possible changes to the structure of National Insurance Contributions (NICs) and the financing of the National Insurance Fund (NIF):

(i) abolition of the Upper Earnings Limit (UEL) for employees (and the Upper Profits Limit (UPL) for the self employed)

(ii) a substantial increase in the Lower Earnings Limit (LEL).

(iii) abolition of the Treasury Supplement.

Background

2. Social security benefits can be divided into two broad categories:

* **contributory benefits** are paid out of the National Insurance Fund. Rights to them are established by a record of having paid or being credited with national insurance contributions for a given period. They are paid when the insured person's circumstances trigger payment eg unemployment, old age etc.

* **non contributory benefits** are paid for out of general taxation. Rights to them depend only on the personal circumstances of individuals - for example, being poor (supplementary benefit), being disabled (mobility allowance) or having children (child benefit).

The NIF is financed mainly from contributions, plus a Treasury Supplement amounting to 5% of contribution revenue. Once the LEL (£41 a week) is reached, contributions are payable on all earnings, below and above it, to the UEL (£305 a week). The total contribution rate (19.45%) includes an allocation for the National Health Service (1.75%). The major national insurance benefits are retirement pension, and sickness and invalidity benefits.

<u>What is the Contributory Principle?</u>

3. The contributory principle can be interpreted in either of two ways:

* all contributions must bring something in the way of benefit rights; this is at present achieved by the earnings related pension (SERPS)

* benefit rights must be restricted to those who have paid or been credited with contributions.

4. The main arguments advanced for preserving the principle are:

* people in work should pay for, and be able to see that they are paying for, the rights which they are building up to benefits

* the contributory principle provides a useful way of rationing benefits. An example is the clause in the Social Security Bill tightening contribution conditions for unemployment benefit, saving about £50 million pa. More generally, the principle may act as a brake on demands for higher benefits because people perceive a direct link between these and the higher contributions they would have to pay.

The strength of the principle should not be underestimated; market research conducted by DHSS at the time of the Green Paper has shown that many people still perceive a strong link between money paid in contributions and benefits received (although they also believe that their contributions pay for the NHS to a much greater extent than justified). The Government has stated frequently that it believes this link is a valuable one.

What remains of the contributory principle?

5. Contributory benefits are financed by contributions levied at the rate broadly necessary to match the current outflow from the NIF. Today's contributors meet the cost of today's benefits. However, in a number of ways, the importance of the contributory principle has been eroded.

6. Contributory benefits are, for many, set below the level of help to which they are entitled under means tested benefits, thus weakening the case for people seeing that they have 'paid for' their benefits. Self employed people also see the profits related Class 4 contributions which they pay (and which bring no benefit rights at all) as undermining the contributory principle (though Class 4 contributions do of course spread the cost of benefits available to the self employed in a more equitable way than would be achieved solely by the flat rate Class 2, which brings benefit entitlement).

7. Furthermore, there is no direct relationship between those benefits which are pledged and those which are contributory (eg supplementary pension is pledged, but unemployment benefit is not), so that contributory benefits do not always offer better protection against inflation. And there is an exception to the rule that contributions finance only contributory benefits: everyone in work is entitled to industrial injuries benefits, paid for from the NIF, regardless of their contribution record.

8. Since the early 1960's the real value of benefits has been increased and reduced, earnings related supplements brought in and withdrawn and entitlement rules frequently changed. The structure of contributions has also been changed radically from the flat rate payments of the 1950's; today payments are more progressive, with higher amounts paid as earnings increase up to the UEL.

9. Entitlement to contributory benefits still, however, depends on meeting certain contribution conditions. Furthermore, there is a direct link between the amount of benefit which an individual

receives and the contributions he pays through the existence of SERPS (a marginal increase in NIC liability leads to a marginal increase in SERPS entitlement, up to the UEL).

<u>Implications of proposed changes</u>

(i) <u>UEL/UPL abolition</u>

10. If NIC payments above the UEL were not to give additional entitlement to SERPS, then there would be no link between those contributions and benefits. People would be asked to pay unlimited contributions for limited benefits. This could be seen as weakening the contributory principle.

11. The self employed, who already resent paying Class 4 contributions, would feel further aggrieved at paying them without an upper profits limit.

12. Benefit payments would still, however, be dependent on a contribution record. Furthermore, since there is no pretence that the overall contributory system is actuarially sound, it is difficult to see why increased contributions should necessarily bring increased benefits (though the calculation of the contracted-out rebate to fund the SERPS guaranteed minimum pension is actuarially based).

13. The abolition of the UEL/UPL would also make the system more progressive. The introduction of the reduced rate bands in the 1985 Budget was a step in this direction; now a low earner can buy entitlement to a basic retirement pension by paying 5% of his earnings up to the LEL whereas a higher earner has to pay 9%. (Abolition of the UEL for employers in 1985 is not strictly relevant as it is only employees' contributions which establish entitlement to benefit).

14. The problem here is partly presentational; it is easier to explain that some people should pay less for a benefit than others (as in the 1985 reforms) than to explain that some people should

pay extra and get nothing in return. But a private insurance company would regard both positions as equally undesirable.

(ii) Raising the LEL

15. Arguably this would strengthen the contributory principle, since by raising the starting point for contributions, the "minimum subscription" for benefit entitlement will be raised. This is the reason usually given for applying the contribution rate to total earnings once the LEL is reached, since if it was only applied to marginal earnings above the LEL entitlement could be bought for virtually nothing.

16. However, it would have the effect of removing people from entitlement to contributory benefits and increasing dependence on means tested benefits. It would weaken the comprehensiveness of the National Insurance system. This is particularly important as regards retirement pension; those earning below the higher LEL would no longer be earning entitlement to a benefit which is seen as providing independence in old age.

17. Take, for example, the option that the LEL would be raised to £70 a week and increased broadly in line with earnings thereafter. This would take about 1.7 million employees out of NICs. Of these about 0.5 million are young people who may have time to build up an adequate contribution record for their basic pension (or other benefits) as their earnings rise. Another 0.8 million are married women, who would become dependant on their husbands for contributory benefit purposes. The remaining 0.4 million are adult men or single women who would lose most in terms of entitlement.

18. Raising the LEL would also reduce SERPS entitlement for everyone, since this is calculated on the basis of earnings between the LEL and UEL. Those with low earnings would be hit proportionately more. Similarly, there would be an impact on personal pensions, since the contracted out rebate would be available over a narrower range of earnings.

! SERPS entitlement based on total contributions? Or just from year 6 contract on?

(iii) Abolition of Treasury Supplement

19. The Treasury Supplement dates back to 1946 and has its roots in the Beveridge tripartite principle of financing benefits. Abolishing the Supplement would strengthen the contributory principle, since an Exchequer subvention makes national insurance less truly contributory. Criticism that abolition would be inconsistent with the tripartite principle could be countered; even with abolition, the State would still be funding nearly 50% of social security expenditure, a much higher proportion than in 1946. The size of the current surplus in the Fund makes abolition possible without raising contribution rates.

Conclusions

20. The abolition of the UEL could be presented as broadly consistent with the contributory principle in the sense that certain benefits would continue to be available only to those with a contribution record. Abolition of the UEL (without increasing benefits in return for contributions above the UEL) would not be compatible with the stronger sense of the principle, that every penny of contributions must produce some return in the form of benefits. But the system cannot be made more progressive unless this is accepted. The introduction of reduced contribution rates in 1985 also marked a departure from the stronger version of the contributory principle, in that payment of reduced rates did not result in reduced entitlement to benefits.

21. Raising the LEL could be consistent with both versions of the principle. As long as those earning less than the LEL, and thus taken out of NICs, were not given entitlement to benefits, there would be no sense in which benefits were being made available in return for reduced contributions. And benefit entitlement would continue to depend on a contribution record. However, the comprehensiveness of the national insurance system would be weakened; more people would depend on means tested benefits in their old age.

22. Abolition of the Treasury Supplement would marginally strengthen the principle.

ST Division, 5 November, 1987.

ANNEX

CONTRIBUTORY PRINCIPLE: HISTORY

1. The Contributory Principle entered the British social security system with the 1911 National Insurance Act, which introduced compulsory unemployment insurance for workers in specific industries. The basic structure of the scheme was as now; benefits were available as of right for contributions and were not means-tested. However, up until the Second World War most social security benefits were non-contributory and means-tested.

2. The institutionalisation of the Contributory Principle as the basis of the benefit system came with the Beveridge Report. All contributions and benefits had been flat rate. However, the National Insurance system never operated as Beveridge intended. Instead of a funded scheme, the National Insurance Fund was introduced on a pay-as-you-go basis, essentially because full rate pensions were introduced immediately.

3. The next major change came with the introduction of the graduated pension in 1961, funded by graduated contributions. Flat rate weekly "stamps" continued to pay for all other benefits.Where occupational schemes offered members at least equal benefits as the graduated scheme, employers and employees could both contract out of the state graduated scheme. By generating a much greater income than additional pension payments, this graduated scheme also solved the immediately pressing funding difficulties.

4. This was followed by the 1975 Social Security Pensions Act, which replaced graduated contributions with earnings-related contributions on earnings above the lower earnings limit. These gave entitlement to earnings related benefits such as the additional component of the retirement pension. The flat rate 'stamp' was abolished, although its spirit lived on in the form of NICs paid on earnings up to the LEL. The latter were in effect flat rate and gave entitlement to flat rate benefits such

as the basic retirement pension. The State Earnings-Related Pension Scheme was introduced in 1978.

5. The principle was further eroded by the introduction of reduced rate contributions in 1985, which meant low-earners were paying 5% of the LEL for entitlement to the basic retirement pension, while high earners had to pay 9%.

6. Since 1946 increasing reliance on means-tested non-contributory benefits such as Supplementary Benefit and Housing Benefit has arguably undermined the National Insurance system; benefits like Supplementary Benefit are no longer seen as Beveridge intended them, a 'safety net' for those few who are not in the National Insurance system, but instead are regarded as an integral part of the benefit system as a whole. So Beveridge's ideal of a comprehensive insurance system is simply not a reality today.

NATIONAL INSURANCE FUND (NIF)

This paper sets out our latest projections for the NIF, taking account of the Budget measures you are planning.

2. The table below shows the base case for the NIF surplus and the main changes which are likely to affect it (the changes are assumed to take effect in October 1988):

	£ billion	
	1988-89	1989-90
Base case surplus[(1)]	1.9	0.8
UEL/UPL abolition[(2)]	0.4	1.5
Treasury Supplement abolition	-0.8	-1.0
Measures to help employees at lower end	-0.4	-0.7
NIF surplus for the year	1.1	0.6
Balance	8.0	8.6
NIF surplus at end-year as percentage of outgo.	29.9	30.3

(1) List of assumptions at Annex A.
(2) A 7 per cent rate above UEL assumed from October 1988, rising to 8 per cent in April 1989 and 9 per cent in April 1980. A 6.3 per cent rate above UPL is assumed from October 1988.

3. The table shows that in the short term (1988-89 and 1989-90), abolition of the Treasury Supplement and measures to cut NICs for the lower paid (assuming the existing budget for this is retained) will more than offset the effect of abolishing the UEL.

4. Nonetheless, the balance of the Fund will continue to grow. Moreover, although our model does not yet extend to 1990-91, our rough calculations suggest that the net effect of your Budget measures will be reversed by then (adding to the surplus) as the income from UEL/UPL abolition increases and the impact of abolishing the Treasury Supplement falls away. These calculations point to a NIF surplus of around £1 billion in 1990-91, resulting

in a NIF balance of £9.6 billion, equivalent to over 32 per cent of outgo. The minimum balance recommended by GAD is 17 per cent of outgo.

5. NIF surpluses of this size would not be unprecedented, as the table at Annex B shows. The predicted surplus in 1979-80 was 34 per cent of outgo; and the actual surpluses in the late 70s and early 80s were above 30 per cent.

6. However, an increase in the balance to 30 per cent or more would represent a marked increase on both the levels predicted by the GAD and the outturns of more recent years. Moreover, in the absence of significant demographic change, a rising surplus is the inevitable product of contributions rising with earnings and benefits with prices. We might well therefore face pressure to reduce contribution rates and/or increase benefits.

7. We may well see some reaction of this kind when the GAD's projections for 1988-89 are published later this month. They will project a surplus of around £2 billion, increasing the balance to £9 billion or 33 per cent of outgo. (This of course is on the basis of the Autumn Review "business as usual" decisions for next year.) Mr Moore's letter to you of 14 October referred to the GAD projections of a considerable surplus and said that he would like to consider with you in the longer term how this could be tackled "strategically".

8. As your Budget measures will significantly reduce the surplus for next year and slightly for 1989-90, they may help us to see off, for the time being, any pressures for further changes in contribution rates or benefit increases. But it may not be too soon to begin considering how the surplus problem might be tackled in the medium term.

9. In principle, there are two approaches to this problem. The first is to regard a substantial annual NIF surplus as a positive development which should be allowed to continue, on the grounds that we need to build up the Fund's assets for the time when demographic pressures will result in heavier calls on it. The second is to take steps to reduce the surplus, whether by cutting contribution rates further (and so requiring additional taxation

to meet a given PSBR target) or by financing more of government expenditure out of the NIF (leaving taxation unchanged to meet a given PSBR target).

Running a Large NIF Surplus

10. GAD expect a significant fall in the ratio of NI contributors to pensioners in the first quarter of the next century, from around 2¼ to 1 currently to 1.8:1 by 2025 (though little change in the ratio is expected between now and 2000). On the basis of their central assumptions about mortality, unemployment, etc, in the long term, GAD projected last year a required average NIC rate (for employers and employees combined) of between 14.4 and 20.9 per cent in 2023-24, depending on whether benefits were uprated in line with prices or earnings. Using the same economic assumptions, the average NIC rate in 1986-87 would have been 15.7 per cent ie near the bottom of the range projected for the long term. (The actual average rate in 1986-87 was 17.65 per cent mainly because of the higher unemployment assumption.)

11. Overall, the budget changes would require higher NIC rates in the next century than the GAD projections. This is mainly because GAD assumed continuation of a 9 per cent Treasury Supplement (worth around £2½ billion in 1986-87) throughout the forecast period. Abolition of the Treasury Supplement, together with the measures to reduce employees' contributions at the lower end, would reduce income to the NIF by more than the additional income from UEL abolition. We have not of course consulted GAD in order to quantify the effect of these changes on their long term projections. But they imply an upward shift from the 14.4 to 20.9 per cent range projected by GAD last year.

12. It could therefore be argued that in order to avoid increasing the NIC burden on future generations, the current work force should be prepared to run a substantial NIF surplus to build up the Fund's assets. Germany and Japan have already decided to do this.

13. It is not clear whether, presentationally, this argument would be strong enough to withstand pressure for reduced

contribution rates and higher benefits, especially as we could not claim that the NIF is run on anything but a Pay as You Go basis. Moreover, adopting this line of argument could box ourselves in unnecessarily. In a year or two's time, ~~we~~ you might have reasons for wanting to take action (eg cut contribution rates) which would lower the NIF surplus and run counter to the professed strategy of running a large surplus. X

14. This approach might also require a change in social security legislation. We understand that DHSS are concerned that the currently projected surplus for 1988-89 might be challenged as incompatible with existing legislation. They are also worried about criticism from the NAO.

Cutting the Surplus: Reducing Contribution Rates

14. Further reductions in rates would be attractive in alleviating the unemployment trap and improving work incentives. However, for any given PSBR target, cuts in contributions would require increased taxation. We would need to consider whether it was desirable to collect a higher proportion of revenue through taxes as opposed to NICs.

Cutting the Surplus: Financing More Expenditure

16. This could be done in two main ways:

a. Increasing the NHS allocation (and thus cutting NIF income)

b. Financing more social security benefits out of the NIF (and thus increasing expenditure out of the NIF)

17. There is, in principle, a third option, namely increasing the Employment Protection Allocation. But the Redundancy Fund is already in considerable surplus and likely to remain so for the foreseeable future. For this reason, the EPA will be zero next year.

18. The NHS allocation in 1988-89 will be 0.8 per cent for employers and 0.95 per cent for employees. Under current legislation, it can be increased by no more than 0.1 per cent a year. In 1989-90, the increase of 0.1 per cent for both employers and employees will reduce income to the NIF by around £350 million.

19. If we wanted the flexibility to increase the NHS allocation by more than this in future years, we could use the opportunity of the Social Security Bill next year (already needed for abolition of the UEL and of the Treasury Supplement) to amend the relevant legislation.

20. A possible disadvantage of doing this is that it may excite expectations of higher spending on the NHS. In fact, of course, the total resources devoted to the NHS would not be changed; a higher NHS allocation would be matched by lower contributions from the Consolidated Fund. So careful presentation would be needed.

21. It might also be argued that it would be wrong for NI contributors to pay a larger share of the costs of the NHS, which is available to non-contributors, and that this would be contrary to the contributory principle. This argument would be strengthened if we were to raise the LEL significantly, thus increasing the number of people not paying NICs. However, many non-contributors are pensioners who will have contributed during their working lives and others will be young people on low (sub-LEL) incomes who will become contributors as their earnings rise. And this is not an argument that has been used up to now, as far as we are aware. (Indeed a DHSS survey carried out a few years ago found that the idea of NICs helping to pay for the NHS was a strong and popular one.)

21. The other possibility is to finance more benefits out of the NIF. At present, the NIF finances only one non-contributory benefit, the Industrial Injuries Scheme (expenditure in 1988-89 £½ billion).

23. Proposals to finance other non-contributory benefits out of the NIF might be controversial. As with the NHS, some people may object to contributors financing benefits for non-contributors, in breach of the contributory principle. Moreover, the more we make the distinction between contributory and non-contributory benefits seem arbitrary, the less effective contributions become as a way of rationing benefits. But the candidates worth examining could include:

War Pensions: (£600 million in 1988-89)
Disability Benefits (£2000 million)

24. The case for including these is that, as with the established contributory benefits, entitlement is based on a specific contingency other than income. NI contributors might also feel reluctant to complain about financing war pensions or benefits for the disabled.

25. The income-related benefits would be too large to finance from the NIF, and none of the existing benefits financed from the NIF are means-tested. Child Benefit, though a universal benefit and therefore more naturally financed by NICs than income-related benefits, would also be ruled out by size ($4^{3}/_{4}$ billion in 1988-89) and by the possibility of future reform.

26. One way of countering potential complaints from NI contributors would be to go a step further and bring some currently non-contributory benefits within the contributory system. This would strengthen the contributory principle (at a time when UEL abolition might be seen as weakening it). But it is difficult to think of any good candidates. It would be hard to reconcile the contributory principle with means testing, and most of the existing non-contributory benefits are either means-tested already or might become so.

Conclusions

27. On the basis of our current projections, allowing for your Budget changes, we may well come under pressure from Mr Moore in next year's Autumn NICs review to reduce the NIF surplus. No

doubt he will come forward with his own ideas for achieving this. Outside pressures might also build up for cuts in contribution rates and increases in benefits.

28. We could decide to resist this pressure by defending a large surplus on the grounds given in paragraph 10-12. Alternatively, if we want to reduce the surplus, without cutting contribution rates or increasing benefits, the most promising route appears to be increasing the NHS allocation. To give ourselves more scope to do this, we would need to amend existing legislation; this could be done in the Social Security Bill which will be necessary next year for UEL and Treasury Supplement abolition.

ST(1) and ETS Divisions

4 November 1987

ANNEX A

BASE CASE: ASSUMPTIONS

1. Contribution rates unchanged.

2. Class 1 reduced rate bands, and Lower and Upper Earnings Limits increased in 1989-90 in usual way.

3. Treasury Supplement reduced to 3 per cent in 1989-90.

4. NHS allocation increased by 0.1 per cent for both employers and employees in 1989-90. From October 1988, the allocation is assumed to apply above the UEL and UPL.

5. EPA remains at zero in 1989-90.

6. For self employed, usual increases in Class 2 rate, and Lower and Upper Profits Limits for Class 4. No change in Class 4 rate.

ANNEX B

Table 2

End year balances of NIF as % of outgo

	November prior year forecast	November in year forecast	Outturn
1977-78	n.a.	n.a.	39
1978-79	n.a.	37	37
1979-80	34	34	36
1980-81	29	34	32
1981-82	30	27	23
1982-83	24	19	22
1983-84	16	22	23
1984-85	22	25	24
1985-86	27	21	24
1986-87	20	23	[23]
1987-88	26	[27]	n.a

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY

AT 10.15AM ON FRIDAY 6 NOVEMBER 1987

Present: Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Kemp
Mr Scholar
Miss Sinclair
Mr Michie
Mr Cropper
Mr Tyrie

Mr Battishill - IR
Mr Isaac - IR
Mr Lewis - IR
Mr Prescott - IR
Miss Rhodes - IR

TAXATION OF BENEFITS IN KIND

Papers: Employer based tax - Mr Scholar's minute of 28 October, Mr Isaac's minute of 20 October, and previous papers. Taxation of car benefits - Financial Secretary's minute of 30 October, Mr Lewis' minute of 22 October and previous papers.

Employer based tax

The Chancellor thanked the Financial Secretary and Revenue and Treasury officials for their preparatory work. His objective was to level the jungle which at present surrounded the taxation of benefits in kind. He was not interested in replacing one jungle with another; if that were the only result of reform, he would prefer not to go ahead. One way through might be to take a specific number of benefits and place the burden of taxation on the employer, as Mr Isaac had suggested. Cash benefits could remain covered by the P11D system, and other benefits exempted altogether.

2. Mr Isaac doubted whether this would be workable. If tax were confined to the main benefits, and many of the remainder exempted, those remaining benefits would be exploited.

3. The Chancellor suggested that an alternative route might be to deal with those benefits not covered by the new employer based tax by raising the P11D threshold. His objective was not to reach some equitable ideal. It was, instead, to simplify the present system; to minimise the difficulties of administration; to lessen the political sensitivity of making future changes in this area; and to reduce the proportion of payment in this form (ie. to encourage employers to "cash out").

4. Sir Peter Middleton noted that, unless a change of this sort were made, benefits in kind would be encouraged by abolishing the employees UEL. The more expensive benefits had spread throughout the system, and there was a good case for cutting back on them. He doubted whether the use of alternative benefits would be encouraged by their exemption from tax: there were limits to the demand for these. The remainder of benefits could, however, be covered by action on the P11D threshold.

5. The Chancellor said that a consultative document should not be issued. There would be ample time for representations between legislation in 1988 and the proposed implementation date. He would prefer to avoid difficulties by being cautious with the proposals themselves.

6. The Chancellor noted the importance of avoiding too high a compliance burden on employers. The Revenue had suggested a possible two-tier approach: if this were pursued, there should be

no threshold for benefits on which employers paid tax and a high threshold for employees, by raising the P11D threshold, say, to £20,000. Mr Scholar suggested that an alternative possibility might be to define the threshold in terms of benefits received, not income. The Revenue thought this might encourage payments in benefit form, and hence give rise to a revenue cost. The Chancellor asked that this possibility be considered further.

7. The Chancellor invited views on an approach which dealt with benefits in kind in three categories. First, there would be an employer based tax for widespread benefits (and any other which could be dealt with without difficulty in this category). Second, exemption of minor benefits in kind, eg. car parking. Third, for those benefits which could neither be covered by an employer based tax nor could sensibly be wholly excluded, the existing system but with a much higher P11D threshold.

8. The Chief Secretary agreed that the possibility of an employer based tax for the main benefits should be examined. But the small businesses' perception of a change of this sort should not be under estimated. They would be very hostile. He agreed that there was a strong argument for exemption of the minor benefits, provided that there was no scope for abuse. He agreed entirely with the proposal to raise the P11D threshold for the remainder. In summary, the Chancellor's approach should be examined, but without a full commitment at this stage to go ahead on that basis.

9. The Paymaster General noted that encouraging employers to pay in cash rather than benefits was patently fairer. This was an important political point. He agreed with the Chancellor's general approach, although he noted that raising the P11D threshold encouraged paying in benefits up to that level. But he also agreed with the Chief Secretary that there could be a substantial perception problem with a change of this sort.

10. The Financial Secretary noted that the proposals needed to be considered in the context of Lord Young's initiative for reducing burdens on business. A number of the proposals here could be shown to point in the right direction. He supported the Chancellor's proposal, provided that the employer based tax were done in a sufficiently rough and ready way that the burden of compliance was kept to a minimum.

11. The Chancellor, summing up this part of the discussion, said this three part approach was agreed. On the other points in Mr Isaac's paper, he proposed to start from the presumption that payments would be made within the year (although not necessary monthly). The system would start in 1990-91. A study team should go to Australia; and further work should be done on the position of the self-employed.

12. The Chancellor said that he favoured non-deductibility for corporation tax purposes. This would, *inter alia*, avoid discrimination between the public and private sectors. Moreover, if the employer based tax were made deductible, it would need to be set at a high rate, giving rise to presentational problems.

13. Mr Isaac said that deductibility would ensure symmetry between cash payments and benefits in kind. Businesses would complain about non-deductibility of this tax in contrast to other charges.

14. In discussion, it was noted that the presentational difficulties of non-deductibility needed to be set against the presentational difficulties of fixing a high rate. It was noted that there were advantages in deterring employers from paying in kind; to the extent that the tax regime for these benefits appeared harsh employers were at liberty to transfer into payments in cash.

15. After further discussion, it was agreed to plan on the basis of non-deductibility. The rate should be set at 45 per cent. It

was noted that the presentational effects of this on basic rate taxpayers vis a vis higher rate taxpayers will need to be considered carefully.

16. The Chancellor invited officials to take forward work on an employer based tax on the basis of the decisions reached.

Taxing car benefits

17. The Chancellor invited the Financial Secretary, in association with the Paymaster General, to consider again the taxation of car benefits in the light of the decisions made. He would, if necessary, hold a further meeting at a later date.

J M G TAYLOR
10 November 1987

Circulation

Those present
Economic Secretary