PO-CH/NL/0476
PART A

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PART. A

PO CH/NL/0476
PART. A

1989 BUDGET CORPORATION TAX CAPITAL GAINS TAX AND INDEPENDENT TAXATION.

* I do not understand Parly. Counsel's pt @ X. Income Tax has 3 rates – IHT (nothing odd abt it), 25% & 40%; yet no Table to define. Pse look @ this again.

L.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Ch./

Your note below on IHT rates, + drafting in the Bill.

2. Mr Jenkins looked at this in November. He concluded that we should leave the drafting as it is. Mr Jenkins letter of 25 November to Janndoo (IR) is attached. Irritatingly, the letter was not copied to us (the cc at the top refers to this copy coming to me now, when I asked for it having first become aware of it).

3. I do find Mr Jenkins' argument pretty persuasive, however. Do you want to do anything further?

14/2

cc MR PITTS
MRS EVANS
For information

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Office of the Parliamentary Counsel 36 Whitehall London SW1A 2AY
Telephone Direct line 01 210 6640
Switchboard 01 210 3000

cc Jonathan Taylor.

L E Jaudoo Esq
Inland Revenue
Policy Division
Somerset House
Strand
London WC2

25 November 1988

Dear Jaudoo

INHERITANCE TAX ACT 1984

1. When we simplified the rate structure of inheritance tax in the last Finance Act, the Chancellor asked whether we could not do away with the Table of rates. We agreed on the telephone some weeks ago that I would look at the idea again.

2. When the Chancellor made his suggestion this Spring, we had no time then to do more than point out that, even if simplification were possible, it could not be done in one or two lines. Not only would section 7 have to be reorganised but extensive amendment would be needed elsewhere - in particular Schedule 2. This was enough to rule out the proposal for the Bill which was then about to be finalised.

3. I have now looked at the provisions to see whether there are more substantial difficulties, and have come to the conclusion that there are.

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4. If there were now only one rate of tax, I am sure that simplification would be both desirable and possible. However, despite appearances to the contrary, there are in fact two rates - nil and 40 per cent. The existence of two rates means that it continues to be necessary to identify the point at which one moves from one rate to the other, which is the reason for much of the apparent verbosity of section 7. Moreover, the notion of a nil rate is an odd one, and probably better tucked away in a Schedule.

5. Even if we cannot make radical changes in section 7 or Schedules 1 and 2, it might be possible to produce some simplification of section 7(2) and (4). We could, for example, refer to a rate of 20 per cent in subsection (2) and to rates of 16 per cent, 12 per cent, 8 per cent and 4 per cent in subsection (4). But I doubt whether this small improvement would be worth the trouble of a clause; and it would create extra complications if the main rate were changed in the future.

6. So my conclusion is that no fundamental simplification offers itself, and that any minor simplifications that could be made would produce only a marginal improvement in the short term, and would create potential difficulties in the future.

Yours sincerely

Christopher Jenkins

J C JENKINS

culpin/25.11.01

SECRET AND PERSONAL

Many thanks. I am convinced that CGT on houses should be forgotten for 1989: (a) because it is no longer necessary to tackle the housing bubble (it has already been punctured), which psychologically CGT might well have helped to do; (b) because we cannot afford the necessary political distraction in 1989 (c) – connected with (a) – what matters now is that we have the courage to stick closely to the tough [illegible]. Clearly this is going to be a long haul

FROM: ROBERT CULPIN
DATE: 25 November 1988

CHANCELLOR

cc: Financial Secretary
Mr Scholar

CGT ON HOUSES

I promised you a note.

2. Let me start with some facts, or rather estimates:

- abolishing domestic rates will lift £8 billion of tax from houses, double the fiscal privilege of housing, and raise real house prices over time by perhaps an eighth, compared with what they would otherwise have been

- if you want to do anything at all to offset this, it is effectively CGT or nothing

- in this Parliament, putting CGT on houses is unlikely to yield anything, because we start from the top of the market

- after 20 years, Cayley might yield £300 million, Riley £600 million - all figures in today's prices

- on consistent assumptions, Cayley would never catch up with the yield of inheritance tax on houses; and it would take Riley at least 20 years - probably longer - to do so

Δ of the next Parl^t. Instead, we must concentrate on working up the best possible single package to reduce [illegible] for the longer term. Post: [illegible] IBPs work [illegible]?

(and if [illegible] all this Parl^t, in 1988, & we must now be glad [illegible] for the 1st Budget

- after a generation, Cayley might raise less than £½ billion, Riley perhaps £1¼ billion

- after 45 years, Riley might reach £3 billion

- and after a century, restore the present revenue from domestic rates.

The figures are bound to be wrong, but they seem reasonable guesses.

3. So while the abolition of the rates provides an obvious reason and occasion to put CGT on houses, no option on offer comes remotely near to restoring the present yield of the rates for the best part of 100 years, or even matches the likely yield of inheritance tax on houses for 20 years at the least. Both Cayley and Riley must therefore be regarded as very long term investments.

4. As such, they would clearly be pain and grief to introduce, whenever you did it and however you did it. As with the lump sum, you would get the political flak a generation before the money. People would be unwilling to accept that the houses they need to live in are really investments. And although CGT is an excellent tax in economic terms, it is an absolutely dreadful one to understand and administer. I expect, for instance, that you know roughly how much your house is worth, and if not you could readily find out: but have you any idea what real gain you have made? The Revenue would be asking that question of people who have at present nothing to do with CGT, and may indeed never have to fill in a tax form.

5. What's more, if you are willing to take this further, it will be necessary to get down to some hard choices of detail. Cayley and Riley are very different options, and there is room for variants. And to take just one example, there is some tension between saying, as you did on Monday, that you

want a scheme which will reliably prick speculative bubbles, and saying that you want full rollover, so that the tax falls mainly on the dead.

6. You may conclude that the game is not worth the candle. If so, I would rather recognise that than generate fruitless work.

7. But you may be prepared to make the investment, or at least to explore it further. The clearest case for doing that is that some of our present problems, for example with mortgage relief, are essentially costs of ducking such things in the past.

8. All I really want to suggest in this note is that <u>if</u> you are seriously in the market for CGT on houses, despite all the enormous difficulties, then the case for doing it in 1989, on its own, is stronger than you implied on Monday, and the case for doing it in 1990, with the abolition of inheritance tax, is weaker.

The case for 1989

9. If you were to act in the next Budget, you could use at least four arguments.

10. First, it has long been recognised that the tax system loads the dice too heavily in favour of institutional savings and investment in bricks and mortar; and while the abolition of the rates has other things to commend it, it is bound to load the dice a bit further. So the 1989 Budget tries to redress the balance by bringing together a wide range of corrective measures. On the one hand, it limits modestly the tax privileges of pensions, life assurance and housing - and in the case of pensions and housing, it allows a long time for the measures to take effect. On the other hand, it increases the attractions of direct investment in shares, personal equity plans, employee share schemes, and possibly unit trusts. There is thus a balanced package to reform the

taxation of savings, which will have beneficial effects over at least a generation to come.

11. Second, the 1989 Budget continues the major reform of CGT which you put in place in 1988. It restores the rule that gifts should be treated as realisations, as Mervyn King and others want; but it ensures that gifts of business assets, and gifts to charities, will be tax-free. And since two thirds of the gains which people actually make are on houses, it brings those gains within CGT, with rollover or other protection for people when they move house.

12. Third, the 1989 Budget completes the changes begun in 1988 with the ending of double mortgage relief, and the abolition of relief on home improvement loans. Together, the reforms mean that the tax relief for owner occupied housing will be better concentrated in future on house <u>purchase</u>.

13. Fourth and last, you have thought it right to introduce this change at what everyone recognises (especially after today) to be the peak of the housing market. This will ensure that there should be no sharp effects on anyone. The change should be seen as a structural reform, to which people will have plenty of time to adjust, and certainly not as a short term expedient.

14. You may say that this is all very well, but it is unthinkable without a sweetener. I can think of a number of possible answers.

(a) The true sweetener on houses is the abolition of the rates - though that of course is already in the market.

(b) There will be other sweeteners on savings- - paragraph 10 above.

(c) The conventional wisdom this time last year was that you could not abolish double mortgage relief, or act on home improvement loans, without raising the £30,000 limit for mortgage relief. Indeed, you held to this view at Chevening. Yet you have managed it.

(d) There are unlikely to be significant losers from CGT on housing for some years. The pill to be sweetened is very slow-acting.

(e) Although a big, quick-acting sweetener might in principle be available, in the immediate abolition of inheritance tax, I am not completely convinced that it would do the trick. To abolish inheritance tax would look like lifting yet another tax from dukes. To substitute CGT could scarcely be described as shifting it to dustmen, even if they have bought their council houses; but I suspect it would be perceived as shifting more of a burden on to the middle classes.

The case against 1990

15. This brings me to the option for 1990: to extend CGT to housing and death, and abolish inheritance tax. I was attracted by this earlier in the year, but went off it for the following reasons.

16. First, to put CGT on houses is the sort of thing which could easily prove a recipe for your early retirement. It could be worth brazening this out if it helped to address the problem that housing is undertaxed, and about to become more so - in other words, if it raised additional revenue from housing, as a partial offset to abolishing domestic rates. But if you were to abolish inheritance tax, at a stroke, at the same time, you would <u>reduce</u> the taxation of housing - and

very probably reduce it for more than twenty years. That seems to me plain daft: a lot of agony for a perverse result.

17. Second, the option is no more attractive if you look at assets other than housing. It would just substitute one tax for another. The Isaac/Pitts notes of 5 August - which you found "pretty daunting" - persuaded me that it would be necessary to carry many, if not most, of the inheritance tax rules into CGT. So there would be a lot of reinventing the wheel, and not much simplification, if any.

18. Third, whatever its academic attractions, CGT on death would in practice be a far worse tax than inheritance tax. Suppose you are trying to clear someone's estate, and you have to deal with assets acquired at different times. With inheritance tax, all you need to know is how much they are worth. If it is more than the threshold, you pay 40 per cent of the difference, and that's that. With CGT, you need to establish what the gain has been, and what that is worth in real terms. This is difficult enough if you are handling your own property. But with CGT on death, the person with the records is dead.

19. Fourth, as I have already hinted, I am not sure the politics work. Are you really sure you want to abolish inheritance tax at the same time as you introduce the community charge?

20. Fifth, if and when we come to a year in which we have, say, £1 billion in hand and don't want to use it to reduce income tax, I would rather reduce the rate of corporation tax or national insurance contributions than abolish inheritance tax.

Conclusion

21. My instinct, for what it is worth, is that if you do not put CGT on housing in 1989, you will not do it in this Parliament. That is partly because second Budgets are easier

than third Budgets; and partly because I doubt whether, when it came to the point, you would judge CGT on death to be a better enough buy than the inheritance tax you already have to be worth all the upheaval of introducing it. But I may of course be quite wrong.

22. The main questions for decision are these.

(a) Is CGT on housing a serious runner?

(b) If so, are you still sure it would be better to introduce it in 1990 than 1989?

(c) Or do you want to go on now to the next step, which would be to decide which CGT option you would choose if you were to proceed with any of them?

RC

ROBERT CULPIN

culpin/28.11.03

SECRET AND PERSONAL

FROM: ROBERT CULPIN
DATE: 28 November 1988

CHANCELLOR

Ch./ OK for me to write as proposed? 28/11

OK

cc: PS/Financial Secretary
Mr Scholar

CGT ON HOUSES, ETC

Many thanks for your clear decision. I suggest the attached note to put it to bed.

2. The answer to your question on PEPs is that the Financial Secretary is having a meeting on Thursday. You will need one soon after that.

OK

3. It would be a great help if you could combine it with Employee Share Schemes/ESOPs and Unit Trusts. This would put pressure on the Revenue to deliver papers, which we now need badly.

4. On the other savings items, you have Life Assurance on Thursday; Stamp Duty is OK; and you have broken the back of Pensions - Tony Kuzcys is doing a short stocktaking note.

RC

ROBERT CULPIN

culpin/28.11.04

SECRET AND PERSONAL

Psc type final

~~DRAFT~~

FROM: J M G TAYLOR
DATE: November 1988

MR CAYLEY - INLAND REVENUE

cc: PS/FST ~~As before~~ Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Culpin
Mr Riley
Mrs Chaplin
Mr Tyrie
Mr Battishill IR
Mr Isaac IR
Mr Painter IR
Mr Pitts IR

STARTER 250, AND THE TAXATION OF OWNER-OCCUPIED HOUSING

The Chancellor was grateful for your minute of 16 November, and for Mr Riley's very interesting paper of 17 November.

2. He has decided not to pursue Starter 250 in 1989, and does not expect to return to it in this Parliament; but he is most grateful for all the work which has been done on it.

3. He agrees with the general thrust of the analysis in Mr Riley's paper, and in particular that no further work need be done on a tax on imputed rent.

J M G TAYLOR

CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

From: E McGIVERN
Date: 8 December 1988

FINANCIAL SECRETARY

FINANCE BILL STARTER 205: ADVANCE CORPORATION TAX

1. Mr Reed's note deals with three areas of the ACT rules where you will wish to consider the case for legislation.

2. The Coats Viyella case is a deserving one although as Mr Reed explains, there is no evidence that this is a general problem. The Bill is already over-long and as you are anxious to reduce it if at all possible, we do not think there is a compelling case for legislation on this point alone.

3. But you will see that a bank and a major UK company are testing the ground on an ACT avoidance device (paragraph 28). I find it difficult to believe that a company of the size involved here would have gone ahead with arrangements of this kind for, in effect, a borrowing of £1 million: this has all the hallmarks of a trial run with the promise of bigger things to come. The device is not vulnerable to attack on Ramsay lines; and we shall probably have to concede shortly that it works.

4. The problem is then the familiar one. Should we wait until there is hard evidence of significant use of the device before recommending legislation; or should we advise Ministers to take pre-emptive action now in view of the potential loss to the Exchequer. I believe that waiting could prove very costly.

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cc	PS/Chancellor	Mr Isaac
	PS/Chief Secretary	Mr McGivern
	PS/Paymaster General	Mr Bush
	PS/Economic Secretary	Mr Cleave
	Mr Culpin	Mr Campbell
	Mr Gilhooly	Mr Fitzpatrick
	Mrs Chaplin	Mr Reed
	Mr Tyrie	Ms St Quinton
	Mr Jenkins (OPC)	PS/IR

In 1986 an oil company used a device involving preference shares to save ring-fence CT of £16 million before Ministers could act in the 1987 Bill to block that particular scheme. All our experience indicates that major players in the tax planning industry are quite prepared to use a one-off device (if it is worthwhile) knowing that it is quite possible it will be stopped for the future in the next Finance Bill.

5. Moreover, you will be aware from our recent discussion on POS that attempts have been made to interest at least one of the major oil companies - which is not the company referred to in paragraph 3 above - in schemes to reduce its substantial ACT surplus. My hunch - and I am afraid it can be no more than a hunch - is that once we clear the trial run scheme, its attractions may well prove irresistible to companies with tax losses or surplus ACT. I believe the risk of waiting is too great and my recommendation would be to legislate against the preference shares device.

6. If you wished, you could stop at that; but it would not take much to deal with the Coats Viyella case and you might feel that you should give them what they have asked for.

7. That would leave the other ACT "change of ownership" devices which Mr Reed discusses in paragraphs 9 to 16 of his note. These could be blocked in a fairly short and simple way by adapting existing anti-avoidance provisions in the group relief field. Although there is no evidence that the devices are currently being used, our fear is that the legislation on the "trial run" scheme and the Coats Viyella changes will attract attention to them and that they will be exploited. Certainly some of the Inspectors who have recently left the Revenue could quite easily put together arrangements which could not be countered under existing legislation. While there is an argument for awaiting developments, my recommendation is that we should take action in next year's Bill to prevent what could be a substantial cost to the Exchequer.

Repayment supplement

8. The arrangements being used to circumvent the rule that there is no repayment supplement when CT is repaid as a result of ACT surrender and carry-back are blatant abuse. We are quite likely to lose a case on this point which is on its way to the High Court. Other groups similarly placed can be expected to follow suit. There is no risk involved and the arrangements are simple in the extreme: all that is required is the preparation of a couple of letters of claim and surrender.

9. Ministers could wait until the outcome of the High Court case is known and we can see what further claims emerge, but on the information already available, this does not seem a very attractive course. It is only a slight exaggeration to say that for the groups concerned a repayment supplement of 45% of ACT surrendered is there for the taking and I believe there is already a good case for legislating in the 1989 Bill.

10. If you were to agree to legislate on all these matters, the legislation should not exceed 2 pages in all.

11. I am sorry we have to come to you with these proposals, particularly as I know that Ministers are anxious to cut back on the length of the Bill but you will see from these notes that we believe there is a considerable risk to the Exchequer in the areas in point. We are at your disposal if you would like a discussion on any of the issues raised.

E McGIVERN

CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

FROM: J H REED
DATE: 8 DECEMBER 1988

1. MR McGIVERN

2. FINANCIAL SECRETARY

FINANCE BILL STARTER 205: ADVANCE CORPORATION TAX

This note deals with three separate issues concerning ACT:

- the problem raised by Coats Viyella that if they reorganise the group they will lose the use of some surrendered ACT;

- tax avoidance schemes using preference shares; and

- a device to obtain excessive repayment supplement on a repayment of CT.

SURRENDERED ACT

2. Sir James Spooner wrote to you last year about Coats Viyella's tax problem. We then discussed this with their Group Finance Director and reported back to you. You wrote to Sir James on 28 April saying that you would give further consideration to the point. On 6 September Coats Viyella wrote to us suggesting an amendment to the legislation with the aim of solving their problem.

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cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Ms Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Isaac
Mr McGivern
Mr Bush
Mr Cleave
Mr Campbell
Mr Creed
Mr Shaw
Mr Fitzpatrick
Mr Reed
Mr Sutcliffe
Ms St Quinton
PS/IR

The law

3. When a company pays a dividend it normally pays ACT. This ACT can be set against its subsequent liability to CT or it can be surrendered to its subsidiaries to set against their own CT liabilities. If there were no restriction on this surrender it would be possible for a group of companies effectively to sell ACT by surrendering it to a subsidiary and then selling the shares in the subsidiary. To prevent this, Section 240(5), ICTA 1988 provides that ACT surrendered to a subsidiary can only be set off against the CT liability for those accounting periods of the subsidiary for the whole of which it was a subsidiary of the surrendering company. So if it ceases to be a subsidiary of the surrendering company, the surrendered ACT cannot be set against CT.

Coats Viyella

4. Coats Viyella is the result of a number of mergers over the years and the group now wants to restructure its operations to get a more rational group organisation. It also wants to avoid having to publish separate sets of consolidated accounts for two of its subsidiaries which have listed securities held by third parties. It proposes to achieve this as part of its restructuring by transferring the subsidiaries of these companies elsewhere in the group. We are satisfied that there are good commercial reasons for this restructuring and that there is no alternative which does not have commercial disadvantages.

5. Their problem is that the transfer of subsidiaries would bring Section 240(5) into operation since they would no longer be subsidiaries of their existing parent companies (although they would of course still be within the Coats Viyella group). The result would be that ACT which had been surrendered to the subsidiaries but not yet used would be lost. This would cost Coats Viyella several million pounds. We see no way in which they could proceed with the reorganisation without incurring this cost.

Case for amending the law

6. In principle there is no reason why the legislation should be so restrictive. Since the subsidiaries will remain part of the same group there is no good reason why the set off of the surrendered ACT should be prevented.

7. We do not know how many other groups of companies are in a similar position to Coats Viyella, although we doubt that there are many. So we do not see a compelling case for amending the legislation. However, we now consider what change could be made.

Possible amendments

8. Coats Viyella have suggested a change which would solve their problem. It would allow the ACT to be set-off provided that the surrendering company and the surrenderee company remained part of the same group of companies. This could be a simple change to make which would, we think, require only a few lines of legislation.

Risk

9. However, we think there is some risk that it would lead people to think about the scope for selling a company with surplus ACT and, possibly, hit upon an existing weakness in the legislation. At present this weakness is not, so far as we are aware, being widely exploited but it could be used to sell large amounts of surplus ACT.

10. The current position is that a mere change of ownership of a company does not cause it to lose its own (as opposed to surrendered) surplus ACT. But if there is a change of ownership and a major change in the company's business (within three years of the change of ownership), any surplus ACT is lost. The intended effect is that a company with surplus ACT can be sold by one group to another and still be able to set the ACT against future CT on the profits of its business. But if its business changes radically within three years of the

sale the ACT is lost. This means that the group of companies which purchases the company cannot quickly transfer profitable business into the company in order to use up the surplus ACT. The objective is to prevent companies, in effect, buying and selling ACT.

11. In general, this restriction works well enough. The fact that the purchasing group would have to wait three years before transferring a profitable business seems to be a sufficient deterrent to the purchase of companies with surplus ACT. But it is possible to avoid this restriction, with the result that a profitable business can be put into the company immediately after the purchase.

12. There are basically two ways of doing this:

i. creating certain shares ("funny shares"), possibly of no real value, which are retained by the original group - the effect is that, taking these shares into account, there is no change of ownership <u>for the purposes of our legislation</u>, even though in reality the ownership has changed; and

ii. selling the company along with another company (the "parent") which owns most of its shares - again there is a weakness in our rules which allows such a sale not to amount to a change of ownership of the first company.

13. The "funny shares" device used to be a problem with group relief (which involved tax losses being transferred within a group of companies).

14. The device enabled the tax losses to be sold by one group to another. In 1973 legislation was introduced to prevent this tax avoidance. What it does is to look at not only the amount of share capital but also the rights attaching to the shares in respect of the company's profits and assets. The effect is

to disregard "funny shares" which have no real value. Similar legislation could easily be introduced for the purpose of deciding whether or not there has been a change of ownership.

15. The device mentioned in paragraph 12(ii) could also be countered fairly simply by looking at whether the ultimate real ownership of the company had changed (in other words, was it commercially still really a member of the original group, or had it moved into the purchasing group). And where the company had had ACT surrendered to it by its parent company, we would want to ensure that the ACT would be lost if there had been a major change in the business of either company.

16. The rules about "change of ownership" run not only for ACT but also for carry-forward of trading losses. The device in paragraph 12(i) therefore also works to enable tax losses to be sold and so the amendments we propose should also apply to prevent the sale of tax losses.

Case for stopping these devices

17. There is no evidence that these devices are currently being used. And making the change Coats Viyella are requesting would only marginally increase the options for exploiting the devices. So even if Ministers decide to meet the request by Coats Viyella, there is a case for leaving alone the defects in the legislation unless and until we see evidence of abuse. But there is a danger that any change in the rules might cause advisers to focus on the existing weaknesses.

18. But "funny shares" are being used in another device to avoid ACT (see the second part of this note). Our judgment is that it is likely that funny shares will be used to prevent a change of ownership (and may already be being used without our yet being aware of it). This is potentially serious. A large group of companies can pay ACT running into tens of £million a year. And in total companies with a continuing surplus of ACT are paying about £500 million of ACT a year. A group of companies in this position could arrange for all its current

ACT to be paid by a single company in the group and could then sell the company using one of the devices we have described. The purchasing group could transfer one or more profitable trades (or simply transfer profitable business) into the company from elsewhere in the group. No tax would be payable on this transfer. The ACT in the company would then be set against the CT on the profits of the trade.

19. Apart from current ACT, there is about £5 billion of surplus ACT already in existence (at present, this figure seems to be staying roughly constant from year to year). Depending upon which companies have the surplus ACT (eg is it in the parent company of a group or in one or more of its subsidiaries) it may also be practicable to arrange for the sale of surplus ACT in the way I have described.

20. So there is potentially an enormous loss of tax. On the other hand, apart from the device described below there is little evidence that people are looking for ways to sell ACT. So you may prefer to wait for evidence of widespread abuse before taking any action.

21. On 30 November I sent you a note ("Sections 768 and 245 ICTA 1988") which also concerned the legislation preventing the buying of tax losses and surplus ACT. The note recommended the issue of a Statement of Practice about how we apply the legislation. But we warned that there were some aspects that would still be criticised. The legislation we have proposed might increase the strength of these criticisms. But we doubt that the new legislation itself would be criticised since this would merely be removing defects in the existing legislation.

PREFERENCE SHARES

22. The Finance Act 1987 blocked an avoidance device involving preference shares which was being used to create ACT to set against CT within the North Sea ring-fence. At the

time, we told Ministers that preference shares could be used for avoidance outside the North Sea, but there was not sufficient evidence of abuse to justify counteraction.

23. My note to you of 26 February 1987 explained the various ways in which preference shares could be used instead of loans so as to reduce the overall tax liability. The main possibilities are described below but the effects are as follows.

i. A tax-exhausted <u>borrower</u> can reduce the total tax liability on the loan interest from 35 per cent to 25 per cent.

ii. By exploiting a defect in the existing legislation even the 25 per cent tax charge can be avoided.

24. There has not been much evidence of increased abuse since my earlier note. This is why we did not recommend legislation concerning preference shares when we were reviewing the starters for the coming Finance Bill (instead, it was on the list of discarded starters). But there is evidence that the device in (ii) above is being actively marketed by a well known bank (see below). We think that the risk is sufficiently serious that there is a good case for early legislation.

25. The straightforward avoidance device (paragraph 23(i)) works like this. A company which is tax-exhausted may choose to raise finance by issuing preference shares instead of taking a loan. The commercial effect may be much the same, but the tax consequences are different. In the case of a loan, the borrower gets tax relief for the interest paid, but if it is tax-exhausted the tax relief is of no immediate use. While if the lender (which could be either a bank or an ordinary company) is currently tax-paying it will have to pay CT at 35 per cent on the interest.

26. A preference share reduces the overall tax liability. The issuer normally has to pay ACT (effectively at 25 per cent) but the holder of the shares pays no tax (because a UK company is not liable to CT on a dividend received from another UK company). So the overall tax bill has dropped from 35 per cent to 25 per cent, and the benefit can be shared between the two companies.

27. There is a more sophisticated version of this device (paragraph 23(ii)) which avoids even the ACT liability. It takes advantage of a relief which allows dividends to be paid between members of a group of companies without any liability to ACT - the relief also applies to a dividend paid by a company to the members of a consortium which control it. Because of weaknesses in the definitions of what constitutes a group for this purpose, it is possible to construct artificial arrangements, using "funny shares", whereby a company which is in reality a subsidiary of one company is dressed up to qualify as a subsidiary of another company. Similarly a subsidiary of one company can be dressed up as a company owned by a consortium. The point of this device is that the subsidiary can issue preference shares to the provider of the finance and it will pay no ACT on the dividends because it is dressed up to look like a subsidiary of the finance company (or like a company owned by a consortium of which the finance company is a member). The subsidiary will then lend the money to its real parent.

28. In the past, attempts were made to use this device but they failed on a technicality. But a new version avoids the defect. And, as I have said, a well known bank has been marketing the scheme. The only use we know of so far is by a major UK company but is on a small scale (£1 million of preference shares). We believe that it was a trial run, to see how we would react, before the device is marketed more widely and used on a large scale. We have sought various pieces of information before committing ourselves but we think it likely that we shall soon have to concede that the device works. Our fear is that when we do this, use of the device will become widespread.

29. In my note last year I said that there was a case for taxing preferential dividends paid between companies as if they were interest. This would counter the avoidance devices I have described. But our view remains that there is insufficient evidence of abuse to justify such a radical change.

30. We are more worried about the sophisticated version of the device, which avoids any liability to ACT. It would be a fairly simple matter to prevent it by tightening the definitions of "group" and "consortium" for this purpose. This legislation would be similar to the existing legislation concerning group relief, and to the possible legislation for deciding whether or not there has been a change of ownership (see paragraph 14). We think that the risk of substantial abuse here is sufficient to justify introducing this legislation in the coming Finance Bill.

REPAYMENT SUPPLEMENT

31. If a company pays too much CT the excess is repaid to it. If the repayment is made more than 12 months after the CT was paid it carries with it a "repayment supplement" - this is effectively a payment of interest to compensate the company for not having had the use of the money it overpaid.

32. A repayment of CT can arise because of a relief carried back from a later year. One relief allows a company's surplus ACT to be carried back for up to six years for set-off against the company's earlier CT liabilities. The reason for this relief is that a company's current dividend may be paid not out of current profits, but out of earlier profits which had borne CT. So it is reasonable, given our imputation system of CT, to allow the ACT to be set-off against that earlier CT.

33. Where the set-off occurs the company is entitled to be repaid the CT, but <u>without</u> any repayment supplement. This is fair because it was right that the company should have paid CT

on that earlier occasion since it had made profits. The repayment of CT arises only because our imputation system is here working the wrong way round - the <u>advance</u> corporation tax (ACT) is being paid <u>after</u> the CT on the company's profits.

34. But groups of companies have found a way round the rule denying a repayment supplement in these circumstances. This is shown by the following example.

<u>Example</u>

A group consists of a parent company and its subsidiaries. The parent, and at least some of the subsidiaries, pay CT on their profits. The parent pays a dividend to its shareholders every year and pays ACT, which is set primarily against its own CT liability. The balance of the ACT is surrendered to its subsidiaries to set against their CT liabilities, but there remains a substantial amount of CT against which no ACT is set. (This example is in this respect fairly typical of large groups of companies.)

One year the parent company decides to claim to increase its surrender of ACT for an <u>earlier</u> year to its subsidiaries. They are then entitled to be repaid CT for that earlier year and this repayment will carry with it a repayment supplement. If nothing else were done the parent company would have to pay more CT for that earlier year (because it has surrendered the ACT that had previously been set against its own CT liability). And often it would have had to pay interest on this payment of CT, thereby negating the advantage of the repayment supplement on the CT repaid to its subsidiaries (I explain below the circumstances in which interest would be chargeable). But there is a way of avoiding this. What it does is to claim to carry back its <u>current</u> surplus ACT to set against its (now increased) CT liability for the earlier year. This replaces the ACT surrendered to its subsidiaries, so it does not have to pay any extra CT for the earlier year. The net result is that the subsidiaries obtain repayment supplement that would not have been due if the parent had simply surrendered its ACT surplus against the current CT liabilities of its subsidiaries.

35. This is a clear abuse. There should not be any entitlement to repayment supplement in these circumstances. Earlier this year we lost a case on this point before the Special Commissioners, and the result has become quite widely known. Already, a number of claims are in the pipeline. We have given notice of appeal to the High Court but we are not confident of success (and if we did win there would be wider implications, and criticism that the law concerning ACT surrender was too restrictive). We therefore see a case for legislation in the coming Finance Bill to ensure that this device does not work. If Ministers decide to legislate against this device we may conclude that it is not worth proceeding with the appeal.

36. So far the amount at stake is not large. But many large groups of companies could take advantage of this device to carry back ACT for up to six years and therefore obtain up to five years worth of repayment supplement. At present, this would in total amount to up to 45% of the ACT carried back. It is difficult to estimate how much ACT could be carried back in this way. But with the total yield of ACT approaching £6 billion it is clear that the scope for carry-back is very significant (we are currently considering whether we can produce a more precise estimate). So the potential cost may be large.

<u>Interest charge</u>

37. In the example I said that where a company had to pay more CT as a result of surrendering its ACT to a subsidiary, the CT would often carry interest. This is the case where the company's CT liability is still under appeal at the time of the surrender, and for large groups this is likely because their tax liabilities usually take many years to determine. But if the CT liability had been determined before the

surrender was made then, under existing law, no interest would be payable on the increased CT liability resulting from the surrender. So in this case the device produces an advantage even if the company does not carry-back any ACT to replace the surrendered ACT.

CT Pay and File

38. The position will change when the CT Pay and File arrangements come into force. You will recall that you have decided that this should happen in 1993. Under these arrangements, interest will always be payable on an increased CT liability as a result of a surrender of ACT - this will be so whether or not an appeal is still open and even where the CT liability is covered by a carry-back of ACT from a later year. This gives the right result.

Amending legislation

39. One option would be to wait for Pay and File to solve the current problem. But there could be a large loss of tax before then. The avoidance device can be used at present to surrender ACT for years going back to 1982. And even after Pay and File comes into operation the device could be used for years up to 1992. So we recommend changing the existing law to counteract this device.

40. It would not be easy to draft provisions to prevent repayment supplement being paid in these circumstances. So instead we propose to follow the Pay and File arrangements. The company which surrenders the ACT should have to pay interest on its (increased) CT liability from the normal date (even though the claim to surrender ACT may not have been made until several years later). And the carry-back of ACT from a later year against the (increased) CT liability would not be allowed to prevent interest running. The overall effect would be to impose an interest charge which would offset the entitlement of the subsidiary to repayment supplement. We think that these provisions would be simple to draft.

41. Ministers may wish to see whether widespread abuse develops before deciding whether to legislate. But we think that there is a good case for legislating in the coming Finance Bill.

CONCLUSION

42. There are four issues for decision.

i. Do you want to give Coats Viyella the relief they have requested (paragraph 8)?

ii. If so, do you want to prevent the sale of companies with surplus ACT in a way which avoids a "change of ownership" (paragraphs 13 to 16)?

iii. Do you want to prevent devices to avoid the payment of ACT on preference share dividends (paragraph 30)?

iv. Do you want to prevent repayment supplement being paid as a result of a company carrying back ACT (paragraph 40)?

43. Our advice is that there is a real risk of abuse using the device mentioned in (iii), and that you should legislate in 1989 to deal with this. If there is to be legislation, you might think that it would be right to meet the Coats Viyella point at the same time; and also to deal with the "funny share" device which avoids a change of ownership ((i) and (ii)). All the legislation should be short and simple, being largely based on existing provisions. We feel that the repayment supplement point (iv) should also be included in this "ACT package". We have not consulted Parliamentary Counsel about the length of the proposed legislation. But our view is that in total, the legislation for all four items should amount to about two pages.

J H REED

Robert 5.19.12.88

CONFIDENTIAL

FROM: R C M SATCHWELL

DATE: 19 December 1988

MR McGIVERN - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Reed - IR
PS/IR

STARTER 205: ACT

The Financial Secretary was most grateful for your and Mr Reed's minutes of 8 December. He agrees that you should legislate in this area, subject of course to the general caveat about pressures on the Finance Bill. In particular, he says yes to all 4 of the questions in para 42 of Mr Reed's note.

R.C.M.S.

R C M SATCHWELL
Private Secretary

BUDGET CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

FROM: B ST QUINTON
DATE: 13 JANUARY 1989

Wd this change mean a reduction in the CT bill for all taxpaying companies with profits betw £100,000 & £750,000? How many such companies are there?

1. MR REED 13/1
2. MR McGIVERN 13/1
3. FINANCIAL SECRETARY

STARTER No 200: CORPORATION TAX RATE FOR FINANCIAL YEAR 1989
STARTER No 201: SMALL COMPANIES RATE AND MARGINAL RELIEF PROFITS

1. I understand that at Dorneywood two provisional decisions were made on corporation tax. The main rate is to remain at 35 per cent for the 1989 financial year. (We assume that the Chancellor will want to announce this in advance in his Budget in line with practice in recent years.) Ministers are also attracted to the idea of raising the small companies rate profits limit (currently £100,000) and the marginal relief profits limit (currently £500,000) by 50 per cent (to £150,000 and £750,000 respectively). This minute describes the effects of raising the two profits limits.

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cc Chancellor
Chief Secretary
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Monck
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)
Chairman
Mr Isaac
Mr McGivern
Mr Bush
Mr Calder
Mr Campbell
Mr Fitzpatrick
Mr Weeden
Mr Reed
Ms St Quinton
PS/IR

2. Both limits have not been changed since the 1983 Finance Act (when the rate was set in arrears ie for financial year 1982). Revalorisation would mean an increase of about 40 per cent.

3. The cost of the 50 per cent increase would be:

89/90	90/91	Full Year
Neg	35	55

4. The effect of this change on the numbers of companies paying corporation tax at different marginal rates would be as follows:

Rates	Current Profits Limits No of companies in thousands	Proposed Profits Limits No of companies in thousands
0	650	650
25 (small companies rate)	200-250	200-250*
37.5 (marginal relief)	20	18
35 (main rate)	20	16

* The change would mean that 6,000 more companies would pay tax at the small companies rate.

5. The marginal rate (ie the rate at which companies are charged on profits within the two limits) will remain at 37.5 per cent if the rates of corporation tax do not change.

BSQ

B ST QUINTON

rc 1989/20.1.02

BUDGET CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 20 January 1989

CHANCELLOR

Thanks. I agree with X — but not this year. N

cc: (with attachment)
Financial Secretary
Economic Secretary
Sir Peter Middleton
Mrs Chaplin

(without attachment)
Sir Terence Burns
Mr Scholar
Mr Gilhooly
Mr Matthews
Mr Wilson
Mr Macpherson

CORPORATION TAX DEPRECIATION ALLOWANCES

You asked this morning about indexing depreciation allowances.

2. I attach a handy paper on corporation tax by Mr Wilson and Mr Matthews.

3. At some stage, you should clearly reduce the main rate. And this year, you have already agreed to raise the small companies' limits (not covered in the paper). That apart, I think indexing depreciation allowances is the only interesting option. X

4. On the whole, I would not pursue it. Depreciation allowances are, on average, too generous. They allow for assets to depreciate faster than in fact they do: the tax system allows about 8 years, accountants at least 10, the CSO 25. This broadly compensates for the fact that the allowances are not indexed. In principle, there is a case for reducing the allowances but indexing them; but I doubt if

it is worth the hassle. It would be a complication, when we are looking for simplifications. It would no doubt require umpteen Revenue staff to administer. And in present circumstances, companies do not need the money, and we do not have it to spare.

5. These, clearly, are only broad judgements. If you would like more, we should need a Revenue submission. That would be well worth having sometime; but I do not think I should want it to crowd out other work at this time of year.

6. There is, incidentally, some prima facie case for reducing depreciation allowances, once we have got inflation down. That would recognise the fact that assets last longer than the tax system allows. But that, of course, is another story.

Rc

ROBERT CULPIN

CORPORATION TAX

A. Introduction

The objectives of the 1984 corporation tax reforms were, in brief:

- to encourage enterprise by reducing the corporation tax rate;
- to reduce the distortionary effect of the tax system on investment, leading to a better quality and more productive capital stock;
- to reduce the distortion between debt and equity as a source of company finance (by reducing the CT rate);
- to simplify the CT system (eg by rationalising capital allowances and abolishing stock relief).

2. It is now approaching 5 years since the reforms were announced, and it is perhaps time to consider what further reform might be desirable. There have been important changes in the economy since 1984; and in the tax system - changes in income tax, for example, have left the CT rate well above the basic rate of income tax.

3. The main issues discussed in the paper are the effects of the CT system on the choice between different sources of finance (Section C), its effects on takeover activity (Section D), neutrality between capital and labour (Section E), and neutrality towards inflation (Section F). Section G offers some conclusions.

4. The analysis is based on the assumption that among the desirable features of the CT regime, other things being equal, are: stability; simplicity; and neutrality. The first of these aids long term planning and avoids undermining past decisions taken by firms by creating windfall gains and losses; the second can reduce

administration costs for both firms and the Inland Revenue; the third is rather more difficult to define, but the broad objective is to avoid distortions in economic activity arising purely for tax reasons.

5. The paper does not deal in detail with the issue of tax harmonisation in the EC*.

B. Background: The Financial Position of the Corporate Sector

6. It is useful to set the options for reforming the corporation tax system against a background of the general financial state of companies. This is looking increasingly healthy. The pre-tax rate of return (net of stock appreciation and capital consumption) to industrial and commercial companies (ICCs) is estimated at nearly 11½% in 1987, up from 10% in 1986 and 6% in 1981. Gross trading profits (net of stock appreciation) of non-North Sea ICCS rose by over 20% between 1986 and 1987 and by over 24% in the year to June 1988; and were nearly 140% higher in real terms in 1987 than in 1981. Rates of return appear, however, to remain lower than those achieved by industrial and commercial companies in most other major countries.

7. The growth of profits is also reflected in the amount of CT being collected, although the most recent increases in profits will not yet be reflected in tax payments, which are collected well in arrears. CT has risen as a percentage of all taxes and royalties from 5.7% in 1981-2 to 13.3% in 1988-9 (forecast in FSBR).

8. Companies are well able to afford the tax bills involved, however - the healthy pace of investment, marked growth in dividends and buoyancy of pay settlements all suggest ample corporate profitability. There is thus no pressing need to reduce the burden of corporate taxation because of short term macroeconomic or company finance considerations.

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*Earlier this year the European Commission issued a "preliminary draft Directive" on the harmonisation of the business tax base. It argued that closer alignment of firms' tax burdens is necessary, "in the interests of tax neutrality". Harmonisation of the base was described as "an indispensable first step towards harmonising tax rates".

C. Neutrality between Sources of Finance

9. Table 1 compares total tax rates (ie the sum of corporation tax, income tax and CGT) for different categories of income tax payer, for the pre-1984 regime and the current 35% rate. It also shows the total tax rates produced by the present 35% CT rate combined with 1984 personal tax rates and for the present personal income tax rates combined with a 25% CT rate.

Table 1: Total Tax Rates on Sources of Company Finance

	Basic (25%) rate tax payers	Higher (40%) rate tax payers	Exempt tax payers
Current regime			
Interest	25%	40%	-
Dividends	35%	48%	13%
Retentions*	51% (35%)	61% (35%)	35%
Current regime, with 1988 personal tax rates but 25% CT rate			
Interest	25%	40%	-
Dividends	25%	40%	-
Retentions*	44% (25%)	55% (25%)	25%
Current 35% CT rate with 1984 Personal Tax rates (CGT = 30%)	(30%)	(60%)	
Interest	30%	60%	-
Dividends	35%	63%	7%
Retentions*	55% (35%)	55% (35%)	35%
Pre-1984 regime with CT rate of 52% and CGT at 30%	(30%)	(60%)	
Interest	30%	60%	-
Dividends	52%	73%	31%
Retentions*	66% (52%)	66% (52%)	52%

* Figure in brackets is the rate applicable below the CGT threshold. The figure given for the total tax rate on retentions is a notional one since it assumes that retained earnings are reflected 1 for 1 in share prices and it makes no allowance for the reduction in the effective rate of Capital Gains Tax brought about by the deferral of payment until capital gains are realised, or for the CGT indexation provisions.

10. The Table shows that, compared with pre-1984, the current regime gives lower aggregate tax rates with less dispersion between the rates on interest and dividends (compare top and bottom sections of table 1). However, the reductions in the basic rate since 1984 have increased the gap between the aggregate tax rates on interest and dividends (compare the top set of figures in table 1 with the third set). This gap will widen further if the basic rate is reduced further to 20%. There may therefore be a case for reducing the CT rate to make the system more neutral between different sources of finance.

11. Reducing the CT rate to 25% would mean that debt and equity finance were taxed equally regardless of the income tax position of the provider of the finance. But it would not bring them entirely into line with retentions. How far this matters is open to discussion, given the notional nature of the figures for tax rates on retentions. The relatively high annual exemption from Capital Gains Tax means that only an estimated 155,000 individuals and trusts will be liable to CGT in 1988-89. One could also argue that the figures for tax rates on retentions are notional since retained profits will eventually be distributed and hence taxed as dividends.

12. The implication of a desire for neutrality between debt and equity finance is thus that the CT rate should be brought down to somewhere closer to the basic income tax rate of 25%. The cost of each percentage point reduction would be of the order of £½ billion in a full year. Two other possible ways of achieving greater neutrality were considered in the run up to the 1988 Budget - allowing imputation at the full 35% CT rate or allowing only partial (25/35ths) deductibility of interest payments. Both are subject to major objections and are not considered further.

13. In considering the strength of the case for reducing non-neutralities between sources of company finance, it is worth bearing in mind that tax considerations are in practice only one factor influencing a company's investment and financing decisions. Hence the distortions caused by different aggregate tax rates on debt and equity finance may not be too important in practice. For example, retained earnings finance most company investment in the UK in some years, despite being overall the most expensive source from a tax point of view. Jeremy Edwards, in describing "Recent Developments in the

Theory of Corporate Finance," (Oxford Review of Economic Policy, Winter 1987) reports "a growing suspicion that assigning a major role to taxation in the explanation of corporate borrowing may be quite mistaken." This suggests that in practice the gain from eliminating the bias in the system (which is now modest) may be fairly small. Nevertheless, there is a presumption in favour of a neutral system; and cutting the main CT rate would be a step in this direction.

D. Neutrality towards Takeovers

14. The effects of the tax system on companies also influence the attractiveness of takeovers and mergers. This arises in a number of ways. First, a tax-exhausted firm's tax losses will decline in value (in real terms) as they are carried forward before they can be used. This creates an incentive to merge with a tax-paying company so that the full value of the tax losses can be utilised immediately. This factor has declined in significance since the 1984 reforms because tax-exhaustion is now a less prevalent phenomenon.

15. Secondly, because profits in the company are subject to a partial (rather than full) imputation system of corporation tax, there is a tendency for assets to be valued less highly than in the unincorporated sector. This may make it cheaper, ceteris paribus, for a firm to acquire assets through takeover rather than new investment. This is the basis of Mervyn King's model of takeover activity but the underlying assumptions are controversial.

16. Thirdly, the more favourable tax treatment of debt than equity creates an incentive to replace equity with debt. This can be effected by leveraged management buy-outs or by a company borrowing to make its acquisition of another company. However, the difference between the tax treatment of debt and equity is much less marked in the UK than in the US where the "classical" system of corporation tax (ie without any imputation) has helped encourage the wave of LBOs. Debt/equity ratios in the UK have tended to decline in recent years and are probably around half the levels prevailing in the USA (although precise comparisons are difficult).

17. The second and third arguments both point to reducing the CT rate to somewhere nearer the basic rate of income tax, reinforcing the conclusion of Section C.

E. Neutrality between Capital and Labour

18. It is often claimed that the present CT regime is relatively less favourable to investment than the pre-1984 system which gave significant subsidies to certain types of investment. This is not necessarily a bad thing since labour has to bear the costs of income tax and NICs, and one of the factors behind the 1984 reforms was the view that the subsidy to capital investment in the old system had produced a misallocation of resources by encouraging investment with a negative pre-tax rate of return - some reduction in the discrimination in favour of investment was thus in order.

19. The actual tax wedge on investment depends on the type of asset, the length of its life, the rate of return, the type, source and cost of finance, and the position of the company as regards tax exhaustion. It also depends on the inflation rate, as discussed in the next section. Because of the numerous different factors that can be taken into account, there is a danger that calculations of tax wedges can multiply and make it difficult to see the wood for the trees. Nor is there agreement between the different researchers in the field on the most appropriate methodology. The figures presented below should therefore be regarded as illustrative rather than definitive.

20. Table 2 gives calculations, which are based on a methodology devised by Mervyn King and others at LSE, and derived using their computer program PTAX. The figures are stylised calculations averaged across assets, industries, sources of finance and ultimate savers. They are based on 81 hypothetical investment projects and weighted on the basis of the structure of the capital stock in the economy. The total tax wedge given is the difference (in percentage points) between the pre-tax real rate of return on a marginal investment and the post-tax real return to savers. The CT wedge measures that part of the total wedge on investment in the corporate sector which is due to corporation tax alone.* The figures assume a full taxpaying company (ie one that is not tax exhausted or paying surplus ACT) and inflation of 5%.

*Advance Corporation Tax is regarded as satisfying a personal, not corporate, tax liability on the grounds that if it were not paid, individuals would be expected to pay the same amount as income tax on their dividend receipts.

Table 2: Average Tax Wedges on Investment

%	Pre-tax real rate of return (after rates and grants) 8%	10%	12%
1988-89			
CT wedge	1.83	2.22	2.61
Total wedge*	3.10	3.70	4.29
1978-79			
CT wedge	-1.20	-1.32	-1.44
Total wedge*	1.96	2.25	2.52

* Including income tax and capital gains tax (where appropriate). The figures are averages, weighted according to the funds provided by investors paying different tax rates.

Source: PTAX

21. The 1988-89 wedges are all positive, indicating that the pre-tax return is greater than the post-tax return, and rise with the underlying pre-tax rate of return. Thus the tax system now taxes rather than subsidises the return on investment, irrespective of whether CT only or all tax is taken into account.* This contrasts with the pre-1984 situation in which, from the company's point of view, investment was subsidised - CT wedges were on average negative.

22. This is an average result. Table 3 shows how the wedge varies according to the type of investment or the source of funds by breaking down an average wedge into different components for each of four factors. Within each component results are again averaged according to the relevant weights of the components of the other factors in the Table. Inflation and the real pre-tax rate of return are both assumed to be 5%.

*The IFS in 1987 estimated CT wedges. Averaging across 19 model firms (each based on the average characteristics of a particular sector), they come up with a figure of 1% for the CT wedge on investment at a 5% rate of inflation. This is slightly lower than the figures in Table 2, but the basic message is the same.

Table 3 : Tax Wedges on Different Components of Investment

		Tax Wedge
(a) Type of Asset		
	Machinery	1.4%
	Buildings	4.7%
	Stocks	3.5%
	Overall	2.9%
(b) Sector		
	Manufacturing	2.8%
	Other industry	2.5%
	Commerce	3.5%
	Overall	2.9%
(c) Type of Funds		
	Debt	2.2%
	New share issues	1.8%
	Retained earnings	3.2%
	Overall	2.9%
(d) Source of Funds		
	Households	3.1%
	Tax-exempt investors	2.5%
	Insurance companies	3.2%
	Overall	2.9%

Source: PTAX

23. Section (a) of the table shows a particularly marked difference in the tax wedge on machinery and buildings arising from the differences between writing down allowances for tax purposes and actual depreciation, with the allowances for tax purposes being relatively more favourable in the case of machinery. The table also shows a slightly surprising result: the average tax wedge on new investment financed by debt is higher than on than financed by equity. This does not in fact contradict the results in Section C which show a higher tax wedge on equities than debt. It arises because the figures are averages based on actual weights. A much larger proportion of shares than debt is held by tax exempt investors and this brings down the weighted average tax wedge for equity.

24. Table 4 shows how these figures can be broken down further to give individual tax wedges for specific types of investment, in this case manufacturing investment in plant and machinery. It is based on the same assumptions about inflation and the real rate of return as

Table 3. The table shows that for this type of investment retentions suffer the biggest tax penalty regardless of the type of investor, whilst debt is generally less highly taxed than equity.

Table 4 : Tax Wedges on Manufacturing Investment in Plant and Machinery by Source and Type of Funds

	Type of Funds		
	Debt	**Equity**	**Retentions**
Source of Funds			
Households	0.9%	1.3%	2.0%
Tax-exempt investors	-3.4%	-1.7%	1.2%
Insurance companies	1.3%	0.5%	1.9%

Source: PTAX

25. Whatever the exact figure for the tax wedge in a particular set of circumstances, there has clearly been a change from the pre-1984 tax system which provided a subsidy to investment. This was intentional, but we still need to consider whether worthwhile investment is being discouraged by the positive tax wedge.

26. In considering this question, one must of course remember that there is also a tax wedge on labour, ie a difference between pre-tax payments to labour and post-tax receipts of workers, due to income tax, employee NICs and employers' NICs. Effective tax rates on labour can be compared with those on capital by expressing the wedges for 1988-89 in Table 2 as a percentage of the pre-tax return, as in Table 5.

Table 5 : Effective Tax Rates on Capital and Labour

	Effective tax rate
(a) Capital	
8% real rate of return	39%
10% real rate of return	37%
12% real rate of return	36%
(b) Labour	
Basic rate tax payer	
- below UEL	40%
- above UEL	32%
Higher rate tax payer	46%

27. The table shows that the effective tax rate on labour is of a similar magnitude to the tax rate on investment, if anything slightly higher. It is therefore not clear that the choice between capital and labour is significantly distorted under the present system, assuming that inflation is broadly constant at around 5 per cent.

28. Moreover, interview studies of companies' behaviour (conducted by various researchers) have tended to find that companies take little or no notice of tax in their investment decisions, although there may be greater effects on their financial behaviour. This may be because uncertainties are such that investments are only likely to be undertaken when high returns are possible, and strategic factors are likely to be to the fore. In these circumstances one or two percentage points difference between pre-tax and post-tax rates of return are unlikely to lead to the rejection of an otherwise attractive investment project.

29. Even so, it is often argued that it is desirable to aim for a lower tax wedge on investment, because investment is the engine of growth and technical change. In addition it will be necessary to review the taxation of investment as the Government achieves its objective of reducing income tax rates further, and hence the taxation of labour.

30. There are perhaps three main options for reducing the rate of tax on investment:

(i) increase writing down allowances
(ii) reduce the rate of CT
(iii) index writing down allowances for inflation.

31. The first of these options has the disadvantage that it reverses the direction of part of the 1984 reforms and also that it will normally take depreciation allowances further out of line with economic depreciation. 25% a year is a faster rate than many assets depreciate at, and the introduction of special treatment for short-life assets means that the average length of life of assets in the pool has increased since the first years of the new system.

32. A variant on the first option, would be to replace reducing balance by straight line depreciation. This was estimated last year to have an annual cost building up over a 4 year period to a maximum of about £2½ bn. This may overstate the effective cost, however, since there should be a saving in subsequent years. In all cases, the effect of changing the writing down system should be on the timing of tax receipts, although this will have a real cost when inflation and interest are taken into account.

33. Section C suggests that the second option, that of reducing the CT rate, is also desirable on other neutrality grounds.

34. The third option, indexing depreciation allowances, is rather more radical. It is discussed in more detail in the next section which considers the sensitivity of the overall CT regime to inflation.

F. Sensitivity to Inflation

35. An important feature of the present system is that the burden of corporation tax varies with the inflation rate. There are three main reasons for this:

- nominal rather than real interest payments are tax deductible and the value of deductibility to the corporation thus rises as higher inflation pushes up total interest payments.

- following the abolition of stock relief, companies pay tax on nominal gains on the value of stock even though in replacement cost terms they may have made no profit at all.
- depreciation allowances are not indexed and hence their real value tends to fall over time as inflation rises.

36. The first of these effects lowers corporation tax payments as inflation rises, the other two raise them. On average the second and third outweigh the first, so the burden of taxation on companies tends to increase with inflation. This is in contrast to the pre-1984 system which produced the opposite result: effective average tax rates tended to fall as inflation rose. The IFS calculate (in the same way as described in the footnote to paragraph 21) that the burden of taxation is lower under the present system than the previous one so long as inflation is below 7.5 per cent a year. Above that level of inflation, it is higher.

37. Not only does the overall CT yield vary with inflation, so do the non-neutralities between different sources of finance and the tax wedges between pre- and post-tax returns on investment. The bias in favour of debt and against equity finance increases with inflation because higher nominal interest payments are deductible from tax liability. The tax wedge against investment (unless debt-financed) also rises with inflation, because depreciation allowances are worth less. The IFS calculate that the overall effective average tax rate rises with inflation under the current tax system, but falls with inflation under the 1979 system. They also calculate that the average wedge across different types of assets rises from around ½% with no inflation to 1% with 5% inflation and 2% with about 14% inflation. These effects are shown in the charts, reproduced from an IFS study.*

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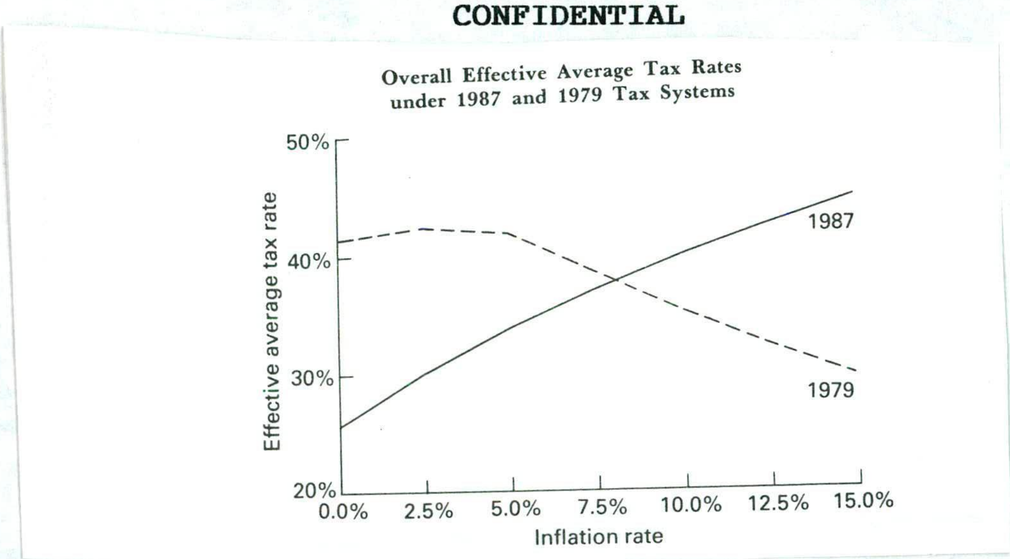
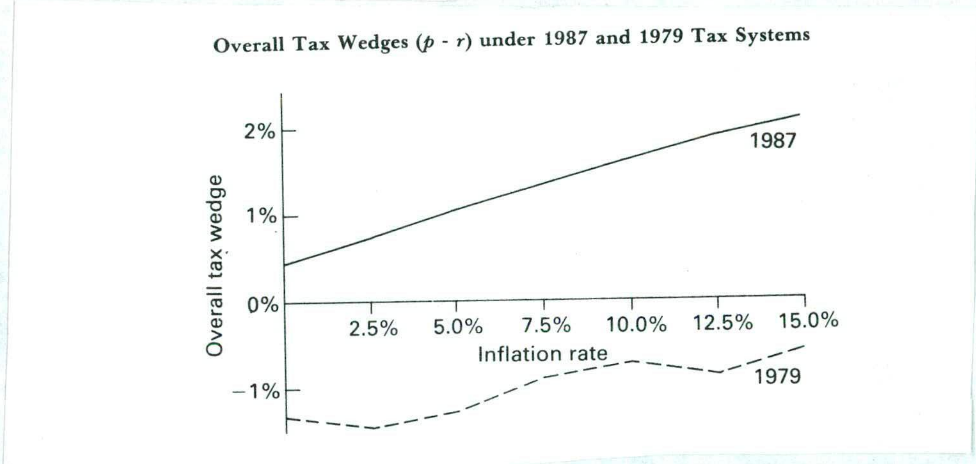
*Inflation : the Achilles' Heel of Corporation Tax", King and Wookey, IFS 1987.





38. There has been some debate about whether neutrality towards inflation is desirable. One could perhaps argue that a tax system which increases the burden of corporation tax as inflation rises has a stabilising influence by increasing the level of government revenue. This might make it easier to maintain a prudent fiscal stance in the face of rising inflationary pressure, so reining back the growth of nominal demand in the economy. However, the long lags involved in collecting CT somewhat weaken this argument; the fiscal effects could, in principle, even be destabilising if the upturn in CT revenue coincided with a downturn in inflation caused by other policy responses.

39. Another consideration is that taking action to make the tax system more neutral with regard to inflation might be seen as a sign that the Government's commitment to keeping down inflation was weakening. Nevertheless the micro arguments all point to aiming at a more neutral system, so that if macro policies fail to control inflation the supply side is not distorted.

40. To eliminate the sensitivity of the CT system to inflation, one would need to:

- make only real interest payments tax deductible;
- express profits in inflation adjusted terms, excluding stock appreciation;
- index depreciation allowances.

This would be difficult to implement except as part of a general move to full inflation accounting, which is not on in current circumstances. The accountancy profession is not agreed on how to implement such a system, and we would also need to look carefully at the effects on tax revenue.

41. There is therefore a case for looking at the measures separately with a view to moving some way towards inflation neutrality. Of the three changes outlined above, only the third looks to be really feasible. The first has not been given much consideration since it would increase the burden of taxation. The second has tended to be dismissed on the grounds that it would, on its own, overcompensate for the effects of inflation of the average CT yield and that it would be a very visible sign that the Government was worrying about inflation. It would also involve a direct reversal of part of the 1984 reforms.

42. That leaves indexing capital depreciation allowances as a possible way of reducing the CT regime's sensitivity to inflation. Rough costings carried out last year show the cost of such a measure to be about £250-300 million a year. This would rise with inflation. Although it would mean some complication of the existing system, this need not be excessive: it should be possible simply to index the value of the pool of existing unwritten-down investment before adding the current year's investment to it. [Inland Revenue may have views on the feasibility of this.]

G. Conclusions

43. The paper has raised a number of possible changes which might be introduced to the corporation tax system. The most attractive for further consideration appear to be:

- reducing the main rate of CT from 35%
- indexing depreciation allowances

These options involve some loss of tax revenue and should perhaps be seen as medium term objections.

44. Section B on the financial position of companies shows that there is no pressing need to reduce the tax burden on companies in 1989-90 since they are not short of money.

chex.md/jmt/53 BUDGET CONFIDENTIAL

PWP

FROM: J M G TAYLOR
DATE: 23 January 1989

MR CULPIN

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Gilhooly
Mr Matthews
Mr Wilson A.
Mr Macpherson
Mrs Chaplin

CORPORATION TAX DEPRECIATION ALLOWANCES

The Chancellor was grateful for your note of 20 January.

2. He agrees that indexing depreciation allowances is the only interesting option apart from reducing the main rate and raising small companies' limits; but it is not for this year.

J M G TAYLOR

PMP

Inland Revenue

BUDGET CONFIDENTIAL

Personal Tax Division
Somerset House

Ch/ Are you content with the IR recommendation on timing of this change, which has been agreed? PMG is content.

FROM: J D FARMER

DATE: 24 January 1989

PAYMASTER GENERAL

OK

DJS

PRP : INCREASE IN TAX RELIEF LIMIT

1. This submission invites your agreement to the effective date for the proposed increase in the tax relief limit for PRP (from £3,000 to £4,000).

2. The background to this question is the present legislation's stipulation that one-half of PRP is free from income tax subject to an overall limit in respect of PRP for any particular profit period of the lower of

   i. 20 per cent of the total of PRP-exclusive pay which is paid in the profit period plus PRP paid for that period; or

   ii. £3,000.

The tax relief is given at the time PRP payments are made. So whilst the limit applies to PRP received for a particular profit period, the relief itself may be given in whole or in part after the profit period has ended.

---

c PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Burgner
Mr Culpin
Mr Burr
Mr Gilhooly
Ms Young
Mr Jenkins (OPC)

Mr Painter
Mr Ridd
Mr Lewis
Mr Farmer
Mr Eason
Mr Brannigan
Mr O'Hare
Ms Fairfield
Mr Annys
PS/IR

3. The effective date of the increase from £3,000 to £4,000 remains to be decided. There are two choices:

A between increasing the limit for all PRP payments made on and after the effective date, or increasing it only for payments made for profit periods commencing on or after the effective date;

B between an early effective date (eg Budget Day or some other early date) and leaving the increase to have effect from Royal Assent.

4. As to Choice A, allowing the limit increase to apply for any PRP payments made after a given date could lead to administrative difficulties for both employers and the Revenue (since different limits would apply to the single PRP entitlement for a profit period, depending on when the payment or payments of that PRP chanced to be made); and it could produce very unequal results as between employees in schemes with the same profit periods, depending on when interim or annual payments under existing schemes were made to them. Although the alternative would mean that some existing scheme participants might still have their tax relief subject to the old £3,000 limit for another year or so, these are likely to be very few in number, and the point does not seem as significant as these administrative implications.

5. It seems doubtful, in any case, whether there is any strong argument for allowing the increase to benefit employers and participants in existing registered schemes in respect of profit periods which have already begun. The benefit which Ministers will hope accrues from the limit increase will be in terms of new scheme registrations and renewals of expiring registrations. We consider, therefore, that the limit should be raised in respect of PRP paid for profit periods commencing on and after the effective date.

6. On this assumption, a decision on Choice B appears relatively straightforward. An effective date delayed until Royal Assent might reduce the beneficial effect of the change on PRP take-up, and lead to renewals of some schemes already registered being postponed (perhaps for a year). We consider therefore that the limit increase should be made effective from 1 April.

Conclusion

7. We should be grateful to know whether you are content that the increase in the limit on tax relieved PRP, which has already been agreed, should be made effective

- from 1 April,

- for PRP paid under registered schemes' profit periods which commence on or after that date.

J D FARMER

chex.md/aa/45 BUDGET CONFIDENTIAL

FROM: A C S ALLAN
DATE: 25 January 1989

MR CULPIN

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Riley
Mrs Chaplin
PS/IR

CT THRESHOLDS FOR SMALL COMPANIES

The Chancellor would be grateful for a note on the following CT proposal, as a possible substitute for the existing proposal on raising small companies' thresholds:

(i) first £5,000 of profits tax free;

(ii) next £100,000 at 25%;

(iii) next £X at 37½%;

(iv) the remainder at 35%.

£X, as now, would be set so that the total tax on profits of £105,000 plus £X would be 35%. The purpose is to inject into CT a £5,000 tax free slice for small companies. The Inland Revenue may want to offer variants.

ACSA

A C S ALLAN

818
226

BUDGET CONFIDENTIAL

PAYMASTER GENERAL

FROM: MALCOLM BUCKLER
DATE: 26 January 1989

pmp

MR FARMER - INLAND REVENUE

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Mr Monck
Mr Burgner
Mr Culpin
Mr Gilhooly
Ms Young
Mr Jenkins - OPC
PS/Inland Revenue

pwp

PRP: INCREASE IN TAX RELIEF LIMIT

The Paymaster General was most grateful for your minute of 24 January. He is content that the increase in the limit on tax relieved PRP, which has already been agreed, should be made effective

- from 1 April;
- for PRP paid under registered schemes' profit periods which commence on or after that date.

MALCOLM BUCKLER
Private Secretary

fp.pk/rc/1989/27.1.01

BUDGET CONFIDENTIAL

FROM: ROBERT CULPIN

DATE: 27 January 1989

CHANCELLOR

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Riley
Mrs Chaplin

PS/IR

Thanks. Much of the same for me, there can appear so. I will come @ a later stage.

CT THRESHOLD FOR SMALL COMPANIES

PS. In para (ii) below, £100,000 has been £45,000. How would this affect X and cost?

Mr Allan's note below.

2. Briefly:

- X is 470,000;

- the option would cost much more than the Scorecard proposal: possibly about £250 million in a full year instead of £70 million;

- it would benefit <u>all</u> companies with profits of less than £575,000, whereas the Scorecard option does nothing for those below £100,000 (because they are already on the small companies' rate);

- it would give sweet shops and such like an incentive to incorporate;

- unlike the Scorecard proposal, it would not reduce the marginal rate for any significant numbers of companies.

3. Do you want more?

RC

ROBERT CULPIN

Robert 02.27.1.89

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: **FINANCIAL SECRETARY**
DATE: **27 January 1989**

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr JENKINS – OPC

Mr McGivern) IR
Mr Elliott)
PS/IR

Thanks. I w[oul]d like to do something for the unincorporated sector. How much w[oul]d this cost? N

CGT: SET-OFF OF TRADING LOSSES

As you asked, I have looked at David Young's suggestion that trading losses should, for unincorporated businesses, be offsettable against capital gains eligible for rollover relief. I don't think David's reason for this measure, namely to help ailing businesses, is very peruasive. But we could, in my opinion, do this if you particularly wanted to help the unincorporated sector.

The present dividing line between the tax regimes for incorporated and unincorporated businesses is somewhat arbitrary. The unincorporated sector has advantages such as retirement relief, the CGT exemption, and the ability to relieve trading losses against other personal income. The question is whether these advantages outweigh the inability to offset trading losses against capital gains.

The proposed relief would not apply to assets other than those eligible for rollover relief; that is largely business assets, not (for example) shares. The Revenue feel there would be a lot of difficulty in holding this line. It would be argued that it was illogical to force businessmen to sell assets rather than shares if a business was in trouble. And for many unincorporated businessmen, wealth is derived from, or tied up with, the business,for exmaple as collateral. Yet to allow losses to be set against a small businessman's holdings of ICI would be going too far.

There are other difficulties with it; the fact that most of the relief would go to farmers, and some widening of the perceived gap between unincorporated traders and (say) landlords, who are not allowed sideways relief for losses. But these are rather second-order issues, and are not insurmountable. I don't believe the present balance between incorporated and unincorporated is unreasonable. But as I say, the real issue is whether you want to do something for the unincorporated sector.

NL

NORMAN LAMONT

chex.rm/jmt/120 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 20 December 1988

26/1

PS/FINANCIAL SECRETARY

cc Mr Culpin
Mr Gilhooly
Mr Michie
Miss M Hay

LORD YOUNG'S BUDGET REPRESENTATIONS

The Chancellor has seen Lord Young's letter of 15 December.

2. One of the suggestions which Lord Young makes relates to CGT and business losses. Companies can offset trading losses against total profits including capital gains of the same or preceding periods. Unincorporated traders, however, cannot offset trading losses against capital gains. Lord Young proposes aligning the treatment of unincorporated traders with companies. He suggests that this might be restricted to gains eligible for rollover relief. This is a new proposal aimed at isolating business from personal gains. The Chancellor would be most grateful if the Financial Secretary could look carefully at this proposal, which he thinks may be a starter.

J M G TAYLOR

pf.dc.FP.2 CONFIDENTIAL

FROM M HAY
DATE 19 DECEMBER 1988

PS/CHANCELLOR Thanks

cc Mr Culpin
Mr Gilhooly
Mr Michie

LORD YOUNG'S BUDGET REPRESENTATIONS

/ letter behind.

You asked for a few lines on each of Lord Young's Budget representations. Mr Michie has supplied the notes on the indirect taxes.

MISS M HAY

PS. I wd be grateful if FST wd look carefully @ stamp duty. many

LORD YOUNG: BUDGET REPRESENTATION

A MAIN POINTS

(1) General

Argues for cautious Budget stance.

Measures to encourage savings - "Budget for savers" (mentions PEPs but no specific proposals).

(2) Training

(a) Proposes extension of extra statutory concession (and put on statutory basis) giving an employee tax relief for incidental expenses of training courses of 4 weeks or longer where employer pays basic fee. Extension to cover all employer funded courses.

(b) Proposes new relief for employee financing his own professional or management training - possibly limited to pursuit of approved qualifications.

Comment: Similar proposals resisted in the past.

(a) ESC works well in practice no general pressure to legislate or to extend relief. Expenses concerned are likely to be small.

(b) Policy has been to target relief on employer sponsored courses since these are likely to be of most benefit in employee's job. New relief for employees own costs could be very expensive if not closely targeted.

(3) Collaborative R&D

Proposes that R&D carried out by a consortium which is not yet trading should be deemed to be trading so that relief for initial costs can be obtained against consortium members' other profits.

Comment: Treasury Ministers have resisted this in the past (put forward by DTI in 1987 and 1988) because (a) little hard evidence of much likely additionality rather than deadweight cost for R&D going ahead anyway; (b) relief would run counter to 1984 reforms which were intended to remove distortions and special tax breaks.

(4) Company cars

Argues for restraint in pushing up car scales to protect "middle managers" (who have not benefited substantially from cuts in tax rates), although accepts case in logic for increasing car scales to improve neutrality.
If car scales to be significantly increased, then argues for removal of restrictions of writing down allowances for expensive cars and for allowance against VAT on company's products and services of input VAT on purchase of cars.

Comment: Ministers currently considering four options on company cars (including WDA point) in light of detailed Revenue note.

The blocking of input VAT on cars has been maintained mainly for revenue reasons and yields some £700 million annually and if deduction were allowed, it could be difficult to exercise effective control on private use.

(5) Unleaded petrol

Lord Young proposes increased tax differential between leaded and unleaded petrol.

Comment:

1987 Budget

- tax differential of just under 6p per gallon introduced
- in next twelve months the number of garages selling unleaded petrol rose from about 200 to over 700;
- but unleaded petrol still accounted for only 0.1 per cent of all petrol sales.

1988 Budget

- tax differential increased to around 10.6p per gallon (pump price of unleaded is, on average, 5.3p cheaper than 4 star, and 1.9p cheaper than 2 star)
- since then, the number of garages selling unleaded petrol has increased to around 3,000;
- but unleaded petrol still accounts for less than 2 per cent of all petrol sales.

Other measures to promote unleaded petrol

- DTI reviewing the price marking rules to make space for unleaded petrol prices to be displayed;
- Department of Environment will be encouraging motor dealers to improve the quality of advice which they give about which cars can run on or be modified to take unleaded petrol.

(6) Company purchase of own shares

Proposes that purchases of own shares through a market makers should be exempt from rule which treats POS as a distribution and therefore liable to ACT.

Comment: This would be major break from imputation system and could distort decisions on dividends versus POS. Ministers inclined not to act but to keep situation under review.

(7) Stamp duty

Proposes abolition of stamp duty and stamp duty reserve tax to maintain London's competitive position.

TECHNICAL TAX POINTS

(1) CGT and business losses

Companies can offset trading losses against total profits including capital gains of the same or preceding accounting periods.
Unincorporated traders cannot offset trading losses against capital gains. Lord Young proposes aligning treatment of unincorporated traders with companies. Possibly applying only to gains on assets qualifying for "rollover".

Comment: Difficult to justify allowing set-off of trading losses against gains in addition to £5000 exemption available to individuals. Suggestion of restricting new rules to gains eligible for rollover relief is a new one aimed at isolating business from personal gains. But still difficult to justify such a change in rules for unincorporated traders in isolation. They benefit from other differences in incorporated/unincorporated tax rules.

(2) Entrepreneurs scheme

Supports consideration of British Venture Capital Association's proposed relief from CGT of gains in investment of up to £120,000 in any year by director or employee in unquoted company.

Comment

FST has considered Revenue starter and recommends its rejection.

DEREGULATION

(1)VAT Threshold scheme

Lord Young encourages adoption of this scheme.

Comment: This is covered by starter 35 and would considerably simplify the rules relating to when a business must register for VAT by having a single threshold based on turnover in the previous 12 months. Revenue cost is thought to be in the region of £120 million in a full year (£20 million-£40 million more than Lord Young estimates).

(2) Bad Debt Relief

Lord Young proposes extension of bad debt relief to put VAT on same basis for income and corporation tax.

Comment: This is covered by starter 37. Except where traders use cash accounting or a retail scheme, they are liable to pay VAT on their sales whether or not their customers pay them; relief for bad debts is available where the customer becomes formally insolvent. There is a public undertaking to review the existing bad debt relief provisions. A move to a more comprehensive form of relief would be widely welcomed but would cost £150 million in a full year.

(3) Default Surcharge

Lord Young proposes maximum surcharge to be limited to an amount approximately equivalent to a commercial rate of interest.

Comment: This is covered by starter 38. Experience suggests that by the time a trader reaches a surcharge of over 20 per cent, he has moved from the "won't pay" to "can't pay" and the even higher surcharge rates do little practical good. Reducing the maximum surcharge rate from 30 per cent to 20 per cent would cost £20 million in a full year.

(4) VAT Cash Accounting

Lord Young hopes that if existing review of cash accounting identifies a need for legislative changes, these will be included in the 1989 Budget.

Comment

As Lord Young indicates, take-up of the scheme has been very poor - but there are no obvious reasons why this should be so. The EST is awaiting a report from Customs.

(5) Free-standing AVCs

Lord Young concerned about compliance burden on employers - they have to certify that an employee wishing to take out FSAVCs will not be likely to breach the $2/_3$ pension limit. DTI are aware of FST's review of administration of FSAVC rules.

Comment: Ministers are considering range of options for easing FSAVC rules and associated administration - from minimal administrative measures, to relaxation of benefit limit tests and tax on refund of any surplus contributions.

YOUNG - CX
15 DEC
1989 BUDGET

dti
the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

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

CH/EXCHEQUER 16/12
REC. 16 DEC 1988
ACTION Mr. Michie
COPIES TO

Department of Trade and Industry
1-19 Victoria Street
London SW1H 0ET
Switchboard 01-215 7877
Telex 8811074/5 DTHQ G
Fax 01-222 2629

I'd like IR & (where relevant) C&E comments on these proposals ASAP.

Direct line 215 5422
Our ref PB4AGZ
Your ref
Date 15 December 1988

Dear Nigel,

1989 BUDGET

I would like if I may to comment on your 1989 Budget and to suggest measures you might like to consider for inclusion in that Budget which I consider would contribute to a further improvement in the supply potential of the economy.

This year the supply side response has been particularly encouraging with output, productivity and investment surging ahead. Business confidence is high. But demand has been growing at an even faster, unsustainable, rate resulting in increased inflationary pressures and a rapid deterioration in the external balance. I agree that policy should be to concentrate on reining back the growth of domestic demand to a more sustainable level but, at the same time, we need to be careful not to damage business confidence and supply potential. There are already some signs that the increases in interest rates are beginning to have their desired effect.

Of course, high interest rates and the associated strengthening of sterling are not an ideal combination, either for business or to improve the current account, although I accept that it is the price that has to be paid to squeeze out the upsurge in inflation. But I would urge, in these circumstances, a very cautious stance on the 1989 Budget even to the exclusion of a further cut in income tax. A restrained fiscal policy will yield a more balanced policy mix and holds out the best hope of containing both interest and exchange rates and restraining the growth of domestic demand whilst sustaining business confidence and supply potential. I am sure that such an approach is in the best long term interests of business.

In addition to commenting on personal savings, my suggestions for the Budget are primarily cost-effective measures designed to improve the supply responsiveness of the economy while adding little or nothing to domestic demand.

In my view measures to encourage an increase in personal sector savings could have an important influence on industrial performance. The sharp drop in the personal sector saving ratio means that personal sector savings in relation to income are at very low levels. Of course, given the state of the national accounts it is very difficult to be at all certain about how far the ratio has fallen, but it is certainly true that savings have been much lower than expected and conversely that consumption has been much higher than expected. This has been a key factor in explaining the much faster than anticipated growth in domestic demand which, in turn, has led to a build up of inflationary pressures and the sharp deterioration in the current account. The necessary response has been a tightening of monetary policy with higher interest rates and stronger sterling. A higher level of personal saving would produce a better and more sustainable relationship between demand and output in the economy, thus easing inflationary pressures and allowing a reduction in interest rates.

It is impossible to be certain why the savings ratio has slumped so far: lower inflation, improved consumer confidence, rising employment, pensions, holidays and the increased wealth (particularly stemming from the increased value of the housing stock) are all important. Some of these factors are cyclical and likely to be reversed as the economy slows and most commentators expect the savings ratio to increase in the next year or so. But any further measures to increase household savings would be welcome and should allow the same level of economic growth with a lower level of interest rates.

You have already announced your intention of introducing a new National Savings instrument in the new year. But national savings constitute only one small component of savings. I note that the Treasury have recently invited suggestions on ways of making Personal Equity Plans more popular. A "Savers Budget" would be a prudent use of a small part of the large fiscal surplus likely next year. Thus consistent with my letter of 1 December on taxation of personal savings and life insurance I would strongly support more general tax encouragement of savings.

TRAINING

I remain very concerned about the low level of vocational training in this country by comparison with our main competitors. A number of improvements have been made in publicly funded training schemes, and Norman Fowler is proposing improvements in the delivery mechanisms. But the fiscal environment must have a strong influence on the amount and quality of training undertaken in the private sector. When training is financed by the employer, our tax treatment is as favourable as that in most other countries. But there is one improvement I should like to suggest. Where an employer pays for a training course for his employee, the employee sometimes has to meet some incidental expenditure himself, the latter cannot be set off against the employee's tax liability.

An extrastatutory concession allows the employee to claim a deduction where the course is a full time one of at least four weeks' duration. But it would be helpful if this provision were given statutory force, and if its scope could be widened to cover all courses where the cost of the training itself is met by the employer. This would be in line with the general trend towards more varied and flexible training modes, including open and distance learning.

I turn now to training financed by the individual. I supported last year a proposal by Kenneth Baker that expenditure by members of professional institutions on continuing professional development should be allowable against tax; and myself proposed that an individual's expenditure on his own management education should be allowable, with a facility to carry forward unused relief to set off against future income. I still consider that these two changes would give good value in stimulating additional high quality training. But they would still leave our tax treatment of training financed by the individual less generous than that in any other European country. I know that concessions in this area are not easy, because they are open to abuse by people claiming relief for courses with no real vocational function. This might be overcome by limiting relief to courses taken in pursuit of approved qualifications; or by limiting the amount any individual could claim by way of tax relief for his expenditure on training.

COLLABORATIVE R&D

When I wrote to you a year ago about the 1988 Budget, I proposed the extension to consortia set up to undertake collaborative R&D the tax treatment enjoyed by trading consortia - notably the ability to set off initial losses against profits achieved by consortium members on their other business. This would be achieved, (subject to appropriate safeguards, already discussed between officials) by deeming R&D to be a trading activity for the purposes of consortium relief. My predecessors had also urged the merits of this suggestion, and I remain convinced of its value. It is not primarily an incentive to firms to carry out more R&D. Rather, it removes a feature of the tax system which discriminates in favour of "in house" R&D by big companies, and against collaborative R&D. The change would therefore support the new direction my Department's innovation policy is seeking to encourage. It would also have the following advantages:

a) it would encourage two or more companies to set up joint subsidiaries to undertake R&D which was too risky, or too demanding in resources, for them individually;

b) companies would be encouraged to "spin out" R&D projects peripheral to their main activity into separate companies in which others could have an equity stake. At present, such projects too often remain "on the shelf";

c) financial institutions would be enabled to invest in an R&D company on the same basis as they can invest in a trading company; and

d) there would be a convenient new vehicle for collaborative research, not only between companies, but between companies and education institutions.

The cost would depend on take up, but is most unlikely to be significant. I hope that you will examine the case for the proposal seriously.

COMPANY CARS

In your last Budget, you increased sharply the car benefit scales, and indicated that you intended to make further increases in real terms. I accept the case in logic for greater neutrality between the taxation of company cars and other forms of remuneration. But I am concerned about the impact. The effect of higher benefit scales will be felt most sharply by middle management in the private sector, on salaries somewhat below the threshold for higher rate tax. This group has benefited rather modestly from our tax cuts, and higher mortgage interest rates have hit them hard. I do wonder if this is the right time to increase the tax burden on their company cars, particularly if there are few if any cuts in general taxation to soften the blow.

If and when you do increase car benefit scales, I hope that you will take the opportunity to introduce full neutrality into the tax on company cars, by ending the limitation on the rate at which expenditure on so-called "expensive" cars is written down, and discontinuing the rule that input VAT on a company's purchases of cars cannot be offset against output VAT on the company's products and services. These restrictions impose both a tax and a significant regulatory burden on companies; and once the incentive for employers to give remuneration in the form of a company car rather than cash disappears, there will be no reason to treat cars differently from other business assets for tax purposes.

UNLEADED PETROL

You will be urged to increase the tax differential in favour of unleaded petrol, given the heightened concern about the environment and the very small number of retail outlets selling unleaded petrol even now. Hitherto, this Department has not favoured using the tax system to promote the use of unleaded petrol, since the majority of models sold by the Rover Group are difficult to convert to the use of unleaded petrol. But despite this, I now believe that it would be right to widen the tax differential in favour of unleaded petrol.

COMPANY PURCHASE OF OWN SHARES

Last year, I suggested a relaxation in the tax arrangements arrangements where a company, with the approval of its shareholders as required under the Companies Acts, purchases its own shares. At present, such purchases are treated for tax purposes as distributions, with a very limited exception confined to unquoted companies. I remain convinced that a company ought to be able, without tax penalty, to organise repurchases of its own shares where it feels that the market is undervaluing them. Simply to abandon the present treatment of purchase of own shares as a distribution could lead to avoidance if companies operated repeated small share purchase programmes instead of paying dividends. This could be avoided if the only transactions exempted from Advance Corporation Tax were those carried out on the market through intermediaries. The requirement to obtain consent from the shareholders for any programme of company share purchases should remain, as should the law against wrongful manipulation of share prices.

STAMP DUTY ON SECURITIES TRANSACTIONS

You have reduced this duty successively from 2% to 0.5%. On each occasion, the result was an increase in the yield thanks to the expansion of the volume of trading. But since the October 1987 crash volume has fallen sharply. The International Stock Exchange is still handicapped on its competition with New York and Tokyo by being the only centre of the three where securities are subject to a transaction tax. Other EC Governments are considering ways in which they can increase the attractiveness of their own financial centres in the run up to 1992. (The recent Lebegue report on the French system of taxation of financial assets included a recommendation that the French abolish their stamp duty on stock exchange transactions.) I note that the Chairman of the Stock Exchange in his representations to you on the 1989 budget drew particular attention to the implications of 1992 in expressing concern over the continued imposition of stamp duty. London will face increasing competition for its role as the key financial centre in the European time zone. It would greatly help London to maintain and enhance her competitive position if stamp duty on securities was finally removed, and with it the 1.5% Stamp Duty Reserve Tax.

I have written to you separately about the Inland Revenue proposals for changes in the tax regime for individuals who are resident but not domiciled in the UK; about the tax treatment of all forms of personal saving, in the context of Inland Revenue proposals for a new tax regime for life insurance companies; and I am currently considering together with Kenneth Baker writing to you about the tax treatment of gifts to educational institutions.

I also have a number of more detailed proposals, which are set out in the memorandum enclosed with this letter.

I am copying this letter to the Prime Minister, to Norman Fowler and Kenneth Baker, and to Sir Robin Butler.

Yours
David

ANNEX

1 This Annex includes:

i) two more detailed tax points; and

ii) four deregulation points

I TAX POINTS

A CAPITAL GAINS AND LOSSES OF BUSINESSES

2 Private individuals are subject to separate Income Tax and Capital Gains Tax. Capital losses cannot be offset against income, nor can expenses be set off against capital gains. For companies, both trading profits and capital gains are subject to corporation tax, at a common rate; and trading losses of the same year (but not earlier years) can be offset against that year's capital gains. But capital losses may never be set off against trading profits.

3 This separation of profits and gains is a long-standing source of complaint from business who argue that the distinction between trading profits and capital gains is artificial in a business context, and can lead to harmful decisions. For example, a loss-making retailer may go out of business sooner than would be necessary if he could sell some valuable property and offset his losses against the resulting gain.

4 It is proposed that the limited degree of cross-offsetting already permitted for companies should be extended to unincorporated business. This would end a form of discrimination against unincorporated businesses; and the cost would not be heavy. There would be no need to draw new distinctions between the business and personal affairs of an unincorporated trader if the trading losses were allowable only against capital gains eligible for CGT rollover relief.

B ENTREPRENEURS SCHEME

5 The rapid growth of the venture capital industry in recent years has greatly improved the supply of equity finance for new businesses. The British Venture Capital Association (BVCA) now believe that the main constraint on further growth is not finance as such but the dearth of experienced managers willing to involve themselves in new companies with high growth potential. Paradoxically, the tax changes in the last Budget have not helped. The reduction in the higher rates of Income Tax, and the alignment of Capital Gains Tax rates with Income Tax, have reduced the attractions of the gains from successful participation in venture capital; and increased those of the salaries available in secure jobs in big companies.

6 At present, reliefs under the Business Expansion Scheme (BES) are not available to investors who are directly involved in

managing the company. The reasons are deadweight, and the risk of avoidance. The BVCA have put forward what is in effect a variant of BES for the managers and employees of unquoted companies. The initial investment would not be relieved of Income Tax (unlike the BES proper), but any gains on the disposal of shares would be exempt from Capital Gains Tax; the maximum qualifying investment in any year would be £120,000 (against £40,000 for the BES), but anyone claiming relief under this scheme would be debarred for up to three years from taking advantage of the BES proper. Most of the conditions for BES relief would also attach to the new scheme; but two would be relaxed. The rule against a change of ownership of the company during the qualifying period would not apply; neither would the condition that any subsidiaries must be at least 90% owned by the company receiving the investment.

7 The DTI cannot assess the technical feasibility of the BVCA proposal. But we urge that it be examined carefully; and that Treasury Ministers should give serious consideration to this, or other possible, fiscal incentives to experienced managers to participate in the launch of new unquoted companies.

II DEREGULATION POINTS

C VAT THRESHOLD SCHEME

8 EDU have been discussing with Customs and Excise ways of mitigating the effect on small traders of the way the VAT threshold is operated. At present traders have to register as soon as their turnover passes certain quarterly limits or if they expect their turnover to exceed the threshold in the following 12 months. The Customs have proposed the abolition of the quarterly turnover limits and the 12 months forward look; traders would register only when their turnover actually passed the registration threshold. Under this proposal traders would be able to benefit by having up to 12 or 13 months tax-free trading if they wished. Traders who found it advantageous to register straight away would still be able to do so. The cost of this has been estimated at £80-100m per annum. The DTI support the prompt implementation of this proposal.

D VAT REVIEWS

a) Bad Debt Relief

9 VAT is accounted for on the basis of invoice sales rather than cash receipts (unless the business has a turnover under £250,000 and can opt for cash accounting in which case see Item E). Relief in respect of VAT on debts which turn out to be bad is only available if the customer becomes formally insolvent. A form has to be signed and stamped by the Official Receiver acknowledging the claim before any relief can be granted. In contrast the Inland Revenue allows bad debt relief for income tax and corporation tax by reference to standard accountancy practice for the type of business involved. The Inland Revenue's approach is practical and realistic. The DTI suggest that Customs & Excise should introduce a similar system.

b) <u>Default Surcharge</u>

10 Where two VAT returns from the same trader have been received late by Customs & Excise in a 12 month period he becomes liable to the penalty regime. Any further late VAT return in the following 12 months triggers a default surcharge of 5% of the VAT payable on that return. For any subsequent late return the surcharge increases in steps of 5% up to a maximum of 30%. There has to be a system to deter habitual late payers. But the rate of the surcharge particularly at the maximum level gives cause for concern. As long as the "offence" is simply one of late payment, without any evidence of intent to defraud, it would be sufficient to set the level of the maximum surcharge so that it is approximately equivalent to a commercial rate of interest.

11 At the initiative of EDU, both the above systems are presently being reviewed by Customs & Excise. DTI hope that any proposals for change flowing from these reviews be included in the 1989 Finance Bill.

E VAT CASH ACCOUNTING

12 The 1987 Budget introduced a new scheme to simplify VAT for small traders. Businesses with turnover of up to £250,000 have the option of accounting for VAT on the basis of cash receipts and payments rather than invoiced sales and expenditure. This means that small businesses need not have to pay VAT on unpaid sales invoices.

13 The new scheme has not had as good a level of take up as had been hoped and Customs and Excise are to review it at the end of this year.

14 DTI hope that if the review identifies a need for legislative changes these will be included in the 1989 Budget.

F FREE STANDING ADDITIONAL VOLUNTARY CONTRIBUTIONS (FSAVCs)

15 Members of occupational pension schemes may top up their pension entitlement under the scheme by making FSAVCs, provided that their pension provision as a whole does not exceed the Revenue limits for tax relief.

16 The arrangements needed to police these limits place a burden both on the pension provider who must confirm that total contributions do not exceed 15% of salary; and the employer, who must certify that total pension benefits do not exceed two thirds of final salary. The Inland Revenue do not think it practicable to transfer to the individual pensioner responsibility for ensuring that the limits are not exceeded; but the Financial Secretary has promised to review procedures to see if the burden of compliance can be reduced. The DTI hope that this review can be completed soon, and any resulting changes implemented as quickly as possible.

Department of Trade and Industry
November 1988

chex.ps/jmt/64

BUDGET

CONFIDENTIAL

FROM: J M G TAYLOR

DATE: 30 January 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr McGivern - IR
Mr Elliott - IR
PS/IR

CGT: SET-OFF OF TRADING LOSSES

The Chancellor was grateful for the Financial Secretary's note of 27 January.

2. He would like to do something for the unincorporated sector. How much would this relief cost?

JT

J M G TAYLOR

chex.ps/jmt/64

BUDGET

CONFIDENTIAL

FROM: J M G TAYLOR

DATE: 30 January 1989

6/2/2

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Gilhooly
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Mr McGivern - IR
Mr Elliott - IR
PS/IR

CGT: SET-OFF OF TRADING LOSSES

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J M G TAYLOR

CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

From: M J G ELLIOTT
Date: 19 January 1989

1. MR McGIVERN   Note at end   19/1

2. FINANCIAL SECRETARY

CAPITAL GAINS TAX: SET OFF OF TRADING LOSSES

1. One of the more detailed tax points in the Annex to Lord Young's Budget representations letter of 15 December to the Chancellor is a proposal to liberalise the arrangements under which trading losses can be set against capital gains. We understand that the Chancellor has asked you to consider this as a possible starter.

2. The proposal is that trading losses made by unincorporated businesses should be available for set-off against capital gains eligible for roll-over relief (ie broadly, gains on disposals of business assets, including land and buildings, plant and machinery, and goodwill).

Present position

3. For both income tax and corporation tax purposes a trading loss can be carried forward indefinitely for set-off against future trading income arising from the same trade.

4. A trading loss made by an unincorporated trader may also be set-off against other forms of income (not capital gains)

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Monck
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Isaac
Mr Painter
Mr Bush
Mr Cleave
Mr Pitts
Mr McGivern
Mr Elliott
Mr Cayley
Mr Hamilton
Mr Campbell
Mr Keelty
Miss Brand
PS/IR

received by the trader in the year in which he makes the trading loss or in the following year. A trading loss of a company, however, can be set against the company's total profits (ie other forms of income and capital gains) arising in the accounting period when the loss is made or in the period immediately preceding it.

5. A capital loss cannot be set off against trading income either in the case of an unincorporated trader or in the case of a company.

Lord Young's views

6. Lord Young's paper says "This separation of profits and gains is a long-standing source of complaint from business who argue that the distinction between trading profits and capital gains is artificial in a business context, and can lead to harmful decisions. For example, a loss-making retailer may go out of business sooner than would be necessary if he could sell some valuable property and offset his losses against the resulting gain".

Comments on the proposal

7. The provision of relief to enable trading losses to be set against capital gains could be presented as a useful measure to help the unincorporated sector. It seems reasonable in principle that an unincorporated trader should not have to distinguish between his trading income and capital gains, when there is no such distinction for companies.

8. There are one or two other considerations, however. First, a new relief for losses would be of most help to failing or uneconomic businesses. That might be a little difficult presentationally. Looking at Lord Young's example, it would arguably be better for the loss-making retailer to go out of business sooner rather than later, both in the interests of the

economy as a whole and from the point of view of the retailer himself. It would also mean that a significant proportion of the cost of the relief (paragraph 11 below) would be deadweight.X In practice, many beneficiaries of the extended relief would be farmers making losses but sitting on potentially large gains on land with development value (farmers have of course already benefited from the 1988 capital gains tax reforms, especially re-basing).

9. Second, this new relief would go further than bringing the regime for unincorporated businesses into line with companies; it would tip the balance in favour of the unincorporated, notwithstanding Lord Young's proposal to limit the widened set-off to gains eligible for CGT roll-over relief (ie gains on business rather than personal assets). This is because -

- the CGT annual exemption applies to trade - related gains of unincorporated traders, while companies have no annual exemption;

- individuals can get CGT retirement relief on trading assets;

- individuals can set trading losses against personal income totally unconnected with their business. (So, incidentally, there would no doubt be pressure to extend this relief to any capital gains and not just gains on business assets).

10. The new relief would also widen the perceived gap between unincorporated traders and people who make non-trading losses - eg landlords.

Exchequer Cost

11. Our information about unrelieved losses is far from comprehensive, though we estimate that about two-thirds of all such losses are incurred in agriculture. And it is hard to

X in the sense that Lord Young sees it as delaying the final closure judge what the take-up of this relief might be. Furthermore, decisions would be needed on how widely the relief would run (see paragraph 17 below) and these could have a significant impact on the cost. Given these uncertainties, we cannot attempt a very precise estimate, but - as a broad indication - the full year cost might be in the range £50-100 million.

Staff cost

12. The same uncertainties apply here, and it is very difficult to make any sensible estimate. But the cost would probably lie somewhere between 10 and 20 units, at Inspector level: and you know of the difficulties here.

Length of legislation

13. The existing loss reliefs are a cat's cradle of intertwined provisions. It might be possible to adapt and extend the existing provisions which allow set-off of losses against other income. If not, we would need a free-standing provision with specific rules about eg order of set-off, elections to have a loss set off against gains rather than future profits, etc. Either way, we think at a minimum we should need a page of legislation and almost certainly more.

Conclusion

14. There are some presentational attractions in this proposal, which would help unincorporated traders at a time when the going can be rough. But at the same time it looks a little strange to provide a tax relief to prolong the agony for businesses which are already nearing the end of the road; there would be nothing much in the relief for the arguably more deserving case of the successful business which suffers only a temporary drop in profits.

15. The largest beneficiaries would be in the agricultural sector. Looking at that sector specifically, there may be something of a case for giving relief to a working farmer who in recent years has invested in new equipment and perhaps bought more land, but who now feels obliged by Government policies to cut back production at a time when his farming activities are showing a loss and accordingly sells off some land.

16. But the same considerations would not apply in the case of a hobby farmer who made a windfall gain by selling off a piece of land ripe for development. It is not easy to see any reason why he should be able to set his gain against his hobby farming losses - or indeed against any other trading losses he might have, say as a Lloyd's underwriter.

17. These two contrasting examples suggest that, if you are attracted to this proposal in principle, we shall need to consider carefully with you the sorts of circumstances in which you would want the relief to run; and inevitably cutting out the undeserving would add to the length of the legislation.

MJE.

M J G ELLIOTT

The read across to the rules for companies is perhaps uncomfortable; but the benefits are not all one way, as the brief analysis in para 9 brings out. And there will be some very tricky dividing lines to be drawn - paras 10 + 16. All in all the case for the extension does not seem very compelling.

[signature] 19/1

cst.rj/docs/27.1.3

BUDGET CONFIDENTIAL

FROM: A G TYRIE

DATE: 31 January 1989

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Matthews
Mr Culpin
Mrs Chaplin
Mr Call

CORPORATION TAX DEPRECIATION ALLOWANCES

I obtained a copy of Robert Culpin's note of 20 January yesterday, via Judith.

2. I agree with Robert that we have to reduce the main rate of CT, but not this year. We have a 10% differential between the treatment of interest and dividends, creating a preference for debt over equity finance. Of course with the pre-84 regime that gap was enormous but briefly we got it down to 5%.

3. On the possibility of indexing depreciation allowances, I think that, apart from the staff costs, a strong argument against is that indexation reduces the company sector's aversion to inflation. Money illusion is alive and kicking. We need to keep a chorus of allies who are inflation averse.

4. Depreciation allowances are probably too generous. But the time to reduce them would be in conjunction with a further significant drop in the CT rate, possibly at the start of the next Parliament. Many of our backbenchers still bleat from time to time about the capital allowances reform. So perhaps it is too soon to tamper with this area again.

AGT.

A G TYRIE

Inland Revenue

Business Tax Division
Somerset House

BUDGET CONFIDENTIAL

FROM: J H REED
EXT: 6442
DATE: 1 FEBRUARY 1989

1. ~~Mr McGivern~~ 1/2
2. Mr Isaacs 1.2
3. Chancellor of the Exchequer

CT THRESHOLD FOR SMALL COMPANIES

You asked Mr Culpin for advice on the following proposal, as a possible substitute for the existing proposal on raising small companies' thresholds

i. first £5,000 of profits tax free;

ii. next £100,000 at 25 per cent;

iii. next £x at 37 1/2 per cent;

iv. the remainder at 35 per cent.

£x would be the amount which would exactly claw-back the benefit of i. and ii. from a company with larger profits (in fact it would be £470,000).

2. Mr Culpin's note of 27 January (copy attached) briefly listed some of the main consequences of the proposal and Mr Taylor's note of 27 January records that the Chancellor thinks there is much to be said for this proposal if it can be afforded.

3. This note offers further advice.

Companies to be included

4. We assume that the measure would be intended to help trading companies but not close investment companies. So these would be excluded whether or not they passed the distribution test (Starter 206: close company legislation).

5. The profits limits for the small companies rate of CT and for the marginal relief are reduced where the company has "associated companies". This prevents someone getting an advantage from dividing activities between several companies. We assume that the same rule would apply to reduce the £5,000 exempt slice.

Cost

6. Looking first at existing companies, there are between 200,000 and 250,000 companies currently paying the small companies rate of CT and another 20,000 obtaining marginal relief. All of these would benefit to some extent, except for the close investment companies (but these are a small minority). Not all would benefit from the full £5,000 exempt slice, either because their profits were not large enough after taking into account payments of remuneration and dividends (just over half of the companies have profits of less than £5,000) or because they had associated companies. But we think a reasonable estimate of the short-term tax cost would be about £250 million (this is the source of the figure quoted by Mr Culpin). The cost would not be significantly different if the 25 per cent band were reduced from £100,000 to £95,0000 (Mr Taylor's note of 27 January). The 37 1/2 per cent band would then be £450,000 wide.

7. The longer-term cost in respect of these companies would be less because tax would be payable if and when the owners of the company sought to make use of the money retained in the company. If they took it out as remuneration or dividends tax would be payable in the normal way. Of course, in many cases the retained profits will be used to build up the business and so in practice

will never be paid to the shareholders. But if they eventually decide to sell the business by selling their shares in the company the (real) capital gain would reflect the retained profits - although the retirement relief or death exemption might reduce or eliminate the tax liability. In terms of the longer-term tax consequences there are similarities with the position of close investment companies once apportionment has been abolished. But here there is unlikely to be any increased tax liability in retaining the money in the company even if it is eventually paid out. And even if the same amount of tax is ultimately payable, the company will have had the use of the money in the mean-time.

8. It follows that where the owner of a company wants to save money, or use it for capital expenditure, the exempt slice would give him a real benefit, even if only by delaying payment of tax. We therefore think it likely that some owners of companies which currently do not pay corporation tax (usually because the company's income is paid out as director's remuneration) might wish to take advantage of this benefit by leaving some of the income in the company. It is very difficult to quantify this but if, say, each of the 600,000 companies concerned retained profits of £1,000 the cost would be a further £150 million assuming the distributed profits would otherwise have been liable at the basic rate (in practice, there would have been some higher-rate tax and some NIC liability).

9. Some unincorporated businesses might choose to incorporate to take advantage of the exempt slice. Again, this is difficult to quantify. But if, say, 100,000 out of the 3 million self-employed chose to incorporate and retained profits of £5,000 the additional cost would be £125 million.

10. Finally, there is the possibility that some existing employees might set up companies, either to provide their services to their current employer or to become more independent (perhaps finding work through an agency). This happens already and people in some industries (eg computers) might find this attractive. However, it seems reasonable to assume that, at least in the short-term, this effect would not be substantial in

relation to the cost in respect of existing companies and unincorporated business.

11. If there were no behavioural changes, the effect of the proposed change would be that about 200,000 companies would pay £1,250 each less in tax (costing £250 million). The money saved could be reinvested in the company's business or used to pay off borrowings, invested (for example in a bank account) or withdrawn from the company (in which case more tax would be payable).

12. To the extent that existing companies (particularly the 600,000 currently paying no tax) increased their retentions this might increase business investment or at least reduce consumption. But to some extent it would displace personal savings. The same would be true of unincorporated businesses which incorporated.

Reaction of the unincorporated sector and employees

13. While some people would incorporate their businesses others would be reluctant, perhaps because of the costs involved. Those which did not incorporate would be likely to complain that they were being disadvantaged. They would press for a similar exemption for unincorporated businesses. And you will recall that the Conservative Smaller Businesses Committee in proposing a £5,000 exempt slice for companies said "An equivalent allowance should be made for unincorporated businesses". Conceding this would cost over £1 billion extra. And it would greatly increase the pressure from people that we currently tax under Schedule E to be reclassified as Schedule D. Furthermore even those who accepted that they were correctly classified as Schedule E might complain that there was no justification for favouring Schedule D taxpayers.

14. We do not see any satisfactory answer to these criticisms, nor any way of extending a similar relief to the one for companies to some taxpayers without increasing the sense of grievance felt by other taxpayers. Essentially, the problem is that we do not see the justification for a £5,000 exempt slice for companies. The underlying purpose of corporation tax is to

prevent profits retained by companies escaping taxation. Business profits made by a company are therefore taxed in broadly the same way as the profits of an unincorporated business. And of course the shareholders have the same entitlement to personal allowances and reliefs as self-employed businessmen. So the present system provides approximate parity of treatment. Giving companies a special £5,000 exempt slice would clearly break this parity.

Conclusion

15. The proposal would be simple to draft and to administer. It would, depending on behavioural changes, probably cost around £500 million (although we would want to do more work on this costing) and it is unclear to what extent this would lead to increased business investment or reduced consumption. But the main objection we see is the difficulty of defending the proposed system against criticism from unincorporated businessmen and Schedule E taxpayers.

for J H REED

fp.pk/rc/1989/27.1.01

BUDGET CONFIDENTIAL

3cc

FROM: ROBERT CULPIN

DATE: 27 January 1989

CHANCELLOR

~ Show C.D
cc Mr Reed
Ms St Quinton

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Riley
Mrs Chaplin

PS/IR

cc Mr McGiven

CT THRESHOLD FOR SMALL COMPANIES

Mr Allan's note below.

2. Briefly:

- X is 470,000;

- the option would cost much more than the Scorecard proposal: possibly about £250 million in a full year instead of £70 million;

- it would benefit <u>all</u> companies with profits of less than £575,000, whereas the Scorecard option does nothing for those below £100,000 (because they are already on the small companies' rate);

- it would give sweet shops and such like an incentive to incorporate;

- unlike the Scorecard proposal, it would not reduce the marginal rate for any significant numbers of companies.

3. Do you want more?

RC

ROBERT CULPIN

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Ch- You have the previous pps., I think

FROM: A J G ISAAC
1 February 1989

1/2

Thanks. No further work needs to be done on this proposal.

CHANCELLOR OF THE EXCHEQUER

SMALL COMPANIES: CORPORATION TAX

1. I am sorry that I did not recognise this proposal, when you raised it at Monday's Overview. Part of the explanation (as I surmised) was that Mr Taylor's minute of 27 January did not reach my office until after I had left for the Overview; and the correspondence of 25 January was treated here as a "private" enquiry, and not copied above desk level.

?

2. Turning to the substance, for the reasons that Mr Reed explains, we find it difficult to get a handle on the merits of this proposal. The company itself is not an individual, needing a "personal allowance" to cover its personal expenses. Its shareholders, directors and employees all will have personal allowances; which they can set against any income which they derive from the company.

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Byatt
Mr Culpin
Mr Riley
Mrs Chaplin
Mr Hardcastle (Chief Accountancy Adviser)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr McGivern
Mr Bush
Mr Campbell
Mr Fitzpatrick
Mr Reed
Miss St Quinton
PS/IR

3. If - in addition to these personal allowances - the company is to have a tax-free ration of £5,000, then it is difficult to see any economic or equitable reason to deny a similar tax-free ration to the self-employed, in addition to their normal personal allowances. The authors of this proposal themselves go out of their way to say that the arguments for it - to finance increases in working capital etc etc - apply with at least equal force to the unincorporated as to corporate businesses.

4. And, if so, very much the same argument for an exempt slice or increased personal allowance could then run for employment income - otherwise the already heavy pressures on the D/E borderline would surely become insufferable.

5. I understand from the Treasury that you may have it in mind to balance this distortion - the tilting of the playing field in favour of companies as against self-employed people - by the other new proposed concession for set-off of losses against CGT on certain defined gains. However:

(a) As is clear from paragraph 11 of Mr Elliott's note of 19 January, the two things are simply not of the same order of magnitude. Those costs are very uncertain but of the order of £50m-£100m. We may be looking here at potential costs - including behavioural costs, of the broad order of £500m and

(b) in any event, I am not sure that the "macro" costings help all that much at the "supply side" level of the individual trader. If he is trading profitably, he will be faced with a choice between

i. incorporating, and getting a £5,000 tax-free ration in addition to his personal allowances, or

ii. remaining self-employed, without a tax-free ration.

It will be of little help to say that he might derive some other advantage _if_ he was trading at a loss _and_ he had an unpaid CGT bill.

6. Of course, there are other differences between the tax treatment of companies and the self-employed - if only because corporate status does impose some differences. But this would be a particularly large and transparent new discrepancy, with no such justification in company law.

7. In brief, once you have reduced the small companies rate of corporation tax to the same level as the basic rate of income tax, I am afraid that I have not not understood the rational argument for - and I do see real "supply side" costs in distorting commercial decisions in - going further, until you can reduce both the small companies rate and the basic rate of income tax together.

Cfer

A J G ISAAC

chex.ps/jmt/77 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 2 February 1989

pmp

MR A J G ISAAC - Inland Revenue

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Hardcastle
Mr Scholar
Mr Byatt
Mr Culpin
Mr Riley
Mrs Chaplin

Sir A M W Battishill - IR
Mr Painter - IR
Mr Beighton - IR
Mr McGivern - IR
Mr Reed - IR
PS/IR

SMALL COMPANIES: CORPORATION TAX

The Chancellor was grateful for your note of 1 February, and for Mr Reed's note of the same date.

2. He has decided that no further work need be done on this proposal.

J M G TAYLOR

CONFIDENTIAL

BF 20/2

Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: L E JAUNDOO

DATE: 2 FEBRUARY 1989

1. MR PITTS 2/2

2. FINANCIAL SECRETARY

INHERITANCE TAX - THRESHOLD AND RATE
STARTER 259

1. This minute seeks a decision on the level of inheritance tax threshold and rate for 1989/90.

Background

2. Inheritance tax is charged at a flat rate of 40 per cent on all estates exceeding the current threshold of £110,000.

cc	Chancellor	Chairman
	Chief Secretary	Mr Painter
	Paymaster General	Mr Pitts
	Economic Secretary	Mr Bush
	Sir P Middleton	Mr Calder
	Sir T Burns	Mr Gonzalez
	Mr Scholar	Mr Jaundoo
	Mr Culpin	Mr Thompson
	Mr Gilhooly	Mrs Evans
	Mr Riley	PS/IR
	Mrs Chaplin	
	Mr Tyrie	

3. If no other action is taken, the threshold will be increased with effect from 6 April 1989 in line with the RPI increase for the year to December 1988, and rounded up to the next £1,000. The December RPI figure of 6.8 per cent produces a threshold of £118,000.

Estates and their yield

4. Table A below illustrates the expected distribution of the tax burden under the 1989-90 statutory indexed scale.

Table A

Range of Estates £000s)	Total Number of Estates	Number of Taxpaying Estates	Tax Payable £m
0- 118	237,381	0	0
118- 150	11,621	7,214	43
150- 200	10,268	6,391	135
200- 250	4,820	3,115	123
250- 300	2,741	1,873	110
300- 400	2,943	1,966	162
400- 500	1,433	1,157	138
500-1,000	1,800	1,287	230
1,000-2,000	424	325	117
2,000 and above	119	92	87

The table shows that more than 90 per cent of taxpaying estates would not exceed £500,000; and that this group would produce around 70 per cent of the tax. Estates of £300,000 and below would produce around £400m tax - roughly 40 per cent of the total yield.

Why look beyond statutory indexation?

5. The main criticisms of the IHT threshold are that

- it has failed to match increases in house prices, so that small estates containing little more than a house have been drawn into tax; and

- small to medium sized estates still pay more tax in real terms than they paid under a Labour Government in 1975.

If you wished to meet these criticisms indexation alone would not be enough.

House prices and the threshold

6. Over the past few years the prices of houses and shares have risen faster than the RPI and this has contributed considerably to the buoyant yields. Since the main components of taxable estates are houses and share prices, the number of estates liable to tax rises disproportionately when house and share price inflation moves ahead of the RPI. Annex 1 shows how house and share prices have risen since 1975 (when capital transfer tax came fully into effect) in comparison with the RPI (with estimates for 1988-89 and 1989-90).

7. In 1988-89 share prices have so far still dipped in value, but house prices have continued to outstrip the RPI. Although houses currently account for 35 per cent of the value of all estates over £110,000 in 1988-89, only 75 per cent of such estates include a United Kingdom residential property. Perhaps more relevant is Table B; this shows the components of those of the estates which include a UK house.

Table B

Components of all estates over £110,000 in 1988/89 which include UK residential property

	£ million	Per cent of whole
Houses and land	2,990	46
Securities	1,370	21
Business and Agriculture	150	2
Other	1,950	30
Total	6,460	

8. Table B shows that houses account on average for almost one half of the value of all estates with homes in the UK. Statistics Division advise that liquid assets (available to pay IHT) included in the rest of these estates are equal to about 30 per cent of their value. This suggests that generally such estates should have no difficulty in paying IHT on their homes, particularly since the tax attributable thereon can be paid by 10 annual instalments while the house remains unsold, though these are averages and in individual cases there may be a problem.

Small and medium-sized estates at a disadvantage

9. There is a further consideration. Houses account for a greater proportion of the assets of smaller estates than of larger ones. Annexes 2 and 3 show in chart form the components of all taxable estates in the range £118,000 to £300,000 compared with those in the range £500,000 to £1m. Whereas houses form only around 22 per cent of total assets in the higher band, they form 44 per cent in the lower range. So finding the money to pay the tax might be a problem in some of these small estates.

10. Although the threshold has been increased substantially above statutory indexation in the last two Budgets and the top rates of tax have been abolished, these improvements have not been sufficient to offset the increase in value of the family home in relatively modest estates. As a result many of these smaller estates still pay more tax in real terms than under a Labour Government in 1975.

11. Table C below shows the tax payable on specimen estates under the 1975-76 scale (RPI adjusted to December 1987 prices) and under the current 1988-89 scale:-

Table C

Specimen estates £000s	1975-76 scale revalorised to 1988-89 Tax payable £	Current 1988-89 scale, tax payable £
100	6,800	-
150	19,550	16,000
200	35,800	36,000
250	55,350	56,000
300	76,400	76,000
400	123,950	116,000
500	178,050	156,000
1000	476,900	356,000
2000	1,089,800	756,000

The Table shows that although most estates pay less tax than under the "Healey" scale, those within the band £196,000 to £292,000 still currently pay more. There have been critical comments about this, and several representative bodies have argued that the marginal rate of IHT is too high and the threshold is too low. The Institute of Directors (IOD) for example have suggested a threshold of £200,000, and the Association of Independent Businessmen (AIB) a threshold of £250,000.

12. There have also been suggestions for example from the National Farmers Union (NFU) that a lower rate of IHT might be reintroduced. It is claimed that this would ameliorate the position of estates just above the threshold who are particularly affected by the comparatively high marginal starting rate of IHT. However if it is the intention to help smaller estates, a return to differential rates of tax may be an unattractive option, given that the flat rate of 40 per cent was introduced only last year.

Cost

13. (i) The cost of indexation (already included in the forecasts) will be £35m in the first year, £70m in the second, and £80m in a full year.

(ii) IHT receipts continue to be buoyant. 1988-89 receipts are now estimated at £1,080m (compared with the estimate for £1,000m at Budget time), and 1989-90 receipts (after allowing for statutory indexation) at around £1,060.

(iii) The cost per £1,000 increase in the threshold varies a little with the starting point but broadly is as follows:

Ranges	1989-90	1990-91	Full year
	cost per £1,000 increase £m		
118-122	4	8	9
123-132	3	7	8
133-144	3	6	7
145-150	3	5	6

(iv) However a substantial increase in the threshold is expensive. To increase it to £200,000 as the Institute of Directors suggest would cost £230m in the first year and £540m in a full year. To raise it to £250,000 as the AIB suggest would cost £290m in the first and £680m in a full year.

Staff effects

14. If the threshold is increased by statutory indexation only the number of taxpaying estates is estimated to rise in 1989/90 to 23,500 compared with an estimate of 20,000 for 1988/89.

15. An increase in the number of taxpaying estates would add to the workload of our staff in the Capital Taxes and Valuation Offices which have serious problems of recruitment and retention. The precise effect on staff numbers depends upon decisions taken on the threshold, but a significant increase in the threshold over and above statutory indexation would be needed to hold staff numbers at current levels.

Some possible options

16. When Ministers have considered IHT thresholds and rates in recent years they have had regard to

- the number of estates taken out of tax altogether
- the burden borne by smaller estates
- comparisons with the 1975-76 scale
- Revenue costs and staff effects.

Annex 4 has been prepared to reflect these considerations by reference to a range of Options. Option 1 shows the effects of statutory indexation. Option 2 increases the threshold to the level necessary to hold the number of taxpaying estates steady. Option 3 illustrates the effects of a substantial threshold increase. Option 4 combines the indexed threshold with a lower flat rate of 35 per cent.

Analysis

17. Option 1 represents the least cost solution. It costs - £35m in the first year, £70m in the second and £80m in a full year - are already assumed in the forecasts. However it has (unless you accept Mr Culpin's proposition that the tax should bite more widely) three disadvantages. It would increase the number of taxpaying estates from 20,000 to 23,500. It would also require 10 more staff in the Capital Taxes and Valuation Offices by April 1990, rising to 20 by April 1992. Finally it leaves estates in the range £218,000 to £303,000 paying more tax than under the "Healey" scale.

18. Option 2 eliminates all the disadvantages noted under Option 1. It holds taxpayer numbers - and so staff costs - to current levels. It also betters the "Healey" scale for all taxpayers. Its disadvantage is that its Revenue costs exceed those of Option 1 by £40m in the first year £90m in the second year and £100m in a full year.

19. Option 3 represents a fivefold increase in the threshold over the RPI. It is thus more like the scale of such increases in the last two years (6 times RPI in 1988, 7 times in 1987). It also responds positively to the representations for a substantial threshold increase to reduce the tax burden on smaller estates. Compared with Option 2 it reduces taxpayer numbers by a further 4,500, and would require up to 40 fewer staff by 1992. However its Revenue costs are higher (£60m in the first year and £135m in a full year).

20. Option 4 answers representations for a lower marginal rate. But like Option 1 it compares unfavourably with Options 2 and 3 on the number of taxpaying estates and staff costs. Its Revenue costs are marginally more than under Option 2 (£15m more in the first year and £35m more in a full year).

Conclusion

21. Statutory indexation alone would increase the number of taxpaying estates and staff costs. It would also prolong unfavourable comparisons with the "Healey" scale. It would reverse the trend of the last two years in which the burden at the lower end was being reduced by significant threshold increases. Unless therefore cost is an overriding consideration, it looks an unattractive option. Option 2 by comparison continues to lift the burden from smaller estates while holding the number of taxpaying estates and staff numbers steady. Option 3 achieves similar effects, but does so more dramatically. The critical judgement here is whether the Budget arithmetic can bear the additional Revenue costs. (£60m in the first year, and £135m in a full year more than Option 2.) Option 4 only appears attractive if a lower marginal rate is preferred even though it results in an increase in the number of taxpaying estates.

Matters for decision

22. The first question for Ministers is whether the IHT threshold should be increased beyond statutory indexation. Our recommendation is that the threshold should be raised to at least £130,000.

23. If Ministers wish to raise the threshold beyond statutory indexation, do they wish to raise it to

a) £130,000 as in Option 2 (paragraph 18)

or b) £150,000 as in Option 3 (paragraph 19)

or c) some other figure?

24. If however Ministers would like us to explore some other options we would be happy to do so.

L E Jaundoo

L E JAUNDOO

Annex 1

Rises in RPI, House Prices, and Share Prices
Increase in value to 1975 base

Year	RPI	House Prices	Share Prices
1975-76	100	100	100
1976-77	115	107	103
1977-78	131	115	135
1978-79	142	137	150
1979-80	165	174	167
1980-81	192	197	189
1981-82	214	199	211
1982-83	229	206	244
1983-84	240	229	308
1984-85	252	248	366
1985-86	266	269	444
1986-87	275	312	561
1987-88	286	367	658
1988-89	(303)	(460)	(627)
1989-90	(321)	(493)	(660)

[The figures for 1988-89 and 1989-90 are estimates.]

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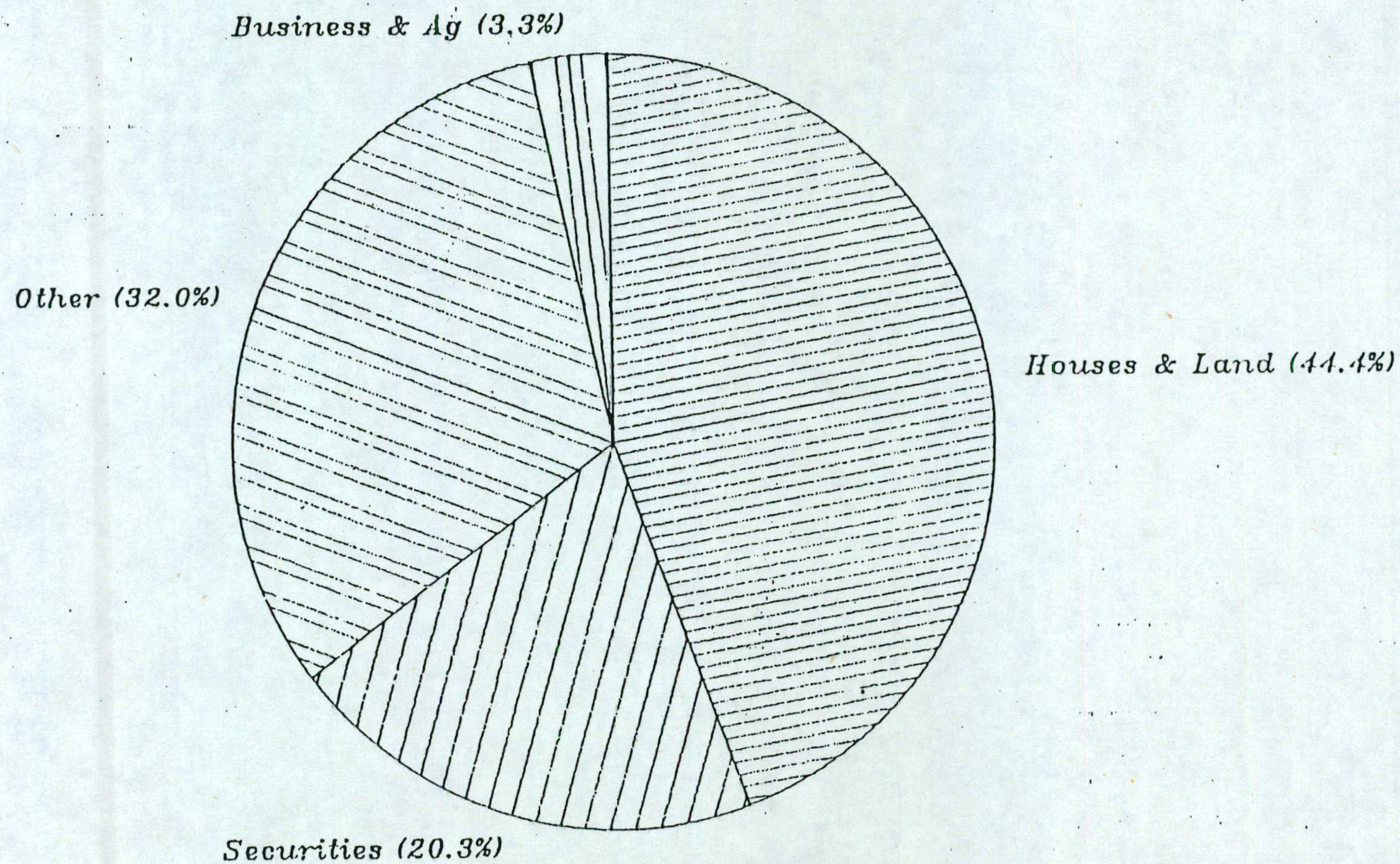
Annex 2.

Components of estates in 1989/90

between £118,000 and £300,000



Annex 3

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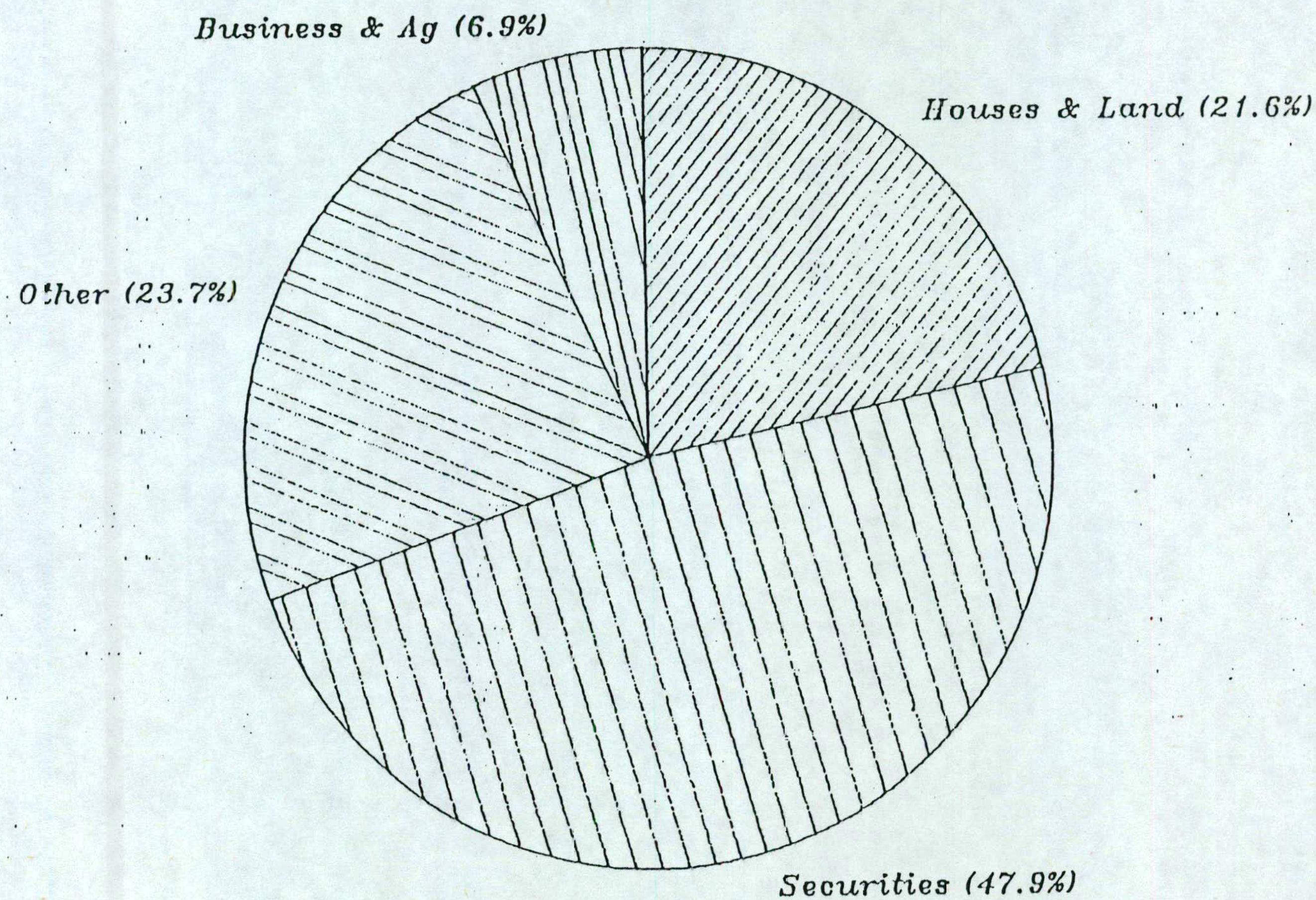
Components of estates in 1989/90

between £500,000 and £1,000,000



ANNEX 4

Specimen estates £000s	1975-76 scale revalorised to December 1988 Tax payable £	Option 1 Threshold £118,000 Rate 40% Tax payable £	Option 2 Threshold £130,000 Rate 40% Tax payable £	Option 3 Threshold £150,000 Rate 40% Tax payable £	Option 4 Threshold £118,000 Rate 35% Tax payable £
120	10,450	800	0	0	700
130	12,950	4,800	0	0	4,200
150	18,000	12,800	8,000	0	11,200
200	33,700	32,800	28,000	20,000	28,700
250	52,550	52,800	48,000	40,000	46,200
300	72,650	72,800	68,000	60,000	63,700
400	119,050	112,800	108,000	100,000	98,700
500	171,700	152,800	148,000	140,000	133,700
1000	468,800	352,800	348,000	340,000	308,700
2000	1,075,750	752,800	748,000	740,000	658,700
Costs above indexation	1989-90	£NIL	£40m	£100m	£55m
	1990/91	£NIL	£90m	£210m	£120
	Full year	£NIL	£100m	£235m	£135
Number of taxpaying estates		23,500	20,000	15,500	23,500
Increase/decrease in staff units at 1/4/90		+10	NIL	-25	+10
Increase/decrease in staff units at 1/4/92		+20	NIL	-40	+20

Indexation itself costs	1989-90	£35m
	1990-91	£70m
	Full year	£80m

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FROM: J M G TAYLOR
DATE: 2 February 1989

MR CAYLEY - INLAND REVENUE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Painter - IR
Mr Pitts - IR
PS/IR

CGT

The Chancellor has asked what rate of CGT would be needed to raise the current yield, if CGT were extended to gross funds. I should be grateful for advice.

J M G TAYLOR

Mr Gieve →

With Compliments

Alex

What rate of CGT would be needed to raise the current yield if we were extended to gross funds? M.

HOUSE OF COMMONS
LONDON, SW1A 0AA

chex.rm/jmt/90 **BUDGET CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 2 February 1989

67 3/2

MR CAYLEY - INLAND REVENUE

cc **PS/Chief Secretary**
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Painter - IR
Mr Pitts - IR
PS/IR

CGT

The Chancellor has asked what rate of CGT would be needed to raise the current yield, if CGT were extended to gross funds. I should be grateful for advice.

J M G TAYLOR

BUDGET CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: M F CAYLEY

DATE: 2 FEBRUARY 1989

1. MR PITTS ✓ 2/2

2. CHANCELLOR

Thanks. NFA

CGT AND GROSS FUNDS

1. Mr Taylor asked for urgent advice on what CGT rate would be needed to raise the current yield if capital gains charges were extended to gross funds.

2. For working purposes, I have assumed for the moment that the present exemption for charities would continue (though as will be clear from what I say below, in the short term that might make no real difference to the yield). That leaves us, essentially with exempt funds associated with pension and retirement annuity arrangements.

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cc. Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill
Mr Painter
Mr Isaac
Mr Beighton
Mr Bush
Mr Pitts
Mr Calder
Mr Cayley
Mr Kuczys
Mr Gonzalez
PS/IR

3. The answer depends critically on three factors:-

(i) Rules for expenses. Some deduction for expenses of running the funds would have to be allowed. The precise rules would need detailed thought, but almost certainly something on the lines of those for life assurance would be called for. There is a clear interaction here with the life assurance review. (And life assurance companies are commonly running both exempt funds and taxable life assurance funds.)

(ii) behavioural reactions, which would almost certainly be substantial, and their effect on the stock market,

(iii) whether any charge extended to gains that had already built up but not been realised. If it did, there would be accusations of retrospection, and a risk of making it difficult for some pension commitments to existing retirees to be honoured. It would, I suspect, be difficult to introduce a change of this kind without a current base date for computing gains. And with a current base date taxable gains could build up slowly.

4. If the judgment at (iii) is right then in the short term deductible expenses may well exceed taxable gains, so there would be capital losses. If a life company could set those losses on its pension business against gains on other business, there could be some reduction in tax yield.

5. So in the short term the answer to your question is probably that there would be no extra yield - and that to have a revenue-neutral result it might even be necessary to <u>increase</u> rates of tax on gains.

6. The funds concerned probably total at present over £m250,000. In the longer term, the yield on gains might build up (probably slowly) to over £m1,000. This might enable, on a revenue-neutral basis, rates of CGT alone (i.e. leaving

companies' rates unaffected) to be cut by over a third (from 40% and 25% to say 25% and 15%); if the corporation tax rate on companies' gains were also reduced, the cut might be around a quarter: a CGT cut to two rates of, say, 30% and 20%; and an effective full corporation tax rate on gains of say around 25% instead of the present 35%. These are, though, only broad guesses.

7. These guesses allow for the probability that the gross funds would substantially curtail their realisations of chargeable gains - either by holding on to assets for longer or by investing more heavily in CGT exempt assets like gilts and bonds or by sheltering gains in tame unit trusts like many life assurance funds do. They ignore the revenue implications of second order effects: because a capital gains charge would reduce the build-up of value of the funds, it is likely that either

(i) in order to maintain the quantum of pension benefits, contribution levels would increase (with a corresponding increase in tax deductions for contributions), and/or

(ii) over time, pension benefits would reduce compared with what they might otherwise have been, with a corresponding reduction in income tax yields on pensions as they are paid out.

Both these effects could build up to a sizeable offset to the extra tax on the funds themselves.

8. You have not asked for any evaluation. But it may be helpful if I mention a few things:-

(i) there was a commitment in the 1985 Budget Speech not to tax pension funds without prior consultation,

(ii) to reduce tax rates on gains without a corresponding reduction in rates on income would run counter to the thrust of reforms in 1987 and 1988,

(iii) it would seem odd to tax gross funds' gains but not their income. The general position has been - and still is (because of indexation and the annual exemption)- of gains being more lightly taxed than income. And one behavioural effect of taxing gains rather than income would almost certainly be to encourage gross funds to invest more heavily in assets that yielded relatively high income but relatively small, or no, taxable gains (gilts, bonds, high yielding convertibles and equities, etc.)

(iv) there would almost certainly be an immediate reduction in the level of payments out under retirement annuity, AVC and personal pension arrangements, because - as happens with life assurance now - fund managers would feel a need to set money aside to meet future tax liability on accrued but unrealised gains.

Michael Cayley

M F CAYLEY

BUDGET CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

From: E McGIVERN
Date: 3 February 1989

FINANCIAL SECRETARY

CAPITAL GAINS TAX: SET OFF AGAINST TRADING LOSSES

1. We understand that the Chancellor has asked for our views on two of the questions posed in Mrs Chaplin's note of 1 February on this starter, ie -

- should the relief enable someone to offset a trading loss in one business against a capital gain arising in another business, or should relief only apply to gains and losses arising in the same business, and

- should the relief only apply to gains on assets qualifying for roll-over relief (ie broadly business assets) or should it extend to gains?

2. He has also asked about the cost figures.

(i) Losses of more than one business

3. We agree with Mrs Chaplin that logic and equity point in the direction of allowing set off of gains across businesses - just as at present an individual can set a trading loss in one business for a particular year against the profits of another of his businesses for the same year. We also agree with Mrs Chaplin that generally no one will continue to run (or set up) loss making businesses simply to wash capital gains. In

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cc	Chancellor	Mr Isaac
	Chief Secretary	Mr McGivern
	Paymaster General	Mr Pitts
	Economic Secretary	Mr Elliott
	Sir P Middleton	Mr Cayley
	Mr Scholar	Mr Gonzalez
	Mr Culpin	Mr Hamilton
	Mr Gilhooly	Mr Campbell
	Mrs Chaplin	Miss Brand
	Mr Tyrie	PS/IR

practice, what abuse there might be will be most easy to arrange through hobby farming; Mrs Chaplin's note assumes, we think, that hobby farming losses would not be available for set off under any new relief and that would be our recommendation.

(ii) Gains on all assets

4. As you will recall, we suggested at your meeting to discuss this starter that it would be difficult to justify restricting relief to gains on business assets, for precisely the reasons given by Mrs Chaplin in her note, ie that if someone's business has fallen on hard times it may make better sense for the businessman to support it through what he expects to be temporary difficulties by selling an asset outside the business, eg shares if he has any, than by selling off an asset of the business itself. And the case for the wider relief is arguably stronger where in the first few years of a new business, the owner feels he must sell some investments to raise additional capital to help him carry his growing business through its early loss making period.

5. The difficulty then, as Mrs Chaplin recognises, is that the balance of advantage would be tipped very much in favour of the unincorporated business - paragraph 9 of Mr Elliott's note of ? January 1989.

General

6. If however Ministers decide to introduce the new relief on the basis that, hobby farming apart, it applied to all gains and to trading losses from any business, we think it would be important not to do so in a way which appeared to be conceding the thrust of Lord Young's representations. His argument that the extended relief would help defer the closure of failing businesses is hardly a convincing reason for making an important change in tax policy. And his main point - that "the distinction between trading profits and capital gains is

harmful in a business context and can lead to harmful decisions" - has very wide implications going far beyond the treatment of losses.

7. But even on the narrower losses point, the argument is essentially that there should be no distinction between income and capital losses nor any restriction in the way in which they can be used, ie income losses against capital gains and vice versa (although Lord Young at present stops short of asking for capital losses to be available against profits). Those who take this view generally argue that equally there should be no restriction in the way in which income losses can be relieved ie there should be a more liberal use of trading losses; and losses arising from income assessable under Schedule A and Case VI (mainly from investment in property) should be available for set-off sideways against tax on other income.

8. Many of the commentators who argue for this more general relief for losses tend to see the present restrictions as being due solely to the United Kingdom's schedular system of taxation. But even if the schedular system were to be abolished, the question would still arise whether it would be sensible for the tax system to cross-subsidise unprofitable activities or investments in this way, quite apart from the question of cost. The United States, for example, has a rather more generous regime for the use of losses and a much more closely integrated income and capital gains tax (no CGT exempt amount or indexation); but nevertheless does not allow trading losses to be set against capital gains nor capital losses against trading profits.

9. The presentation of any new relief here would therefore require careful handling. In particular, it would be important to avoid giving any impression that this was a step towards conceding the wider argument that trading, other "business losses" and capital losses should be freely available for set-off against tax on profits, income or gains. Such a regime would of course involve very substantial Exchequer costs.

Costs

10. As Mr Elliott explained in his note of 19 January (paragraph 11) our information about the unrelieved losses in the unincorporated sector is somewhat limited; and it is not easy to put a precise figure on the number of cases in which there will be accrued gains and in which the individuals might wish to take advantage of the new relief. At present, our best guesstimate is that the annual cost might be something of the order of £50 to £100 million.

11. This range takes into account 1985/86 data on the relationship between capital gains and taxable income which shows that:

i. more than 10 per cent of CGT payers with 10 per cent of chargeable (indexed) gains had no taxable income;

ii. more than a quarter of those gains exceeded £m1/4. Clearly trading losses would provide one reason why these people had no taxable income, and our most recent data shows losses carried forward of some £200-250 million a year. These two sets of data indicate that loss-makers can have very large capital gains and that there are large amounts of unrelieved losses available to be set off against gains.

12. When the main shape of the relief has been settled, we shall need to do some further work on second order issues (eg whether the relief should be available in respect of existing losses; and to what extent losses carried forward should be available for set off sideways against gains from another trade) and we shall come back to you again as soon as possible. And we shall then see if we can firm up the figures for cost. In the meantime you might like to have some broad indication of how the cost might be affected by a more restricted targeting of relief or by extending it more widely. Thus -

i. if hobby farming losses were excluded, the cost might be of the order of £50 million per year;

ii. on the other hand, (and again on the basis that hobby farming would be excluded), extending the relief to all gains on assets held by the self-employed (including shareholdings and other investments), would take the cost back towards the top of the range.

13. Part of all these costs, of course, are timing costs because some of the losses would in any event be allowable against profits of later years.

Points for decision

14. Do Ministers wish to introduce the new relief?

15. If so, should hobby farming losses be excluded?

16. Is the relief to be available across businesses?

with proviso.

17. Subject to the final figures for cost, do you want the relief to run against all the individuals gains and not just against gains on trading assets qualifying for rollover relief.

E McGIVERN

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FROM: J M G TAYLOR
DATE: 2 February 1989

MRS CHAPLIN

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Culpin
Mr Gilhooly
Mr Tyrie

PS/IR
Mr McGivern - IR
Mr Elliott - IR

CAPITAL GAINS TAX: SET OFF AGAINST TRADING LOSSES

The Chancellor was grateful for your note of 1 February.

2. He would be grateful if the Revenue could provide answers to the questions in your paragraphs 4 and 5 (ie whether someone will be able to offset a trading loss in one business against a capital gain arising in another business; and whether it is necessary to confine the relief to assets which qualify for rollover relief). He would also be grateful for further Revenue advice on where the cost of the current proposal arises from.

J M G TAYLOR

chex.pj/jc/1.2.1

BUDGET CONFIDENTIAL

FROM: MRS JUDITH CHAPLIN
1st February 1989

CHANCELLOR

Thanks. I am grateful for IR's answers to [illegible] C's questions in paras 4 & 5. On para 2. Where does [illegible]

~~[illegible]~~

Cover in para 6 [illegible]?

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Culpin
Mr Gilhooly
Mr Tyrie

PS/IR
Mr McGivern) IR
Mr Elliott) IR

CAPITAL GAINS TAX: SET OFF AGAINST TRADING LOSSES

If the assumption behind last year's Budget change was that there is no essential difference between a capital gain and any other income flow, it seems to follow logically that an individual should be able to offset income lost through a trading loss against income gained through disposal of a capital asset within the same business.

2. I think the argument that the main effect of the relief would be to make failing or uneconomic businesses go out of business later rather than sooner is highly questionable. It is often just as a company is expanding that there are problems with cash flow and it needs additional capital, and if the owner can acquire the necessary capital by selling an asset, it seems right that he should be able to offset the gain against the loss the business is currently making.

3. Nor am I wholly convinced by the argument about farmers and their development land. Having worked for accountants in Norfolk I am well aware of the losses farmers can achieve (although more are genuine now than previously), but with the uncertainty of obtaining planning permission I doubt if farmers would build up losses counting on the possible capital gain. And anyway the losses are limited by the hobby farming restriction.

4. I am not clear from the current proposal whether someone will be able to offset a trading loss in one business against a capital gain

arising in another business. As individuals can set a trading loss in one business against a trading profit in another, presumably they should also be able to set off across businesses.

5. Indeed, is it really necessary to confine the relief to assets which qualify for rollover relief? If you are prepared to sell a capital asset to keep your business going, should you not be allowed to set the gain against the business's loss? I imagine that in many cases this would be a presentational relief rather than a real one, since many of these gains would be exempt anyway under the annual exemption, and most businessmen would prefer to carry forward their trading losses against future trading profits or offset them against other income in the current year.

6. I do not know whether such a relief would be open to abuse or how much it would cost. The cost of the current proposal seems fairly nebulous at between £50m-£100m, but I cannot believe that many people would continue to run loss-making businesses just to obtain a set off against capital gains tax.

7. Certainly allowing unincorporated businesses' trading losses to be set off against capital gains would tip the balance in favour of unincorporated businesses, but this would to some extent be redressed by the current proposals to have a CT threshold for small companies before tax is paid or to raise small companies' thresholds. It would certainly then be what the backbenchers call a "budget for enterprise".

JC

JUDITH CHAPLIN

CHANCELLOR OF THE EXCHEQUER

Ch/

I think FST is agnostic about all this (his note of 27 January). What are your reactions to the questions in paras 14 – 17 of Mr McBrien's note?

[illegible]
7/2

I have misgivings.

PS AA This is part of the items that can be dropped. SLS would be welcome to schedule something @ a later stage.

chex.rm/jmt1/4 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 6 February 1989

MR TYRIE

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Matthews
Mr Culpin
Mrs Chaplin
Mr Call

CORPORATION TAX DEPRECIATION ALLOWANCES

The Chancellor has seen and noted your minute of 31 January.

J M G TAYLOR

chex.ps/jmt/83   BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 6 February 1989

MR CAYLEY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A M W Battishill - IR
Mr Painter - IR
Mr Isaac - IR
Mr Beighton - IR
Mr Bush - IR
Mr Pitts - IR

CGT AND GROSS FUNDS

The Chancellor was grateful for your note of 2 February. No further action need be taken on this.

J M G TAYLOR

FROM: J M G TAYLOR
DATE: 8 February 1989

PMP

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie

Mr Isaac - IR
Mr McGivern - IR
Mr Pitts - IR
Mr Elliott - IR
Mr Cayley - IR
PS/IR

CAPITAL GAINS TAX: SET OFF AGAINST TRADING LOSSES

The Chancellor has seen Mr McGivern's note of 3 February.

2. On Mr McGivern's "points for decision":

- he does wish to introduce the new relief;

- hobby farming losses should be excluded;

- the relief should be available across businesses;

- <u>subject to the final figures for cost</u>, the relief should run against all the individual's gains and not just against gains on trading assets qualifying for rollover relief.

JT

J M G TAYLOR

chex.ps/jmt/16 **BUDGET CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 10 February 1989

MR HAIGH - Inland Revenue

cc **PS/Financial Secretary**
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Ilett

Sir A Battishill - IR
Mr Beighton - IR
Mr Deacon - IR
Mr Newstead - IR

FRENCH INSURANCE LEGISLATION

... The Chancellor has seen Paris TelNo.169 (attached).

2. He has noted in particular Bérégovoy's intentions in relation to the tax regime for the French insurance industry.

3. He would be grateful for a quick note on how this affects our own proposed package. (How does the French tax regime rate in the Euro-league?)

J M G TAYLOR

UNCLASSIFIED

071466
MDLIAN 5327

* PB/Lebrun – Can we quickly note on how this ~~[illegible]~~ affects our own proposed package. (How does the French tax regime rate – no Euro – (bigger!)) –

Ch.
– NB promised tax reductions (para 5).
JS

UNCLASSIFIED
FM PARIS
TO ROUTINE FCO
TELNO 169
OF 081419Z FEBRUARY 89
INFO ROUTINE DTI, HM TREASURY, UKREP BRUSSELS, BONN

FRAME ECONOMIC
INSURANCE LEGISLATION FRANCE

SUMMARY
1. FRENCH INSURANCE LEGISLATION TO BE OVERHAULED.

DETAIL
2. THE FRENCH MINSISTER OF FINANCE, M. BEREGOVOY, ANNOUNCED YESTERDAY THAT FUNDAMENTAL CHANGES TO THE OPERATION OF THE INSURANCE MARKET IN FRANCE WILL BE INTRODUCED LATER THIS YEAR. CHANGES TO THE INSTITUTIONAL AND REGULATORY FRAMEWORK WILL BE THE SUBJECT OF A BILL TO BE DEBATED DURING THE NEXT (SPRING) SESSION OF THE NATIONAL ASSEMBLY. THE FISCAL REGIME WILL BE LOOKED AT SEPARATELY, AS PART OF THE 1990 FINANCE BILL. THE MAIN CHANGES ARE AS FOLLOWS:

REGULATORY FRAMEWORK

3. AN INSURANCE COMMISSION (COMMISSION DE CONTROLE DES ASSURANCES) INDEPENDENT OF THE STATE, BUT WITH POWERS OF SANCTION, IS TO BE ESTABLISHED AS INDUSTRY WATCHDOG. IT WILL TAKE ON MANY OF THE POWERS CURRENTLY EXERCISED BY THE DIRECTION DES ASSURANCES AT THE MINISTRY OF FINANCE, AND WILL BE BROADLY ANALOGOUS TO THE BANKING COMMISSION SET UP IN FRANCE LAST YEAR.

MODER~~I~~NISATION OF PROCEDURES

4. THE INSURANCE CODE IS TO BE SUBSTANTALLY REWRITTEN, TO PROVIDE GREATER CLARITY OF OPERATION AND TO PREPARE THE FRENCH MARKET FOR 1992. M. BEREGOVOY EMPHASISED THAT THE CHANGES WOULD GO WELL BEYOND THE MINIMUM NECESSARY TO BRING FRENCH LAW INTO LINE WITH THE EC NON-LIFE INSURANCE DIRECTIVE: THEY WOULD BE DESIGNED TO PROVIDE THE FRENCH MARKET WITH SUFFICIENT FLEXIBILITY TO REACT TO FUTURE CHANGE AND TO COMPETE EFFECTIVELY WITHIN THE SINGLE MARKET. SPECIFICALLY, AND IN RESPONSE TO LOCAL INDUSTRY PRESSURES, HE ANNOUNCED THAT FRENCH INSURANCE HOUSES WOULD BE GIVEN THE RIGHT FOR THE FIRST TIME TO QUOTE IN CURRENCIES OTHER THAN FRENCH FRANCS.

071/66
MDLIAN [illegible]27

FISCAL CHANGES

5. M. BEREGOVOY ACKNOWLEDGED THAT FISCAL CHANGES WERE ESSENTIAL IF THE FRENCH INSURANCE INDUSTRY WAS TO REMAIN COMPETITIVE. THERE WERE BUDGETARY CONSTRAINTS TO HOW FAR HE COULD MOVE AT ONE TIME. BUT THE INDUSTRY COULD LOOK FORWARD TO SUBSTANTIAL REDUCTIONS IN TAXES PAYABLE ON PREMIUMS AT THE TIME OF THE NEXT FINANCE BILL. AREAS TO BE TACKLED FIRST WOULD BE THOSE WHERE COMPETITION FROM ABROAD WAS STRONGEST.

6. M. BEREGOVOY EMPHASISED THAT HE WAS OFFERING A FRAMEWORK WITHIN WHICH FRENCH INSURERS COULD COMPETE EFFECTIVELY, BUT THAT THIS WOULD NOT IN ITSELF BE ENOUGH TO ENSURE THE SURVIVAL OF A HEALTHY FRENCH INSURANCE INDUSTRY. IT WAS UP TO THE INDUSTRY TO SHARPEN ITS PERFORMANCE DOMESTICALLY, AND TO CONSOLIDATE ITS POSITION AT HOME AND ABROAD IN PREPARATION FOR THE SINGLE MARKET. HE REFERRED TO THE LINK BETWEEN THE GAN INSURANCE COMPANY AND THE CIC BANK AS A POSSIBLE MODEL.

COMMENT

7. FIRST REACTIONS FROM THE INDUSTRY HAVE BEEN MUTED. THESE PROPOSALS ARE NOT IN THEMSELVES DISSIMILAR TO THOSE ANNOUNCED, BUT NEVER IMPLEMENTED, BY M. BALLADUR TWO YEARS AGO. THE SIGNIFICANCE OF MANY OF THE MEASURES WILL DEPEND, TOO, ON THE FINE PRINT. NONETHELESS, THESE ARE IMPORTANT CHANGES, WHICH UNDERLINE THE FRENCH GOVERNMENT'S DETERMINATION TO MAINTAIN AN IMPORTANT POSITION FOR THEMSELVES IN A KEY FINANCIAL SERVICES SECTOR UP TO AND BEYOND 1992. THE CHANGES WILL NOT BE PAINLESS. THE REVENUE LOSSES FROM TAX REDUCTIONS WILL BE PARTICULARLY UNWELCOME ON TOP OF THE DOWNWARD PRESSURE THAT ALREADY EXISTS ON VAT, TAXATION ON SAVINGS AND COMPANY TAXES.

LLEWELLYN SMITH

FCO PLEASE PASS LANKESTER, ILETT, (TSY), A C RUSSELL (DTI),

ARTHUR (ECD (I))

YYYY

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.FRAME ECONOMIC

ECD (I)

ADDITIONAL 5

FRAME
MR LANKESTER TRSY
MR ILETT TRSY

MR AC RUSSELL DTI
MR ARTHUR ECDI FCO

NNNN

Inland Revenue

Insurance and Specialist Division
Somerset House

(a) that a different company has to write the business in each country & (b)

FROM: M HAIGH
10 February 1989

Thanks. X is an important pt, which needs to be in Budget brief etc. But presumably this means that (eg) the French subsid of a UK Life Assurance co. writes business in France, there is no way in which either it or the parent co. can incur any UK tax liability. Pse confirm.

CHANCELLOR

FRENCH INSURANCE LEGISLATION

1. You have asked (Mr Taylor's minute of 10 February) what implications the French proposals reported in Paris Telno 169 have for our own life assurance package.

2. The short answer is none. The proposals relate to non-life insurance business, and reflect the greater progress towards freedom of services achieved on that side of the industry. Cover for large-scale industrial and commercial risks can now be bought freely across borders.

3. French general insurers are at a tax disadvantage compared to inward cross-border competition, because they are subject to an indirect tax on premium income which foreign offices cannot be made to pay. The proposal (foreshadowed in the Boiteaux report last year) is to cut this premium tax, at least for those general business lines most exposed to cross-border competition. A similar tax applies to French life business premiums: we have heard of no proposals to remove or reduce it.

---

cc Financial Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Ilett

Sir Anthony Battishill
Mr Beighton
Mr Deacon
Mr Newstead
PS/IR

4. For the record, you asked how France stands in the Euro league of life assurance tax regimes. Any comparison is precarious given the differences between countries in regulatory constraints, product design, and the mix of underlying life fund assets. They are complicated in the French case by the tax on premiums, by a limited personal income tax relief on some premiums, and by stiff exit charges on policies which run for less than six years. Judging by the ABI's material on international comparison, the overall tax treatment in France is somewhat harder than the UK regime on protection policies; somewhat kinder to regular premium investment-orientated policies (a difference which seems to be more than accounted for by the income tax relief on premiums); and much the same as regards single premium investment bonds, compared with the ABI's other European comparators, the French regime seems a little kinder than the German and Dutch regimes to investment-orientated policies.

5. As I have said in earlier notes these comparisons are of little direct relevance to the competitive position of different EC life businesses. So long as life business is done, de jure or de facto, on an "establishment" basis, French offices doing business here get our tax treatment, and UK offices doing business in France get theirs.

M HAIGH

chex.rm/jmt1/30 CONFIDENTIAL

bf 22/2

FROM: J M G TAYLOR
DATE: 15 February 1989

MR JAUNDOO - INLAND REVENUE

cc Mr Pitts - IR
Mrs C Evans - IR
PS/IR
Mr Jenkins - Parly Counsel

INHERITANCE TAX - TABLES

You sent me yesterday a copy of Mr Jenkins' letter of 25 November, which concluded that there were substantial difficulties with the Chancellor's suggestion of doing away with the table of IHT rates in the Finance Bill.

2. I have shown this to the Chancellor. He does not understand the problem which is apparently caused by the "nil rate". Effectively, income tax has three rates - nil, 25 per cent, and 40 per cent; yet no table is required. He would be grateful if this could be looked at again.

J M G TAYLOR

CONFIDENTIAL

Inland Revenue

Insurance and
Specialist Division
Somerset House

Thanks. I don't recall having read of this earlier proposal! 2. Is the position reciprocal, i.e. so far as eg the terms offered to UK citizens by British life offices are concerned? L

FROM: M HAIGH

15 February 1989

CHANCELLOR

FRENCH INSURANCE LEGISLATION

1. You have raised a couple of follow-up questions (Mr Taylor's note of 13 February) arising out of my note of 10 February.

2. First, an office wanting to do business abroad on an "establishments" basis does not have to set up a foreign-based subsidiary. It can instead do business through a branch. A number of long-established players in the UK market are branch operations of foreign offices: Sun Life of Canada, and Australian Mutual Provident to quote two examples at random. A recent survey report suggests that UK offices expanding into Europe are in fact likely to do so through separate legal entities, since they aim to proceed by acquisition or joint venture rather than green-field start-ups. But the right to establish on a branch basis if they wish is guaranteed by Community law.

---

cc	Financial Secretary	Sir Anthony Battishill
	Sir P Middleton	Mr Beighton
	Mr Scholar	Mr Deacon
	Mr Culpin	Mr Newstead
	Mr Gilhooly	Mr Haigh
	Mr Ilett	PS/IR

3. As we discussed on Monday night, the UK parent of a foreign subsidiary or branch cannot be sure of paying absolutely no UK tax on its foreign operations. In the case of a foreign subsidiary, the UK parent - as in any other business - may have UK tax to pay on dividends paid upwards, subject to credit for foreign tax paid by the subsidiary on its profits. In the case of foreign branch business, there is a special UK provision called "foreign life fund relief": although somewhat ramshackle technically, it broadly achieves the objective of excluding the income and gains of foreign branch policy holders from the normal "I minus E" charge. Either way, therefore, the terms which can be offerred to foreign policy holders should not be affected by the UK tax regime.

M HAIGH

BUDGET - CONFIDENTIAL

Office of the Parliamentary Counsel 36 Whitehall London SW1A 2AY

Telephone Direct line 01 210 6640
Switchboard 01 210 3000

X is clear. The answer, & I shd be most grateful if it cd be done, once the drafting of the rest of the Bill is complete.

J M G Taylor Esq
Private Secretary to the
Chancellor of the Exchequer
H M Treasury
Parliament Street
SW1P 3AG

Ch./ Mr Jenkins has said he would be happy to come over and have a word about this, if you like.
17/2

16 February 1989

Dear Taylor

INHERITANCE TAX

This is in response to your note of yesterday to Mr Jaundoo in the Inland Revenue about the possibility of eliminating the table of rates from the Inheritance Tax Act 1984.

It would certainly be <u>possible</u> to eliminate the table and incorporate the rates into the text of the section introducing it (section 7). The question is whether the advantages of doing so would outweigh the disadvantages.

As I said in my letter to Jaundoo of 25 November 1988, the main difficulty arises out of the fact that there is a nil rate of inheritance tax. This means that if we incorporated the effect of the table into section 7, that section would have to begin with a proposition on the following lines -

> "The tax charged on the value transferred by a chargeable transfer made by any transferor shall, to the extent that it

BUDGET - CONFIDENTIAL

does not exceed £110,000, be charged at the rate of nil per cent."

This seemed to me an unattractive proposition, and was the reason why I concluded that the nil rate was best left tucked away in a Schedule.

This objection assumes that we retain the present structure of inheritance tax. It would disappear if we could get away from the nil rate altogether.

As the Chancellor has pointed out, there is in effect a nil rate of income tax also. But the structure of income tax is different. There the effect of the nil rate is produced not by charging tax at nil per cent, but by the mechanism of personal allowances, which reduce taxable income. In other words, with income tax only a net amount (after allowances) of income is taxed, whereas with inheritance tax <u>all</u> chargeable transfers are taxed (see section 1 of the 1984 Act) but the first slice is taxed at nil per cent.

X This leads to the question whether we could alter the structure of inheritance tax so as to introduce into it the notion of a tax-free slice, rather than a slice charged at nil per cent. I believe it would be possible to do this, probably without any very extensive rewriting of the 1984 Act. But, as it involves interfering with one of the present fundamental building blocks of the tax, it would be a tricky exercise taking a good deal of time. Moreover, I suspect that if, after we had changed the basis of the tax, it were at some future time decided that there should once again be more than one positive rate of tax, it would be necessary to re-invent something like the present structure of section 7 and the table of rates.

Yours sincerely

Christopher Jenkins

J C JENKINS

cc Mr Jaundoo - IR
Mr Pitts - IR
Mrs Evans - IR
PS/IR

chex.ul/jt/17.2.5

CONFIDENTIAL

FROM: J M G TAYLOR

DATE: 17 February 1989

MR HAIGH - IR

cc PS/Financial Secretary
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Ilett

Sir Anthony Battishill IR
Mr Beighton IR
PS/IR

FRENCH INSURANCE LEGISLATION

The Chancellor was grateful for your note of 15 February.

2. He does not recall having read of the "foreign life fund relief" in earlier papers. He notes the conclusion that the terms which can be offered to foreign policyholders should not be affected by the UK tax regime. He has asked whether this position is reciprocated, so far as eg the terms offered to UK citizens by Dutch life offices are concerned.

J M G TAYLOR

chex.md/jmt/30 **BUDGET CONFIDENTIAL**

cc: Mr Jaundoo IR
Mr Pitts IR
Mrs Evans IR
PS/IR

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

20 February 1989

J C Jenkins Esq
Office of the Parliamentary
Counsel
36 Whitehall
London SW1A 2AY

Dear Christopher

INHERITANCE TAX

Thank you for your letter of 16 February, which I have shown to the Chancellor.

The Chancellor has noted the possibility of altering the structure of inheritance tax so as to introduce into it the notion of a tax-free slice, rather than a slice charged at nil per cent. He has commented that this is clearly the answer to the problem. He would be most grateful if this could be done, once the drafting of the rest of the Bill is completed.

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

Susan 1.23.02.89 **BUDGET CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

Thanks - Grateful for your views of prob.

		FROM:	**FINANCIAL SECRETARY**
		DATE:	**23 February 1989**
CHANCELLOR		cc	PS/Chief Secretary PS/Paymaster General PS/Economic Secretary

PAYROLL GIVING

1. I have been giving some further thought to the payroll giving limit. As you know, we have already decided to raise it from £240 to £480.

2. It was originally set at a relatively low level because, had the scheme taken off rapidly, it could have been quite expensive. But as we know, the take-up - while steady - has not been spectacular. The cost of the relief is small (estimated at about £m 1.5 this year).

3. I understand that the two main agencies - CAF and Littlewoods - are still finding it an expensive scheme to operate, and requiring considerable subsidisation. But they both report a surprisingly large number of people donating the full amount possible - at present £20 a month. It has been suggested that a fair proportion of these would give up to the maximum even if the limit were increased well beyond what we have had in mind.

4. I see advantages in doing just that - perhaps to as much as £1200 a year (£100 a month):

- a dramatic increase would clearly demonstrate our commitment to charitable giving, to the scheme, and to the future viability of the agencies.

- the cost would not be great - probably about £m5 a year at the most, in the early stages.

- we ought not then to have to return every year to tinker with the limit (though at the cost of not having a handy annual lollipop)

- there may be some switching from the use of covenants - which would be no bad thing administratively, and something which you have favoured anyway.

5. The case against is that this would be a very big increase (well above the percentage increase in PEPs, for example), and it could smack of being tailored too much to the well-heeled, instead of ordinary employees. In addition, we would probably have to face up to renewed pressure to allow some form of tax relief for one-off gifts by those unable to get within the scheme, particularly the self-employed. But that is something which I think we shall have to return to anyway.

6. For this year, I see considerable merit in an unexpectedly large increase in the limit, which would give the new Payroll Giving Association and charities something to get their teeth into.

NL

NORMAN LAMONT

fp.nh/sf/46 **BUDGET CONFIDENTIAL**

Rc 23/2

FROM: S J FLANAGAN
DATE: 23 February 1989

1. **MR CULPIN**
2. **CHANCELLOR**

x Shd be used in Budget Speech & press notices generally.

cc Financial Secretary
Mr Gilhooly
Mr Matthews
Mr Macpherson
Mr A Wilson

Mr J Reed - IR

Mr Scholar
Mr Pickford

CORPORATION TAX

You asked what proportion of companies generating over £100,000 profits would benefit from the threshold increases. Our admittedly rough estimate is that the break-down of companies paying CT under the current and proposed regimes is approximately as follows:

Profits £ 000	Number of companies (000s)	Current tax regime: Marginal tax rate	Current tax regime: Average tax rate	New tax regime: Marginal tax rate	New tax regime: Average tax rate
0-100	200-250	25%	25%	25%	25%
*100-150	6	37 1/2%	25-29%	25%	25%
*150-500	14	37 1/2%	29%-35%	37 1/2%	25-34%
*500-750	4	35%	35%	37 1/2%	34-35%
over 750	16	35%	35%	35%	35%

2. Asterisked groups benefit from the threshold changes. You will see that these total 24,000, but some of these - we estimate about a thousand - will be caught by the new close companies regime. The figures are particularly dubious because of the effects of groups of companies. Thresholds are divided between group members, so it is possible for a company to be paying the main rate when its profits are under £100,000.

3. These provisos apart, the answer to your question is about 60 per cent. Given the uncertainties, we suggest that any public reference should be to "over half" the companies currently paying at the main CT rate or receiving marginal relief.

S J FLANAGAN

chex.md/jmt/58 **BUDGET CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 24 February 1989

bf 28/2

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary

PAYROLL GIVING

The Chancellor was grateful for the Financial Secretary's note of 23 February. He would welcome the views of the Paymaster General.

J M G TAYLOR

chex.rm/jmt1/60 **BUDGET CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 24 February 1989

MR FLANAGAN

cc Financial Secretary
Mr Gilhooly
Mr Scholar
Mr Culpin
Mr Pickford
Mr Matthews
Mr Macpherson
Mr A Wilson

Mr J Reed - IR

CORPORATION TAX

The Chancellor was grateful for your note of 23 February.

2. The reference to "over half" the companies currently paying at the main CT rate or receiving marginal relief should be used in the Budget speech and in presentation generally, to describe the proportion of companies generating over £100,000 profits who would benefit from the threshold increases.

J M G TAYLOR

chex.ps/jmt/31 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 27 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary

PAYROLL GIVING

The Chancellor has seen PS/Paymaster General's note of 27 February.

2. He agrees with the Paymaster General's conclusion in favour of an increase of £240.

J M G TAYLOR

pmg.vd

BUDGET CONFIDENTIAL

FROM: MALCOLM BUCKLER
DATE: 27 February 1989

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary

PAYROLL GIVING

The Paymaster General has seen the Financial Secretary's note of 23 February and has commented that the level of increase in the Payroll Giving limit is a matter of taste. He can see the Financial Secretary's arguments, but Payroll Giving is going to be a gradual exercise in education, and he would prefer to retain the annual momentum so as to keep it in the public eye. If we are adding £240 a year, £1,200 should be reached in three years, but with less risk of the charge that we were primarily wooing the wealthy and with a better index of how much it would cost us. The Paymaster's instinct is that a large increase is a confession of failure, whereas steady increases are business as usual.

I agree with this.

MALCOLM BUCKLER
Private Secretary

BUDGET CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: M F CAYLEY
DATE: 27 February 1989

1. MR PITTS SEEN IN DRAFT

2. MR PAINTER 28 2

3. FINANCIAL SECRETARY

STARTER 264: CAPITAL GAINS AVOIDANCE ON SALE OF SUBSIDIARIES

1. Ministers agreed that legislation should be introduced this year to tackle avoidance by company groups of capital gains charges on the sale of subsidiaries. (The minutes of 30 January from Mr Isaac and myself refer.)

2. As we expected, it is not going to prove possible to have legislation ready until Committee Stage. But we have now reached the point in our work when it is possible to prepare a public announcement. A draft press release is attached. This has been drawn up on the basis that it will be issued on Budget Day: but I discuss timing towards the end of the minute.

---

cc. Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Culpin
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)
Mr Painter
Mr Isaac
Mr Beighton
Mr Deacon
Mr McGivern
Mr Pitts
Mr Campbell
Mr Cayley
Mr Hamilton
Mr Reed
Mr Beauchamp
Miss Dyall
Ms McFarlane
Mr Denton
PS/IR

3. The following paragraphs outline the rules we have in mind, and set out some issues on which we seek Ministers' guidance.

4. You will recall that there are two main ways of achieving the avoidance:-

(i) the stripping out of gains in tax-free form by a dividend in advance of the sale of a subsidiary

(ii) the sale of commercial control of a subsidiary while retaining it within the group for capital gains purposes.

<u>Gains - stripping</u>

5. Here our countering approach is to quantify the amount of chargeable gains that have been stripped out by previous dividends, and then add it to the consideration received for the sale of the subsidiary. The addition will be of such amount as is just and reasonable in all the circumstances, with all the normal rights of appeal. There are precedents in existing anti-avoidance legislation for such a "just and reasonable" approach. We cannot readily go for a more mechanical addition, in particular because

(i) of the need to allow for a very wide range of group structures, and

(ii) in some cases part of the gain may have been brought into charge.

Precise rules to cater for all the possible situations would be impracticable.

6. But we will narrow things down. We envisage carefully targetting the statutory rule so that we cannot catch

(i) dividends that could have been paid out of normal profits and reserves,

(ii) gains that have been fully brought into charge (because the asset concerned has been sold between the date of dividend and the date of sale of the subsidiary), and

(iii) gains on assets which have been transferred since the date of dividend to another company which is remaining in the group (so that the group will bear a full charge when the asset is sold).

7. The policy issue here on which we would welcome Ministers' guidance is the commencement arrangements. Here there are three options:-

(i) to catch all cases where a subsidiary is sold on or after the date of announcement. This would give maximum safeguard to the Exchequer. It would be no more retrospective than the general run of CGT changes, since the trigger would be a disposal on or after Budget Day. But it would in principle require our Inspectors, whenever a subsidiary was sold, to review whether at some point in the past gains had been stripped out by dividend: they would generally lack the information to do this. The outside world may express fears that some of our Inspectors would indulge in excessive archaeology and make unreasonable enquiries about dividend payments some years in the past. And, if pre-1988 dividends were caught, rules would probably be required to prevent us imposing a charge on gains accrued on assets before 1982.

This option would thus be likely to involve both practical difficulties and controversy. Since all the evidence suggests that, at present, dividend strips are followed fairly speedily by the sale of the subsidiary, it is doubtful if the Exchequer really needs the degree of protection the option would offer.

(ii) to catch cases where the dividend strip takes place on or after the date of announcement. This would be the least controversial approach, and the simplest operationally, and would accord with precedents for avoidance legislation of this kind. It would, though, mean we would not catch arrangements already under way. We cannot, by definition, quantify the tax that would be lost, but one or two big cases alone could take it to £m50 plus.

(iii) to catch cases where the dividend strip took place in or after, say, April 1988 and the subsidiary was sold on or after the date of announcement. This should avoid the risk of catching pre-82 gains, and should, we believe, in practice give the Exchequer as much protection as the first option. One difficulty is that the choice of April 1988 would look fairly arbitrary in the context of these provisions: and a commencement rule of this kind would be novel. It would have to be justified on the basis that some cut-off was, for practical reasons, desirable, and April 1988 will give the Exchequer adequate protection.

8. The main issue here is whether Ministers are prepared to accept the risk of a loss of tax from arrangements already in train but not completed. If so, then the answer must be - as in (ii) above - to catch cases where the initial transaction is on or

after Budget Day. If not, and Ministers are prepared to accept the probable controversy of a rule which catches cases where the operation is already in process, then the choice is between (i) and (iii). (We do not think any of the options is inconsistent with what we propose in paragraph 14 below for the Start date for the rules to counter the other type of scheme).

Sale of Commercial Control

9. The arrangements here involve selling commercial control of a subsidiary while retaining it within the group for tax purposes. After 6 years, when existing anti-avoidance rules run out, the subsidiary can, if desired, leave the group for tax purposes as well, though there is no necessity for it to do so. Arrangements of this kind can be set up with the use of special classes of shares.

10. The rule we propose is that the subsidiary shall be treated as leaving the group for tax purposes when the sale of commercial control occurs. We would ensure that this change did not lead to tax charges suddenly being imposed overnight on Budget Day where the share structure had been set up before Budget Day and the subsidiary had already passed into the commercial control of the purchasing group: but equally for such cases we would wish to ensure that the capital gains benefits of group membership - mainly the ability to transfer assets tax-free from one company in the group to another - ceased to apply to transactions on or after Budget Day.

11. There is, though, one aspect of targeting which we should like to raise:

- the corporation tax test for group relief turns on the top company in the group having 75% ownership (of shares, profits, assets etc) in all companies of the group.

- For CGT purposes, the existing test is simpler: the top company needs to own 75% of its immediate subsidiary, which in turn needs to own 75% of its immediate subsidiary, and so on. Thus, assets may pass from company A through companies B and C to company D under the shelter of the capital gains group rules, even though company A has a less than 50% interest in company D; and in the extreme case the continuous interest can be a very low percentage indeed.

This is obviously not the time, and a Committee Stage amendment not the occasion, to undertake any fundamental revision of the CGT group relief rules, or the implication of bringing them directly into line with the corporation tax rules. At a minimum, however, there is a need to specify for the purposes of these new provisions some minimum continuing interest between group members. That is, we need a rule which says the anti-avoidance provision is not to apply if the selling group retains more than an x% interest in profits and assets. The question is, how high should x be. For present purposes - and bearing in mind the limited scope of the changes we are envisaging this year, we would recommend an "over-50%" test. This would accord with the commonsense approach that the capital gains benefits of group membership should not run if the group parent has only a minority interest in a company's income and assets.

12. There is an issue on commencement arrangements here as well. The new rules would apply in full where the arrangements were all set up on or after Budget Day. But there will probably be at least one case - involving a household name and a takeover battle - where shareholders will have approved the arrangements before Budget Day but they will not be set in place before Budget Day because High Court approval is needed and will not be obtained till, probably, late March. The shareholders will have effectively committed the group concerned before Budget Day. If we catch this case, we are likely to have a controversial, and highly public, last minute effect on the outcome of the takeover battle as the option approved by shareholders could well become unviable. We would suggest that, to avoid this, we should let out any share restructuring which has been approved by shareholders before Budget Day. We will need to set a cut-off date beyond which the benefits of group membership will no longer be available in these cases. This needs to allow time for the scheme to be fully implemented. We would suggest six months from the date of the shareholders' meeting.

13. If a let-out of this kind is built in, even though it would be drafted in relatively general terms, it may well be recognised as designed to safeguard the group concerned (we doubt any other company will benefit). And it is possible that some other companies still in the process of setting up arrangements on Budget Day may also seek special treatment. But capital gains changes normally affect transactions on or after a given date, including those where arrangements are in the course of being set up: and we think it is defensible to single out for special safeguard only cases where the shareholders in general meeting have effectively committed the company before Budget Day but some formalities remain to be completed after Budget Day.

Timing of Announcement

14. Obviously, the earlier the announcement is made, the sooner the Exchequer will have protection. Even a delay of two weeks could carry a sizeable risk to the Exchequer. So there are arguments for issuing the press release (probably with an accompanying Parliamentary Question and Answer) as soon as possible.

15. On the other hand, it would be unusual to issue an announcement of this kind in the period immediately before Budget Day, and Ministers may therefore prefer to include this in the Budget Day announcements. We would welcome your views.

Conclusion

16. I would be grateful for your guidance on:-

(i) the commencement rule for the provisions dealing with the dividend strip device (paragraphs 7 and 8),

(ii) whether you agree that, for the second device - involving sale of commercial control - we should apply the new anti-avoidance provisions if the selling group ceases to have a more than 50% interest in income and profits of the subsidiary (paragraph 11),

(iii) again for the second device, whether you agree that we should let out cases where shareholders have approved a share restructuring before Budget Day (paragraphs 12 and 13); and

(iv) whether or not an announcement should be delayed till Budget Day (paragraphs 14 and 15).

17. The attached press release contains alternative formulations dependent on your decision on commencement arrangements. Subject to that, are you content with the draft?

18. We are of course available for a discussion if you wish.

Michael Sgl

M F CAYLEY

BUDGET CONFIDENTIAL

INLAND REVENUE

Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01–438 6692 OR 6706

[3x] 14 March 1989

CAPITAL GAINS: SALE OF SUBSIDIARIES

1. In his Budget, the Chancellor proposes to close two ways in which groups of companies may seek to reduce or eliminate capital gains charges on the sale of subsidiaries. Without new legislation, there would be a risk of a large loss of tax to the Exchequer.

2. The first device involves reducing the value of the subsidiary before its sale. One method of doing this is for the subsidiary to distribute, before the sale, what are in substance unrealised capital gains to another member of the group. The distribution gives the group the benefit of the unrealised gains but is not chargeable to tax in the hands of the company receiving the distribution. At the same time, it reduces the value of the subsidiary, and hence the gain that is made when the subsidiary is sold. Effectively therefore the group has converted potentially taxable gains into tax-free distributions. The general approach of the rules to counter this will involve making an appropriate addition to the consideration received for the sale of the subsidiary. The legislation will be framed in a way which ensures it does not catch distributions which could be made out of normal profits and reserves. The legislation will also counter certain other ways in which the gains on the sale of a subsidiary may be artificially reduced or eliminated.

3. The second device involves selling commercial control of a subsidiary while retaining it within the group for the purposes of the corporation tax rules for gains. This can be achieved through the use of special types of share. Legislation will be introduced to deny the benefits of group membership to the selling group in such cases.

4. In addition some technical changes will be made to the value-shifting provisions in Section 26 of the Capital Gains Tax Act, which counter various arrangements to reduce the value of assets.

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starter.264

DETAIL

A. DEPRECIATORY DISTRIBUTIONS

1. The new provisions will apply where

(i) a company (A) disposes of shares in another company (B) other than to another member of the same group, and

(ii) at some point before the sale the value of the shares in B has been reduced by a depreciatory distribution, and

(iii) that distribution is attributable, in whole or in part, directly or indirectly to increases in distributable profits resulting from specified types of transaction.

2. The specified types of transactions will be

(i) the disposal of an asset to a company which is in the same group (so that the disposal is at no gain/no loss for tax purposes), or an exchange of shares involving another company in the same group, and

(ii) the revaluation of an asset (this will not normally increase distributable profits under UK company law: but it may in some cases do so if the company holding the asset is incorporated outside the UK).

Transactions in assets outside the capital gains charge (eg gilts and qualifying corporate bonds) will be left out of account.

3. The new provisions will apply if the transaction is in an asset which, at the date of sale of shares in company B, is held by a company directly involved in the transaction or has been transferred in one or more transactions between group members to another company which is no longer in the same group as company A immediately after the sale of shares in B. Accordingly, transactions in assets which have been sold outside the group between the date of the transaction and the time of sale of the shares in B or in assets which remain in the group after the sale of the shares in B, will generally be left out of account.

4. The new provisions will not apply to the extent that distributions could be made wholly out of distributable profits and reserves not derived directly or indirectly from transactions of the types described above.

5. Where the provisions apply, the consideration for the sale of shares in company B will be increased by such amount as is just and reasonable, up to a ceiling of the amount of the distribution or distributions attributable directly or indirectly to transactions of the kinds described. These provisions will also apply with the necessary modifications where shares in a subsidiary are exchanged for shares in a company outside the group.

Commencement

[6. These provisions will apply to sales of shares on or after [14] March 1989.]

OR

[6. These provisions will apply where the distributions concerned have been paid on or after [[14] March 1989] [1 April 1988].]

Other depreciatory transactions

7. The value of shares in a company may also be reduced where assets are transferred at less than market value to another company in the same group. Normally asset transfers within a group will be for commercial reasons, but arrangements can be made which enable such transfers to give the group a tax advantage on the sale of a subsidiary. The value-shifting rules in Section 26 of the Capital Gains Tax Act may not apply because subsection (7)(b) specifically excludes reductions in value attributable to a disposal of assets to another group member by the company whose shares are being sold.

8. In future if the value of shares in a company is reduced by a transfer at other than market value to or from another company in the same group, the value-shifting rules will apply unless avoidance of tax was not the main purpose, or one of the main purposes, of the scheme or arrangements.

9. This change will apply in relation to [sales of shares on or after [14] March 1989] OR [disposals to another group member on or after [[14] March 1989]/[1 April 1988]].

10. The value-shifting rules in Section 26 of the Capital Gains Tax Act apply if a scheme or arrangements have been adopted which reduce the value of an asset at the time of the disposal. If the asset whose value is reduced is transferred to another company in the same group, the effect of the Section can be avoided by, for example, selling the shares in that other company rather than the asset concerned. Provisions will be introduced to extend the value-shifting provisions to such cases. These changes will apply in considering the operation of Section 26 in relation to disposals on or after [14] March 1989.

B SALES OF COMMERCIAL CONTROL OF A SUBSIDIARY

11. For capital gains purposes, a group is defined in terms of a principal company and companies with which, directly or indirectly, there is a 75% shareholding relationship in terms of ordinary share capital. "Ordinary share capital" for this purpose is defined as any issued share capital other than shares carrying a right to a fixed dividend and no other interest in the profits of the company.

12. This wide definition of ordinary share capital means a group can sell commercial control of a company (a"bridge company") while retaining it within the group for capital gains purposes. This can be achieved by the use of special classes of

share. In this way the normal capital gains charges on a company leaving a group can be avoided, and assets can be sold tax-free to the commercial purchaser of the bridge company by being transferred, at no gain/no loss for tax purposes, to the bridge company.

13. The capital gains benefits of group membership will in future not apply to a company if its parent does not, directly or indirectly, have a more than 50% interest in the company's profits and assets. Existing companies which are members of a group under current law but fail this test will cease to be members of their present group on [14] March 1989. The provisions in Section 278 of the Income and Corporation Taxes Act 1970 (which charge gains where a company leaves a group) will not however apply in relation to an asset acquired by a company before [14] March 1989 where the company leaves its existing group on [14] March 1989 solely as a result of the introduction of the new rules: but subsequent events which would have led to the company leaving the group under the pre-Budget rules will continue to give rise where appropriate to Section 278 charges.

14. A parent and a subsidiary bridge company may still benefit from the existing capital gains group rules if the parent's acquisition of its shares in the subsidiary, and the rights attaching to those shares, are in accordance with a scheme of arrangement under Section 425 of the Companies Act 1985 approved by the shareholders of the parent or the subsidiary in a meeting held before [14] March 1989.

BUDGET CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

From: L E Jaundoo

Date: 28 February 1989

I wd strongly favour 6 April start date, with no clause in Bill unless & until the restructuring as per 4(a) can be done.

1. MR PITTS ✓ 28/2

2. FINANCIAL SECRETARY

INHERITANCE TAX - THRESHOLD AND RATE

Indexation Order

1. Section 8 of the Inheritance Tax Act 1984 provides for the indexation of inheritance tax rates. This means that the threshold will rise in line with the Retail Prices Index, rounded to the nearest £1,000, unless Parliament determines otherwise. Ministers have decided to make no changes to the IHT threshold or rate other than those that result from the process of statutory indexation.

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cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mrs Chaplin
Mr Tyrie
Parliamentary Clerk
Mr Jenkins
(Office of the Parliamentary Counsel)

Chairman
Mr Painter
Mr Pitts
Mr Bush
Mr Calder
Mr Gonzalez
Mr Jaundoo
Mr Thompson
Mrs Evans
PS/IR

2. The Treasury are required to make an Order - usually entitled the Inheritance Tax (Indexation) Order - before 6 April each year to implement the results of statutory indexation. (The Order is usually made and published on Budget Day to allow comparisons of the Chancellor's Budget proposals on this subject with statutory indexation.) So in a year like this - when indexation is intended - there is no need for a Clause in the Finance Bill to implement the new threshold.

3. Statutory indexation brought in by an Order will take effect from 6 April 1989. In the same way, a corresponding operative date applied when the threshold and rate were indexed by an Order in 1985.

4. However if you want the indexed threshold to apply from Budget Day - as usually happens when changes other than statutory indexation are made - it will be necessary to effect the change by a Clause in the Finance Bill. On the basis that you could hardly introduce a Bill with no Clause at all, there are then two options for the Bill as published:

a) a Clause giving a tax free slice - the method the Chancellor has chosen. But this means also much more extensive changes to the structure of inheritance tax. These have lowest priority (Jeremy Taylor's note of 20 February), and given Parliamentary Counsel's other commitments, it seems unlikely they could be ready for the Bill as published; Who he?

b) a Clause on the traditional lines, providing for a slice charged at nil per cent and so repeating the table of rates which the Chancellor wants to move away from. The aim would be to replace it with a Clause on the new lines at Committee Stage.

5. But you may think b) - the more likely outcome - is messy. Unless you feel strongly about changing the threshold as from Budget Day, the simplest course is to change it from 6 April. This could if necessary be implemented by Order alone (no Clause in the Bill as published); and if the restructuring proves feasible at Committee Stage, that Clause would repeat the same starting date.

Matters for decision

6. The first question is whether you want the starting date to be 6 April or Budget Day. Our recommendation is that it should be 6 April.

7. If you wish the starting date to be Budget Day, do you want a Clause in the Bill as published on the lines of 4b) above (should 4a) not prove possible)?

L Jaundoo

L E JAUNDOO

chex.rm/jmt1/93 **BUDGET CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 2 March 1989

PS/FINANCIAL SECRETARY

cc **Chief Secretary**
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mrs Chaplin
Mr Tyrie

Mr Jenkins (OPC)

Mr Battishill - IR
Mr Painter - IR
Mr Pitts - IR
Mr Jaundoo - IR
PS/IR

INHERITANCE TAX - THRESHOLD AND RATE

The Chancellor has seen Mr Jaundoo's note of 28 February.

2. He has commented that he would strongly favour a 6 April start date, with no clause in the Bill unless and until the restructuring at paragraph 4a of Mr Jaundoo's note (ie. a clause giving a tax free slice) can be done.

J M G TAYLOR

Robert 01.2.03.89 **BUDGET CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL

DATE: 2 March 1989

MR JAUNDOO - IR

cc
PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Matthews
Mr Dyer
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Pitts - IR
PS/IR

IHT - THRESHOLD AND RATE

The Financial Secretary was grateful for your minute of 28 February.

He would prefer to have a 6 April starting date.

R.C.M.S.

R C M SATCHWELL
Private Secretary

BUDGET CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

FROM: J H REED

DATE: 2 MARCH 1989

1. MR McGIVERN
2. FINANCIAL SECRETARY

STARTER 205: ADVANCE CORPORATION TAX

My note of 8 December recommended Finance Bill legislation on various points and you agreed to this. While producing the instructions for this we identified a related point where we see a good case for making a change.

2. As my previous note explained, if there is a change in the ownership of a company and a major change in the company's business (within three years of the change of ownership) any surplus ACT is lost. The purpose of this is to prevent a company with unused ACT being sold to another company which would transfer its existing profitable activities to the purchased company to make use of the ACT. A similar provision applies where there are unused trading losses.

3. The Finance Bill legislation will remove some weaknesses in the existing legislation, although its purpose will be unchanged. But work on the drafting has brought to light a new way in which purchased ACT could be used without being caught by the anti-avoidance provision. We have not yet seen any cases but this is not surprising because it only became possible in 1987 when the Finance (No 2) Act allowed ACT to be set against CT on chargeable gains (previously, it could only be set against CT on income).

cc PS/Chancellor
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Isaac
Mr McGivern
Mr Bush
Mr Cleave
Mr Campbell
Mr Hamilton
Mr Beauchamp
Mr Fitzpatrick
Mr Cayley
Mr Reed
Ms St Quinton
PS/IR

4. The device is quite simple. A company with surplus ACT is sold into new ownership and continues its previous activities. The new owner transfers to it an asset with an accrued gain - the transfer is within a group and so is on a no gain/no loss basis. The asset is then sold and CT is payable on the gain. The ACT can be set against the CT. The device enables a group with surplus ACT to transfer it to another group with insufficient ACT to set against the CT on any chargeable gains. Since companies are now making large capital gains and there is over £5 billion of surplus ACT the scope for avoidance is considerable. And the Finance Bill measure to prevent capital gains avoidance of the sale of subsidiaries which hold assets with accrued gains (Starter 264) will lead companies to look for other ways of avoiding tax.

5. Until recently, they might have been deterred by fear that we could successfully challenge the device under the principle set out in Furniss v Dawson. But last summer's decision in Craven v White makes it clear that this device will work, provided that a purchaser for the asset has not been lined up at the time when the asset is transferred to the newly-acquired subsidiary with the surplus ACT. In practice this need not impose any real restriction on a group's freedom of action, although it might delay a sale for a few months if the company with surplus ACT is not purchased in good time.

6. We think it would be simple to prevent this device by preventing ACT set-off against a capital gain if:

i. the asset was acquired on a no gain/no loss basis after a change of ownership of the company; and

ii. the asset is disposed of within three years of the change of ownership.

This would be consistent with the restriction that a company's ACT is lost on a change of ownership if there is a major change in its business within three years. The three year restriction seems a reasonable cooling-off period and so far it seems to have been effective in deterring avoidance.

Conclusion

7. We think there is a real risk that this avoidance device will be used and it could prove costly. We therefore recommend that the Finance Bill should contain a provision to prevent it and this should be mentioned in the ACT press release. We suggest that it should apply where the change of ownership occurs on or after Budget day.

J H REED

Robert 05.3.03.89 **BUDGET CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL

DATE: 3 March 1989

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins - OPC

Mr Isaac) IR
Mr Cayley)
PS/IR

Ch/ Agree FST?

6/3

STARTER 264: CGT AVOIDANCE ON SALE OF SUBSIDIARIES

The Financial Secretary has discussed Mr Cayley's minute of 27 February with officials.

The Financial Secretary is strongly against options i and iii in para 7 of Mr Cayley's note; he feels the charge of retrospection would be extremely difficult to refute. He is therefore in favour of option ii, even though it would not catch arrangements already underway.

On Mr Cayley's other points for decision in para 16 of his note, the Financial Secretary agrees with the new anti-avoidance provisions where the selling group ceases to have more than a 50% interest in income and profits of the subsidiary; but also agrees that there should be a let-out in cases where the shareholders have approved a share restructuring before Budget Day; and would delay an announcement until Budget Day.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Robert 03.6.03.89 **BUDGET CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL

DATE: 6 March 1989

MR REED - IR

cc PS/Chancellor
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr McGivern - IR
PS/IR

STARTER 205: ACT

The Financial Secretary was grateful for your minute of 2 March. He agrees that the Finance Bill should contain a provision to prevent the avoidance device outlined in para 4; and that this should apply where the change of ownership occurs on or after Budget Day.

R.C.M.S.

R C M SATCHWELL

Private Secretary

fp.nh/docs/6.3.macp **BUDGET CONFIDENTIAL**

FROM: N I MACPHERSON
DATE: 6 March 1989

1. **MR GILHOOLY** 6/3
2. **CHANCELLOR**

cc Sir P Middleton
Mr Scholar
Mr Dixon
Mr Rayson
Mrs Chaplin
Mr Tyrie

BUDGET CONSULTATIONS: MR YOUNGER AND MR CLARKE, TUESDAY 7 MARCH

You are meeting Mr Younger tomorrow to tell him about the pension proposals and their implications for the armed forces. You are also meeting MR Clarke to tell him about their implications for NHS staff. The attached note has been provided by Superannuation Division.

Nick Macpherson

N I MACPHERSON

GENERAL NOTES

1. As part of Budget package to simplify and permit greater flexibility in pension rules (and lift administrative burden from employers and pensions managers), intend to withdraw tax advantage from pension benefits arising from earnings in excess of £60,000. Cap will be index linked. Applies to new schemes introduced after Budget day, and to new members of existing pension schemes after an "appointed" day (1 June). Existing members of existing schemes will be unaffected.

2. Change means - in respect of earnings over £60,000 only -

- no tax relief on employee or employer contributions
- no tax-free build up of pension fund
- lump sum benefits will be taxed.

3. Finance Act will override private sector and local government scheme rules. Statutory public service scheme rules need amending - and "appointed" day delayed until 1 June to allow for this. Seeing all main public service Ministers so they can have scheme amendments made in time. All need to give priority to legal and procedural aspects of amending their schemes.

4. Scope for top-up schemes (without tax privilege) to provide benefits on earnings over £60,000. Nature of top-up schemes for public services to be decided - but should follow, not lead, private sector. Top-up for Board Members to be decided ad hoc, in light of private sector practice.

ACTION FOR MR YOUNGER

Recognise procedures for amending Order in Council, Royal Warrant and Queens Regulations take time. Important, therefore, to give early priority to drafting amendments to have them in place before 1 June. Currently about 20 military earning over £60,000. Only bites on new recruits who subsequently earn more than cap.

ACTION FOR MR CLARKE

NHS scheme regulations need amending before 1 June. Currently some 900 consultants earning over £60,000. Only bites on new employees who subsequently earn more than £60,000.

chex.ps/jmt/53 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 6 March 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins - OPC

Mr Isaac - IR
Mr Cayley - IR
PS/IR

STARTER 264: CGT AVOIDANCE ON SALE OF SUBSIDIARIES

The Chancellor has seen your note of 3 March. He agrees with the Financial Secretary's conclusions.

J M G TAYLOR

chex.ps/jmt2/88 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 6 February 1989

MR B A MACE

cc PS/Financial Secretary
Sir P Middleton*
Mr Scholar*
Mr Culpin
Mrs Chaplin

Sir A Battishill
Mr Painter - IR
Mr Lewis - IR

* with previous papers

AGE ALLOWANCE

The Chancellor was grateful for your note of 2 February.

2. He has commented that, if it is really true that Option B would take 15,000 people out of tax compared to 5,000 for Option A, then Option B wins.

J M G TAYLOR

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: B A MACE

DATE: 2 FEBRUARY 1989

CHANCELLOR OF THE EXCHEQUER

([illegible] Option B looks attractive.] Thanks. 1/4 X as many taken out of tax (15,000 v. 5,000), then Option B wins.

AGE ALLOWANCES

1. You asked (Mr Allan's note of 31 January) for a quick note setting out the comparative effects of

   a. Raising the over 80s age allowance by 10 per cent on 1988-89 levels (Option A);

   b. Extending the over 80s age allowance at its indexed level in 1989-90 to those aged 75 and over (Option B).

2. The results are in the attached table. As you will see there is little to choose between the two options on distributional grounds: Option B costs a little more than Option A in 1990-91 (because the allowance increases are slightly larger and slightly more taxpayers benefit). In practice the differences are probably within the margins of error in costings from our personal tax model. Option A is somewhat easier to implement than Option B, but neither is very difficult.

---

cc PS/Financial Secretary
Mr Culpin
Mrs Chaplin

Chairman
Mr Painter
Mr Lewis
Mr Calder
Mr Mace
Mr Eason
Miss White
Mr Wardle
PS/IR

3. Possibly a better buy overall might be the double indexation of the over 80s age allowance that you were considering before Christmas (Mr Taylor's note of 5 December). This costs a little more (about £15 million in 1989-90, £20 million 1990-91) but compared with indexation it is worth £1.10 per week (single) and £1.73 per week (married) to taxpayers aged 80 and over. It would take 15,000 single people and married couples out of tax. The change would increase the cash differential between the over 80 and the over 65 married age allowances by 200 per cent (165 per cent increase for the single allowance).

B A Mace

B A MACE

CONFIDENTIAL

TABLE

AGE ALLOWANCE

	Option A		Option B	
	1989-90	1990-91	1989-90	1990-91
Direct Revenue cost	£10m	£10m	£10m	£15m
Number of taxpayers who benefit (single people and married couples)	360,000		400,000	
Reduction in number of taxpayers	5,000		15,000	
Increase in allowance on top of indexation				
Single	£110		£140	
Married	£170		£180	
Weekly gain on top of indexation				
Single	53p		67p	
Married	82p		86p	
Proportion of age group not liable to tax after change	four-fifths of all over 80s.		three-quarters of all over 75s.	

Option A: Raise over 80s age allowance by 10 per cent on 1988-89 levels.

Option B: Extend over 80s age allowance to over 75s.

chex.ps/aa/40 BUDGET CONFIDENTIAL

FROM: A C S ALLAN
DATE: 31 January 1989

MR MACE - Inland Revenue

cc PS/Financial Secretary
Mr Culpin
Mrs Chaplin

PS/IR
Mr Calder

AGE ALLOWANCES

At present, the proposal in the starters list is for the over 80s age allowance to be uprated by 10 per cent, rather than by the 6.8 per cent implied by indexation. The Chancellor would be grateful for a quick note on an alternative option: extend the relief to all over 75, but raise the amount by 6.8 per cent only. He would be grateful if this note could compare the effects and costings of the two options.

ACSA

A C S ALLAN

BUDGET CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

FROM: J H REED
DATE: 23 JANUARY 1989

Bayers
Discuss

PS/CHANCELLOR

STARTER NO 200: CORPORATION TAX RATE FOR FINANCIAL YEAR 1989
STARTER NO 201: SMALL COMPANIES RATE AND MARGINAL RELIEF PROFITS LIMITS

Your note of 16 January said that the Chancellor had asked two questions in response to Ms St Quinton's note of 13 January. These, and our answers, are as follows.

Would this change mean a reduction in the CT bill for all tax paying companies with profits between £100,000 and £750,000?

If a company has "associated companies" its profits limits for the small companies rate, and the marginal relief, are reduced (so if it has three associated companies its profits limits would at present be £25,000 and £125,000 instead of £100,000 and £500,000). But for companies which do not have associated companies it is true that all companies with profits greater than £100,000 but less than £750,000 would obtain a reduction in their CT bill.

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cc	Chancellor	Chairman
	Chief Secretary	Mr Isaac
	Economic Secretary	Mr McGivern
	Sir Peter Middleton	Mr Bush
	Sir Terence Burns	Mr Calder
	Mr Monck	Mr Campbell
	Mr Scholar	Mr Fitzpatrick
	Mr Culpin	Mr Weeden
	Mr Gilhooly	Mr Reed
	Mrs Chaplin	Ms St Quinton
	Mr Tyrie	PS/IR
	Mr Jenkins (OPC)	

<u>How many such companies are there</u>?

Given the complication of the associated companies provision, it seems sensible to look at the number of companies which would pay less CT, rather than the number with profits falling within the band £100,000 to £750,000. We estimate that there are 24,000 companies which would pay less CT as a result of the proposed increase in the profits limits. If this increase is combined with a special tax regime for close investment companies (Starter 206) there would be fewer companies benefiting (because some of the 24,000 companies would become liable at the special rate of CT). It is not easy to quantify this effect, but we estimate that fewer than 1,000 of these companies would be affected, so there would still be about 23,000 companies which would benefit.

J H REED

chex.md/aa/45 BUDGET CONFIDENTIAL

FROM: A C S ALLAN
DATE: 25 January 1989

MR CULPIN

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Riley
Mrs Chaplin
PS/IR

CT THRESHOLDS FOR SMALL COMPANIES

The Chancellor would be grateful for a note on the following CT proposal, as a possible substitute for the existing proposal on raising small companies' thresholds:

(i) first £5,000 of profits tax free;

(ii) next £100,000 at 25%;

(iii) next £X at 37½%;

(iv) the remainder at 35%.

£X, as now, would be set so that the total tax on profits of £105,000 plus £X would be 35%. The purpose is to inject into CT a £5,000 tax free slice for small companies. The Inland Revenue may want to offer variants.

ACSA

A C S ALLAN