PO-CH/NL/0026

PART A

SECRET

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PART A

FINANCE BILL 1988 - ENTERPRISE ZONES

DD's 25 years 30-03-95 NAJ

22.2.88

PO -CH /NL/0026

PART A

(c)

EXECUTIVE SUMMARY OF MAIN RESULTS

1. The Enterprise Zone experiment has simultaneously encouraged the provision of modern industrial and commercial premises in problem localities and attracted firms into them. It is a good design feature of the experiment that it influenced both the supply side and demand side of the market for premises and in so doing stimulated local property markets, improved the quality of premises in local economies and hence brought environmental improvement.

2. The experiment has been effective in attracting private sources of capital, both from the City of London and elsewhere, into designated zones with severe economic and dereliction problems which had hitherto been starved of private sector investment.

3. The experiment has made some progress in maintaining and generating additional economic activity and employment both on the zones and in their local areas. By 1986 there were 63,300 jobs in firms located on the 23 British zones. About 35,000 of these were on the zone sites as a direct consequence of the EZ policy. Although most of these additional jobs on zone were transferred from elsewhere in their respective local economies, some new jobs were created and linkage and multiplier effects feed out of the zones into the local economies to offset in part losses arising from diverted activity. In total it is estimated that for every 10 additional

jobs on Enterprise Zones there are 3 genuinely additional jobs generated in the local economy as a whole. Thus about 13,000 net additional jobs are estimated to be additional jobs which have been generated in these local economies[1] as a direct consequence of the experiment.

4. The total public cost of the experiment between 1981 and 1986 was approximately £297 million (at constant 1985/86 prices). Of this some £82 million was devoted to rate relief for zone firms, (for which Local Authorities are compensated by Central Government). £150 million arises from tax allowances on new building expenditure, and £65 million is an estimate of additional public expenditure on infrastructure as a consequence of zone designation.

5. One important indicator of the cost effectiveness of the experiment is the public cost per net additional job generated in the local economies in which zones have been designated. If zone related infrastructure expenditure is included on the public cost side, the cost per net additional job in the local economy is estimated in the range £20,000 - £25,000. If zone related infrastructure is excluded from the cost side, leaving only the direct Exchequer cost of rate relief and capital allowances, the range for the cost per net additional job in the local economy falls to £15,000 - £20,000. The public cost of attracting firms on the zone site areas[2] themselves is considerably less and is estimated between £7,000 and £10,000 per net additional job on the zones. These

(1) The definition of the local economy varies between areas but it is usually an area of about five miles radius around the zone site

(2) The smallest zone area is 54 hectares and the largest is 454 hectares.

public costs will increase because the Government is already committed to continuing rates relief for existing firms on the zone for a number of years whether or not these firms expand further in the future. At the same time the number of net additional jobs created by the experiment will change.

6. Enterprise Zones have attracted a mix of different types of economic activity. Some firms are setting up new branches on the zone (14% of all firms on zones at present fall into this category), others are transferring into the zones (37%), but perhaps of most significance in the long run is the stimulation given to the start-up of new independent small businesses (26%).

7. There are some differences in the extent to which different economic sectors attracted to the zones generate additional economic activity and employment to their respective local economies. Manufacturing and retailing show above average local net job additionality whilst other kinds of distribution, construction and other local service activities generate below average local additionality.

8. As part of the wider study, a detailed study of the impact of retailing on the Swansea Enterprise Zone on other retailing centres in West Glamorgan was undertaken. In this case study there was evidence that the zone had encouraged the development of out of town retail facilities which were accessible to the public and contributed to increased consumer choice and

improved competitiveness. There was also significant additional retailing activity and employment for the local economy as some shoppers switched expenditure from Cardiff and other centres outside West Glamorgan. There was little indication of serious damage to other retailing centres elsewhere in the Swansea area, although there was some impact, particularly on Swansea City Centre and Morriston as the nearest shopping centres where some jobs and sales were lost. Any longer term implications cannot yet be evaluated. In the short term there is some evidence that other centres were able to adjust to counter the impact of retailing on the zone. In the Swansea case the experiment served to compliment and accelerate market trends which were already taking place. These results for Swansea cannot, however, be used to make general conclusions about retailing on zones. The Metro Centre in Newcastle and Merry Hill in Dudley have not been subject to detailed analysis and represent quite different complexes located in different circumstances.

9. Additional employment and economic activity on the zones and in their local economies is only one indicator against which to judge the cost effectiveness of the experiment Further benefits are secured via the stimulation of local property markets. Thus local economies have benefitted by improvements in the supply of new modern premises of appropriate kinds, the absence of which had previously constrained growth in these areas. The provision of modern property has also been associated with the removal of dereliction and improvements to the local environment. This in turn has stimulated local enterprise and new employment opportunities. The experiment has also demonstrated, to both public and

private sectors, the potential for successful property and economic development. Not least in this process is the urgency with which land is released and assembled for development, often previously in the ownership of public utilities, as a consequence of Enterprise Zone designation. This conclusion, about non-job benefits, finds support from businessmen both on and off the zones. Both groups of entrepreneurs considered that the experiment had made a significant contribution to economic development, physical renewal and environmental improvement, not only on the zones, but throughout the local economies in which they are situated.

10. The main policy instruments used in the experiment are industrial and commercial building allowances, rate relief for occupants of zone premises and special measures to facilitate and accelerate planning decisions. Although these measures provide financial and other benefits to tenants and owner occupiers on the zone, developers and other operators in the property market also benefit. For example capital allowances raise significantly the rate of return on the financing of property development on the zones. On the more economically depressed zones this increase in the rate of return is necessary if development is to take place at all. On other zones, and particularly in the provision of retailing generally, unsubsidised rates of return are generally high enough to encourage development. The payment of allowances in these cases can be regarded as 'deadweight' which reduces cost-effectiveness because it raises the cost of the initiative without bringing additional benefits.

11, Some 88% of firms on the zones perceive exemption from rates to be the main policy instrument from which they benefit. It is also not surprising that this is the perception of firms, since it is the one benefit all firms receive. This gain may, however, be somewhat illusionary because there was evidence of rate relief being partly appropriated by landlords in the form of increased rents, particularly in the more successful zones. Nevertheless, the way in which rate relief is perceived by firms has been important in attracting firms to the zones. Inevitably, however, there must be some 'deadweight' in this incentive also, because it is paid to zone firms for up to ten years. Benefits also accrue to developers and other operators in the property market.

12. The establishment of a clear and simplified planning regime for Enterprise Zones was considered beneficial by one fifth of zone firms and for some firms, including retailers, the nature of the planning scheme adopted has been crucial to their development. Almost 10% of firms said that the relaxed planning regime had facilitated additional investment. If, as suggested here, the planning reforms have been beneficial to zone areas and this is taken in conjunction with the fact that such reforms do not involve significant public costs, then there are important implications for future policy on Simplified Planning Zones.

ANNEX D

DRAFT LETTER FROM THE CHIEF SECRETARY TO THE SECRETARY OF STATE FOR THE ENVIRONMENT

Enterprize Zones

I have seen your minute of 30 July to the Prime Minister on the consultants' report of their evaluation of the Enterprise Zone experiment. I have also seen Malcolm Rifkind's letter to you of 21 July concerning his proposal for designation of a new zone at Greenock, for which he sought approval from my predecessor earlier this year.

I agree with your conclusion that, given the generally limited impact of zones on employment in their locality and the relatively high public sdector costs per job at the local level, disignation of further zones should occur only in very exceptional circumstances. As a general rule I think designations should be considered only where alternative, more cost effective policy options are not available and where the circumstances of the local economy offer particular prospects of a zone making a significant contribution to local employment and economic activity.

It is also important that any proposals for designation of further zones are considered in the context of our policies towards the inner cities and the total level of resources to be committed to those. Against this background, it is essential that proposals for new enterprize zones, such as that proposed by Malcolm Rifkind for Greenock, should be subjected to a detailed examination of the expected benefits and total public sector costs, including tax revenue foregone, and a comparison of these with alternative policy options having similar objectives. We would also need to consider how far such a designation could lead to pressure from other cases which might be difficult to resist, and how it could be reconciled with our longer term aims of lower tax rates and tax simplification..

Copies of this letter go to recipients of your minute.

John Major

SECRETARY OF STATE FOR SCOTLAND

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

CHIEF SECRETARY
REC. 22 JUL 1987
Mr Waller Mr Allan White
CX Mr Boutler
Mr Monck Mr Burgner
Mr Gilmore Mr Haustin
Miss Peirson Mr Turnbull
Mr Cropper Mr Tyrie

The Rt Hon Nicholas Ridley MP
Secretary of State for
the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

21 July 1987

Dear Nick,

ENTERPRISE ZONES

You will recall our correspondence in the spring about my proposal to designate an enterprise zone at Greenock. At that stage, while I remained convinced of the case, I offered not to pursue the proposal until the expected consultants report on the existing EZs was available.

I understand that this report has now been received and gives reasonable encouragement to enterprise zone policy. In the light of this, I am anxious that we should now make early progress with the proposed designation at Inverclyde. Some improvements in our present approach to EZs may well be desirable in the light of the report and it may be for example that designations should in future be limited more to circumstances where not only is there demonstrable need and opportunity but also where existing measures have been tried and proved insufficient and a proven public/private sector partnership is in existence. I believe nevertheless that in appropriate circumstances an EZ may be the only practicable answer to help tackle the economic problems of some of our most difficult areas.

I hope therefore that you will be taking early steps to make the report available and that we can move rapidly to agreement in principle on my proposed designation at Greenock. It is a lengthy process to put a new EZ in place and while, since the spring, I have announced further measures to support the regeneration of the area through the SDA led Inverclyde Initiative, I need to be able to make an early announcement about the EZ if these measures are to be properly effective and our commitment to the area seen as fully credible.

Copies of this letter go to the Prime Minister, David Young, Peter Walker, Tom King, Norman Fowler, George Younger, John Major, Kenneth Clarke and Sir Robert Armstrong.

Yours ever,

MALCOLM RIFKIND

JMM201A7

PRIME MINISTER

ENTERPRISE ZONES

We now have the consultants' report of their evaluation of the Enterprise Zone experiment up to the end of 1986, about half way through the life of the first 12 EZs and when the remaining 14 had been in existence for only two to three years. It is therefore an interim assessment: there will be further costs, and more jobs, to come. For convenience I attach at Annex A a list of the existing zones and a summary of the benefits available.

The key points of the report are as follows:-

(1) So far, EZs have attracted 35,000 jobs into the zones: most of these transferred from elsewhere but, taking into account jobs resulting from EZs both in the zones and in the local economies around them, there are about 10,500 new permanent jobs. This is a net figure, taking account of jobs lost in local firms as a result of the EZ and excluding construction jobs, which are temporary.

(2) The total costs of the experiment so far (excluding those which are judged would have been incurred without the EZs) are £297m, of which £82m is the cost of the rates relief, £150m the estimated costs of the capital allowances and £65m the additional public expenditure on infrastructure, etc.

(3) the cost per job created in the zones and their local economies is £28,000, although if the local multiplier effects as well as the temporary construction jobs are excluded the cost per job is about £48,000.

(4) Rate relief is seen as by far the greatest benefit by EZ firms and the simplified planning regime is perceived as a useful benefit by many firms. The capital allowance benefits developers and investors rather than tenant firms.

(5) EZs are seen as beneficial by firms off the zones because of the new economic activity and environmental improvement they bring to areas previously in a depressed condition.

(6) The consultants conclude that "real benefits are being provide to designated zones and their surrounding local economies."

In my view, this report confirms that the experiment continues to be successful; we have already made the option of the simplified planning regime available throughout the country in the form of Simplified Planning Zones, provided for in the Housing and Planning Act 1986. However, Enterprise Zones are expensive and we now have better targeted means of achieving our objectives, particularly UDCs and mini-UDCs, and the new Urban Regeneration Grant. In view of this, while I consider that we should keep Enterprise Zones as a policy option, I do not consider that any further zones in England would be warranted at present. I enclose at Annex B a list of the applications I have received for further zones and extensions to existing zones. I do not propose to endorse any of these, although I know that Malcolm Rifkind wishes to press the case for an EZ at Greenock.

I intend to publish the report and expect to be able to do so by the time Parliament reassembles. We will then need to make a statement on our future policy for EZs.

I am copying this to other members of the Cabinet (and to Sir Robert Armstrong) and would be grateful to know if colleagues agree that we should retain the EZ concept in our armoury but that in future we should consider using it only in very exceptional circumstances.

N R

30 July 1987

ENTERPRISE ZONES AND BENEFITS

FIRST ROUND ZONES (11)

England (8)	Date of Designation
Corby	22.06.81
Dudley (Extended 3.10.84)	10.07.81
Hartlepool	23.10.81
Isle of Dogs	26.04.82
Salford/Trafford	12.08.81
Speke	25.08.81
Tyneside	25.08.81
Wakefield (Extended 23.09.83)	31.07.81

Scotland (1)	Date of Designation
Clydebank	3.08.81

Wales (1)	
Swansea (Extended 6.03.85)	11.06.81

Northern Ireland (1)	
Belfast	21.10.81

SECOND ROUND ZONES (14)

England (9)	Date of Designation
Glanford	13.04.84
Middlesbrough	8.11.83
North East Lancs	7.12.83
North West Kent (Extended 10.10.86)	31.10.83
Rotherham	16.08.83
Scunthorpe	23.09.83
Telford	13.01.84
Wellingborough	26.07.83
Workington	4.10.83

Scotland (2)	Date of Designation
Invergordon	7.10.83
Tayside	9.01.84

Wales (2)	
Delyn	21.07.83
Milford Haven	24.04.84

Northern Ireland (1)	
Londonderry	13.09.83

BENEFITS

The following benefits are available, for a 10-year period from the date on which each zone is designated, to both new and existing industrial and commercial enterprises in the zones:

(i) Exemption from rates on industrial and commercial property. (The rates revenue foregone by local authorities is reimbursed to them by central government.)

(ii) 100% allowances for corporation and income tax purposes for capital expenditure on industrial and commercial buildings.

(iii) A greatly simplified planning regime; developments that conform with the published scheme for each zone do not require individual planning permission.

(iv) Those controls remaining in force are administered more speedily.

(v) Government requests for statistical information have been reduced.

(vi) Exemption from Development Land Tax (but the tax was abolished with effect from March 1985).

(vii) Employers are exempt from industrial training levies and from the requirement to supply information to Industrial Training Boards.

(viii) Applications from firms in Enterprise Zones for certain customs facilities are processed as a matter of priority and certain criteria relaxed.

ANNEX B

ENTERPRISE ZONES AND EXTENSIONS: APPLICATIONS RECEIVED

Location	Applicant	Date of most recent letter from applicant
ALLERDALE (1)	Allerdale District Council	2 Apr 1986
ALSTON	Mr DAvid Maclean MP	21 Oct 1983
BOSTON	Boston Borough Council	19 Jan 1987
BURNLEY	Burnley Borough Council	19 Sep 1986
CAMBOURNE	Camborne Town Council	8 Sep 1985
COPELAND (WHITEHAVEN)	Copeland Constituency Conservative Association	25 Jun 1984
CORBY (1)	Corby District Council	18 Nov 1984
HARTLEPOOL (1)	Borough of Hartlepool	14 Jun 1984
HYNDBURN (2)	Hyndburn BC	15 Dec 1986
ISLE OF DOGS (1)	London Docklands Development Corporation	21 Jan 1985
ISLE OF SHEPPEY	Mr Roger Moate MP	14 Feb 1986
KETTERING	Kettering Borough Council	30 Nov 1984
KERRIER	Kerrier District Council	12 Dec 1984
MIDDLESBROUGH (1)	Middlesborough Borough Council	12 Jan 1987
PENDLE (2)	Pendle Borough Council	12 Apr 1985
NW KENT (1)	North Kent Enterprise Office	4 Feb 1986
NW LEICESTER (COALVILLE)	(Leicester CC (Hinkley and Bosworth BC	18 Jun 1986
PLYMOUTH	Rt Hon David Owen MP	13 Dec 1985
Rossendale (2)	Borough of Rossendale	28 Sep 1986
ROTHERHAM (1)	Rotherham BC	21 Jun 1986
SHEPWAY	Shepway DC	20 Jan 1986
TELFORD (1)	Wrekin Council	9 Apr 1986
THANET	Mr Roger Gale MP	13 Jan 1987
WELLINGBOROUGH (1)	Borough Council of Wellingborough	17 Jan 1985
DOVER, THANET AND CANTERBURY	Dover DC) Thanet DC) Canterbury City Council) (Part of petition in respect of CFL))	20 Jun 1986

Notes:

(2) Part of existing North East Lancashire EZ

(1) An existing EZ

FROM: N R WILLIAMS

DATE: 3 August 1987

1. MR WALLER 4/8

2. CHIEF SECRETARY

cc Chancellor
Financial Secretary
Mr Butler)
Mr Anson)
Mr Monck)
Mr Burgner)
Mr Gilmore) without
Mr Hawtin) attachments
Miss Pierson) A-C
Mr Turnbull)
Mr A M White)
Mr Potter)
Mr Cropper)
Mr Tyrie)

Ch
You raised tax treatment of EZs sometime ago. I spoke to officials who said consultants report due soon. Seems a good case for pursuing X in para 9 further, & perhaps more radical options on withdrawing tax reliefs.

ENTERPRISE ZONES: LETTERS FROM THE SECRETARY OF STATE FOR THE ENVIRONMENT AND THE SCOTTISH SECRETARY

Summary

The consultants report on Enterprize Zones (EZs) commissioned by DOE Ministers has now been received, and they intend to publish it before Parliament resumes. Its publication can be expected to lead to pressure for a statement on the Government's future policy for EZs, and for designation of new zones. In his minute to the Prime Minister of 30 July (attached at A) the Secretary of State for the Environment seeks agreement that the EZ concept should be retained but future zones should only be designated in very exceptional circumstances. In his letter to the Secretary of State for the Environment of 21 July (attached at B) the Scottish Secretary seeks agreement in principle to designation of a new EZ at Greenock. An earlier request for this was set aside pending receipt of the report.

2. It is recommended that the Chief Secretary write to the Secretary of State for the Environment arguing that further EZs should be considered in the context of the Government's policies for Inner Cities and the total resources it is prepared to commit to these, and only where the circumstances of the local economy offer real prospect of success and there is no more cost effective option. His letter should agree that new EZs should be designated only in exceptional and rare circumstances.

Background

3. The first Enterprise Zones were established in 1981, with a further tranche in 1983. In June 1986 the Department of the Environment (who take the lead on EZ policy and are responsible for designation of zones in England) commissioned PA Cambridge Economic Consultants to carry out an evaluation of the EZ experiment.

The report

4. The consultants report, which runs to some 200 pages, was delivered at the end of June. A copy of the executive summary is attached at C. The report examines the extent to which the EZ experiment has contributed to:

(a) Economic activity and employment;

(b) The physical regeneration of local areas.

5. The Inland Revenue have some reservations about the methodology used by the consultants in relation to the treatment of capital allowances. However, overall it is a reasonably thorough piece of work and the reservations are not so serious as to cast doubt on its qualitative findings.

6. The consultants conclude that the EZ experiment has made some progress in maintaining and generating additional economic activity and employment both on the zones and, to a much lesser degree, in the locality. It has encouraged private sector provision of modern industrial and commercial premises in problem locations and attracted firms into those locations. By 1986 some 35,000 jobs were located on zone sites as a direct consequence of the EZ policy. The quality of premises locally and the physical environment have been improved.

7. However, they estimate the total public costs over the period 1981-86 at some £300 million, of which about 50 per cent is attributed to tax allowances on industrial and commercial buildings. This figure for tax revenue forgone must be regarded as subject to a high margin of error, but it is clear that EZ allowances have become a major tax shelter especially since the 1984 business tax reforms. The consultants found that on average only 3 additional jobs were generated in the local economy for every 10 additional jobs on enterprise zones; they did not attempt to estimate the impact on local levels of unemployment. They also found that developers in many cases enjoy enhanced rates of return on investments where unsubsidised returns would anyway have been sufficient to encourage development. The total public sector cost per net additional job in the EZ localities is estimated in the range £20,000 to £25,000 if zone related infrastructure is included. The Secretary of State of the Environment points out that this figure rises to perhaps £28,000 if temporary construction jobs are excluded, and some £48,000 if local multiplier effects are excluded (eg for the purposes of comparison with other programmes not involving estimation of

such effects). The total public sector costs will increase since the Government is committed to continuing rates relief for existing firms on the zone for a number of years whether or not these firms expand further in the future. The public sector cost per job may therefore increase.

Policy implications

8. The evaluation does not justify another tranche of zone designations. Equally it also could not easily be used to justify a decision to refuse on principle all further requests for designation of zones. But the limited impact on employment in the locality of the zones and the relatively high public sector costs per job at the local level caution against further designations other than in exceptional circumstances.

9. Although not within the terms of reference of their study and hence not included in the report the consultants are understood to have suggested to DOE officials three possible policy changes intended to improve value for money:

- Limit tax incentives to certain types of development (eg to encourage manufacturing, R&D etc but not retail/warehouse development);

- Target rates relief in similar ways and by variations in the periods for which reliefs are available;

- Avoid creating fragmented zones made up of small packets of widely dispersed land;

10. Proposals to establish further zones would need to provide satisfactory answers to the following questions.

- What, in terms of the total public sector costs, including tax revenue foregone, is the likely cost of zone designation?

- How would zone designation fit into the inner city programme and decisions still to be taken on the total level of resources to be committed to that programme?

- How far could the costs be mitigated by more careful targetting, and how could any extension of tax reliefs, even if on a more targeted basis be reconciled with Treasury Ministers longer term aims of lower tax rates and tax simplification?

- Given projected costs and benefits would particular proposals for further zones represent value for money both in absolute terms and compared to alternative policy measures with similar objectives eg mini UDCs?

Recommendations

11. These points are best considered in the context of detailed proposals for individual further zones. However, it is recommended that the Chief Secretary writes now to establish the framework within which he would wish such considerations to take place. In particular to emphasise that he would wish any proposals for further enterprise zones to be examined against the questions outlined above and having full regard for the extent to which designation of the proposed zone could be expected to lead to pressure for similar cases which might be difficult to resist. Such a letter would serve to indicate to the Scottish Secretary the steps he should now take if he wishes to pursue his proposal for a new EZ at Greenock. A draft is attached at D.

12. The terms of this submission have been cleared with the Inland Revenue.

Neil Wil

NEIL WILLIAMS

Saturday July 4 1987
THE TIMES

Revival with profits

Enterprise Zones offer higher-rate taxpayers a relatively secure tax shelter and the prospect of an attractive return. KEVIN LEAVER gives details

The Enterprise Zone concept was introduced by the Government in 1980 to revive the regions worst affected by the recession.

A total of 25 Enterprise Zones have been created and a number of incentives are offered to those who are prepared to invest in these areas. In particular, extremely generous tax relief is offered to potential investors. Although there is some debate as to whether the scheme has been successful in achieving its overall aim, there is little doubt that it has created a tax-efficient investment opportunity.

The primary tax advantage is that the full cost of construction of a commercial building located within an Enterprise Zone is allowable as a deduction for income tax purposes.

To the extent that this allowance exceeds the rental income, it can be set off against the investor's other taxable income.

Consequently, Enterprise Zones are often considered as an alternative "tax shelter" to Business Expansion Schemes (BES) or Woodlands. The higher the investor's marginal rate of tax, the greater the tax relief.

As with BES investments, therefore, Enterprise Zones are particularly attractive to taxpayers whose marginal rate of income tax is 50 per cent or more. A £20,000 investment in an Enterprise Zone will effectively cost a 60 per cent taxpayer just £8,000. Furthermore, there is no limit on the amount of the investment that will qualify for tax relief (unlike BES).

The relief is available not only for investment in industrial buildings but also in shops or offices. It is the cost of constructing the building that is eligible for the tax allowance; no relief is available for the cost of the land.

Steady flow of rental income

An investment in an Enterprise Zone should not, however, be made solely because tax relief is available. The most important consideration must be whether it is a good commercial proposition.

Investments in Enterprise Zones should generate a steady flow of rental income as many of the properties are pre-let. There is also the prospect that the property will appreciate in value and produce a gain on disposal.

The overall return will depend, among other things, on movement in property values in the region, and success in finding suitable tenants. It is essential that a potential investor seeks professional property investment advice.

The appeal of an Enterprise Zone investment, resulting from the combination of the available tax relief and the prospect of a good return, can be shown by a simple example.

Consider a 60 per cent taxpayer who invests £50,000 in an Enterprise Zone building, which generates a rental yield (net of charges) of 7 per cent per annum. The investment produces a gross annual return of approximately 17.5 per cent on the net outlay of £20,000. There is also the prospect of a capital gain when the investor disposes of the property. Even if he merely recovers the original cost of £50,000 he will realize a gain of 150 per cent.

The investment can be funded by borrowing, with interest payable on the loan qualifying for tax relief by deduction from rental income generated. The interest relief is not restricted where loans exceed £30,000, as in the case of the purchase of a private residence.

Funding the "net" investment by way of a loan is particularly attractive when no capital repayments are required until the loan is redeemed. The rental income received from the property can be used to fund the interest charges, and the loan can be repaid out of the proceeds from the eventual sale of the property.

Let us extend the above example. If the net £20,000 investment is funded with a loan on which interest is charged at 13 per cent, the annual rental income of £3,500 can be used to meet the interest of £2,600, with the balance of £900 being assessed to tax.

The net cash outlay is nil, so the surplus income and any capital gain represent a return from a zero base.

There are considerable benefits in Enterprise Zone investments, but the potential drawbacks should not be overlooked.

Although property represents a relatively secure form of investment, it must be remembered that Enterprise Zones are situated in the more depressed areas of the country. Accordingly, the properties could depreciate in value.

The building may prove difficult to let, the rental income could be disappointing and it may not be easy to dispose of the property.

Furthermore, Enterprise Zone investments must be considered to be long-term if the tax benefit is to be retained. The reason for this is that the tax relief obtained on making the investment may be wholly or partly clawed back if the property is sold within 25 years. This penalty can be avoided by disposing of an interest in the property that is different from the interest held (for example, by granting a long lease from a freehold) rather than selling outright.

Smaller investors can subscribe

You should not make the mistake of believing that Enterprise Zone investments are only for those with substantial funds to invest. Smaller investors can subscribe a minimum of £5,000 to a syndicate, which will pool the funds of a number of investors to purchase one or more Enterprise Zone properties. Where more than one property is purchased, the investor's risk is spread.

Some specialist Enterprise Zone companies provide a full range of services to the investor. In addition to using their specialized site selection skills and estate management expertise, they will find suitable tenants for the property.

One such company is Enterprise Zone Developments Ltd, which provides all the services above and also offers the investor a period of guaranteed rent and continuing advice on the investment and assistance with it.

The decision on whether or not to invest in an Enterprise Zone should not be rushed and finding a good investment opportunity can take time.

Kevin Leaver is a tax manager with chartered accountants and management consultants Deloitte Haskins & Sells.

PH1/62

RESTRICTED

prop

FROM: A C S ALLAN
DATE: 6 AUGUST 1987

PS/CHIEF SECRETARY

cc PS/Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Cassell(*)
Mr Monck
Mr Burgner
Mr Hawtin
Mr Scholar (*)
Miss Sinclair (*)
Mr Waller
Mr A M White
Mr N R Williams
Mr Cropper
Mr Tyrie
(* with copy of
Mr Williams' minute)

ENTERPRISE ZONES

The Chancellor has seen Mr Williams' minute of 3 August on the consultants' report on enterprise zones.

2. The Chancellor feels that it would be well worthwhile pursuing options for limiting or removing the tax incentives in both new and existing zones. This should cover both limiting the incentives to certain types of development, as suggested in Mr Williams' paragraph 9, and more radical options such as removing them altogether. He was struck, for example, by the attached piece in the Times a month ago about how "enterprize zones offer higher rate taxpayers a relatively secure tax shelter and the prospect of an attractive return."

ACSA

A C S ALLAN

4475/45

CONFIDENTIAL

FROM: MISS C E C SINCLAIR
DATE: 7 August 1987

CHIEF SECRETARY

cc Chancellor
Financial Secretary
Mr Butler
Mr Anson
Mr Monck
Mr Burgner
Mr Gilmore
Mr Hawtin
Miss Peirson
Mr Turnbull
Mr A M White
Mr Potter
Mr Cropper
Mr Tyrie
Mr Waller
Mr Michie o/a

Mr Painter - IR

ENTERPRISE ZONES: LETTERS FROM THE SECRETARY OF STATE FOR THE ENVIRONMENT AND THE SCOTTISH SECRETARY

There is a point of which you should be aware before writing as proposed in Mr Williams' submission of 3 August.

2. The Financial Secretary had already decided to consider again, with the Chancellor's agreement, the future of the capital allowances regime in Enterprise Zones. Mr Allan's minute of 6 August to your Private Secretary goes on to record the Chancellor's view that, in the light of the consultant's report, "it would be well worthwhile pursuing options for limiting or removing the tax incentives in both new and existing zones.

3. One of the factors which weighed with Ministers when the capital alowances regime for Enterprise Zones was looked at last autumn was the degree of public commitment to the present tax regime for existing zone. That will no doubt also be an important consideration in the new review.

4. Given the views which the Chancellor has expressed, it might be as well to make sure that no options are closed off by Government

statements at the time the report on Enterprise Zones is published. We suggest adding a passage on the following lines as a new second paragraph:

"The consultant's work raises a number of questions which we shall need to consider about value for money from the present Exchequer inputs. We shall also need to consider carefully what is said when the report is published later in the Recess to ensure that options are not inadvertently closed off.

Meanwhile I agree with your conclusion that...."

CAROLYN SINCLAIR

CONFIDENTIAL

cc Chancellor, Chief Sec.,
Financial Secretary
Mr Butler, Miss Sinclair.
Mr Anson
Mr Monck
Mr Burgner
Mr Gilmore
Mr Hawtin
Miss Peirson
Treasury Chambers, Parliament Street, SW1P 3AG
Mr Turnbull
Mr A M White
Mr Potter
Mr Cropper
Mr Tyrie
Mr Waller
Mr Michie o/a
Mr Painter - IR

The Rt Hon Nicholas Ridley Esq MP
Secretary of State for
the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

12 August 1987

Dear Nick,

ENTERPRISE ZONES

Your minute of 30 July to the Prime Minister on the consultants' report of their evaluation of the Enterprise Zone experiment was copied to John Major here. I am replying in John's absence. I should also say that I have also seen Malcolm Rifkind's letter to you of 21 July concerning his proposal for designation of a new zone at Greenock, for which he sought approval from the previous Chief Secretary John MacGregor earlier this year.

The consultant's work raises a number of questions which we shall need to consider about value for money from the present Exchequer inputs. We shall also need to consider carefully what is said when the report is published later in the Recess to ensure that options are not inadvertently closed off.

Meanwhile I agree with your conclusion that, given the generally limited impact of zones on employment in their locality and the relatively high public sector costs per job at the local level, designation of further zones should occur only in very exceptional circumstances. As a general rule I think designations should be considered only where alternative, more cost effective policy options are not available and where the circumstances of the local economy offer particular prospects of a zone making a significant contribution to local employment and economic activity.

It is also important that any proposals for designation of further zones are considered in the context of our policies towards the inner cities and the total level of resources to be committed to those. Against this background, it is essential that proposals for new enterprise zones, such as that proposed by Malcolm Rifkind for Greenock, should be subjected to a detailed examination of

CONFIDENTIAL

the expected benefits and total public sector costs, including tax revenue foregone, and a comparison of these with alternative policy options having similar objectives. We would also need to consider how far such a designation could lead to pressure from other cases which might be difficult to resist, and how it could be reconciled with our longer term aims of lower tax rates and tax simplification.

Copies of this letter go to recipients of your minute.

Yours ever

Peter

PETER LILLEY

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON S.W.1

From the Minister

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
2 Marsham Street
London SW1P 3EB

12 August 1987

Dear Nicholas,

Thank you for sending me a copy of your note to the Prime Minister of 30 July about Enterprise Zones.

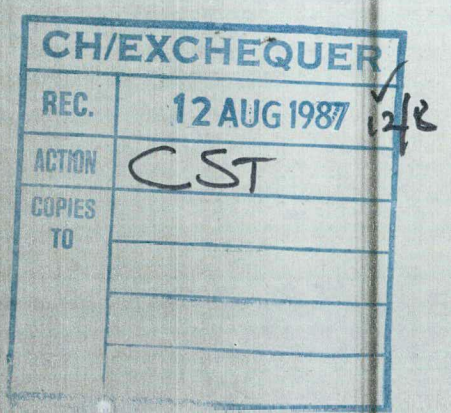
I agree with your conclusion that we should retain the EZ concept in our armoury, but that in future we should consider using it only in very exceptional circumstances.

I am copying this to the recipients of yours.

Yours ever,

JL

JOHN MacGREGOR



DEPARTMENT OF THE ENVIRONMENT (N.I.)
STORMONT, BELFAST BT4 3SS

The Rt Hon Nicholas Ridley MP
Secretary of State for the
Environment
2 Marsham Street
LONDON
SW1P 3EB

14th August 1987

Dear Nick

ENTERPRISE ZONES

You copied to Tom King your letter of 30 July 1987 to the Prime Minister, following the Consultants' Report on the Enterprise Zone experiment. I am replying in Tom's absence.

As you know, the Consultants' study did not extend to Northern Ireland. Because of local differences we felt it best to commission a separate examination of the effect which Enterprise Zones have had in Northern Ireland, again using PA Cambridge Economic Consultants. The findings are expected in mid Autumn.

Until we have received the report of the Consultants following the Northern Ireland study it is difficult to form a precise judgement as to the worth of Enterprise Zones here. We are content, however, that they should be kept as an option which might be used should circumstances so dictate.

I am copying this reply to other members of the Cabinet and to Sir Robert Armstrong.

Yours ever

RICHARD NEEDHAM

Y SWYDDFA GYMREIG
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Switsfwrdd)
01-270 0538 (Llinell Union)
Oddi wrth Ysgrifennydd Gwladol Cymru

WELSH OFFICE
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Tel. 01-270 3000 (Switchboard)
01-270 0538 (Direct Line)
From The Secretary of State for Wales

The Rt Hon Peter Walker MBE MP

CONFIDENTIAL

14 August 1987

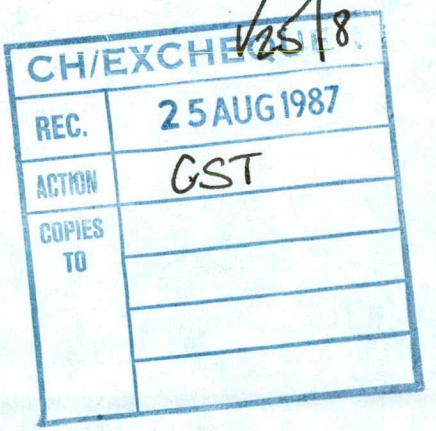
UDC FINANCIAL LIMITS BILL

Thank you for copying to me your minute of 30 July to the Prime Minister.

I agree that the present acceleration of spending by UDCs necessitates a move away from the present system of continual recourse to primary legislation to authorise increased spending. I am content with the solution you propose including the initial limit of £30 million on all borrowing with the ability to move to £100 million subject to affirmative procedure.

I am copying this to the Prime Minister, other members of E(A) and to Sir Robert Armstrong.

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment



FCS 87/174

SECRETARY OF STATE FOR THE ENVIRONMENT

Enterprise Zones

1. I welcome the findings of the consultants' report on Enterprise Zones as outlined in your minute of 30 July to the Prime Minister. I believe that Enterprise Zones fulfilled a vital trail-blazing function of much wider significance for the political and business climate of the country than simply the figures relating to the localities in which they are situated. I have no doubt, for example, that the explosion of (long overdue) activity in London's dockland owed a lot to the Enterprise Zone.

2. But not only that, of course. The Development Corporation has certainly played its part too. That is only one reason why I do accept that the days for establishing new Enterprise Zones as such may now largely be past in most of the country.

3. But I wonder if this is yet the case in Scotland? As we have seen, a climate of enterprise has still not been established in that part of Britain and it could surely be that Enterprise Zones, together with other radical Conservative policies already established elsewhere, have an important role to play in modernising Scottish political and business attitudes.

4. I am copying this to those who received your minute.

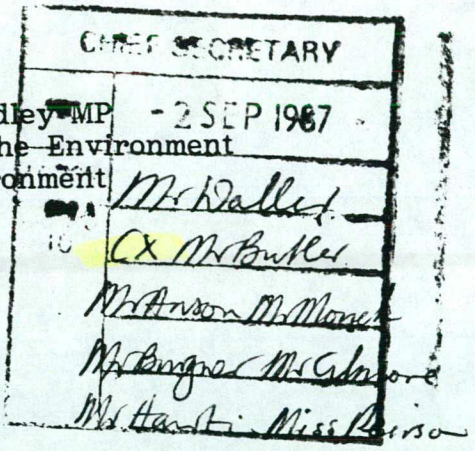
(GEOFFREY HOWE)

Foreign and Commonwealth Office

24 August 1987

pwp

NEW ST. ANDREW'S HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX



The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

2 September 1987

Mr Turnbull Mr Potter
Mr AM White Mr Cropper
Mr Call

Dear Nicholas,

ENTERPRISE ZONES

Thank you for copying to me your minute of 30 July to the Prime Minister on the consultants' report of their evaluation of the Enterprise Zone experiment up to the end of 1986. I have since seen Peter Lilley's letter of 12 August and Geoffrey Howe's of 24 August.

I agree your conclusion that the enterprise zone concept should be retained, for use only in exceptional circumstances where there will be a sufficient local impact to justify the public sector costs. I accept Peter Lilley's view that any future designation proposals must be subject to detailed examination, although I think we should recognise that some of the less tangible, but still important, benefits may be hard to quantify. I would suggest that it should additionally be regarded as essential to any future designations that a sufficient degree of local cooperation among relevant authorities and agencies exists to give the zone a reasonable prospect of success.

As you have anticipated, it remains my view that there are areas in Scotland where EZ designation may still be the answer, to help tackle the problems of some of our most challenging areas. The alternative measures which you example of UDCs, mini UDCs and urban regeneration grant, I have not considered appropriate to our different circumstances and it may well be that EZ status needs therefore to remain a more prominent weapon in our armoury in Scotland than in England. Simplified planning zones, while useful, are no substitute for the financial attractions of an EZ. Geoffrey Howe also has a fair point in his comment on the potential role of EZs in modernising attitudes to enterprise in Scotland.

My immediate concern is Greenock and I have asked officials, in consultation with yours and Treasury, to work up a detailed case for consideration. This will be done as quickly as possible. I must be in a position to announce our intentions by the time the consultants report is published and any statement made in Parliament on future EZ policy and I would ask for your cooperation in achieving this. The only other EZ options I can foresee at present would be for the steel area of North Lanarkshire, where serious local economic problems remain, or associated with any new urban initiatives.

JMM243A5

Copies of this letter go to the Prime Minister, David Young, Peter Walker, Tom King, Norman Fowler, George Younger, John Major, Kenneth Clarke and Sir Robert Armstrong.

Yours ever,

MALCOLM RIFKIND

JMM243A5

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215)
GTN 215) 5147
(Switchboard) 01-215 7877

From the Chancellor of the Duchy of Lancaster and Minister of Trade and Industry

THE RT HON KENNETH CLARKE QC MP

Rt Hon Nicholas Ridley MP
Secretary of State
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

CHIEF SECRETARY
3 SEP 1987
ACTION Mr Dallet
COPIES TO CX Mr Butler
Mr Anson Mr Moore
Mr Burgner Mr Gilmore
Mr Hanbin Miss Peirson

3 September 1987

Mr Turnbull Mr Potter
Mr A M White Mr Cropper
Mr Call

Dear Nick,

Thank you for copying to David Young your letter of 30 July to Malcolm Rifkind and your minute of the same date to the Prime Minister about the consultants' report on the Enterprise Zone experiment. I have since seen comments from John MacGregor and Peter Lilley.

The experiment is obviously making a worthwhile contribution to stimulating private sector activity in the areas in which they are located. I would not dissent, however, from your view that they are relatively costly and that the concept should be used in exceptional circumstances, presumably when it offers the most cost-effective means of achieving particular objectives.

I am not surprised that the simplified planning regime is perceived as a useful benefit by many firms and you mention that Simplified Planning Zones (SPZs) would provide a means of continuing the Enterprise Zones' simplified planning regime. The scaling down of the EZ policy coinciding with the establishment of SPZs will, of course, provide an excellent opportunity to preserve some of the inexpensive features of EZs by including them in the Simplified Planning Zone policy. I have in mind particularly the speedier administration of remaining controls on development, without which the advantages of planning relaxations may be diminished. I hope you will be able to agree that the SPZ policy may be strengthened and made more attractive in this way.

AU3ADX

No doubt you will be consulting colleagues about the statement of future policy which you intend to make when Parliament re-assembles. I am copying this letter to the recipients of your minute.

KENNETH CLARKE

AU3ADX

PWP.

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WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Switchboard)
01-270 0538 (Direct Line)
From The Secretary of State for Wales

The Rt Hon Peter Walker MBE MP

- 9 SEP 1987

Mr Waller
Mr Butler
Mr Ansio Mr Monck
Mr Burgner Mr Gilmore
Mr Hawtin Miss Pearson

8th September 1987

Mr Turnbull Mr Potter
Mr AM White Mr Cropper
Mr Tyrie Mr Call-

Thank you for copying to me your minute of 30 July to the Prime Minister about Enterprize Zones.

I am in broad agreement with your view that we should retain the Enterprize Zone concept as a policy option but that it should be used sparingly. In considering any proposal for an Enterprize Zone we will have to ensure that we are getting value for money and that there are not other more appropriate instruments that can be used; but the report does say that the policy has achieved a measure of success and I accept Malcolm Rifkind's argument that in some circumstances it may be the best way of tackling the economic problems of some of our difficult areas which are not all in the inner cities.

As you know I have an outstanding application for an extension to an existing Enterprize Zone from Delyn Borough Council. Once we have agreed our future policy on Enterprize Zones I will be considering Delyn's case.

I am copying this to the Prime Minister, other members of the Cabinet and to Sir Robert Armstrong.

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON SW1P 3EB

CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

9 September 1987

Dear Robin,

ENTERPRISE ZONES

The Prime Minister has seen your Secretary of State's minute of 30 July which described the evaluation by consultants of the Enterprise Zone experiment and your Secretary of State's conclusions.

The Prime Minister agrees with Mr. Ridley that Enterprise Zones should be retained as a policy option but that further zones in England would not be warranted at present. However, she has noted that the possibility of designating Greenock as an Enterprise Zone remains under discussion.

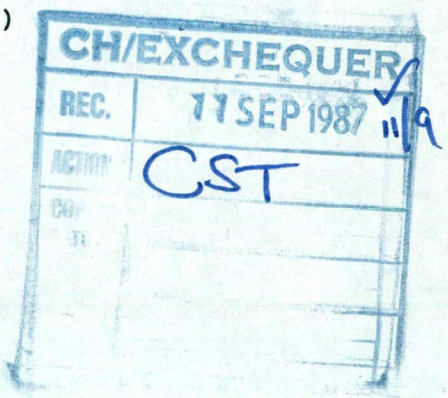
The Prime Minister has suggested that it would be worth keeping open the option of adding other de-regulatory aspects of Enterprise Zones to simplified planning zones in areas where this might be attractive. She has also noted that in any statement announcing the Government's conclusions it would be important to avoid reducing the political credit which has been gained from having created the existing Enterprise Zones.

I am copying this letter to the Private Secretaries to other members of the Cabinet and Sir Robert Armstrong.

Yours,
David.

(DAVID NORGROVE)

Robin Young, Esq.,
Department of the Environment.



CONFIDENTIAL

TASK FORCE SECRET

Copy No 1 of 17

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Ch/ Do you want a mtg. on this?
Shall I ask FST to take it forward + give you advice? 21/10

FROM: T J PAINTER
20 October 1987

CHANCELLOR OF THE EXCHEQUER

FINANCE BILL 1988: ENTERPRISE ZONES (STARTER NO.208)

behind (Mr Driscoll's separate note examines the case - and scope - for restricting the existing tax incentives (100% initial allowances) in enterprise zones.

2. By way of background you will recall that Ministers looked at this last year in the minimum tax exercise. Your conclusion was that restricting the reliefs would be seen as undermining the EZ concept and inconsistent with previous Ministerial statements. The developments since then which have led you to ask for the point to be looked at again are:

- the wider tax reforms you are considering which might justify removing or reducing some of the tax breaks which complicate the system and encourage higher rate taxpayers to shelter income; and

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monck
Mr Byatt
Mr Scholar
Mr Battishill
Mr Isaac
Mr Beighton
Mr Calder
Mr Weeden
PS/IR

- the consultants' report, sponsored by the DOE, on EZs which identified significant deadweight Exchequer costs and therefore questionable value for money from the incentives.

3. Treasury Ministers' response to the consultants' report was set out in the Economic Secretary's letter of 12 August to the Secretary of State for the Environment. In essence it was that, given the generally limited impact of zones on employment in their locality and the relatively high public sector costs per job, new zones should be designated only in very exceptional circumstances; and any proposed designations would, inter alia, need 'to be reconciled with our longer term aims of lower tax rates and tax simplification'. I suggested that this last point should be included precisely to keep options open in the context of possible wider tax reform.

This is in the separate folder, behind.

4. Mr Beighton is putting to the Financial Secretary a separate note on a range of reliefs, essentially income-spreading arrangements, each of them relatively small and of longer standing than the EZ incentive, which Ministers short-listed for further consideration on the assumption of significant cuts in higher rate tax in the Budget.

5. Our view on those is that:

- each would be controversial, whatever the context and would excite articulate lobbies (eg the literary set on copyright royalties);

?

- colourable structural arguments for them can and will be mounted so long as there are <u>any</u> higher rates of tax;

- taken individually none of them offers identifiable resource savings or major simplification.

<u>But</u>

- if they cannot be tackled under the protection of the sort of

radical reform package in contemplation it is difficult to see how this sort of simplification at the edges of the tax system can ever be achieved;

- even though in aggregate it is still not possible to attribute identifiable resource savings to getting rid of them, they represent a block of complexity at the margin of the system which divert time and energy from other, more productive, work. And it is the sort of complication which grows remorselessly.

And

- self-evidently the decision is very much one for Ministers' political judgement.

6. The concession for EZs is even more sensitive, not least because of the public commitments which weighed heavily with Ministers when they were looking at the question last year. It also needs to be distinguished because it was conceived as a positive incentive, taking advantage of relatively high tax rates, not as a structural mitigation of the impact of high tax rates.

7. Looked at only in the context of a higher rate package, a case for restriction can be made out but does not look particularly strong. In principle, the reduction in higher rates also reduces the incentive effect, and, over time, implies reduced take up (though the familiar ratchet effect may operate). That weakens the case for action. The counter-argument, which is broader and therefore perhaps rather more diffuse, is that a net reduction in the burden on higher rate taxpayers releases more funds for investment in total and EZs can be expected to get a reasonable share (though the continuance of the broadly similar, closely-targeted, BES incentive makes that rather more difficult to run by itself).

8. What buttresses the broader argument, distinguishes EZs from the BES, and requires the EZ incentive to be looked at in its own terms, is the consultants' adverse report on value for Exchequer money.

9. Here you may still feel that the crucial consideration as regards existing zones is the strength of the public commitments, including your own as Financial Secretary. Possible arguments in support of a change might range at one extreme from the bold proposition that the reform package as a whole is so radical that all bets are off, to, at the other extreme, the narrow distinction that a restriction of sideways relief in EZs (one of the options) would not breach the letter of past statements since they were strictly about the rate of capital allowances rather than the timing of relief. The risk is of course that that would look pedantic and not find ready acceptance either by the EZ authorities or by the 'brokers' who have made something of an industry of channelling funds into zones - particularly since the immediacy of sideways relief is regarded as the attraction of the package.

10. The fact that any restriction for existing zones would be limited to new investors would not be a complete answer because of the implications of the restriction for some existing investors (paragraphs 27 and 28 of Mr Driscoll's note). And heavy reliance on the consultants' adverse findings could make the whole EZ experiment look like a mistake (the thought underlying the Prime Minister's comments recorded in Mr Norgrove's letter of 9 September to Mr Young at the DOE).

11. By contrast I cannot see that past statements limit your room for manoeuvre on new zones - if there are to be any. Nor would restriction - or, more radically, removal - of the capital allowances incentive for new zones necessarily mean that Ministers had to be particularly defensive about the scheme for existing zones. The tax incentive is available for a limited period (existing zones will cease to qualify over a period of about 3 years to October 1994) and it was, arguably, not

unreasonable to err on the generous side on the introduction of an innovative scheme.

12. The clean-cut option, and the one most consistent with the Budget theme of simplification and also the 1984 business tax reforms, would be to remove the tax incentive altogether for new zones, leaving the emphasis on planning deregulation and, if that is to remain, continuing rates relief. But it would be possible to go less far and act on the rate of capital allowances or the availability of sideways relief, or both. Mr Driscoll's note discusses these options.

13. If you were inclined to take action on EZs it would, of course, be necessary at some stage to open the matter up with the Secretaries of State for the Environment, Scotland and Wales.

T J PAINTER

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

From: P J A DRISCOLL
Ext: 6287
Date: 21 October 1987

CHANCELLOR OF THE EXCHEQUER

FINANCE BILL 1988 : STARTER NO 208
ENTERPRISE ZONES

1. Mr Allan's note of 6 August records your request for a review of "options for limiting or removing the tax incentives in both new and existing zones". This note deals with Capital Allowances options.

2. The note concludes that if new zones were to be designated then the problem of deadweight (highlighted in the PA Cambridge Consultants' report) and of tax shelters might be tackled by reducing the rate of initial allowance offered in those new zones (paragraph 15). Whether legislation should be introduced to do this will no doubt be influenced by Ministers' policy in relation to new zones generally. If there are to be none (or very few) then the case for legislation for new zones alone is less compelling.

Probably won't be any except(?) Greenock.

---

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Byatt
Mr Cassell
Mr Burgner
Mr N Williams
Mr Scholar

Chairman
Mr Isaac
Mr Painter
Mr McGivern
Mr Beighton
Mr Calder
Mr Weeden
Mr Driscoll
PS/IR

3. How far the regime applying to existing zones could be altered must depend crucially on your political judgment on the extent and strength of the commitment in past statements. If you feel that there is scope - within the spirit of those statements - for limiting reliefs then a restriction on sideways relief might be considered (paragraph 29). We also mention the particular treatment of Property Enterprise Trusts (paragraphs 30-32).

4. These matters are considered in more detail below.

Form and Scope of the Existing Relief

5. A person incurring capital expenditure on the construction of an industrial building, a qualifying hotel or a commercial building in an enterprise zone (but not a building in use as a dwelling house) is entitled to a tax deduction for the whole of his expenditure. This is so whether he occupies the building for the purposes of his own trade or whether he is a landlord letting the property to a trader. The whole of the expenditure may be claimed as a deduction in the year in which it is incurred and used to cover income arising from the trade or letting of that or subsequent years. In addition, taxpayers have an option to use any surplus sideways to cover other income rather than, as might be expected in principle, income from the investment itself. The availability of early sideways relief is undoubtedly a big attraction of the scheme as it stands.

6. The relief (contained in Finance Act 1980) is an extension of the allowances normally available for expenditure on industrial buildings and takes the form of a 100% initial allowance (although the taxpayer has the right to opt for a lesser percentage with the balance being written off at 25% per annum on a straight line basis). It extends to expenditure "incurred, or....incurred under a contract entered into, at a time when the site ..... is in an enterprise zone, being a time not more than 10 years after the site was first included in the zone".

Not attached, if only to keep down the bulk.

7. When we were looking at the use of tax shelters by high earners last year (see Mr Johns' note of 31 October 1986 on minimum tax) it appeared that one relatively common shelter was the borrowing of money to invest in buildings qualifying for a 100% initial allowance (now available only in enterprise zones). The relief is available on interest on loans to purchase or improve let property anywhere in the UK (not just in enterprise zones) up to the limit of the rents received. This means that where the investment is financed by borrowing, the whole of the capital allowances can be set sideways immediately against other income.

A. **New Zones**

8. The question of whether any new zones should be created is still under consideration following the independent consultants' report on the scheme. If any new zones were to be designated then the political and presentational implications of offering more limited relief in those zones seem manageable. Although it would be necessary to justify creating a category of intermediate zones (cries of "second class status!" from those responsible for marketing them) there would be answers to any suggestion of a volte-face or breach of faith. And, if the regime (including other measures) for new zones were to differ markedly (if, for example, rates relief were to be less generous) from that for existing zones then a different title for such new zones might perhaps be found, thereby emphasising the change in approach as policy had evolved.

9. So, what should be offered and why? Here Ministers would want to decide precisely what it was intended to achieve through the designation of new zones and to consider whether in any particular case those objectives would better be met through tax incentives than through some other policy vehicle eg a mini Urban Development Corporation. They would want to bear in mind the relative flexibility of non-tax schemes. Such schemes allow better for fine-tuning to meet the special requirements of particular areas.

10. There are two developments that make it opportune to review the reliefs currently available. First, the consultants' findings on deadweight. And second, the fact that the continued survival of this tax shelter may be less justifiable in future years in the context of tax reform.

11. On the first point, the Consultants' findings suggest that the deadweight effect is most marked

- where individual investors with high marginal tax rates are involved (perhaps one quarter of all investment);

- for retail investment (perhaps 2-5% of all investment); and

- in zones in more favoured locations.

The level of deadweight would be reduced if

- the rate of initial allowance were lower; and/or

- if the average marginal rate of individual investors were lower; and/or

- if retail development were excluded from the benefit of EZ allowances.

Targeting

12. In principle, one possible way of achieving better value for money from any new zones would be more precise targeting of incentives. In practice, however, this would be difficult. Experience in existing zones has shown that regeneration can be achieved through a varied mixture of development. For example, in some zones retail development has played a major part whereas in others other commerce, industry and warehouses have played a bigger role.

13. So the differing characteristics of different zones would need to be borne in mind. For example, a specifically R & D targeted relief might not be the most appropriate policy instrument in an area where high local unemployment suggested a need for assembly plants employing significant numbers of semi-skilled workers. If the possibility of new zones were kept open there would be a case for leaving the scope of the EZ relief unchanged (at least for the present) but being more selective in designating any further zones. In other words, while the present approach of favouring investments in all kinds of developments is particularly vulnerable to deadweight (at least in the more favoured zones) a more narrowly focused approach risks missing the target altogether.

Other options for restricting relief

14. If further EZ's were to be designated but the scope of the relief unchanged then possible options would include

- reducing or eliminating the rate of EZ relief in new zones;

- limiting the way relief is given (eg against particular types of income); or

- limiting the people qualifying for relief.

- Reducing Rate of relief

15. There is nothing magical about the 100% relief on business buildings in EZs. It was introduced when expenditure on machinery and plant attracted a 100% first year allowance and when expenditure on industrial buildings attracted an initial allowance of 50% (75% from 11 March 1981). Apart from the effect the rate of initial allowance has on post-tax rates of return an important element in attracting investment to EZs has been the relative treatment of investment inside and outside zones. In so far as EZ allowances go to investment that would have taken place anyway, a reduction in the rate of initial

allowances would reduce the deadweight cost of designating new zones. Given that, following the 1984 business tax reforms,

- initial allowances are not now available outside EZs;

- for industrial buildings and hotels normal writing down allowances are 4%; and

- no capital allowances at all are available on the construction of other commercial buildings (although machinery and plant within all buildings qualifies for ordinary machinery and plant allowances at 25% reducing balance basis);

there must be a case for exploring the possibility of abolishing the initial allowance on business buildings in new EZs or of cutting it to no more than say 40 or 50%. We could produce a note showing the impact of such a reduction on post-tax returns in various scenarios (eg at various rates of tax, various types of investment). Of course, if initial allowances were abolished or radically reduced critics would argue that the EZ concept was being undermined. This argument would have more force if business rates relief were similarly curtailed.

16. Conceivably, a reduction or withdrawal of initial allowances could be selective eg a lower rate for retail buildings than for industrial buildings. (The consultants found that investors in retail developments look for a lower rate of return than other investors and emphasise the deadweight cost where unsubsidised rates of return are already high enough). But this approach would suffer from the same drawbacks as targeting in general (see paragraph 12 above). Although to date retail development has represented no more than 5% of all on-zone development it would be unfortunate to cut back on allowances for this sort of expenditure only to find that the need in the first new proposed zone was for just that sort of investment and that local factors made unsubsidised rates of return inadequate. It would seem more prudent to retain a

wide field of fire but to be judicious in the use of the weapon.

17. An alternative form of selectivity (canvassed in the consultants' report) would involve a differential rate of initial allowance between zones. At first sight this is attractive, since it confronts the deadweight problem and promises some degree of flexibility - the "subsidy" element could be kept to the minimum needed to attract the desired investment. However, on closer examination we do not think that this option should be pursued. First, it would be a matter of fine judgment as to precisely what rate was required to attract investments to a particular zone and, quite apart from practical problems of how differential rates were to be set (eg by Treasury Order when the zone was designated; by reference to some "objective" criterion - region, development status, "inner city", unemployment level; date of designation), there would be some pretty invidious choices to be made. It is hard to imagine any particular zone accepting that it should have a rate of say 20% when another zone, perhaps nearby or with similar conditions, attracted a rate of 50%. There would be constant lobbying for higher rates for particular zones. It would seem preferable to tackle the deadweight problem more directly by a greater selectivity in the choice of sites (and by a lower rate of initial allowance to apply to all new zones).

18. More attractive in principle is the idea of progressively reducing rates of initial allowance over the life of a zone - investors would be encouraged to begin development before the rate of allowance fell. However, apart from the added administrative complexity that multiple rates would entail, practical problems could arise where investors were keen to develop while those responsible eg for land clearance or for providing infrastructure failed to meet planned completion dates (perhaps through no fault of their own). This could lead to pressure on Ministers for an extension of time limits (anyway inherent in the scheme). And the very existence of a highly tapered scheme could lead to hasty and ill-considered

developments being rushed through to obtain maximum advantage from the allowance. On balance, the 10 year period of stability applying in existing zones probably provides the right balance between certainty and a finite period within which work must be contracted-for.

- Limiting the use of relief

19. If it were decided that the initial allowance (at present 100%) for expenditure in new zones were to be abolished and the normal rates of capital allowances applied instead, then we would not see any need to restrict the way in which the allowances are used - eg sideways against other income. If on the other hand the incentive element were to be retained ie with an initial allowance of, say somewhere between 40% and 100% Ministers may wish to consider whether some restriction should be placed on the way in which the relief could be used.

20. The most obvious restriction would be to deny the use of the relief sideways against other income. This would mean that in future relief for capital expenditure (in new zones) would be available for use only against the income arising from, broadly speaking, activity within the zones.

21. We assume, however, that Ministers would not want to limit the sideways use of relief in the case of traders who own and occupy their own buildings in EZs. The relief is available against the whole of the profits of the trade (and can create or augment a loss which can be set off in the normal way against other income) and it is not clear what the justification would be for denying the normal capital allowances treatment in those cases (for which very complex rules would be required). Such an approach would in any event only have an effect where the trader made a loss and would seem to run contrary to the spirit of the EZ concept by denying the full use of tax reliefs when the business needs it most.

22. If this were accepted, the approach would be to restrict the use of relief only in the case of lessors (landlords). For

the reasons set out in paragraphs 24 and 25 below, we believe Ministers would find if undesirable to deny sideways relief to all lessors ie corporate and individuals, but one possibility might be to impose a restriction only in the case of individual lessors who in practice will be the higher rate taxpayers.

23. The options would involve either restricting relief to the amount of EZ income (defined in various ways) or, alternatively, limiting the amount of sideways relief to the sum of -

a. the total net income derived by the individual from letting any buildings in EZs (after any interest on borrowing to purchase or improve the properties); and

b. say £40,000 (or whatever was the BES ceiling).

This sort of approach would retain some (albeit reduced) 'incentive element' for investors but would signal that tax shelters were not to be abused. On the other hand, we should need to be clear as to why individuals were being singled out for less favoured treatment. Discrimination against individuals depends critically for its justification on the need to remove tax shelters for high rate taxpayers; and the attraction of EZs as a tax shelter would, of course, be reduced if the present 100 per cent initial allowance was itself reduced or if the higher rates of tax were to be brought down. Moreover, discriminating between companies and individuals would probably mean that the restrictions should apply also to close companies - to prevent avoidance - and this would inevitably represent a layer of complexity which might well hit some large property investment (but close) companies. You might feel therefore for all these reasons that this is not an attractive option.

If, as I suggest, the main reason for options the 'value for money' one, drawing a new distinction between individuals and companies would be difficult to justify - and would not go much down the road of simplification.

- Limiting the people qualifying for relief

24. Work done by the consultants shows that some 40% of all development to date has been done by firms for their own

occupation, with the remainder being carried out by developers. A proportion of that remainder will have been sold-on to firms for their own occupation with the residue going to landlords. (In fact 74% of all firms on EZs are lessees). While, therefore, one possible option would be to offer incentive allowances in new zones only to persons incurring capital expenditure on the construction of buildings occupied or to be occupied by them for the purposes of a trade (including expenditure on the purchase of new buildings from developers), there would, all things being equal, be a risk that denying relief to all lessors (landlords) would inhibit development on new zones.

25. Moreover, while denying relief to all lessors would both eliminate the use of EZ allowances as a tax shelter for individuals without the need for complex rules and eliminate any possibility of avoidance eg through the use of close companies, such an approach would also adversely affect tax-exhausted or small/start-up businesses for which leasing has come to be the traditional access route to the benefits of capital allowances. Thus new zones would tend to be attractive primarily to the big battalions, with small firms competing at a disadvantage in those areas - to date 60% of development in EZs has been in units of 5,000 sq.ft or less. We assume that Ministers would want to avoid this effect.

B. **Existing Zones**

26. While the general considerations here are much the same as with new zones, we think the main question in relation to existing zones is whether any changes to the relief are ruled out by past Ministerial statements, details of which are given in the Annex. This is very much a matter for your judgment.

27. If you conclude that past statements do not rule out some changes for new investment in existing zones, the main options would, as for investments in new zones, be to reduce the rate of initial allowance; to deny or limit relief for expenditure on retail developments; and/or to restrict sideways relief for

'losses'. These options are reviewed briefly below but they would all involve a significant change and those with potential grievances would include

- property dealers/developers who had bought or developed land in the expectation of being able to sell it to retailers and others able to qualify for and use 100% EZ reliefs;

- local authorities/UDCs who had spent money on infrastructure projects that proved to be abortive;

- retailers and others who had bought land expecting to obtain EZ allowances on future development of that land.

28. Any complaints would be orchestrated by various 'brokers' who have created an industry out of marketing tax shelter schemes. And, to the extent that the absence of EZ reliefs for retail development reduced overall demand for land on EZs, on-zone prices could suffer, to the disadvantage of all existing investors in existing zones. It follows that it might not be easy to argue that restrictions affected only future investment. For these reasons and for the reasons discussed at paragraphs 12 and 13 above you may not wish to narrow the scope of the relief to exclude retail developments.

29. If your judgment is that past statements would make it hard to cut the rate of initial allowances in existing zones, you may wish to consider whether the same difficulties apply to a restriction on sideways relief (on new investment) for lessors. This option - which would limit the exploitation of the relief as a tax shelter - raises the same questions as applying a similar restriction in new zones and is discussed in paragraph 23 above.

Property Enterprise Trusts etc

30. There is a further development of which you should be aware. It concerns a property investment vehicle known by the "brand names" of various individual schemes (Property Enterprise Trusts - PETs - are the best known). These schemes or syndicates exist to enable individual investors to invest at least £5,000 each in EZ properties and to receive the benefit of EZ allowances. To comply with English real property law they take the legal form of trusts but since they are 'bare trusts' we have hitherto had for tax purposes to "look through" the trust to the individual investors. Hitherto, therefore, we have taxed those investors on their share of income from the property investments and (most importantly for the success of the schemes) we give them the 100% EZ allowances. The article attached to Mr Allan's minute of 6 August referred to the attractions of this sort of scheme for high-income investors.

31. PETs etc are unit trusts and as such have been affected by the Financial Services Act and our own consequential legislation in Finance Act 1987 (Section 39). Following Finance Act 1987 all unit trusts are brought into a coherent scheme of taxation. In the case of "unauthorised" unit trusts such as PETs the new rules preclude "looking through" and ensure that income arising to the trustees is regarded as income of those trustees (who also get title to any capital allowances that are available) and not of the individual unit-holders (who are also denied capital allowances). However, there is provision for the Treasury to make regulations to take trusts outside this new scheme.

32. The enterprise zone trusts have made representations to be "regulated out" of the Finance Act 1987 rules and thus retain the 'transparent' treatment they have had hitherto. We shall shortly be putting a note to Ministers on our discussions with them. The current policy stance on EZs is an argument for giving PETs the let-out they seek. But the case for giving

special treatment would be weakened if you decided to limit the generation of sideways relief available to high-income individual lessors. Denying the relief to PETs would then be complementary to a restriction on reliefs obtained by large investors. We will cover this angle in our forthcoming note on PETs, taking account of your reaction to the options in this note for changes in the general EZ regime.

Costs

33. At this stage we have not attempted to estimate the revenue effects of the various policy options discussed This can be done if you wish any of them to be pursued further. The overall 'cost' of EZ capital allowances has risen to about £60m for the year to October 1986 with a significant part of the increase over earlier years' figures coming from the reduction in rates of allowance for development elsewhere. The cost for future years may (subject to rates of tax) be expected to rise further as a number of major projects start to materialise (Canary Wharf is the largest) and as some early low-density developments come to be replaced with high-density buildings. This latter effect is already visible on the Isle of Dogs as empty sites cease to be available.

Summary & conclusions

34. This note looks at options for changing the capital allowances rules in new EZs (if there are to be any) and in existing zones. Whether, and if so in what ways, it would be desirable to limit the incentives on offer would depend crucially on Ministers' future objectives for EZs and on developments on tax reform. However, for new zones, there would appear to be scope - in the context of a tax reform package but more particularly in the light of the consultants' report - for removing, or at least reducing the rate of the initial allowance available on business buildings (paragraph 15). An alternative, but you may feel unsatisfactory, approach would be to limit sideways relief for individual lessors (paragraph 23). For existing zones the

scope for action depends crucially on the extent to which you feel committed to the existing reliefs by previous statements. If you concluded there was room for change, the options and considerations, at least as regards limiting sideways relief, are much the same as for investment in new zones.

35. If you wanted to pursue any of the options for restricting capital allowances you might also like to consider whether relief from local authority rates should also be curtailed.

36. As a separate matter, there will be a need to decide how to deal with PETs etc post-Finance Act 1987. If reliefs to individual lessors are to be limited the case for favourable treatment of these vehicles becomes questionable. We shall be letting you have a separate note on this.

37. You may find a discussion helpful before coming to a final conclusion.

P J A DRISCOLL

ANNEX

MINISTERIAL STATEMENTS

1. In a speech to the Bow Group on 26th June 1978 (the Isle of Dogs Speech) Sir Geoffrey Howe first suggested the creation of "enterprise zones" to bring speedy relief to the worst afflicted urban areas of Britain. Among the key elements listed by Sir Geoffrey was :

> Fourth, businesses in the areas in question should be given a guarantee that tax law (affecting investment, depreciation and so on) would not be changed to their disadvantage.... No Government grants or subsidies would be payable to any enterprise within the area.

2. In his 1980 Budget Speech, Sir Geoffrey Howe announced proposals for setting up, on an experimental basis, about half a dozen enterprise zones (Hansard 26 March 1980, cols 1487-9). One of two tax incentives to be made available within these zones was 100 per cent capital allowances for both industrial and commercial buildings (including hotels). The accompanying Treasury Press Release (extract below) explained that enterprise zones were to be designated for an initial period of 10 years and both new and existing firms would benefit from the tax incentives. It was hoped that zones could be designated by the end of 1980. The Budget Day Inland Revenue Press Release (extract below) said that the main feature of the special scheme of capital allowances (modelled on industrial buildings allowance) was an initial allowance of 100 per cent on capital expenditure incurred on the construction, extension or improvement of industrial and commercial buildings in enterprise zones. As with industrial buildings allowance, the new allowances were to apply both to owners who occupied the buildings themselves and to owners who let them.

3. The legislation provides for enterprise zone status and the associated reliefs to last 10 years from designation of a zone.

Mr Lawson (then Financial Secretary) said "The clause makes it perfectly clear that a contract entered into during the 10 year period enables relief to be claimed under the 100 per cent capital allowance" (Hansard, 4 June 1980, col 1513). Similarly the Inland Revenue Budget Day press release said:

> "It is proposed that the special allowances should apply to capital expenditure incurred within a 10 year period beginning with the day on which the site in question is first included in an enterprise zone; and also to expenditure incurred after the end of that period under a contract entered into within it."

There has been no change in the position since 1980. The 100% initial allowance for building in enterprise zones was deliberately left unaffected by the general phased withdrawal of first year allowances in 1984.

Extract from Treasury Press Release 26 March 1980

"Measures

The Enterprise Zones will be designated for an initial period of ten years - subject to renewal. Both the new and existing firms in the zones will benefit from the following measures:

1. Exemption from Development Land Tax.

2. 100% capital allowances (for income and corporation tax purposes) on industrial and commercial property.

3. Exemption from general rates on industrial and commercial property.

Measures to be applied in Enterprise Zones

During the ten year period both new and existing firms within the Enterprise Zone will benefit from the following measures:

a. Exemption from Development Land Tax;

b. 100% capital allowances (for corporation and income tax purposes) for commercial and industrial buildings;

c. Exemption from rates on industrial and commercial property. The local authorities concerned will be reimbursed for their net loss of rate income by 100% specific grant from the Exchequer.

Extract from Inland Revenue Press Release 26 March 1980

Capital Allowances

1. A special scheme of capital allowances modelled on industrial building allowances is proposed for capital expenditure on business buildings in enterprise zones.

2. The main feature of the scheme is an initial allowance of 100 per cent which will be given on capital expenditure incurred on the construction, extension or improvement of industrial and commercial buildings in enterprise zones.

3. The owner of such a building will be able to elect to have his initial allowance reduced to any amount he specifies. In this case he will receive straight-line annual writing down allowances of 25 per cent in respect of the balance of his expenditure. For example, if an initial allowance of 40 per cent is claimed, the writing down allowances for 3 years will be 25 per cent, 25 per cent and 10 per cent respectively. If the building is put into use in the same year as that in which the

expenditure is incurred, an initial allowance and writing down allowance will be given for that year.

7. It is proposed that the special allowances should apply to capital expenditure incurred within a 10 year period beginning with the day on which the site in question is first included in an enterprise zone; and also to expenditure incurred after the end of that period under a contract entered into within it."

RJ4.21

TASK FORCE SECRET

COPY NO 17 OF 18

FROM: J M G TAYLOR
DATE: 26 October 1987

PS/FINANCIAL SECRETARY

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middlton
Sir T Burns
Mr Cassell
Mr Monck
Mr Byatt
Mr Scholar
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Driscoll - IR
PS/IR

FINANCE BILL 1988: ENTERPRISE ZONES (STARTER NO.208)

The Chancellor has seen Mr Painter's submission of 20 October, and Mr Driscoll's separate note of 21 October. He would be grateful for the Financial Secretary's advice.

J M G TAYLOR

FROM: J J HEYWOOD
DATE: 28 October 1987

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Monck
~~Mr Burgner~~
Mr Scholar
~~Mr Williams~~
Mr Cropper
Mr Tyrie
Mr Painter IR
~~Mr Driscoll IR~~
PS/IR

STARTER 208: ENTERPRISE ZONES

1. The Financial Secretary has seen your note of 26 October, and has discussed this matter with officials.

Existing Zones

2. The Financial Secretary agrees with Mr Painter that the decisive consideration here is the strength of earlier public commitments. The Financial Secretary would recommend that the reliefs available for expenditure in existing zones be left in place, even for new investors. The various existing zones will in any case cease to qualify for the generous tax reliefs over the period 1991-94, as their "10 year periods" come to an end.

New Zones: Handling

3. We need urgently to clarify the likely development of general policy towards future enterprise zones since:

(i) Mr Ridley will shortly be writing to colleagues to get agreement on a statement of the Government's

future policy on enterprise zones; and

(ii) Mr Rifkind is anxious to press ahead with a new enterprise zone at Greenock (already a Regional Development Area and Scottish Development Area!)

4. These developments create an awkward handling problem for us. First, neither Minister is aware of our possible plans for restricting the tax reliefs available on new enterprise zones. Second, if they were told, even in general terms, about our proposals, we would not want these tax proposals to be announced before the Budget. The pressure for a substantive announcement would perhaps be strongest from Mr Rifkind. Even if it were agreed that a new enterprise could be created at Greenock, could any details be given before the Budget about the reliefs which would be available?

5. The Financial Secretary is quite clear that we cannot allow any specific tax proposals to be announced before the Budget. Although our public presentation of any restrictions would rest to a great extent on the consultants' findings, we would, of course, wish to stress the wider Budget context. Given this, the choice lies between

(i) The Chancellor seeking to persuade Messrs Ridley and Rifkind to defer any statements on new enterprise zones until after the Budget, or

(ii) Their statements being couched in very general terms, with perhaps a reference to "tax changes" to be announced in the Budget.

6. The Financial Secretary thinks that we may have to settle for (ii).

New Zones: Policy

7. Turning to Mr Driscoll's minute of 21 October, the following

options were presented:

(i) **Reducing the rate of relief in new zones** (paragraph 15): the Financial Secretary thinks this is the most promising option. He has asked officials to produce a note showing the impact of a reduction in the 100% initial allowance (to either 40% or 50%) on post-tax returns to higher rate taxpayers, under various different scenarios.

(ii) **Selective reduction in the rate of relief** (paragraphs 16-17): the Financial Secretary is not attracted to the idea of different initial allowances either for different sectors (eg retail buildings) or for different zones. The former would in principle allow relief to be denied for sectors where the deadweight effect has been found to be large. However, denying tax relief is a very blunt instrument. For instance, if we abolished initial allowances for retail buildings, this would discourage all investment in retail buildings. Our objective may, however, only be to limit the number of retail developments in any particular zone rather than to stop such developments altogether.

(iii) **Progressively reducing rates of initial allowance** (paragraph 18): the Financial Secretary thinks this is much too complicated.

(iv) **Limiting the use of relief** (paragraphs 19-23): one possibility would be to combine (i) with abolishing or otherwise limiting sideways relief. The Financial Secretary is not particularly attracted to this since it would introduce an additional difference between the tax regimes for enterprise zones and for other areas, where sideways relief would continue as before. This would add a new layer of complexity

into the tax system and would be rather difficult to justify.

(v) **Limiting the people qualifying for relief** (paragraph 24-25): the Financial Secretary saw little advantage in this proposal.

Conclusion

8. On substance, therefore, the Financial Secretary thinks it is worth looking further at the idea of reducing the initial allowance across the board for new zones. However, he will want to be sure that this, taken together with action on the higher rates, would not make enterprise zones totally unattractive to investors. If it did, we would either have to consider having no new zones at all or have to ensure that non-tax incentives remained sufficiently strong (and targetted) to make the creation of enterprise zones worthwhile.

J J HEYWOOD
Private Secretary

2184/025

TASK FORCE SECRET

Copy no 1 of 7

FROM: N MONCK

DATE: 30 October 1987

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Scholar

STARTER 208 : ENTERPRISE ZONES

Could I suggest a possible third option for handling enterprise zone announcements, in addition to the two set out in paragraph 5 of Mr Heywood's minute to you of 28 October. This suggestion is prompted by the possible need for a package of employment measures in Scotland to be announced sometime in the next few months.

2. A Greenock enterprise zone might be a useful component that could improve the prospect for shipbuilding workers, though it is too far away from the steel workers to help them. It might also be a useful bargaining counter to use with Mr Rifkind.

3. If a Greenock EZ turns out to be a useful component of a package announced before the Budget, the third option would be to allow Mr Rifkind to announce it without any reference to tax changes. In other words it would be the last of the old style unreformed EZs.

4. A Greenock EZ would be greatly weakened as a component of a package, if the announcement had to be qualified by vague references to tax changes, whose effect on incentives could not be judged for several months. Equally, however, if tax changes were not mentioned, the assumption that the existing EZ incentives would be available in full could not then be falsified by applying Budget changes retrospectively.

5. If the Budget included specific tax changes to the EZ regime, there would no doubt be criticism of creating a new enterprise zone with the old incentives after the Government had received the consultants' report. But this could be defended. The argument would be that, given the special problems in Scotland, the Government had decided it could not delay a decision on the Greenock EZ until the policy review based on the consultants' report had been completed (or the decisions announced with the Budget).

6. Mr Scholar has suggested that if you think this line is not strong enough but favour a Greenock EZ, it might be best this year to postpone specific action on EZs and to rely for the present on the general reduction in higher rates to reduce the significance of EZs as a tax-shelter. There would be a bit of retrospection but it would be defensible as the result of a general tax measure rather than a change confined to EZs.

7. A corollary of para 5 would be that the Chancellor would need to persuade Mr Ridley to postpone his general policy statement until after the announcement of the Greenock EZ preferably until the Budget. There would be no need for the Chancellor to speak to Mr Rifkind.

8. This third approach is obviously not without difficulties. But, given the special Scottish circumstances and the case for an early announcement of a package there, it seems worthwhile to keep open the option of an old style Greenock EZ.

N MONCK

RJ4.61

TASK FORCE SECRET

COPY NO 6 OF 7 COPIES

FROM: J M G TAYLOR

DATE: 9 November 1987

MR MONCK

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Scholar

STARTER 208: ENTERPRISE ZONES

The Chancellor was grateful for your minute of 30 October.

2. He agrees that a Greenock Enterprise Zone might be worth considering, and that if it turns out to be a useful component of a package announced for the Budget, Mr Rifkind should announce it without any reference to tax changes. He has asked the Financial Secretary to reconsider whether, if Greenock is given old Enterprise Zone status, it is worth taking any action on Enterprise Zones at all.

J M G TAYLOR

FROM: J J HEYWOOD
DATE: 10 November 1987

PS/CHANCELLOR

Ch/ Content to drop this starter?
OK 11/11

cc PS/Chief Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Cropper
Mr Painter IR
Mr McGivern IR

STARTER 208: ENTERPRISE ZONES (EZs)

The Financial Secretary has considered this further, having seen Mr McGivern's minute of 10 November, and yours of 9 November.

2. The Financial Secretary's clear conclusion is that at present it is best to leave the tax regime as it is for future EZs (including Greenock).

3. The Financial Secretary considers the following points relevant:

(i) It would be odd to announce tax changes in the Budget for new EZs if no new EZs were in prospect.

(ii) If we did announce tax changes in the Budget, we would be asked why the Greenock Zone (if it went ahead) a few weeks earlier had been given the existing reliefs: it would be difficult to pin the tax changes on the consultants' report.

(iii) The reduction in higher rates currently envisaged will in any event have a significant impact on the post-tax returns available to higher rate investors. Reducing the initial allowance would make little further difference (See Table 2 of Mr McGivern's minute) as a result of the availability of the special 25% Writing Down Allowance.

(iv) On top of the abolition of RDGs a further measure (however minor) to reduce the attractiveness of investment in "deprived areas" would be very controversial. Although unrelated the two issues would inevitably be linked.

(v) Even if the tax reliefs remain in place, other ways are being developed of targetting EZ reliefs more closely in an attempt to minimise "deadweight" costs.

4. Is the Chancellor content that Starter 208 should now be dropped?

JEREMY HEYWOOD
Private Secretary

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

From: E McGivern
Date: 10 November 1987

Financial Secretary

ENTERPRISE ZONES: STARTER 208

1. At your meeting on 28 October, we undertook to let you have a note setting out the effect on the incentive to invest in EZs of reducing the level of initial allowances (at present 100%) for industrial and commercial buildings in new zones.

2. The effects, assuming various levels of personal and company tax rates, are described in the attached note.

3. The main messages to emerge are:-

a. Confirmation that the existing tax regime provides a considerable incentive to invest in EZs, both for equity and debt-financed investment but particularly for the latter where real pre-tax rates of return of between 0.2% (for a 60% taxpayer) and 2.8% (for a 27% taxpayer) provide a real return of 5% post-tax. With equity-financed investment on zone, the 100% initial allowance equates the pre-and post-tax rates of return. (Table 1).

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cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Byatt
Mr Cassell
Mr Burgner
Mr Scholar
Mr Jenkins (OPC)
Chairman
Mr Isaac
Mr Painter
Mr McGivern
Mr Beighton
Mr Calder
Mr Weeden
Mr M A Keith
Mr Marshall
Mr Pearson
Mr Elmer
Mr Timmins
PS/IR

b. Reducing (or abolishing) the 100% initial allowances and maintaining the special 25% writing down allowance (WDA) on the straight line basis, has only a very small effect on the required rate of return. At worst it raises the required pre-tax rate by just over one percentage point. So under this scenario, there would still be a considerable incentive for investment in industrial and commercial buildings (particularly the latter) on zone in comparison with similar investment outside the zones. (Tables 2 and 3).

c. With only a 25% WDA, a significant tax subsidy for debt financed investment would still remain (Tables 2 and 3).

4. More generally, as we mentioned during your meeting on 28 October, if you decided not to change the existing regime the level of the incentive for debt-financed investment falls as the marginal tax rate falls. You can see the effect of this most conveniently from the 100% column in Table 2. Thus, at present an individual with a marginal rate of 60% requires a pre-tax rate of return of only 0.2% to provide a post-tax rate of 5%. The required rate rises to 1.8% for a 40% taxpayer and to 2.2% for a 35% taxpayer.

5. Still looking at Table 2, you will also see from the 0% columns what effect abolition of the 100% initial allowance (but maintaining the special 25% WDA), combined with lower marginal rates has on incentives. Thus, for debt-financed investment, the 0.2% required rate for a taxpayer with a marginal rate of 60% rises to 0.4%; it rises to 2.0% with a marginal rate of 40%; and to 2.4% for 35% and so on. In each case, there is still a tax subsidy (to achieve a post-tax return of 5%). With equity finance, where the present EZ tax system is neutral, the required pre-tax rates fall as marginal rates fall. This is because replacing the 100% initial allowance with a 25% WDA effectively imposes a tax charge on

the return from the investment; and the tax charge is, of course, reduced as marginal rates fall.

6. In each case, however for a given level of investment and marginal rates, and with 25% WDA, the net of tax return on investment in EZ is likely to exceed that from investment in many other assets. The evidence we have (from the Consultants' report) suggests that average pre-tax rates of return from EZs are in the range 5 to 11%.

7. Conclusion

As marginal tax rates fall, the incentive for debt-financed investment in EZ is reduced but there is still a tax subsidy. For equity-financed investment, the system remains neutral.

8. But there is clearly scope for reducing or abolishing the 100% initial allowance while still retaining a tax subsidy for investment in new zones. And that remains the case at different marginal rates.

9. Replacing the 100% initial allowance with the 25% WDA on a straight line basis looks an attractive proposition. It would be a further step in removing the tax shelters which initial allowances provide for higher rate taxpayers (only the 100% scientific research allowances would remain - apart from the Nissan - type transitional arrangement); and it would help reduce the tax driven distortions in investment decisions. Yet it would still provide an incentive to invest in industrial and commercial buildings in EZs rather than elsewhere. It would mean however that, in accordance with the normal WDA rules, tax relief would be available only when the building is brought into use rather than (as with initial allowances) when expenditure is incurred.

EMcG.

E McGIVERN

ENTERPRISE ZONES

Present regime for capital allowances in EZs

1. Inside EZs 100% initial allowances are available for industrial or commercial building. The taxpayer has the right to opt for a lower percentage with the balance being written off at 25% per annum on a straight line basis.

2. Outside EZs no initial allowances are available. For industrial buildings a 4% straight line writing down allowance (WDA) is available, but, apart from certain hotels, commercial buildings do not qualify for any WDA.

3. Both inside and outside EZs any surplus of capital allowances over income from the trade or letting can be used sideways to cover other income. Because of the more favourable capital allowances this is clearly of more significance inside EZs. Interest on loans also qualifies for relief; companies and traders, but not individual landlords, will be able to offset this sideways against other income. There is no difference in treatment of interest on zone compared with off zone.

Effect of present regime

4. The effect of the existing regime for EZs on rates of return is summarised in Table 1. The method used in this table (and subsequent tables) is to calculate the minimum pre-tax real rate of return required by an investor (individual or company) necessary to obtain a 5% real post-tax return.

/Table 1.

Table 1

Summary of the effect of the present EZ regime on the minimum pre-tax real return necessary to obtain a 5% real return post-tax

	Debt Finance			Equity Finance(1)		
	Building inside EZ	Building outside EZ		Building inside EZ	Building outside EZ	
		a) Industrial b) Commercial			a) Industrial b) Commercial	
Individual marginal tax rate		(a)	(b)		(a)	(b)
60%	0.2	1.7	5.4	5.0	11.7	17.4
50%	1.0	2.5	5.3	5.0	9.4	13.3
40%	1.8	3.1	5.2	5.0	8.0	10.5
Companies with tax rate (2)						
35%	2.2	3.4	5.1	5.0	7.4	9.4
27%	2.8	3.9	5.1	5.0	6.6	8.1

(1) Retentions for a company, own funds for an individual.

(2) The figures would be identical for an individual taxpayer with marginal tax rates of 35% and 27%

Thus Table 1 indicates that in the case of an individual who pays tax at 60% an EZ investment financed by debt requires only 0.2% pre-tax to yield 5% post-tax - a subsidy of 4.8 percentage points. At all marginal tax rates debt financed investment inside EZs requires less than a 5% return pre-tax to earn 5% post-tax and is therefore subsidised. Equity financed investment on zone requires exactly 5% pre-tax to yield 5% post-tax at all marginal tax rates; there is no effective tax liability or subsidy. For buildings investment off-zone, only debt financed industrial buildings are subsidised.

5. Table 1 shows that there is a sizeable gap between returns on buildings in EZs compared with such buildings off zone; the gap on commercial buildings is up to 5 percentage points for debt finance and up to 12 points for equity finance. The gap declines as the marginal tax rate declines and is larger at all marginal rates for commercial buildings (which, apart from certain hotels receive no capital allowances off zone) than for industrial buildings (which receive 4% WDA's off zone).

6. The calculations assume that:

(i) inflation is at 3% in line with Treasury advice on medium term assumptions

(ii) the whole of the 100% allowance is claimed in the first year. In the cases examined below where initial allowances are less than 100%, it is assumed that the building is brought into use immediately and will therefore qualify for a WDA as well as an initial allowance in its first year.

(iii) all interest can be relieved in the year it is paid.

In addition, in these stylised calculations, rate relief and grants are ignored to focus on the effects of the tax regime.

Effect of reducing initial allowances

7. Table 2 shows the effect of reducing the initial allowance from 100% to zero, assuming that the building secures the 25% straight line WDA. Complete removal of initial allowances has a small effect on required rates of return; at most it raises the rate by just over one percentage point. The reason is that with the 25% WDA on the straight line basis full tax relief is obtained over 4 years as opposed to one year with 100% initial allowance. The discounted effect of spreading the relief over a further 3 years is small.

Table 2

Effect of reducing initial allowances on the minimum pre-tax real return necessary to obtain a 5% real return post-tax

	Debt Finance				Equity Finance(1)			
	Initial allowances (2)				Initial allowances (2)			
	100%	50%	40%	0%	100%	50%	40%	0%
Individual marginal tax rate								
60%	0.2	0.2	0.3	0.4	5.0	5.2	5.4	6.3
50%	1.0	1.0	1.1	1.2	5.0	5.2	5.3	5.9
40%	1.8	1.8	1.9	2.0	5.0	5.1	5.2	5.6
Companies with tax rate (3)								
35%	2.2	2.2	2.3	2.4	5.0	5.1	5.1	5.5
27%	2.8	2.9	2.9	3.0	5.0	5.1	5.1	5.3

(1) Retentions for a company, own funds for an individual.
(2) WDA's are assumed to be 25% straight line throughout.
(3) The figures would be identical for an individual taxpayer with marginal tax rates of 35% and 27%

Effect of reducing WDA's

8. From Table 2 it is clear that a straight line WDA of 25% provides generous tax treatment for EZ investment even with no initial allowance; with debt finance a considerable subsidy to investment remains since required returns are well below 5%; for equity finance the returns are not highly taxed.

9. If WDA's were reduced to the level off zone, pre-tax required returns would increase considerably as shown in Table 3. For example an equity financed investment in commercial buildings off zone by a 60% taxpayer would require a 17.4% pre-tax return to earn 5% post-tax, a difference of 12.4%. The difference would be only 1.3 percentage points in a regime with no initial allowances but a 25% straight line WDA.

Table 3

Assuming no initial allowance effect of reducing WDAs on the minimum pre-tax real return necessary to obtain a 5% real return post-tax

	Debt Finance			Equity Finance(1)		
	straight line WDA			straight line WDA		
	25%	4%	0%	25%	4%	0%
Individual marginal tax rate						
60%	0.4	1.7	5.4	6.3	11.7	17.4
50%	1.2	2.5	5.3	5.9	9.4	13.3
40%	2.0	3.1	5.2	5.6	8.0	10.5
Companies with tax rate (2)						
35%	2.4	3.4	5.1	5.5	7.4	9.4
27%	3.0	3.9	5.1	5.3	6.6	8.1

(1) Retentions for a company, own funds for an individual.

(2) The figures are identical for an individual taxpayer with marginal tax rates of 35% and 27%

10. But Table 3 also shows that abolishing initial allowances while maintaining a 25% straight line WDA would ensure that a significant incentive remained to invest in EZs relative to off zone.

Conclusions

11. The main conclusions to emerge from the tables are that the existing EZ tax regime provides a significant incentive for investment in building on these zones; and abolishing initial allowances, while maintaining the 25% WDA only slightly increases the minimum pre-tax real return necessary to obtain 5% real post-tax. A healthy differential relative to investment outside EZs is maintained. The differential remains particularly good for commercial buildings which, apart from certain hotels, do not qualify for capital allowances off zone.

1/C6

TASK FORCE SECRET

No 9 of 10

FROM: J M G TAYLOR
DATE: 11 November 1987

PS/FINANCIAL SECRETARY

cc: PS/Chief Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Cropper
Mr Painter IR
Mr McGivern IR

STARTER 208: ENTERPRISE ZONES (EZs)

The Chancellor has seen your minute of 10 November. He is content that starter 208 should now be dropped.

J M G TAYLOR

42/2.BTW.4374/10

N4/26 PTA

FINANCIAL SECRETARY TO THE TREASURY

AWAITING FROM FST

Pse get hold of attachments

TL 12/1

MS.

FROM: MISS S J FEEST
DATE: 12 January 1988

PS/PAYMASTER GENERAL

cc PS/Chancellor
PS/IR

PRP

PRP - PROBLEMS FACED BY INSURANCE COMPANIES

The Financial Secretary had lunch with the ABI yesterday and I attach the notes provided by ABI of the topics discussed.

2. With reference to the points raised on Profit Related Pay, the Financial Secretary told the ABI that he would look into their problems.

3. I would be grateful for your opinion on their claims and whether the Paymaster General has any solutions in mind.

Susan Feest

SUSAN FEEST
(Assistant Private Secretary)

BUDGET CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: J D FARMER
DATE: 29 January 1988

PAYMASTER GENERAL

PRP : INSURANCE COMPANIES (STARTER No 110)

1. Paragraphs 8-10 of my submission of 23 December referred to the present situation with regard to insurance companies' access to PRP. At your meeting on 12 January you decided not to pursue changes in the PRP legislation in the coming Finance Bill, unless it appeared necessary to react legislatively in some way to the complaints and arguments now being voiced by the insurance sector. In this case, subject to what precise form this reaction took, it might be desirable to put together a slightly larger package of PRP changes.

2. We now comment further on the possible problems with the insurance sector, and offer what seem to us to be the four broad choices from which any further reaction might be chosen. As you know we have had a number of contacts in recent months with individual insurance companies and with their advisers, and at the beginning of December we met the Association of British Insurers (ABI) itself. The latter have still not responded to our invitation then to set their problems out in writing. You may recall that the ABI referred to this matter when they lunched the Financial Secretary on 11 January.

---

c Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Monck
Mr Jenkins (OPC)
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss Sinclair
Mr MacAuslan
Mr Riley
Mr Wynn-Owen

Mr Isaac
Mr Beighton
Mr Easton
Mr Cleave
Mr G Miller
Mr Lewis
Mr Calder
Mr Bush
Mr Eason
Mr Farmer
Mr O'Hare
Miss Dougharty
Mr Fraser
Mr Annys
PS/IR

Background

3. The problems which insurance companies may face were described in Mr Collen's submission of 18 June last year. Broadly these are twofold - the difficulty which mutual insurers may have in meeting the requirement that a PRP employment unit must have "a view to profit", and the requirement that the profit and loss account must comply with Schedule 4 of the 1985 Companies Act. The first does not seem at present to be a major problem; the second - as anticipated - does.

4. Paragraph 5 of Mr Collen's note said that insurance companies almost invariably choose to produce their accounts under Schedule 9 of the Companies Act rather than Schedule 4, and it explained the principal distinctions between the two. Schedule 9 omits a requirement to show a "profit on ordinary activities after taxation"; special exemptions contained in its Part III permit the non-disclosure of certain provisions and of movements in reserves, and the writing-off of fixed assets (rather than their capitalisation and depreciation); and where these exemptions are used the account is subject to independent audit only to the extent of a certificate that it satisfies the rules of the Schedule. Thus because of their particular character insurance companies are enabled under the legislation to produce statutory accounts directed more to demonstrating satisfaction of solvency requirements, stability and the safety of policyholders' confidence in a steady stream of profits. Profits are likely to be smoothed taking one period with others; transfers to and from hidden reserves are made; some fixed assets are written-off rather than capitalised and depreciated. Apart from Schedule 9, life insurance companies are enabled to take unrealised profits into account - but this is a facility already, in effect, permitted for PRP if such companies otherwise comply with the Schedule 4 requirements.

5. By contrast the intended effect of the PRP legislation is that the employment unit's profit and loss account must meet the more formalised and strict requirements of Schedule 4 (subject to a list of permitted adjustments), that profit for PRP purposes means the figure shown by such an account as the profit on ordinary activities after taxation, that the smoothing of profits is not permitted and that the auditor must be able to say that the account gives a true and fair view of the profit of the unit. On this count, Schedule 9 accounts with exemptions claimed would make a somewhat inappropriate basis for PRP.

Insurance companies' representations

6. The insurance companies have not said it would be impossible to produce Schedule 4 accounts for PRP purposes (though they have been given every opportunity to do so). But they apparently find it difficult to see why Government should require different accounts for different purposes, and they may urge it would be awkward for them to have to publish such different accounts. They say that in practice it would be difficult, costly and in their view somewhat pointless to do so. To use such accounts for PRP purposes would mean re-education of staff who were already accustomed to other figures (whether those complying with Schedule 9, or special measurements associated with existing bonus scheme arrangements). They claim also that the existing obligations laid on them and on their auditors amount to a very thorough and effective audit scrutiny.

7. This apart, Save & Prosper Group Ltd (S&P) has, as you know, produced a Counsel's opinion to the effect that the existing PRP legislation does in fact permit the use of Schedule 9. Having seen this opinion, our solicitors' advice is that while we might resist an appeal against our rejection or cancellation of a PRP scheme's registration on the ground that Schedule 4 accounts were not used, we should not be confident of winning. We cannot of course be sure

whether S&P would pursue the matter into litigation, but its chairman is known from previous experience to be persistent and outspoken. (In passing, S&P allege that in their case a Schedule 4 profit would be identical to a Schedule 9 profit. This seems doubtful, and begs the question why they protest so vigorously.)

The case for and nature of any concession

8. Arguments for acknowledging the insurance companies' case and easing their access to PRP appear to be:

i. as a sector with over 230,000 employees, with a record of particular interest in rewarding employee performance, insurance companies might provide a useful and significant boost to PRP take-up;

ii. a high profile dispute, perhaps including litigation, over the acceptability of the use of Schedule 9 for PRP purposes, might on the other hand be damaging, especially if other critics (eg of PRP compliance costs, of other conditions for registration of schemes etc) joined in;

iii. admittedly there may be gulfs (a) between the precision and adequacy in accountancy terms of, on the one hand, a Schedule 4 profit and loss account, and on the other, a Schedule 9 account with exemptions, as a basis for tax relieved PRP payments, and (b) between the worth of independent accountants' reports on the two. But it seems improbable that a Schedule 9 account would be manipulated simply to influence the level of such tax relieved pay - at least where the PRP employment unit was a whole company, rather than a sub-unit;

iv. it is in any event somewhat difficult for Government to insist, on the one hand, that Schedule 9 accounts with exemptions adequately serve the public interest in insurance sector accountability, but on the other, that different accounts are necessary as a statement of true profit for purposes of employee association with real results.

9. As against this, however, must be set the following:

i. Schedule 4 profits were adopted as the common yardstick for PRP deliberately to ensure the closest possible, independently verifiable association between PRP and a true commercial measure of any employment unit's performance in any period. A range of carefully considered adjustments were allowed, but otherwise no special arrangements were admitted (eg to recognise the special circumstances of particular sectors, or to cater for employers who do not have to produce Schedule 4 accounts in the normal course of their business, or to make it easier for sub-unit schemes to be introduced). When the alternative - the use of Schedule 9 accounts with exemptions - would relatively poorly serve to relate PRP to true profit in any given period (paragraphs 4-5 above), there seems little case in principle for making an exception now for the insurance sector;

ii. while it is seen as a particular merit of the present PRP provisions that they expose employees' pay to the external as well as the internal influences on the fluctuating prosperity of the business in which they work, insurance as a sector (together with some other 'City' activities) may be almost unique in the extent to which its 'true' profits are determined by outside factors.

On the basis of published BIA figures, total insurance industry income from premiums and investments exceeded £62 billions in 1986, and total investments exceeded £200 billions. Employees' pay, by contrast, is unlikely to have exceeded £2½ billions.

Pay then constitutes so minimal a component in profit and loss calculation that it seems improbable that the pay flexibility/motivation/ employment benefits which underlie the PRP initiative would be served in any significant way by relaxing the obstacles to insurance companies' access to registered schemes;

iii. PRP for insurance companies would largely be 'deadweight' also for another reason. It is believed that a particularly large proportion of insurance employees already participate in various kinds of performance- or 'profit'-related bonus schemes.

10. A choice between these two sets of arguments might be easier if the nature of any acceptable compromise for the insurance sector was clearly discernible. Paragraphs 8 to 12 of Mr Collen's note considered briefly the possiblity of resort either to the Insurance Companies Act 1982 and its associated Regulations, or to some specially constructed PRP account; but it concluded that either was likely to be unacceptable in principle and difficult to work up in practice. The further option, of simply confirming that we would accept a Schedule 9 account, without any special conditions or qualifications, could be the easiest way of reaching an accommodation (involving publicity but no legislation); but it would allow - at least in theory - some considerable distancing of tax relieved PRP from what for others would continue to be a relationship with real profit. A variant which might interest the insurers would

be to accept a Schedule 9 account so long as no use was made of the Part III exemptions.

11. We should note two further points, before discussing alternative courses of action. First, if any concession was to be considered for insurance companies in regard to the accounts to be used in association with PRP, we should need to decide also whether it should be made available equally to sub-units of such companies - and, for that matter, to groups of companies only some of which are in insurance (the Companies Act allows consolidated group profits, in such cases, incorporating the insurance components prepared on a Schedule 9 basis).

12. Second, a concession of the type sought by insurance companies might mean that we could not require independent accountants to report that the profit and loss accounts prepared gave a 'true and fair' view - only that they complied with the requirements of Schedule 9 (or with those requirements as applied for PRP purposes). This would not necessarily be objectionable on its own, but it could reopen the whole recent debate about the nature of the accountants' reports required by the PRP legislation and our prescribed application and annual return forms, and threaten a weakening of the independent audit/monitoring arrangements generally for PRP.

Choices of action

13. The fundamental question is whether Ministers wish to adhere to their original decision that the policy objectives of PRP are best secured by insisting that Schedule 4 profits form the reference point for determination of PRP, and that variants should not be made available to meet the particular circumstances of individual business sectors or individual kinds of employer.

14. The background described above suggests that in principle Schedule 4 should be adhered to. Practical considerations must weigh, however, in assessing the options identified below.

a. Attempt to continue to deny the use of Schedule 9 profits

15. The risk here is of a successful appeal against our denial of registration to a scheme defining profits as those produced in a Schedule 9 account. We are not aware of any case current where such an appeal might be made, but it would not take long for an employer to create such circumstances. The chances of an appeal actually being made are not easy to assess, but now that one company has produced an opinion favouring the legitimacy of Schedule 9 profits, we would not be confident about successfully resisting any such litigation.

16. However, if Ministers were to wish to stay with Schedule 4 profits, it might prove possible to discourage - at least for some time - any resort to litigation by telling any employer known to want to press the Schedule 9 route either

i. that the Government would propose legislation to block the use of Schedule 9 accounts if any appeal was successful; or

ii. that the Inland Revenue was prepared, without commitment, to consider what relaxations from the strict Schedule 4 regime might be made available to insurance companies, in consultation (or agreement) with the ABI.

b. Amend the PRP legislation to ensure there is no case in law for the argument that Schedule 9 profits may be used

17. This would be the most certain way of ensuring adherence to Schedule 4 profits as the basis for PRP. It would require only a very short provision (to prevent Section 257(4) of the Companies Act 1985 from having any effect in the PRP context). At your meeting with us on 12 January, you said that if this approach was adopted you felt that a slightly larger package on PRP would be sensible - and in this event, bearing in mind pressures on Finance Bill space and Counsel's time together with other factors discussed on that occasion, we would propose adding in the first five of the minor matters described in Annex D to my starter submission of 23 December.

18. Pursuing this option could, however, provoke considerable interest and controversy (and excite criticism of other features of PRP about which employers - especially the 'deadweight' - have complained). The ABI may be slow to move and to put their case to us, but they can be vociferous, and they have sympathetic listeners in the House. It might do the propagation of PRP little good if the first amendment to the legislation appeared to make access harder to a large sector representing itself as keen to take up this new initiative.

19. This option might, of course, be accompanied (as at paragraph 16 ii. above) with an undertaking to explore and consult on possible relaxations from the strict Schedule 4 requirements for insurance companies. But criticism would not necessarily be stilled; and it might in consequence prove very difficult subsequently either to make no more concessions than seemed sensible (in order to reach a measure of agreement with the ABI if that were possible), or finally to capitulate on the limited or full use of Schedule 9, if agreement on some sensible halfway house seemed unattainable.

c. Seek to define a concession which would be least damaging to the PRP concept

20. Unless Ministers were prepared either to stand firm on the full use of Schedule 4 profits (and - sooner or later - to legislate to ensure this position), or to admit straightaway the use of Schedule 9 accounts, it appears that some kind of examination of or consultation on ways of easing insurance companies' access to PRP may have to be offered. While we cannot be sure of this in advance of such consultation, of course, our judgment at this stage is that the definition of a halfway house between Schedule 4 and Schedule 9 which was acceptable to the industry would prove difficult - implying some possibly complex legislation in due course. One particular problem, quite apart from the fundamental differences between the two Schedules, would concern the availability of any such special regime to sub-units of insurance companies (of especial interest to mutual companies, which can already have schemes only for such sub-units because of the 'view of profit' requirement - paragraph 3 above).

21. If the option of consultations to find a halfway house was adopted, our recent contacts with the industry, and with the ABI in particular, do not leave us confident that anything carrying their support could be found - or found in time for this year's Bill.

d. Admit the full or limited use of Schedule 9 profits

22. To admit the unfettered use of Schedule 9 profits would, of course, meet the insurance industry complaint, especially if - as we consider would be necessary - insurance company sub-units were allowed the same facility. It seems very possible that the banking sector would claim and could not be denied a similar facility (it too may at present produce Schedule 9 accounts), but it should not be difficult to resist wider repercussions. Some

detailed aspects would require further consideration, eg the precise wording of independent accountants' reports on applications for registration and on annual returns; but our present view is that none of these would require legislation. The various advantages and disadvantages of this option would be as discussed above. In addition, there would be no need for Finance Bill action on PRP this year.

23. The variant of allowing the use of Schedule 9 profits so long as the Part III exemptions were not used is more difficult. It could be that this would satisfy the industry - a judgment is not easy in advance of discussions which might be protracted, since they have not yet spelled out precisely what they want. But we are inclined to think it would not satisfy them, for the sort of reasons indicated in paragraph 6 (and because entering into discussions on this would encourage them to demand unfettered use of Schedule 9). This variant which probably could not be denied also to other special category companies (notably banks) would require legislation; and though we doubt if this would be lengthy or complex it could well be contentious (cf paragraph 18). It would appear that having accepted that the use of Schedule 9 was already permitted, the Government was seeking to retreat by denying the use of the Part III exemptions. Generally, however, because we doubt whether such legislation would satisfy the insurers, it seems inappropriate to recommend that this be prepared, in advance of any consultations, for inclusion in the Bill as it is to be published.

Conclusion

24. Insurance company accounts produced under and taking full advantage of Schedule 9 of the Companies Act would be an inappropriate basis for tax-relieved PRP. The insurance sector generally is not one in which the real purposes of PRP are likely to be served.

25. Nevertheless the sector appears keen to secure access to PRP and its tax relief, and is likely increasingly to press for the facility to use its Schedule 9 profits for the purpose. The issue has now gained added point from Save & Prosper's production of a Counsel's opinion that the existing legislation already permits such use.

26. The options appear to lie between attempting to continue to deny the use of Schedule 9 profits; legislating to confirm that denial; offering consultation to seek to find an agreed solution; and accepting the full or a limited use of such profits. We suggest a choice between these is essentially a choice between (i) maintaining the integrity of PRP, as linking the tax relief closely and visibly with service of its policy objectives, and (ii) fostering the continued development and spread of PRP by avoiding controversy related to a large sector of commerce keen to embrace it. The judgment to be made is not an easy one, depending largely as it does upon an assessment of Ministers' ambitions for PRP and their judgment of the political pressures likely to be exerted.

27. We should be glad to discuss this question with you, if you would find this helpful. If the legislation discussed in option b. (paragraph 17 above) was favoured, of course, an early decision would be particularly useful, to enable drafting to be put in hand.

J D FARMER

Encl.

BUDGET CONFIDENTIAL

PRP.

FROM: S P JUDGE
DATE: 2 February 1988

MR FARMER - INLAND REVENUE

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Anthony Wilson
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Ilett
Mr MacAuslan
Mr Riley
Mr Wynn Owen
Mr Jenkins - OPC
PS/Inland Revenue

PRP: INSURANCE COMPANIES (STARTER No 110)

The Paymaster General has seen your submission of 29 January. He would like to have an early meeting to discuss this: we will fix this up.*

2. Before then, the Paymaster would be grateful for views from:

- Miss Sinclair on the latest position on Finance Bill space (your **paragraph 17**), bearing in mind recent decisions;
- Mr Ilett, given his general interests in the insurance sector; and
- Sir A Wilson on the audit aspects.

3. In the meantime, the Paymaster has the following comments:

i. he agrees strongly with the last sentence of your **paragraph 18**: "It might do the propagation of PRP little good if the first amendment to the legislation appeared to make access harder to a large sector ...";

ii. option a. i. (your **paragraph 16**) is not much better than option b.;

iii. although it looks as though the odds are against your option c. coming up with anything, he notes that there may

be, as an advertising agency Mrs Malaprop once said, "the mucus of a good idea" here;

iv. he would like to look again at the papers leading to the original decision (your paragraph 13) to use Schedule 4. I suspect we no longer have the papers, and would be grateful if you could let me have copies.

S P JUDGE
Private Secretary

* This has now been fixed for Thursday 11 February at 5.30pm

4481/51/PN

BUDGET CONFIDENTIAL

FROM: MISS C E C SINCLAIR
DATE: 5 February 1988

PAYMASTER GENERAL

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir A Wilson
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr Ilett
Mr MacAuslan
Mr Riley
Mr Wynn Owen
Miss Hay
Mrs Burnham

Mr Farmer - IR

PRP: INSURANCE COMPANIES (STARTER NO 110)

Your Private Secretary's minute of 2 February asked, by way of background, about the latest position on the Finance Bill.

2. Despite recent decisions to drop certain items, Parliamentary Counsel feels heavily pressed because some items are proving more difficult than he expected; and there are some late Starters. Anything which can be done to keep down the size of the Bill would therefore still be very welcome.

CAROLYN SINCLAIR

BUDGET CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: J ANNYS
DATE: 9 February 1988

PS/PAYMASTER GENERAL

PRP : INSURANCE COMPANIES (STARTER 110)

1. You asked, in your note of 2 February, for copies of the papers leading up to the decision to use Schedule 4 accounts in defining profit.

2. Express reference in terms to Schedule 4 profits is not recorded as having been made in the drawn-out decision-taking process for PRP. It was always the intention, however, that the profits to which pay should be linked should be commercial profits. The July 1986 Green Paper said "the size of the pool would depend on profits and a formula determined in advance" and "there would be flexibility within limits ... about the definition of profits built into [a PRP] scheme". It indicated the scope of this flexibility when it went on to set out a "definition of profits" (copy at Annex A). The reference there to "'profit on ordinary activities after taxation' (defined in the Companies Act 1985)" could mean only Schedule 4, since no such item or definition features elsewhere.

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c PS Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Anthony Wilson
Mr Monck
Mr Jenkins (OPC)
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Ilett
Mr MacAuslan
Mr Riley
Mr Wynn-Owen

Mr Isaac
Mr Beighton
Mr Easton
Mr Cleave
Mr G Miller
Mr Lewis
Mr Calder
Mr Bush
Mr Eason
Mr Farmer
Mr O'Hare
Miss Dougharty
Mr Fraser
Mr Annys
PS/IR

3. We can find no evidence that this was actually misunderstood - though many respondents to the Green Paper may, of course, not have considered it carefully. Of the 95 respondents in all, only 10 thought a wider choice was needed for the profits measure, and none appeared to criticise the indicated Schedule 4 requirement (as distinct from either other profits or particular adjustments from that base). The Association of British Insurers were concerned in their response only about access for 'not-for-profit' organisations (eg mutuals), and the sort of figures sub-units of mutuals might be permitted to use.

4. Following the Green Paper, further consideration of the profits definition tended to centre on the nature of the adjustments to be permitted and the possibilities for alternatives to a profits-link for 'PRP' (eg links with added value or other measures of productivity and efficiency). Annexes B and C, respectively, are relevant extracts from Mr Monck's submission of 21 November and from the note of the Chancellor's meeting of 25 November 1986. Decisions at that meeting were to form the basis for instructions to Counsel for drafting the eventual legislation. These instructions, prepared in close consultation between the Revenue and Treasury officials, referred expressly to Schedule 4, and were forwarded to Counsel on 6 February 1987.

5. I regret that none of this is as positive as the Paymaster General may have wished. More thorough research than time has permitted into voluminous papers (stretching back to the summer of 1985) might conceivably cast more light on how the view developed that the profit to which tax-relieved payments came to be related had to be a single defined measure, had to be used for any registrable scheme whoever the employer, and had to be as true, commercial and independently verifiable a measure as possible - and how therefore the decision was effectively taken before issue of the 1986 Green Paper. We will of course be glad to attempt this if desired. But concern has always been felt that,

despite the range of different employers potentially interested, a single definition of profits should be used which was already known to the large majority, which was independently verifiable, which because of such audit was not likely to be manipulated to distort PRP, and which would be thought fair by employers and employees alike. And all these and other strands pointed to 'profits on ordinary activities after taxation' as defined in the Companies Act (ie Schedule 4).

J ANNYS

Changes in employee numbers

A16. The number of participating employees would usually vary during the course of a profit year. This would present no difficulty where the employer paid the whole of PRP after the end of the profit year on the basis of firm figures for both profits and employees, enabling the PRP due to each employee to be calculated exactly. But where employers wished to make interim payments during the profit year, they would need to choose whether the size of the PRP would:

a. be determined only by direct relationship with the profits of the employment unit, or

b. in addition vary with changes in the number of participating employees during the profit year (or over a shorter period if the size of the PRP pool were recalculated more frequently).

A17. Under A16(a) individual PRP payments would vary inversely with changes in employee numbers. With the approach at A16(b) the prospective PRP pool could be used to determine a PRP rate per head or per £ of pay depending respectively on the number of employees or their total pay at the start of the profit year, with the PRP rate being subsequently adjusted only in relation to changes in profits. This approach would mean greater certainty in the amount of PRP paid to each employee since the amount paid would not depend on changes in employee numbers for up to a year; but it would mean a corresponding increase in uncertainty for the employer about total PRP to be paid. Any PRP rate would need to be recalculated in respect of each profit year (or shorter period if the size of the PRP pool was determined more frequently) by reference to the number of employees or their total pay at the start of each period.

New recruits

A18. There would be no requirement to include new recruits in a PRP scheme. Indeed, it would be desirable on employment grounds that employers should adopt a minimum qualifying period of employment of say 12 months or more before a new recruit became eligible to receive PRP, as is the case in some existing schemes.

Definition of profits

A19. There would be some range of choice in the definition of profit while requiring:

a. consistency in accounting policies and methods of determining profits in successive periods; and

b. profit figures used for determining a PRP pool to be consistent with and derived from those in the normal audited accounts.

A20. The proposed approach is to define profit for PRP purposes as the 'profit on ordinary activities after taxation' (defined in the Companies Act 1985) as declared in the annual audited accounts, but to allow scope for certain adjustments. Permitted adjustments (also audited) would be:

a. 'extraordinary items' as shown in the audited accounts;

b. tax (i.e. the charge for tax on profits) or elements thereof; and

c. adjustments required to derive equivalent profit figures using current cost principles.

A21. Other possible adjustments (although they would move the profit measure to an extent away from an overall measure of commercial profit) might be interest charges, depreciation, research, and development (unless capitalised). Such adjustments would need to be taken from the audited accounts or determined on the same basis.

Unincorporated employers

A22. Unincorporated employers seeking tax relief would need to commit themselves to produce independently audited accounts of the profit figures used to determine PRP. This would represent further administrative work for many unincorporated employers, but any scheme of tax relief intended to operate fairly would require independent certification of this kind.

B.

ANNEX D

DEFINITION OF PROFITS, THE MINIMUM VARIABILITY RULE AND VALUE ADDED SCHEMES ETC

The Green Paper said that the size of the PRP pool would depend on profits and a formula determined in advance. This annex considers:

(a) the range of definition of profits to be admissible;

(b) what minimum relationship might be required between changes in profits and the size of a PRP pool.

(c) whether variable payments under schemes based on value added, profitability (profit as percentage either of capital or turnover), or cost reduction should be eligible for tax relief and, if so, on what conditions.

Definition of Profits

2. The Green Paper said that there would be some range of choice in the definition of profit while requiring:

(a) consistency in accounting policies and methods of determining profits in successive periods; and

(b) profit figures used for determining a PRP pool to be consistent with and derived from those in the normal audited accounts.

3. The proposed approach was to define profit for PRP purposes as the "profit on ordinary activities after taxation" as derived for the purposes of the Company's Act 1985 and set out in the annual audited accounts, (employers not subject to the Company's Act would have to prepare accunts on the same basis) but allowing scope by adding back in any or all of the following:

(a) extraordinary items as shown in the audited accounts;

(b) tax or elements thereof;

(c) adjustments required to derive equivalent profit figures using current cost principles.

The responses in consultation have confirmed this basic approach. There has been no significant criticism of the possible adjustments referred to above.

4. The Green Paper also referred to other possible adjustments (ie interest charges, depreciation, research, and development (unless capitalised)) but recognised that these possible adjustments would move the profit measure to an extent away from an overall measure of commercial profit.

5. The general response has been in favour of these exclusions. On balance we think that exclusions for interest charges, research and development (unless capitalised) should be allowed. However the arguments about depreciation are more finely balanced. Allowing depreciation to be excluded could make it easier for sub-unit schemes in some circumstances. However most management accounting arrangements which are robust enough to be considered for PRP schemes do include figures for depreciation although often not for interest charges. On balance as depreciation is an important element in arriving at the overall profits of a business and normally could be calculated if sub unit PRP schemes were contemplated we think that profit figures for PRP should be required to take account of depreciation.

6. Other candidates mentioned by respondents have been "goodwill" payments (as defined by an accounting standard) and management charges. Goodwill payments are a small addition to the list which should be allowed. Management charges are a bigger issue as they are not readily defined and may not in normal accounting practice be subject to scrutiny as to fairness in themselves but only that they have been authorised and are fairly presented in accounts. We will advise you separately on this issue. To help facilitate the development of PRP schemes below the group or single company level it may well be desirable to allow an adjustment for management charges: but such an adjustment could allow management in a sub unit scheme to exclude various costs which should properly be part of the commercial definition of profit.

A Minimum Relationship between changes in profits and the size of the PRP Pool

7. The Green Paper envisaged that the size of the PRP pool would be determined either as a proportion of profit in the profit year or by a fixed formula relating changes in the pool to changes in profits from one accounting period to another. The approach we have envisaged is a fixed formula relationship between profits and the size of the PRP pool although the relationship might be a dampened one. The Green Paper suggested that some legislative rules might be necessary to ensure that the size of the PRP pool varied significantly with profits, or the change in profits compared to the proceeding year, and that these should be for consideration in the light of resopnses to the Green Paper.

C

b) It was agreed that DHSS Ministers should be encourage to end the present exemption from NICs for trusts as soon as possible: we wanted the announcement distanced from PRP itself. Miss Noble would provide a draft letter to DHSS Ministers. It was agreed that there should be no change in NIC arrangements for lumpy payments.

Annex C

(i) It was agreed that PRP must represent at least 5 per cent of pay.

(ii) For the time being, the requirement should remain that 80 per cent of relevant employees within an employment unit were within the scheme. If necessary, we might go to 75 per cent.

(iii) It was agreed that new recruits could be excluded from this calculation for up to 3 years. It was further agreed that

(iv) controlling directors should not be eligible for tax relief, and

(v) schemes must last a minimum of 1 year.

Annex D

a) In discussion, it was noted that most true profit centres would calculate profit after deducting depreciation. It was agreed that this should be the definition of profits used.

b) It was agreed that there should be a minimum relationship between changes in profits and changes in the size of the PRP pool and that the rule should be that the change in the PRP pool must be at least ½ of the change in profits. The Chancellor wondered whether this would sit oddly with ICI's 'amplifier', but Mr Monck said that that applied to value added, not profits.

(c) There was a lengthy discussion on whether schemes relating pay to value added or to profitability should be allowed. In favour of this, it was argued that:

(i) Profitability, and to a lesser extent value added, were sufficiently close in concept to profit, and would frequently move in the same direction. (This distinguished them from cost reduction.) Weitzman had effectively included value added schemes in his proposals.

(ii) Schemes would still have to satisfy the minimum criteria, and when the measure adopted moved in the opposite direction to profit, the over-ride would operate.

(iii) Some existing schemes, including Sainsburys, operated on profitability. It would be worth trying to include them within the definition, so as to gain their support.

Against this:

(i) This was getting away from the original clear link between pay and profit. We would lose the benefit of simplicity: it would be difficult to present the inclusion of value added schemes, and difficult for the individual to understand (especially when the over-ride operated).

(ii) Including value added would make it harder to hold the line against extention to the public services.

(iii) It ought to be possible for existing schemes to adapt, although this would carry a cost (including an industrial relations cost).

(iv) It might be hard to defend the line between value added schemes and cost reduction schemes.

It was agreed that, for the time being, the Revenue should proceed on the basis that tax relief would be restricted to schemes based on the narrow definition of profit. But Mr Monck would produce

alternative defences of both the narrow and the wide definitions, on the basis of which this question could be considered again.

(d) It was, however, agreed that cost reduction schemes should not be eligible for tax relief.

Annex E

(a) The requirement for an audit report at the end of the year was confirmed.

(b) It was agreed that the audit report should concentrate on consistency, and the requirement about reasonableness should be dropped.

Annex F

It was agreed that, at least for the time being, we should not move to a two-tier regime of tax relief. An important consideration here was that it would doubly penalise employees whose firms' profits fell: their profit related pay would fall, and the tax relief on it would be reduced as well.

It was agreed that there should be a cash ceiling of £1500 on tax relief, but that it should be presented as a ceiling of £3000 on profit related pay.

[- It was also agreed to work on the basis of tax relief for ½ PRP (not ¼ as hitherto), subject to a limit of 10% of overall PAYE pay]

A W KUCZYS

BUDGET CONFIDENTIAL

FROM: PAYMASTER GENERAL
DATE: 12 February 1988

CHANCELLOR

cc Financial Secretary
Sir Anthony Wilson
Mr Monck
Mr Scholar
Mr Odling-Smee
Mr Culpin
Miss Sinclair
Mr Ilett
Mr Bradley
Mr Inglis
Mr MacAuslan
Mr Riley
Mr Wynn Owen
Miss Hay
PS/Inland Revenue
Mr Miller - IR
Mr Farmer - IR
Mr Fraser - IR

Ch/ Content with PMG's line?
25/2

PRP: INSURANCE COMPANIES (STARTER 110)

I discussed this with Treasury and Revenue officials yesterday.

2. The background is set out in Mr Farmer's submission of 29 January. In essence:

behind

i. the PRP legislation says PRP profits must be derived from the accounts showing profits on ordinary activities after taxation. Schedule 4 of the Companies Act 1985 applies to such accounts;

ii. but the Companies Act permits "special category" companies - essentially the insurance and banking sectors - to produce accounts using the looser definition in Schedule 9; but

iii. for an insurance company's PRP scheme, it is unclear whether ii. overrides i. or not. Our present line is that it does not; Save and Prosper have obtained a Counsel's opinion that it does.

3. The options I have considered are as follows:

i. to legislate this year to make it clear that all employers (including insurers) must use Schedule 4 for PRP purposes;

ii. to continue to refuse registration of schemes using Schedule 9, and decide that we would legislate to reverse any defeat in the Courts;

iii. as ii., to continue to refuse registrations using Schedule 9, except that after any defeat in the Courts we would consult with the Association of British Insurers (ABI), with a view to reaching a common position;

iv. to consult now with the ABI;

v. to admit the use of Schedule 9, but to disallow the so-called Part III exemptions (**paragraph 23** of Mr Farmer's note); and

vi. to permit the unrestricted use of Schedule 9.

4. Option i. seems to me presentationally disastrous - the first amendment to the legislation would be seen as restricting its availability. I am in any case temperamentally inclined to do what we reasonably can to get the insurers into PRP: I have thus ruled out options ii. and iii..

5. Option iv. has not yet been developed at all. The Revenue are anyway very uncertain (**paragraphs 20 and 21** of their note) that at the end of the process we could reach agreement with the ABI, short of option vi..

6. Option v. has a lot to be said for it. But the need for legislation rules it out - we cannot only **partly** admit Schedule 9 by administrative means.

7. I therefore concluded that we should go for option vi.. If all insurers set up PRP schemes and gave maximum tax relief this would cost about £60m in a full year. The Revenue think they can justify extending this treatment to PRP sub-units of insurance companies. (Strictly speaking these sub-units are not insurance companies **per se**, and therefore have no claim to use Schedule 9. This strict interpretation would rather defeat the object of the concession!)

8. The Schedule 9 arrangements provide some scope for transfers to and from hidden reserves and smoothing profits between different periods. But I am satisfied that the annual report by the independent accountant will impose some real constraint on the manipulation of insurers' PRP accounts, even though we cannot be quite as sure of this as with Schedule 4 accounts. If we were to find evidence that insurers were abusing the Part III exemptions, then we might need to legislate in the future (ie option v.).

9. If you are content with this general line, then I propose the following:

a. the Revenue call the ABI in for a meeting, tell them of the new interpretation, and discuss any necessary changes to the administrative arrangements (annual returns etc);

b. on the same day, I would reply to Save and Prosper's letter of 21 December to you (attached);

c. we would <u>not</u> issue a press statement, but rely on the ABI to spread the news to those interested; and

d. Sir Anthony Wilson would subsequently talk to the chairman of the Auditing Practices Committee, to head off the risk that they might complain about making a PRP declaration on the basis of Schedule 9 accounts. Sir Anthony does not think accountants will have any real problems here.

P.B.

PETER BROOKE

NM/16

SAVE & PROSPER

Save & Prosper Group Ltd
1 Finsbury Avenue
London EC2M 2QY
Telephone 01-588 1717
Telex 883838 SAVPRO G
Facsimile 01-247 5006

21st December 1987

The Rt Hon Nigel Lawson MP
The Chancellor of the Exchequer
H.M. Treasury
Parliament Street
LONDON SW1

Dear Chancellor

Profited Related Pay Schemes

Save & Prosper Group filed a Profit-Related Scheme on 28th September, 1987 immediately after the Finance (No. 2) Act 1987 had become law. The scheme, to start on 1st January 1988, was certified by our auditors, Ernst & Whinney, as complying with the Act and was duly registered by the Revenue on 6th October, 1987 (under reference No. PRP 800010). In the highly competitive environment of the savings industry today we regard such a scheme as an essential means of motivating our staff and involving them in our business.

Consequently, I was appalled to learn that the Inland Revenue now interprets the new legislation as excluding the employees of all insurance companies, banks and holding companies whose consolidated accounts include an insurance company or bank where accounts (as is normal) are prepared under Schedule 9 and not Schedule 4 of the Companies Act 1985.

Recent events in world stock-markets have demonstrated that it is precisely these kinds of risk-taking financial organisation which most need encouragement to shift the balance of their remuneration packages towards the sharing with their staff of rewards as well as risk and away from the one way street of high guaranteed salaries.

I'm enclosing a note which summarises our understanding of the Revenue position and gives a precis of leading Counsel's opinion that the Revenue have no grounds in law for their conclusion.

May we have your assurance that Parliament did not intend to exclude people working in large areas of the Financial sector from an important Government initiative, and that

Registered in England No. 288553
Registered Office as above

some 900 Save & Prosper employees can benefit from Profit Related Pay in 1988?

I'm sending a copy of this letter to Mr Battishill, the Chairman of the Board. Obviously, from our point of view and that of our employees the matter is vitally urgent.

Yours sincerely

C J MESSER
Chairman

PROFIT RELATED PAY SCHEMES

TECHNICAL SUMMARY

REQUIREMENTS FOR REGISTRATION

Companies registering PRP schemes must prepare accounts which give a true and fair view of the company's profit or loss, and which comply with Schedule 4 to the Companies Act 1985: paragraphs 19(2) and (3) of Schedule 1 of Finance (No. 2) Act 1987.

ACCOUNTING PROCEDURES

Schedule 4 introduced various accounting standards which were required by EEC regulations and specified the format of company accounts. However, the special position of insurance companies, banks and shipping companies and of their parent companies was recognised and the accounts of these "special category" companies are allowed to comply with Schedule 9 which is less detailed than Schedule 4. Schedule 9 relies heavily on the overriding "true and fair view principle supplemented by a series of specific rules, including exemptions from some of the normal disclosure requirements.

In order to avoid the need to refer expressly to Schedule 9 whenever legislation or documents refer to Schedule 4, section 257 (4) of the Companies Act 1985 contains a blanket provision that ".... a reference in any enactment or other document to .... Schedule 4 is, in relation to special category accounts, to be read as a reference to .... Schedule 9 ....: but this is subject to any contrary context".

SAVE & PROSPER'S POSITION

Save & Prosper Group Limited ("Save & Prosper") owns all of the issued shares of two insurance companies, Save & Prosper Insurance Limited and Save & Prosper Pensions Limited. It is therefore a special category company which files Schedule 9 accounts. This is in line with the practice of other comparable companies. Save & Prosper's accounts must (under Section 259(1) of Companies Act 1985) give a true and fair view of Save & Prosper's profit or loss.

In Save & Prosper's case, the profit or loss figure arrived at by preparing Schedule 4 accounts would be identical to the Schedule 9 basis. However, for Save & Prosper to depart from its well established Schedule 9 basis would:

- confuse employees: a vital feature of the PRP registered by Save & Prosper is that it relies on normal published accounts and avoids any need to explain a change of basis
- be out of line with the practice of comparable special category companies in the financial sector
- involve additional expense in changing computer systems.

To prepare accounts on both Schedule 4 and Schedule 9 basis would be a totally wasteful additional expense.

LAND REVENUE INTERPRETATION

Based on a meeting on 14th December, 1987 with the Policy Division, Save & Prosper understands the Revenue view to be that the blanket provision of the Companies Act cannot be invoked to import Schedule 9 accounts as a basis for PRP registration because there is a "contrary context". The Revenue therefore insist that all special category companies wishing to register PRP Schemes should prepare Schedule 4 accounts and cannot rely on their normal Schedule 9 accounts.

Although the legal basis for this conclusion was not fully explained, the points put forward by the Revenue in support of this view appeared to be that :

- special category companies do not comply with the "true and fair view" requirement in view of the hidden reserves permitted by the exemptions in Schedule 9

- there is a "contrary context" which prevents special category companies from relying on Section 257(4) of the Companies Act 1985 to prepare Schedule 9 accounts for PRP purposes. The "contrary context" is that paragraphs 19(5) and (6) of Schedule 1 of Finance (No. 2) Act 1987 permit a series of adjustments to Schedule 4 accounts, some of which follow precisely the language used by Schedule 4.

SAVE & PROSPER'S INTERPRETATION

Save & Prosper has obtained a written opinion from leading company law Counsel, Mr. William Stubbs QC, on the correct interpretation of the Companies Act and of the PRP legislation. His conclusions are, in summary, that :

- there is no reason why Save & Prosper's auditors should not certify that Save & Prosper's accounts give a true and fair view of Save & Prosper's profit or loss for purposes of the PRP legislation: Messrs. Ernst & Whinney, who are the auditors, have indicated that they would in principle be prepared to give such a report

- there is no "contrary context" in paragraph 19. It is intelligible and workable if references to Schedule 9 are inserted in place of Schedule 4. Although the words used in sub-paragraph 19(6) mirror those of Schedule 4 this relates to form, not substance: the items described are equally relevant to Schedule 9 accounts.

WORK1/V

RJ4.2

BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 15 February 1988

PS/PAYMASTER GENERAL

cc PS/Financial Secretary
Sir A Wilson
Mr Monck
Mr Scholar
Mr Odling-Smee
Mr Culpin
Miss Sinclair
Mr Ilett
Mr Bradley
Mr Inglis
Mr MacAuslan
Mr Riley
Mr Wynn Owen
Miss Hay
PS/IR
Mr Miller - IR
Mr Farmer - IR
Mr Fraser - IR

PRP: INSURANCE COMPANIES (STARTER 110)

The Chancellor has seen the Paymaster General's minute of 12 February. He is content with the Paymaster General's conclusion that we should go for option (vi) (ie. permit the unrestricted use of schedule 9), and with the arrangements the Paymaster General proposes for taking this forward.

J M G TAYLOR

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: I FRASER
23 February 1988

PS/Paymaster General

PRP: INSURANCE COMPANIES

1. In the Paymaster General's note of 12 February to the Chancellor he proposed (paragraph 9.b.) that he would reply to Save and Prosper's letter of 21 December on the same day as we meet the Association of British Insurers. The meeting with the ABI is fixed for Thursday 25 February. A draft reply, which has been agreed with Treasury officials, is attached.

2. In addition to the measures proposed for spreading the news, we propose to write to those correspondents who have raised this point with us in the past few months. Having changed our views since writing to them we feel obliged to advise them of this.

I FRASER

---

cc PS/Chancellor of the Exchequer
PS/Financial Secretary
Sir Anthony Wilson
Mr Monck
Mr MacAuslan
Mr Ilett
Mr Wynn Owen
Miss Hay
Mr Isaac
Mr Lewis
Mr Easton
Mr G Miller
Mr Farmer
Mr Eason
Mr Bush
Mr O'Hare
Miss Dougharty
Mr Annys
Mr Fraser
PS/IR

C J Messer Esq
Save & Prosper Group Ltd
1 Finsbury Avenue
LONDON EC2M 2QY

You wrote to Nigel Lawson on 21 December 1989 about the registration of a profit-related pay scheme for your Group. I am sorry you have not had an earlier reply but, as you know, the Inland Revenue have been taking legal advice on the points raised in your letter.

After careful consideration of the points raised by you supported by the opinion of leading Counsel, the Revenue, I am please to tell you, are prepared to accept that the effect of Section 257(4) of the Companies Act 1985 is that insurance companies may prepare their PRP profit and loss account under Schedule 9 of the Companies Act 1985. The Inland Revenue have noted the suggestion in the summary attached to your letter that your auditors will be able to give a report to the effect that the Save and Prosper Group accounts give a true and fair view of the profit and loss for PRP purposes. They have confirmed that the Profit Related Pay Office will hope very shortly to be able to issue a notice of registration in response to the application made by your company on 22 December 1987.

I am sure this resolution of a rather complicated and important point will meet with your approval and with that of the Association of British Insurers whom Revenue officials are meeting today to explain the more general application of this decision.

PETER BROOKE

SAVE & PROSPER

Save & Prosper Group Ltd
1 Finsbury Avenue
London EC2M 2QY
Telephone 01-588 1717
Telex 883838 SAVPRO G
Facsimile 01-247 5006

21st December 1987

PRP

The Rt Hon Nigel Lawson MP
The Chancellor of the Exchequer
H.M. Treasury
Parliament Street
LONDON SW1

CH/EXCHEQUER	
REC.	22 DEC 1987
ACTION	
COPIES TO	

22 DEC 1987
IK.
PMG.
30139/87

Dear Chancellor

Profited Related Pay Schemes

Save & Prosper Group filed a Profit-Related Scheme on 28th September, 1987 immediately after the Finance (No. 2) Act 1987 had become law. The scheme, to start on 1st January 1988, was certified by our auditors, Ernst & Whinney, as complying with the Act and was duly registered by the Revenue on 6th October, 1987 (under reference No. PRP 800010). In the highly competitive environment of the savings industry today we regard such a scheme as an essential means of motivating our staff and involving them in our business.

Consequently, I was appalled to learn that the Inland Revenue now interprets the new legislation as excluding the employees of all insurance companies, banks and holding companies whose consolidated accounts include an insurance company or bank where accounts (as is normal) are prepared under Schedule 9 and not Schedule 4 of the Companies Act 1985.

Recent events in world stock-markets have demonstrated that it is precisely these kinds of risk-taking financial organisation which most need encouragement to shift the balance of their remuneration packages towards the sharing with their staff of rewards as well as risk and away from the one way street of high guaranteed salaries.

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I'm sending a copy of this letter to Mr Battishill, the Chairman of the Board. Obviously, from our point of view and that of our employees the matter is vitally urgent.

Yours sincerely

C J MESSER
Chairman

PROFIT RELATED PAY SCHEMES

TECHNICAL SUMMARY

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3975/27

NC/26 A

PRP

BUDGET CONFIDENTIAL

FROM: P J CROPPER
DATE: 26 February 1988

Oh. I suspect it probably is (sadly) too late to do anything about these reliefs

FINANCIAL SECRETARY

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

26 26/2

FINANCE BILL STARTERS: 117 AND 118: TOP SLICING RELIEFS

Andrew Tyrie's note of 24 February.

It may be too late now to launch the consultations with other Ministers which would have to take place if we were to tackle the averaging reliefs on farming, writers and artists. It would, nevertheless, have been good to see the back of them.

2. The key point is this. Whereas with a range of tax rates stretching from around 30 per cent up to 83 per cent it was only reasonable that people with erratic income flows should be enabled to "spread" a one-year bonanza, the case falls away progressively as the gap narrows between the extremities. With the rates proposed for 1988-89 there is hardly anything left of the "hard cases" argument. Tomorrow's top rate, as Andrew points out, will barely exceed the day before yesterday's basic rate.

3. I do not go all the way with Andrew in rejecting the writers' and artists' argument per se. But there is precious little real substance to it now.

P J CROPPER

046/3651

BUDGET CONFIDENTIAL

FROM: A G TYRIE
DATE: 24 FEBRUARY 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Culpin
Mr Scholar
Ms Sinclair
Mr McGivern - IR
Mr Painter - IR
Mr Elliott - IR
Mr Cropper
Mr Call

FINANCE BILL STARTERS: 117 AND 118: TOP SLICING RELIEFS

I have seen Mr Elliott's minute of 23 February.

Mr Elliott points out that there is an inconsistency in tackling some top slicing reliefs but keeping hobby farming, the averaging provisions for artists and writers and farmers' averaging (paragraph 7). Understandably, his suggested justification for leaving these alone looks pretty flimsy.

If we added these three to the list of shelters which we are already tackling it would look quite impressive. The fact that we were getting to grips with these higher rate reliefs would go some way to mitigating the political flack for the reductions in the higher rates.

Is it too late to look again at these three reliefs? In a world of top rates of 40% I do not think any justification for them stands up. We would never be able to pick these reliefs off individually but in the context of a top rate cutting budget this is our chance.

Relief for **hobby farming** looks particularly outrageous. On the one hand, as you observed, we are trying to reduce land in cultivation to help tackle surpluses. On the other hand we are positively encouraging hobby farming.

On **writers and artists** I cannot think of one good reason why they should not be treated like any other supplier to a market place.

Farmers averaging is perhaps slightly more tricky. But we have now arrived at the point where the top rate of tax will be not much higher than the 33% to which they 'averaged down' in 1979. What's more we already have far too many 'hand outs' for farmers in the budget: CGT rebasing, retirement CGT relief, the extension of CGT roll-over relief for the milk and potato quota (already announced), grants for forestry. All that comes on top of the Brussels deal.

AGT.

A G TYRIE

BUDGET CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: M J G ELLIOTT
DATE: 23 FEBRUARY 1988

seen

1. MR McGIVERN

2. FINANCIAL SECRETARY

FINANCE BILL: STARTERS 117 AND 118: TOP SLICING RELIEFS

1. This note seeks your approval for the withdrawal of an Extra-Statutory concession, with effect from Budget day, in parallel with the announcement of the two Budget proposals in Starters 117 and 188.

Background

2. Ministers have decided to remove in this year's Finance Bill the top-slicing reliefs which apply to the tax charged on redundancy payments (Starter 117) and premiums for leases (Starter 118).

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cc. Chancellor of the Exchequer
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Painter
Mr McGivern
Mr Beighton
Miss Rhodes
Mr Cayley
Mr Haig
Mr Elliott
Mr McManus
PS/IR

3. The rationale for the removal of these reliefs will be that they were designed specifically to mitigate the effects of steeply progressive rates of personal taxation on sums which, though actually received in full at one time, can be said to have been earned over a period of years.

4. Apart from these two provisions, there is only one other top-slicing relief as such in the tax law (as distinct from the other sorts of spreading and averaging reliefs considered in the shelters exercise). This is Section 400 of ICTA which applies to the tax chargeable in certain circumstances on gains arising on life insurance policies. This relief is to be left in place pending the outcome of the current review of the tax treatment of life assurance.

The concession

5. But there is also a top-slicing relief which is given by way of a published Extra Statutory Concession. This concession was introduced in 1970, in response to pressure from the accountancy bodies, to mitigate what were seen as the harsh effects of legislation designed primarily to charge tax on amounts of income received after a trade has ceased. I attach a note setting out the text of the concession and explaining what it does.

6. So far as we are aware, this concession is applied in only a few cases every year; and since it is clearly, in terms and in form, a "top-slicing" relief like the two which are to be abolished, it seems to us that it would be appropriate to withdraw it as well. The removal of the other two reliefs will need to be announced in Budget Day Press Releases, because both will require Budget Resolutions. We would propose to announce the withdrawal of this concession at the same time; and in the circumstances we suggest that the withdrawal should take effect from Budget day.

7. It may be asked, when the Budget proposals are announced, why this concession and the relief for premiums are being withdrawn when a number of other spreading and averaging provisions (e.g. for farmers, artists and writers), which were similarly introduced to mitigate the effect of high marginal tax rates on lumpy receipts, are being left alone. We suggest the response should be that

(i) these reliefs are the only "top-slicing" reliefs as such, i.e. reliefs which work by way of

- treating a part of the particular receipt as the top slice of the recipient's income for the year of receipt and then

- applying the rate of tax applicable to that slice to the entirety of the receipt; or

- in the case of the redundancy payments relief, reducing the tax payable on part of a payment which exceeds an exempt slice.

(ii) it is precisely because these are fairly complicated provisions of limited application that it is appropriate to remove them - as a small but worthwhile measure of simplification - in the context of this year's Budget. There is a clear distinction between rules of this kind which apply to "one-off" payments affecting a limited number of people, and rules of more general application for groups of people whose income is of its nature normally lumpy.

MJG

M J G ELLIOTT

EXTRA-STATUTORY CONCESSION A.18: Change of accounting basis on the merger of professional firms

Where one of the professional firms involved in a merger has to change the basis of its accounting to conform with that of the other, there may be an immediate additional tax liability under section 144(2), ICTA 1970, in respect of the debtors and/or work in progress of the firm making the change. In such circumstances, the additional higher rate tax attributable to the section 144(2) liability is reduced, by "top-slicing" relief, to six times what it would have been if only one-sixth of the amounts in question had been liable to tax. Where a firm has not existed for as long as six years the "top-slicing" relief is reduced accordingly.

Explanation

(i) Before 1968, if a trader or professional man changed his method of accounting from a cash basis to an earnings basis, amounts earned before the change but not paid until after it, escaped tax. They did not come into the cash based accounts because the cash had not been received, and they could not be brought in for the next year because the accounts then had to show the true earnings of that year, and the amounts in question were earnings of the previous year.

(ii) In 1968, as part of a package primarily designed to tax post-cessation receipts, amounts of the kind described in (i) above were also made taxable. But it was subsequently realised that this might cause some hardship in cases where two professional firms with different accounting bases merged. In these circumstances one of the firms has to change its basis to harmonise with the other, and the partners of the firm which is changing will have to pay tax usually in the year of the merger on all their earnings for past

years which have not actually been received before the merger. If nothing were done, this would result in an exceptionally heavy higher rate tax liability on the partners for the year of change, and they would have no extra cash with which to meet that liability.

(iii) The concession mitigates that liability by "top-slicing". For each partner the additional higher rate tax attributable to the amount earned but not received before the merger is reduced to six times the tax which would have been due if one-sixth of that amount had been added to his other income for the year in question and treated as the top slice of that income.

Inland Revenue

Policy Division
Somerset House

FROM: J H REED
DATE: 22 FEBRUARY 1988

FINANCIAL SECRETARY

BES: FINANCE BILL STARTER 203

At your meeting on 18 February you decided that investors in BES funds should be given relief by reference to the time they invest in the fund. This note seeks decisions on the details of this relaxation.

Approved BES funds

2. The BES fund managers, whose representative you saw together with Tim Smith MP, asked for this relaxation to apply to approved BES funds. So far as BES is concerned, the only significance of approval (by the Revenue) is that the fund can invest less than £500 of an investor's money in a company (normally, the individual is entitled to BES relief only if he invests at least £500 in a company). One condition of approval is that there must be a closing date for participation in the fund. We propose that this closing date should be the date by reference to which the BES relief is given.

3. Unapproved BES funds may complain that this will put them at a disadvantage in comparison with approved funds. This is true but we do not recommend extending the relaxation to

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cc PPS
Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Monck
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Call
Mr Jenkins (OPC)
Mr Painter
Mr McGivern
Mr Beighton
Mr Calder
Mr Cleave
Mr German
Mr Eason
Mr Reed
Mr Arnold
PS/IR

unapproved funds because there is no control over how unapproved funds operate. At the extreme, such a fund could simply invest in one company, ie a normal share issue by a company could be dressed up as a fund. We assume you would not want this. The way to avoid this disadvantage is of course for the managers of the fund to obtain Revenue approval. While this imposes some restrictions on the way the fund can operate these are not severe, as is shown by the fact that some funds already seek our approval.

Time limit for investment

4. The BES fund managers asked for a 12 months period from the closing date in which to invest at least 90 per cent of the fund. Mr Roger Carroll suggested a period ending 6 months after the end of the tax year in which the fund closed. We recommend that the fund should have a 6 month period from the closing date in which to invest at least 90 per cent of the fund. Six months ought to give the fund managers sufficient time to find suitable investments, especially since they can, as they do now, start looking for investments before the fund closes. The 90 per cent requirement seems about right - it would not be reasonable to require all the money to be invested in BES companies because the amounts sought by the companies concerned is unlikely to be exactly equal to the amount raised by the fund.

Commencement

5. If this relaxation applies to approved BES funds closing during the first half of 1988-89 it may attract investment in that period by individuals who want to use the carry-back. As you know, this allows half the relief (up to a maximum of £5,000) to be carried back and set against the individual's income on 1987-88. However if the £0.5 million ceiling is successful in diverting investment into the sort of company for which BES is intended, there would not seem to be anything objectionable in this.

6. If you agree, the question arises whether the relaxation should apply to approved BES funds closing between Budget day and the end of the current tax year. This would arguably be consistent with the normal commencement provision for BES changes, which is to apply the change to shares issued on or after Budget day. There is at least one fund which would be affected by this decision. While allowing the relaxation to apply to them would be a pure bonus, with no additionality, it seems difficult to justify denying it to them. So we recommend that the relaxation should apply to approved BES funds whose closing date is on or after Budget day.

J H REED