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PART A

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PART A

1989 BUDGET
STARTER

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INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

FROM: P W FAWCETT
13 JUNE 1988

1. MR HOUGHTON
1a Mr Painter — Two Press Releases pl.
2. FINANCIAL SECRETARY

THE UK/NETHERLANDS ANTILLES DOUBLE TAXATION AGREEMENT

1. You agreed on 19 May that we should move towards termination of the existing UK/Netherlands Antilles double taxation agreement on a contingency basis by 30 June, and continue to try to reach agreement on a new treaty at talks arranged for 1-2 June.

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cc.		
cc.	PS/Chancellor of the Exchequer	Chairman
	Sir P Middleton	Mr Painter
	Sir G Littler	Mr Houghton
	Mr Scholar	Mr Johns
	Mr Culpin	Mr Cleave
	Mr Peretz	Mr O'Connor
	Mrs Lomax	Mr Prescott
	Mr Gilhooly	Mr Phalp
	Mr Ilett	Mr Hunter
	Mr Riley	Mr Sadler
	Mr Cropper	Mr Fryer
	Mr Tyrie	Mr R Thomas
		Mr Elliss
		Mr Fawcett
		Mr Shepherd
		Mr Bryce
		Mr Critchley
		Mr Geraghty
		Miss Pattison
		Mr Pope
		Miss McFarlane
		PS/IR

2. A delegation from the Netherlands Antilles recently came to London and we spent 1-2 June trying to resolve differences. The differences centred on the limitation on benefits article which we have advised Ministers should be a minimum requirement for any future double taxation agreement with the Netherlands Antilles.

3. I set out the main differences between the sides as they appeared at the talks on 11-14 April in paragraph 4 of my minute of 16 May. Very briefly our position on these is now as follows:

(i) we have accepted as a matter of form a positive rather than a negative test for control of companies which would be given or denied the benefits of the agreement provided that such companies are 75% (rather than 50%) controlled by residents of the two countries respectively;

(ii) the Netherlands Antilles have dropped their proposal to extend the benefits of the agreement to individuals and companies of those countries where UK double taxation agreements with those countries would give similar relief;

(iii) the Netherlands Antilles have dropped their objection to the UK requirement that the benefits of the treaty should go to companies only if they are controlled by a resident of the country in which the company is resident;

(iv) we have offered not to exclude from the benefits of the treaty companies with no more than 10% of bearer shares (the difficulty with bearer shares is that it is rarely possible to establish who is controlling the company); and

(v) there are still problems about let outs for what the Netherlands Antilles see as genuine trading companies, and the argument has now moved to the Netherlands Antilles proposal that <u>all quoted companies</u> (the place

of quotation to be for agreement by the parties) should be entitled to the benefits of the agreement: this would greatly expand the field of those who could benefit, involving as it would third country companies but we are considering whether a compromise is possible.

We would in addition stress that there are areas where we think it necessary to stand back and consider whether, in the course of very detailed negotiations on points of great complexity, we have not inadvertently created any unintended gaps or loopholes in our defences against improper use of the treaty.

4. We have offered to reduce our basic rate withholding tax on interest and royalties to 15% (the present agreement has nil rates), and to give matching credit for tax spared in the Netherlands Antilles in respect of specific ordinances relating to hotel and real estate development. We have also agreed in principle to give the payment of the UK tax credit on dividends to individual Antillean investors, subject to the overall balance of the treaty.

5. We made it clear that the UK wishes to give notice of termination of the existing agreement on a contingency basis by 30 June, and the attached Press Release relating to the Netherlands Antilles was agreed by officials of the two countries, subject, of course, to approval by Ministers. The Press Release refers to substantial progress being made and looks to further exchanges at official level. We will of course minute you again in the event that we come near to agreement.

6. As I said in my minute of 16 May, Aruba, which until it recently seceded was part of the Netherlands Antilles, declined to attend the talks on 11-14 April. We have written to Aruba twice since then, making clear that the UK was considering giving notice of termination by 30 June and Aruba appears to accept this as inevitable. I attach a second Press Release relating to Aruba.

7. The Press Release relating to the Netherlands Antilles refers to a commitment to legislation in next year's Finance Bill, should the need arise, to allay market fears on pre-1984 Eurobonds. I mentioned this in paragraph 16 of my minute of 16 May and in earlier minutes and Mr Peretz in his minute of 19 May has said that he agrees with my recommendation. Our consultations show that we are talking about a mere handful of cases but that is perhaps all the more reason for not hesitating to bend over backwards to avoid the serious and well-publicised problems the US had when they terminated their agreement. To that end we propose showing the draft Press Release, on an in confidence basis, to those City institutions previously consulted. We are not aware of any (pre 1984) Eurobonds issued by Aruban subsidiaries of UK finance companies and suggest that we do not mention Eurobonds in the Press Release relating to Aruba. We could always come back to problems with Aruba Eurobonds if it became clear that there were any.

8. I have recently again been in touch with both the Foreign Office and the Department of Trade and Industry and they have no objections to termination by 30 June.

9. We therefore seek

(a) your authority to ask the Foreign Office to put in hand forthwith the exchange of notes terminating the double taxation agreement with the Netherlands Antilles, in relation to both the Netherlands Antilles and Aruba, and

(b) your agreement to the two draft Press Releases attached and to our clearing these, in confidence, with those City institutions already consulted.

PWF

P W FAWCETT

CONFIDENTIAL

DRAFT PRESS RELEASE

DOUBLE TAXATION: NETHERLANDS ANTILLES

Discussions were held at official level in London on 11/14 April and 1/2 June about a new double taxation convention. Substantial progress was made. It is intended that further exchanges at official level will take place shortly with a view to preparing a text for submission to the two Governments. The United Kingdom is proposing contingently to give notice of termination of the existing convention by 30 June in accordance with the provisions of that convention. The convention would accordingly cease to have effect from April 1989 in the United Kingdom.

The Government also has it in mind to introduce legislation, should the need arise, in next year's Finance Bill which would have the effect, from April 1989, of preserving the existing exemption from tax of interest paid from the United Kingdom to the Netherlands Antilles to fund the payment of interest on Eurobonds issued by Netherlands Antilles finance subsidiaries before 26 July 1984.

CONFIDENTIAL

DRAFT PRESS RELEASE

DOUBLE TAXATION: ARUBA

The double taxation convention with the Netherlands Antilles remained applicable to Aruba when Aruba acquired the status of a country within the Kingdom of the Netherlands on 1 January 1986. The United Kingdom is proposing to give notice of termination of this convention by 30 June in accordance with the provisions of that convention. The convention would accordingly cease to have effect in the United Kingdom, in relation to Aruba, from April 1989.

INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

FROM: P W FAWCETT
DATE: 28 JUNE 1988

FINANCIAL SECRETARY

UK/NETHERLANDS ANTILLES DOUBLE TAXATION AGREEMENT

1. I telephoned your office last night and said that I would send you a note this morning on the effect of the termination of the Netherlands Antilles double taxation agreement on the Eurobond market which we believed would be reported in the Financial Times this morning (copies of two articles attached). This note is both for general information and also in case the matter is raised in Committee this afternoon.

2. We have discussed this subject in previous minutes to Ministers of 22 December, 27 April, 16 May and 13 June. We have also consulted in confidence representative bodies from industry and the City, the Bank of England and the Treasury.

3. Ministers accepted that because of the growing abuse of the treaty the UK should give notice of termination of the treaty by

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cc. Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Culpin
Mr Peretz
Mrs Lomax
Mr Gilhooly
Mr Ilett
Mr Riley
Mr Cropper
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Mr Geraghty
Miss Pattison
Mr Pope
Miss McFarlane
PS/IR

30 June to take effect from next April. We have had three rounds of talks to try to reach agreement on a new treaty and substantial progress has been made. It is intended that further exchanges at official level will take place shortly with a view to preparing a text for submission to the two Governments.

Eurobonds

4. Termination of any such agreement is inevitably likely to affect in some way all those to whom the treaty is applicable and because of this there is a case for making no transitional provisions for any particular aspect of the treaty. However, Ministers accepted the case for preserving the existing exemption from tax of interest paid from the United Kingdom to the Netherlands Antilles to fund the payment of interest on Eurobonds issued by Netherlands Antilles finance subsidiaries before 26 July 1984. We would hope to negotiate this as part of a new treaty but the Press Release referring to termination of the treaty said that if necessary the Government would introduce legislation in next year's Finance Bill to achieve this.

5. The point of 26 July 1984 is that the Government introduced legislation from that date to allow interest on quoted Eurobonds to be paid gross direct from the UK. Hitherto the interest had often been paid gross via finance subsidiaries in countries like the Netherlands Antilles under double taxation agreements to enable the finance subsidiaries to pay the bondholders gross interest. After that date there was no tax advantage to be gained by routing issues via the Netherlands Antilles and we are not aware of any good commercial reason for Eurobonds to continue to be issued through Netherlands Antilles subsidiaries and therefore no reason to provide any transitional provisions for such issues.

6. The Press Release referring to the intention to terminate the treaty was issued last Friday and yesterday there was apparently some early confusion in the market. This seems to have been caused by an incorrect report by a market analyst of the number of Eurobond issues involved. He said that there were some 90 but later reduced this figure to about a dozen. We

believe that he was adding Netherlands issues in the total and these are not affected by the termination of this treaty. It is difficult to estimate how many post-1984 Eurobonds involving the Netherlands Antilles there are but we were assured in our meetings in the City that they were sufficiently small in number as not to disturb the market.

7. The main options open to post-1984 Eurobond holders are described briefly in the articles. The companies involved can normally be expected either to continue to pay interest after next April but under deduction of tax or under the small print redeem the loan at par. In addition, the route through the Netherlands is also still open. If companies redeem the loan they should, as things stand, be able to re-negotiate the loan at more favourable terms but in any event, as the Financial Times says, this is what the small print is for.

Line to take

8. If Ministers are questioned on this, we suggest the following line to take:

(i) the UK is now the only country other than the Netherlands to have a double taxation agreement with the Netherlands Antilles;

(ii) that agreement is now being widely used for purposes that were not intended (and professional advice is given widely to enable taxpayers to use the agreement in this way);

(iii) the Government therefore wish to give notice of termination of the existing agreement from next April but are trying to agree terms for a new treaty which could run end on with the existing treaty;

(iv) substantial progress has been made on a new treaty and it is intended that further exchanges at official level will take place shortly with a view to preparing a text for submission to the two Governments;

(v) it is not possible (or desirable) in a situation of this kind to make arrangements so that no-one is worse off but the Government felt that it was right to protect pre-1984 Eurobond holders to be consistent with the legislation which it introduced in 1984 to allow Eurobond interest to be paid gross to non-residents from that date;

(vi) under these pre-1984 arrangements UK companies will continue to be able to pay interest gross to the Netherlands Antilles to fund the payment of interest on Eurobonds issued by their Netherlands Antilles finance subsidiaries before 26 July 1984;

(vii) since 1984 there has been no tax obstacle to UK companies themselves paying Eurobond interest gross and therefore no justification for singling out Eurobonds issued by Netherlands Antilles subsidiaries from any other arrangements which could have been made in the full knowledge that the treaty could be terminated by 30 June any year;

(viii) the Government consulted extensively (within the bounds of confidentiality) with industry and the market before taking this action.

P. W. Fawcett

P W FAWCETT

Tax move unsettles Eurobonds

BY STEPHEN FIDLER, EUROMARKETS CORRESPONDENT

A DECISION by Britain's tax authorities to end the current double taxation agreement with the Netherlands Antilles, a Caribbean tax haven, threw a section of the Eurobond market into confusion yesterday.

The Inland Revenue said it would terminate the existing double taxation convention with the Netherlands Antilles and neighbouring Aruba with effect from the start of the new tax year next April.

Negotiations over a new – but more limited – agreement with the Antilles are in progress, but none are taking place with the authorities in Aruba.

The announcement could have a significant impact on up to 30 Eurobonds issued by UK companies since 1984 through financing subsidiaries in the Antilles, Eurobond houses estimate.

They calculate that issues with a combined value of some $2bn-$4bn could, on the face of it, be affected. However, because of the confusion and the lack of trading in many of the issues, most bond prices were not significantly affected.

The decision means that UK companies which have issued Eurobonds through Antilles subsidiaries since July 26, 1984, face a 25 per cent UK tax on their interest payments on them. Previously, a special zero rate of tax applied. Because of the tax changes, some borrowers will be allowed to redeem the bonds early at face value, which could be significantly below their current market price.

The Revenue said it would ensure that no Eurobonds issued before July 26, 1984, were affected. Prior to that date, UK companies had to issue Eurobonds via overseas finance subsidiaries or pay the withholding tax. Since then, British companies have been able to make the issues direct and avoid withholding tax, although some still chose to issue through offshore subsidiaries.

Bankers and lawyers were yesterday poring over the fine print of Eurobond documentation. Some Antilles issues may escape the tax because they were made through Dutch subsidiaries. There still is a tax treaty between the Netherlands and the Antilles.

The Inland Revenue wants a renegotiation because of general concern that the treaty is being abused. "It became clear that third parties and residents of the two countries were not using the double taxation treaty in the way it was intended," it said. "It was meant to prevent double taxation and not to stop single taxation."

Though on a much smaller scale, the confusion was reminiscent of the turmoil triggered last summer, when the US said it would abrogate its taxation treaty with the Antilles and more than $30bn of Eurobonds was affected.

Apart from the US, which eventually backed down and made special exemptions for the Eurobonds issued through Antilles subsidiaries, Norway and Denmark have also abrogated double taxation treaties with the Antilles. This leaves only the UK and Netherlands with treaties, according to the Inland Revenue.

International bonds, Page 30

STRATFORD-UPON-AVON TEL. 0789 204288

THE LEX COLUMN

Reaching for the brake

Yesterday's authentically lousy trade figures make it the more likely that base rates will move today, and the harder to predict by how much. The market is now settling into the gloomy conviction that the trade deficit could reach £10bn this year – 2¼ per cent of GDP – compared with £1.75bn last year and equilibrium the year before. It also seems increasingly clear – with hindsight, to be sure – that the Chancellor got his demand management wrong by giving away too much in the Budget and then sticking with low interest rates for too long.

In choosing between 9.5 per cent and 10 per cent, the authorities would doubtless prefer to leapfrog the market rather than give the impression of trailing behind it. Since the money market is discounting 10 per cent already, that option is scarcely available. But with sterling below DM3.10 and only a whisker over $1.70, tinkering with a half point rise now seems to invite the risk of being pushed to 11 per cent sooner rather than later.

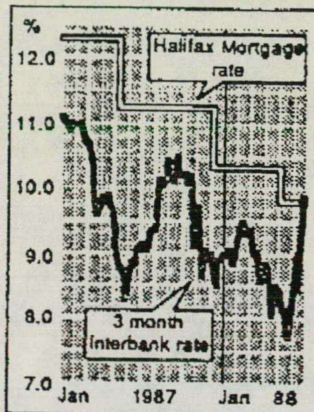
The equity market's problem in all this comes in the threat to UK growth a year or so out. The price of reducing the trade deficit is high base rates and – presumably – no tax cuts in the next Budget.

The City's economists are nervously calculating that making any significant dent in the deficit might entail a percentage point or so off the growth rate. But then, an economy hit by an investment and consumer boom at a time of capacity constraints – a combination, that is, of overheating and misaligned resources – has no other way to go.

S G Warburg

Warburg may well be emerging as the one clear winner in the post-Big Bang environment. But the group's preference for hiding behind its mystique, rather than stooping to disclose sensible information about its affairs, means that any judgment about the success of its long-term strategy remains dependent on such subjective criteria as hearsay, or whether or not you like the cut of the chairman's jib. Admittedly, a 13 per cent rise in full year pretax profits, to £111.1m, looks impressive by contrast with the likes of Kleinwort Benson, BZW, and County NatWest, especially when it is remembered that they only had one dull quarter to contend with and two out of the three still reported full year losses.

FT Index fell 26.8 to 1468.1



If allowance is made for the £8m after-tax loss on the BP underwriting, the second-half slump in merchant banking profits looks nowhere near as bad, and unchanged second-half profits from Mercury Asset Management were surprisingly strong given that they covered the period of the crash. However, Warburg did have £200m of extra capital to play with, and little is known about the success of the group's heavy investment in the securities business apart from the healthy rise in the headcount in New York and Tokyo.

Meanwhile, the complaints about competitors who are prepared to take heavy losses in order to buy market share sound depressingly familiar, and the 10 per cent drop in earnings per share – which is unlikely to be recouped this year – is a reminder that it may not be prudent to repeat the 15 per cent rise in the dividend next time.

Trusthouse Forte

The vitriol directed against the Savoy management yesterday by Mr Rocco Forte, the Trusthouse Forte chief executive, will no doubt guarantee the company a place in the headlines which it would not have merited on profits performance alone. But the battle for the high moral ground on the issue of Savoy directors' salary and perks – not to mention the larger issue of accountability to shareholders – is largely irrelevant to Trusthouse Forte's prospects on anything but a longer-term view.

THF is certainly not going to bid for the Savoy with the shares at their current stratospheric levels – and would not get it if it did, as more than half the shares vote with the incumbent management. Pursuing the possibility of a more normal bid through the courts will probably take a couple of years.

So for the moment, the THF management can afford to be long on rhetoric and short on details in the matter of how exactly it would transform the Savoy's profitability.

Certainly, the performance of THF's existing hotels in the half year reported yesterday suggests that the company knows how these things are done. THF has managed to make good the numbers of missing American guests at its UK hotels (perhaps 20 to 25 per cent fewer than last year) with continental Europeans and Japanese. And although filling beds is not all there is to it – the latter two groups spend less on food and other delights than their American counterparts – this year should still be a good one for THF in the UK, especially with catering turning in ever stronger profits. With Sir Ian MacGregor already despatched to look into the troubled US hotels operation, THF's current 20 per cent premium rating is probably no more than it deserves.

Eurobonds

The news that the UK taxman plans to close the Dutch Antilles loophole for Eurobonds caused some confusion yesterday, mainly because no one was sure how many bond issues would be involved.

The change, as mooted, would affect issues routed direct to the Antilles since 1984, but apparently not those passed through Dutch subsidiaries; early guesses are that the total would be a couple of dozen at most, accounting for less than a half per cent of the Eurobond market by value. The practical effect of such a change would probably be to benefit borrowers at lenders' expense.

At the extreme, a bond issued in August 1984 might carry a coupon of 13 per cent; the requirement to make good UK withholding tax at 25 per cent would mean that the issuer would now have to gross the payment up to an effective 17.3 per cent. But since such a bond would pretty certainly have a clause allowing the borrower to redeem at par in the event of a change in the tax regime, the borrower would be more than happy to take the opportunity of refinancing at today's rates of not much over 10 per cent. Any aggrieved borrower should recall that this, after all, is what small print is there for.

26 JUL 1988

THE NATIONAL TRUST

for Places of Historic Interest or Natural Beauty

36 QUEEN ANNE'S GATE · LONDON SW1H 9AS

Telephone 01-222 9251 · Facsimile 01-222 5097

From the Director-General PLEASE QUOTE: AS/JR/LDS/1

The Rt Hon. Norman Lamont, M.P.
Financial Secretary to the Treasury
Treasury Chambers
Parliament Street
London SW1P 3AG

26 July 1988

26 JUL 1988
MR ISAAC-IR
PS/CHX
Mr GILHOOLY
Mr CROPPER
MR STEWART-IR
PS-IR

Dear Mr Lamont

Further to my letter of 6 July I have now discussed Mr Isaac's letter of 17 June with my colleagues here and I am writing to ask you if you would be good enough to authorise the Board of Inland Revenue to discuss with us a possible change in the law for implementation in the Finance Bill in 1989.

At our meeting with Mr Isaac and his colleagues on 27 May there was a discussion on the possibility of a statutory amendment to remove any difficulty that might face the National Trusts. It was made clear to us that it would not be appropriate for the Board to discuss details with us without ministerial authority to do so. In the circumstances I should be most grateful if you would be prepared so to authorise the Board.

I should add that we have a proposed amendment ready which we would be happy to put forward in draft to the Board.

Yours sincerely
Angus Stirling

Angus Stirling

PRESIDENT: HM QUEEN ELIZABETH THE QUEEN MOTHER
CHAIRMAN: DAME JENNIFER JENKINS · DIRECTOR-GENERAL: ANGUS STIRLING

A J G Isaac CB
Deputy Chairman

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE
LONDON WC2R 1LB

Telephone 01- 438 6601

17 June 1988

Angus Stirling Esq
Director-General
The National Trust
36 Queen Anne's Gate
London SW1H 9AJ

Dear Mr. Stirling,

At our meeting on 27 May, we discussed your concern - expressed in your letter of 12 May to the Chancellor - that Clause 35 of the Finance Bill might have the effect of narrowing the scope of the present relief for charitable covenants and so prejudicing the Trust's position.

I agreed to write and confirm that we do not regard the Clause as narrowing the present relief in the way you feared. A reference to charitable covenants was necessary in the Clause to exclude them from the changes being made in the tax treatment of other covenants made by individuals. But we are advised that it does not alter the position of the Trust's covenants under present law. The Financial Secretary confirmed that in the debate on the Clause in the Finance Bill Standing Committee on 7 June.

We also agreed to let you have a written statement of the legal arguments which Douglas Johnston explained at the meeting. I enclose a note setting them out, and should be glad to have any further comments you may want to make on them. As you will know, the Financial Secretary also referred in the debate on Clause 35 to these discussions in response to the questions put to him by Mr Carrington on your behalf.

I am copying this letter to Mr Borley at the National Trust for Scotland.

Yours sincerely

[signature]

A J G ISAAC

THE NATIONAL TRUST

This is a reply to Andrew Park's opinion of 29 February 1988 and records the views which I expressed at the meeting on 27 May.

The following propositions based on the opinion appear to be common ground:

1. The benefits provided by the National Trust to covenanting subscribers are not de minimis.

2. The covenanted subscriptions are annual payments for tax purposes only if they are pure profit income in the hands of the Trust.

3. The covenanted subscriptions are not prevented from being annual payments merely because there may be conditions or counter stipulations, or because the payments do not represent pure bounty.

4. The covenanted subscriptions are not pure income profit if they represent gross receipts in return for the provision of goods or services against which a deduction for expenses falls to be made.

5. The purposes of the Trust are not only the preservation of the Trust's properties, but also include the provision of public access.

6. The issue is whether the covenanted subscriptions to the National Trust are pure income or are gross receipts of the Trust.

In **CIR v Corporation of London (as Conservators of Epping Forest)** 34 TC at page 320 Lord Normand said it was much too late to say that a charitable body, every penny of whose income must be applied to its exclusively charitable purposes, is incapable of earning profits or gains. In **Campbell v CIR** 45 TC at pages 470-1 Lord Upjohn said that it is well settled that tax cannot be deducted by the payer in respect of payments which in the hands of the recipient are gross receipts for advice or services rendered or goods supplied, which merely form an element in discovering what the profits of the recipient are. Lord Upjohn at page 471 referred to the class of annual payments which the Acts regard and treat as being pure income profit of the recipient undiminished by any deduction. Lord Donovan at page 474 noted that the test of an annual payment within Case III is the same whether the recipient is a charity or not. The type of payment which would not be an annual payment from which tax could be deducted would be an annual payment for goods or services. At page 475 Lord Donovan said that there is no warrant in the Income Tax Acts for applying a special test in the case of charities. The test must be applicable to all annual payments, and the problem

must continue to be resolved on the lines laid down by Scrutton LJ in **Earl Howe.** It is necessary to determine whether the payment is a taxable receipt in the hands of the recipient without any deduction for expenses. If it is simply gross revenue in the recipient's hands out of which a taxable income will emerge only after his outgoings have been deducted, the payment is not an annual payment. Lord Donovan said that, if goods and services are supplied in return for the payments in question, no doubt it will normally be found that this is done continuously or periodically during the time that the sums are payable. At page 462 Viscount Dilhorne approved the passage in the judgment of Morris LJ in the **National Book League** case in which the latter said that, if the payments were made in such circumstances that the League was obliged to afford to the covenantors such amenities and such benefits of membership as would at any particular time be offered to all members, and if those amenities and benefits were appreciable and not negligible, the payments would not be pure income profit in the hands of the charity. Lord Hodson at page 467 said that the decision in **National Book League** could be supported on the broad ground that the payments were in the nature of annual subscriptions to a club. Lord Upjohn at page 472 said that it was a case rightly decided on the **Earl Howe** principle. Lord Donovan said at page 474 that the evidence in **National Book League** established that the so-called "annual payment" was simply a club subscription in return, as the Crown contended, for the annual provision by the League of goods and services, and so was clearly within the scope of the decision in **Earl Howe's** case.

In **Essex County Council v Ellam** T251 Hoffman J said at pages 4-5

> "The question in this appeal is whether Mr Skidmore was entitled to deduct tax in the first place. That depends upon whether his payments were an 'annuity or other annual payment' charged to tax under Case III of Schedule D within the meaning of Section 52 of the Taxes Act.
>
> Now it is well settled that not all yearly payments fall within this description. In order to come within Section 52 it is necessary, among other things, that if the council had been a taxpayer the gross payment would have been taxable income in its hands. It must have been, as the authorities put it, 'pure income' or 'pure profit income' rather than merely a receipt from which outgoings must be deducted before taxable income can be ascertained. So, for example, if the recipient had to provide goods or services in exchange for the payments the cost of those goods or services will be deductible in ascertaining its taxable income and the gross payment would therefore not be 'pure profit income'."

At page 6 Hoffman J referred to the Council's arguments that the payments were not pure profit income in the light of the surrounding circumstances. These were that the Council was exercising a statutory function and not carrying on a trade, the sums went into the Council's general account and were not treated as receipts in a profit and loss account and that the payment of the child's fees did not constitute the provision of a service sufficiently analogous to the kind of services which in the decided cases had taken payments outside the definition of pure profit income. Hoffman J said at page 6:

> "I do not think that there is any need to look for whether the council was carrying on a trade or whether there are sufficient analogies with other cases. One simply asks, as Lord Donovan put it in Campbell v. Commissioners of Inland Revenue, 45 Tax Cases at page 475, whether the payment is 'a taxable receipt in the hands of the recipient without any deduction for expenses or the like'. That requires one to assume that the council is hypothetically a taxpayer, and it seems to me quite untenable to suggest that these payments would, if the council had been a taxpayer, have been taxable in gross in its hands without any regard to the amount which it had paid out to Mencap. The result is that in my judgment the payments were not 'pure profit income' and were therefore not annual payments within the meaning of Section 52."

In the light of the authorities the question whether the covenanted subscriptions to the National Trust are pure profit income or gross receipts must be approached on the basis that the National Trust is taxable. It is considered that the covenanted subscriptions represent payment for services, for the provision of the amenities of the Trust's premises. The covenanted subscriptions effectively procure for the member a season ticket. They are as much gross receipts as the admission fees paid by non members. There is a close analogy with the payment of admission fees by visitors to a private country house. The Trust is not distinguishable from a private country house simply because it is a charity, since in considering whether the covenanted subscriptions are annual payments, as Hoffman J says, it must be assumed to be taxable. The test for an annual payment is the same whether or not the recipient is a charity. The covenanted subscriptions do not represent pure profit income in the Trust's hands since the provision of admission to its premises to covenanting members involves it in expenses. It is not the case that its expenses are simply incurred in any event in order to preserve its properties in fulfilment of its obligations. It incurs additional expenses in order to provide access to those properties. Its expenses are higher than would be the case if it were simply preserving its properties, to which the public was not admitted. It incurs expense in order to provide admission for non members, and for covenanting and

non covenanting members. The receipts from admission fees paid by non members and the covenanted and uncovenanted subscriptions from members represent income from which the expenses of providing admission, if the Trust were taxable, would fall to be deducted. It is immaterial that only a small proportion of this income may be represented by covenanted subscriptions, since this was also the case in the **National Book League** case. As Hoffman J makes clear, it is irrelevant that the recipient may have statutory purposes, or that the payments may go into its general funds. In view of the Trust's statutory duty to provide public access, the expenses of preserving the properties are referable not only to their preservation but also to the provision of public access to visitors, including covenanting subscribers. The Trust is not in a unique position in having to incur expense in preserving its properties before the public is admitted and even if no visitors appear. A private country house is in a similar position. It is irrelevant that the Trust's expenses may greatly exceed its covenanted subscriptions. In Hoffman J's words it is untenable to suggest that those payments would, if the Trust had been a taxpayer, have been taxable in gross in its hands without any regard to its expenses.

There is a very great difference between the covenanted subscriptions under consideration which entitle the covenantor to free entry, and the case where a visitor pays the admission fee and enters into a covenant for additional payments. The admission fee would be a gross receipt out of which the expenses would be deductible. The covenanted payments would be pure income profit in the recipient's hands, on the basis that no goods or services would be provided in return for those payments. By contrast, where the visitor is allowed to enter without payment, the covenanted payment is not pure income profit since the reality is that goods or services are being provided for the covenantor and any similar visitors.

It will be noted that the relevant expenses are those incurred in providing goods or services. Expenses of administration in connection with covenants to charity not made in return for the provision of goods or services are not the sort of expenses referred to in the authorities. Otherwise the clear distinction drawn by the courts between pure income profit and gross receipts would be eliminated in the case of covenants, and no covenanted payment could be pure income profit in the hands of the recipient, where administration expenses are incurred.

Andrew Park's opinion has been carefully considered, but the Revenue is firmly of the view that the covenanted subscriptions are not annual payments, and that the courts could be expected so to hold.

253/51/JRF

?| TH-x/i

FROM: MISS S J FEEST
DATE: 1 August 1988

MR A J G ISAAC - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Call
PS/IR

NATIONAL TRUST

The Financial Secretary was grateful for your minute of 28 July 1988 and is happy for you to enter into discussions on the basis set out in paragraphs 5 of your minute.

Susan Feest

SUSAN FEEST

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
28 July 1988

FINANCIAL SECRETARY

NATIONAL TRUST

1. Mr Angus Stirling of the National Trust wrote to you on 26 July, asking if you would authorise the Board of Inland Revenue to discuss with them a possible change in the law for implementation in the Finance Bill in 1989.

2. This is very much the approach which I forecast in my note to you of 1 June (paragraphs 13 to 16).

3. The background is that the National Trust has now seen the precis of the legal arguments, which I sent to them on 17 June in response to Andrew Park's Opinion. They do not seem anxious to test their case in the Courts (perhaps because they are not confident of success; perhaps also because there would be a period of uncertainty, whilst the case made its way through the judicial process). They want therefore to explore the possibility of a change in the legislation, which would extend

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cc PS/ Chancellor of the Exchequer
PS/ Chief Secretary
PS/ Paymaster General
PS/ Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Call

~~Mr Battishill~~
~~Mr Isaac~~
~~Mr Painter~~
~~Mr Miller~~
~~Mr Corlett~~
~~Mr Deacon~~
~~Mr Johnston~~
~~Mr Stewart~~
~~Mr Davenport~~
~~Mrs Fletcher~~
PS/IR

the "charity" exemption to the Trust's membership covenants. They have apparently worked up some ideas, and are asking you to authorise us to discuss these with them.

4. As I explained when I met the Trust (paragraph 14 of my minute) I need your authority before embarking on discussions of this kind. To accept their invitation would carry the clear implication that the Government would be prepared to legislate if (and it may not be easy) it is possible to define a reasonably closely targeted exemption.

5. I should be grateful for your guidance.

(i) Would you like us to enter into discussions with the National Trusts for England and Scotland, to see if it possible to devise a reasonably closely targeted exemption for membership covenants to the Trusts, and similar charities? (I imagine you would want us to enter into these talks formally without commitment. But it would be unrealistic to deny the implication that the Government would be prepared to consider legislation in the 1989 Finance Bill, if a satisfactory form of words can be found.)

(ii) Without prejudging at this stage precisely what we mean by "reasonably closely targeted", can we take as a working assumption that there should not be relief in any event for covenants etc capable of procuring a substantial individual benefit, such as a discount on public school fees?

(iii) At my meeting last June, Mr Andrew Park saw some attraction in making use of a list of "special" charities, as at least part of the statutory exemption - perhaps making use of a list that already exists for certain IHT purposes. The difficulty with this approach is that the list does not include some charities - such as the Wildfowl Trust - which are

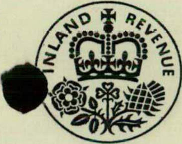
really on all fours with the National Trust. And, however the list were drawn up, Ministers would inevitably face constant pressure for it to be extended. My response, off the cuff, was that Ministers might not find that suggestion attractive, but I did not try to rule it out completely. Should we continue to take that line at this stage?

(iv) Meanwhile, the alternative which we have been thinking about would involve laying down certain criteria which might allow us to secure free entry benefit (but not other significant benefits) where a charity was involved in preserving property for the public. Shall we pursue that sort of approach, again of course without commitment?

(v) Subject to your views, I should be happy to draft a letter for your Private Secretary to send (in your absence). Alternatively, if you want us to talk to the National Trust, I should be happy to write myself, under your instructions.

C.f.A.

A J G ISAAC



Inland Revenue

Policy Division
Somerset House

SECRET AND PERSONAL

FROM : M A JOHNS
9 August 1988

1. Mr Painter
2. Chancellor of the Exchequer

MORTGAGE INTEREST RELIEF

1. You asked (Mr Allan's note of 28 July) for advice on the possibility of restoring the mortgage interest relief ceiling to £25,000 for both new and existing borrowers.

Practicability

2. Technically and administratively such a change would be very straightforward. You would have to decide how you wanted to handle protected loans under this year's Budget. Loans taken out before 1 August are eligible for relief up to £30,000 per taxpayer and those taken out on or after that date to £30,000 per residence. We assume you would want the former reduced to £25,000 per taxpayer rather than all the way down to £25,000 per residence.

3. You would also need to decide whether you wanted to reduce the ceiling for home annuity loans as well as those for home purchase. This would go in the opposite direction to that sought by Mr Butterfill who got a lot of support for widening the relief in this year's Finance Bill debates. The numbers of annuities is

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cc. Financial Secretary
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mr Cropper

Mr Isaac
Mr Painter
Mr Beighton
Mr Johns
Mr O'Connor
Mr Stewart
PS/IR

small (Mr Butterfill suggested 20,000 which we suspect is on the high side) but the elderly people affected would nearly all have borrowed the full £30,000 and so would lose £144 a year when their total income from such annuities may well be only £1000-£2000. On the other hand, to retain a higher limit for loans to purchase annuities than for loans to purchase houses would look odd.

4. The legislation would be a few lines only. There should be few administrative problems for either lenders or the Revenue if the change took effect from the start of the new tax year on 6 April provided Budget Day was before then. If the change applied to new and existing loans there would be none of the forestalling problems which arose this year. (Restricting action to new loans, by contrast, would not require as long a period as the residence basis for lenders to adopt, but would require a balance between letting through people with commitments at Budget Day and not setting off a new rush to forestall.)

Yield

5. The yield depends on a number of factors, the most sensitive of which is the interest rate. Assuming an interest rate of 11.5% throughout 1989/90 and unchanged rates of tax, the yield would be about £450 million. This is an 8% reduction in the projected £5.75 billion cost of mortgage interest relief. While this figure does not take account of behavioural effects, we would not expect these to be very large.

Distribution

6. We estimate that 3.6 million tax units (ie. counting husband and wife as one) would lose from the change. This is made up as follows:

thousands

Size of loss (£)	Basic rate taxpayers and non-taxpayers	Higher rate taxpayers	Total
1- 50	460	50	510
51-100	550	50	600
101-150	2070	50	2120
over 150	0	400	400
Total	3080	550	3630

If home annuity loans were also included there could be up to 20,000 additional basic rate losers nearly all losing between £101 and £150.

7. The maximum loss for a mortgagor paying interest at 11.5% is £144 in the case of a non-taxpayer or basic rate taxpayer and £230 for a higher rate taxpayer. This compares with a loss of £394 in a full year on a £30,000 loan for a basic rate taxpayer and £315 for a higher rate taxpayer from the 1.75% increase in mortgage interest rates recently announced.

Proportion of new borrowers affected in each region

8. Figures for the regional distribution of the size of loans taken out by first time buyers are available for building society loans but not for loans from other lenders. However building societies probably account for over three quarters of the loans to first time buyers. The average first time buyer loan from banks is about 10 per cent higher than the corresponding building society average so the following figures are probably a slight underestimate. The figures relate to the first quarter of 1988, and, if the size of new loans continues to grow, the proportion of first time buyers who would lose will also increase.

SECRET AND PERSONAL

Regions	Proportion of first time buyers who would lose
London	85%
Other South East	80%
South West	70%
East Anglia	60%
East Midlands) West Midlands) Northern Ireland)	between 25% and 50%
Northern) Yorkshire & Humberside) North West) Wales) Scotland)	less than 25%
United Kingdom	45%

M.A. Johns

M A JOHNS

SECRET AND PERSONAL

COPY NO 1

Inland Revenue

Policy Division
Somerset House

FROM M A JOHNS

DATE 25 AUGUST 1988

CHANCELLOR OF THE EXCHEQUER

MORTGAGE INTEREST RELIEF

You asked (Miss Wallace's note of 23 August) what the yield would be if the mortgage interest relief ceiling was reduced to £25,000 for loans entered into on or after Budget Day.

If Budget Day was on 6 April, assuming unchanged tax rates and a 11.5% interest rate and ignoring behavioural effects the yield would be:

£million

	1989/90	1990/91	1991/92
	70	220	350
This compares with	450	520	590 if the

change were applied to all loans.

The receipts would be slightly higher if Budget Day was before 6 April. (We assume that the change would relate to interest paid on or after 6 April but on loans made on or after Budget Day.) On the other hand, one would expect some locking in which would reduce the yield somewhat.

cc Financial Secretary
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mr Cropper
Mr Isaac
Mr Painter
Mr Beighton
Mr Johns
Mr O'Connor
Mr I Stewart
PS/IR

While this approach would avoid losers and there would be no forestalling problem, there would, of course, be people who felt they were morally committed on Budget Day even though no loan had been made. As this year there would probably need to be a let out where there had been a written offer of a loan and a binding contract for purchase of the property. And you might need to consider whether to apply the change to loans made on Budget Day as although people have been warned that changes will generally apply on Budget Day this may not have registered with house purchasers.

Different ceilings for different borrowers might cause some initial problems for lenders but they have been tending to argue that they could have coped with this year's changes earlier so they ought to be able to cope with more-or-less immediate implementation of what would be a much simpler change. If Budget Day were a week or two before 6 April as usual there should be no problem.

As with the proposal for all loans you would need to decide whether to include new home annuity loans or not. But there should be no practical problems on this.

M.A. Johns

M A JOHNS

CONFIDENTIAL

NORTH SEA FISCAL REGIME WORKING PARTY

REPORT 1988

- INCREMENTAL PROJECTS

- PROFITABILITY

CONFIDENTIAL

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Review of Field Profitability	23-27

INCREMENTAL PROJECTS

BACKGROUND

1. The impact of the tax system on incremental projects has been reviewed regularly by the Working Party, and in the 1986 Budget the Chancellor said that if ever there was evidence of worthwhile incremental projects being frustrated by the fiscal regime, the Government "would not hesitate to introduce at the earliest opportunity any changes which may be necessary".

2. On each occasion this has been looked at, however, the conclusion has been that there was no real evidence generally of difficulty in practice. Moreover, the problem was seen to be that of devising a relief which would target the investment at risk without on the one hand incurring unacceptable deadweight cost and, on the other, giving a tax subsidy to projects that were uneconomic even before tax.

3. The conclusion in 1987 was, again, simply to keep the matter under review. However, D/Energy subsequently became aware of at least one actual project - Columba, a sizeable development in the Ninian field - which they believed was in fact being inhibited by the current tax rules. They also believed that similar problems might arise with certain other prospective projects which could be developed in the near future.

4. Ministers therefore agreed that the Group should review the matter again as part of its 1988 work programme.

Definition of incremental project

5. In the broadest terms, an incremental project is any investment that occurs in a mature field after PRT "pay back" has been reached (the point at which uplift on initial expenditure is cut off). Conceptually it can be divided into two broad classes: incremental expenditure (on wells or enhanced recovery techniques) which increases the flow of oil within an existing development; and expenditure which enables oil which would not be reached by existing facilities to be recovered. But in practice there is a considerable grey area between the two.

The problem in theory

6. The economics of incremental projects will depend on a number of things including cost, the extent of the reserves, the type of expenditure, and the rate of return and the net present value of the project. The tax

position of the individual participators in the host field may also have an important influence, and the question is whether and to what extent the fiscal regime causes distortions - in particular, by making marginal projects (those on the borderline of profitability at the company's required rate of return) that are economic pre-tax, uneconomic post-tax.

7. When uplift was cut off at payback (in 1981) this was justified on the grounds that it was a proxy for interest and borrowing was no longer needed once costs had been recovered out of revenue. It was also argued that there is no tax disincentive to investment after payback because there will then be immediate tax relief on investment at the same rate as the income resulting from the investment is taxed. This had the effect that pre and post tax rates of return were more or less the same (the Government was almost an equity partner in the investment) so there should be no distortion. (Strictly, there was still a small distortion because of Royalty.) A "tax wedge" reducing post-tax returns below pre-tax returns was introduced in 1984 when 100% capital allowances were replaced by 25% writing down allowances. But this reflected Ministers' general decisions on corporation tax reform and, for fields subject only to CT, this had the effect of ensuring that the tax wedge which incremental projects face is a reflection of the similar tax wedge which other investments face and should not distort the allocation of resources between different types of investment in the economy generally.

8. However, because of the detailed operation of the North Sea regime, this picture is a bit oversimplified and there are a number of situations where there could be a quite sizeable wedge and that would, therefore, represent a potentially serious fiscal deterrent to this kind of incremental investment. The Working Party has in previous years identified four main situations in which the present tax and Royalty regime could in theory inhibit incremental investment, as follows

(a) In fact, because of the interaction of PRT and CT the tax wedge on expenditure on North Sea plant and machinery is higher where PRT is paid than it is on other plant and machinery. This is because of a mismatch between the corporation tax clawback of PRT relief and the timing of CT relief for the expenditure - the clawback of PRT is chargeable to CT in full, immediately, whereas CT relief for the expenditure is given more slowly on a (mostly) 25% WDA basis. This means that where incremental investment consists mainly of non drilling capex there can be a disincentive.

Where the investment consists mainly of drilling there could be an over-incentive in that intangible drilling costs are treated as revenue expenditure and therefore qualify for 100% relief for CT under an old ruling by the Special Commissioners (an appeal body) - the "New Brunswick" practice. It is doubtful whether the Courts would today uphold this ruling but it provides a counter-balance to the disincentive in many cases.

(b) Impact of royalties where the cost of the incremental project consists mainly of drilling capex - such expenditure not being allowable as "conveying and treatment" costs for royalty purposes. New offshore fields would not pay Royalties at all. Consequently, all other things being equal a new development will always be preferred to an incremental project of comparable size and profitability in an existing Royalty paying field.

(c) Impact of PRT where the effect of the incremental project is to bring the field into PRT for the first time.

(d) The "absolute return" problem. The suggestion here is that companies do not look just for the required minimum rate of return on a project, but that the absolute level of profit also matters because of other considerations including management constraints. Over the years we have had several discussions with the industry on this argument and it is very difficult to establish how cogent it is. It is certainly true that companies look at measures of absolute profit (especially net present value) when deciding whether to develop or not but this is particularly relevant when deciding between alternatives. In principle, in the absence of additional capital rationing it should pay companies to go on investing in all projects earning a rate of return exceeding their cost of capital. A small project earning a high rate of return is worth investing in and it is only if it squeezes out a project earning a larger NPV that the size of its profit matters. There is no evidence of any overall shortage of capital in the North Sea which would justify capital rationing and only proceeding with high NPV projects. The companies argue that there is a shortage of management and engineering skills and that it is therefore necessary to ration their activity

to large profit earning projects. There is probably some truth in this (and because of the lumpiness of oil investments it may not be possible to take action to remove all the shortages); certainly the companies refusal to negotiate royalty refunds on Columba (see paragraph 15 below) gives some weight to this. On the other hand, there may be other explanations (eg a belief that the Government will change its mind, and eg agree to separate field status, if the participators hold out) and we do not think too much weight should be given to this argument.

Problem in practice - generally

9. On every occasion that we looked at this in the past we concluded that there was no evidence of a problem concerning incremental investment generally. That remains our view.

10. Every year, NEDO undertakes a survey covering the investment intentions in the context of incrementals, looking 5 years ahead. According to the 1988 Survey total incremental investment over the 5-year period to 1993 is expected to amount to £2.3bn (1987 prices) - some 13% of total forecast expenditure of £18.3bn excluding PRT-exempt Southern Basin gas fields. The same survey also suggests that incremental investment will be about £700m in 1989, compared with an outturn of £370m in 1987 and a forecast of £600m in 1988.

11. Thus, there is a sizeable continuing interest in incremental investment - despite the fact that most of this investment will not qualify for uplift (so the proceeds from it will almost certainly in all cases be taxed at a higher average rate of PRT than those from new fields which are also entitled to the full amount of oil allowance), and that something like 40% of it relates to drilling of production wells, most of which would be in-fill drilling and so not eligible for relief against royalty. On the other hand, the above figures include some £370m of expenditure on the re-instatement of the Piper field, but take no account of additional incremental expenditure imposed for safety reasons. D/Energy's current view is that such safety related expenditure could increase the above figure by £600m over the 5 year period.

12. Some analysis by D/Energy of two particular incremental projects (Central Brae and Forties Artificial Lift) that have been approved in 1988, and of various other minor on-going incremental investments in mature fields mostly involving in-fill drilling, also confirmed

that tax was not seriously a problem in those cases. It did make a difference to the economics in these cases, but the projects were still economic post-tax.

"Discrete peripheral accumulations"

13. However, analysis by D/Energy also suggests that a problem has now arisen in one particular case already, and may arise again in the near future, where significant non-drilling expenditures are involved. The cases which seem most likely to give rise to problems are accumulations of oil which are within the PRT boundary of a mature, tax paying field but which cannot readily be developed from existing structures. Geologically the field is all one structure but the original development plan did not provide means for extracting oil throughout the area of the filed. These accumulations of oil are sometimes known as "discrete peripheral accumulations" (DPAs).

14. So far, only one such project has become a major issue. This is Columba which comprises a series of oil accumulations to the South and West of Ninian known as the Ninian Terraces. This would be a phased development, involving individual projects on the so called "B and D Terraces".

15. The companies* have indicated that they would like to proceed with the development of these two Terraces, but only if they were taxed as a separate field or fields from Ninian. However, they are clearly part of the same geological structure as Ninian and so separate field status has been refused. The licensees were invited to apply for a royalty refund, which could be set at a level sufficient to yield an adequate commercial return on their investment. But this was declined on the grounds that a refund designed to give an adequate internal rate of return (IRR) would still leave the absolute size of the profit after tax too small to justify the complexity of putting such a deal together. (This may be an example of the "absolute return" problem mentioned at paragraph 8(d) above.)

16. D/Energy also looked at a few other relatively large DPAs whose economics might depend on whether or not separate field status is given. For some of these, insufficient detailed information is available to reach a judgement and in some cases it is likely that the project would still be economic even without separate field status. But there are few cases - Strathspey and conceivably Tay and West Claymore - where it seems possible that, as with Columba, the interaction of PRT and CT could create a tax wedge of sufficient size such that the projects would be economic pre-tax, but not post-tax.

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*The participators in Columba are Britoil, Enterprise, Chevron, Murphy, Ocean, Conoco, Deminex, Lasmo & Ranger. All except Conoco and Deminex already have an interest in Ninian.

17. Prima-facie, therefore, there is now some evidence of an emerging problem. There is firm evidence in respect of one particular project - Columba - and other actual projects may be affected as well, though except possibly in the case of Strathspey there is no firm evidence as yet. The scale of the problem is relatively small but not insignificant, in that Columba, Strathspey, Tay and West Claymore together have total recoverable reserves of about 225 million barrels, which is equivalent to a medium sized field like, say, Maureen.

18. D/Energy also believe that there is some urgency, especially as regards Columba. Allowing for development time, and on low (but not unrealistic) oil price assumptions, this project would need to reach first production in, say, 1991 if its economics are not to be damaged; if it starts much later its later life would be after the Ninian field is abandoned and it could not support the cost of the Ninian collection facilities on its own. On the Base price case, however, Ninian's last year of production is 2005 which leaves a much longer window of opportunity for Columba. And, while the companies are keen to proceed if the economics can be got right there is a risk that they might simply loose interest if this is not done quickly. If there was to be action to help incrementals, therefore, D/Energy believe there would be a strong case for action in Finance Bill 1989 in order to help Columba. If left later, the risk of the project becoming uneconomic increases considerably.

ALTERNATIVE APPROACHES

19. The companies' preferred solution would undoubtedly be <u>separate field status</u>. But the boundaries of the field for PRT purposes are determined on geological criteria, and separate status would by definition not be appropriate in these cases where the DPA in question is part of the same geological structure as the host field. Changing the geological criteria to let in Columba would risk unwinding the determinations for several other very large fields such as Brent at enormous cost to the Exchequer.

20. Linked to field determination, we considered whether it might be possible in some way to introduce an <u>economic dimension in the exercise of the discretion by the Secretary of State in determining separate status of field</u>. Thus, the existing geological criteria would remain, but in addition separate status might also be granted where, for example,

- the project was worth developing in the national interest,

- the various cash flows could be identified and separately monitored,
- the project would not otherwise go ahead.

The advantages of this approach are that it might be workable in practice, and would fit in with proposals from the industry for a more flexible approach.

21. But there would also be major disadvantages. It would introduce a new and unwelcome element of discretion. It could induce companies to sit on projects, in the hope of getting separate status, and it would be one sided in the sense that there would be no corresponding discretion to disallow projects which got separate status and are highly profitable. And, there would no doubt be considerable room for argument about the impact of the tax system on the remaining NPV of the project and, therefore, the field in question. Moreover, in some of the DPAs concerned there is pressure contact with the main part of the field. It could, therefore, be difficult to measure the extra oil produced by the project - as would be necessary if separate field status was to apply. For this and other reasons there could be practical (though not insuperable) problems in drawing the line in some cases.

22. In the past the Working Party has also looked at various proposals which related to production from incremental developments, but these proposals have been discarded because it is not possible to establish a separate output of oil. Proposals such as a supplementary oil allowance and a royalty refund based on incremental output come into this category.

23. Another approach considered in the past was some kind of incremental uplift, determined by a time trigger related to pay back or to the ending of safeguard for the mature field. There are however, a number of drawbacks to this approach. Such a relief would be likely to be poorly targetted, covering all fields of a particular age, and thereby involving a considerable deadweight cost. Again, there is the risk that this might also encourage companies to delay the proposed project so as to get the benefit of the new relief - ie where there is a gap between ending of uplift and the start of the project.

24. Finally, there is discretionary use of royalty refunds. This has been considered in the past and was offered, but rejected in the particular case of Columba.

25. There are two reasons why licensees find royalty refunds unattractive. The first is a general distaste

for discretionary reliefs and a feeling that it is difficult to rely on them (although we have tried to meet this concern by providing that once the initial discretion was exercised future payments would be contractual). The second is that even though it may guarantee whatever is their required minimum rate of return on their share of the investment, companies are still likely to be left with a relatively small absolute level of profit.

26. In theory, companies could increase their share of the profit in this situation by not claiming their costs against PRT on the host field so that a much larger royalty refund would then be needed to achieve the guaranteed rate of return on their (increased) share of the cost of the profit. Because the return would have to be earned on a larger cost base, the absolute profit would have to be larger. However, this would not remove their general dislike of discretion and would add to it the presentational difficulty of a measure which involved deferring tax relief in return for a much larger grant.

TARGETING

27. There may be other forms of incremental expenditure which will be discouraged by the effects described at paragraph 8 (a) to (d) above, but at present no evidence has been produced of such problems and no way has been devised of giving relief which does not carry heavy deadweight costs. We have therefore looked to see if we could devise a relief targetted on developments that are economic pre-tax and whose purpose is to extract oil from outside an existing development area of a field, and that would not otherwise go ahead without the concession. More specifically, it should be for undeveloped reserves that are

- part of an existing field for PRT,
- but not originally identified as suitable for development in the original development plan, and
- not part of the existing development area.

In addition, it would need to be expenditure and not production related because of the difficulty of separately identifying incremental production from that of an existing development.

28. The approach would also, so far as possible, try to build on existing definitions - the most important for this purpose being the "development area" and the PRT "field".

29. As noted, the boundaries of the PRT area are set by D/Energy on geological criteria based on the best data available at the time. As new information becomes available, either through further appraisal or development drilling, there might be a need to redetermine the original PRT area. This might involve a contraction or an expansion.

30. The expression "development area" is in general use but does not have any statutory definition. It is, rather, the boundary of the area of development proposed by the operator. In essence, it can be defined as the area specifying the limit of works approved by D/Energy in the development plans. D/Energy are confident that in all fields this area is unambiguous and that there are adequate definitions on which they could build, either in Annex B development plans, or equivalent consents for earlier years. (There could in theory still be some room for disagreement, but only within a very fine margin.)

31. In more recent fields the boundary of a development area is normally coincident with the PRT boundary of one or more fields. There are a number of cases, however, in pre-1982 fields where the PRT area is not wholly covered by development areas because at the time development consent was given not enough was known about the geology of the whole area to make a plan for it.

32. Because of the likelihood in post-1982 fields that the development area and the PRT boundary will be coincidental, the operator will be able to control the expenditure over time throughout the PRT area so as to get benefit of expenditure within the current uplift and safeguard etc rules. Nowadays, developments are often done in stages and consent is similarly staged. The operator will try to ensure that the works come within the pre-pay back period to secure the application of the appropriate tax reliefs. In such cases the problem of DPAs should not arise.

33. The situation in some pre-1982 fields is different. In a number of cases, the development area was significantly smaller than the PRT area - therefore, no development was possible in the areas between the two boundaries because there was no consent.

INCREMENTAL INVESTMENT ALLOWANCE

34. Against this background, and in the light of the above desiderata, we have considered the possibility of a new incremental investment relief, which would take the form of a specified percentage enhancement for qualifying incremental expenditure to compensate for the various tax disincentives described earlier. More specifically, this

new "Incremental Investment Allowance" (IIA) would operate and be targeted as explained below.

35. First, it would apply only to capital expenditure and exclude that which attracts uplift under the current regime. The expenditure would be that whose purpose was exclusively to win oil from new wells which penetrated the top of the reservoir outside the field development as defined on Budget Day 1989, but inside the field as a determined for PRT purposes at the time of consent for development in the qualifying area.

36. Second, the concession would be confined to pre-1982 fields, off-shore, and outside the Southern Basin. These limitations would help target the IIA on the problem areas outlined above.

37. Third, the IIA would be available only for capex on assets used exclusively for the new development - it would not be available for assets which were shared between the new development and existing production. This limitation is necessary because in the absence of accurate measurement of the incremental production, it would be difficult to see how the costs of shared assets could be apportioned. This might introduce a bias - and therefore a distortion - in favour of dedicated rather than shared assets, but we would not expect this to be of major significance.

38. We also considered whether it would be possible to restrict the allowance to reserves that were not "in communication" with the existing field even though they were geologically part of that field. This would have been desirable as an additional safeguard against distortion - eg a company attempting to drill in to the reservoir at a point just outside the development area so as to produce reserves which, but for the IIA, they would otherwise have produced anyway from within the development area. However, it would not be feasible technically to restrict IIA to reserves that were not in communication with the existing fields, and in practice D/Energy believe that any distortion would be likely to be minimal and more than outweighed by the benefit of not having to make new and potentially difficult geological determinations in each case.

39. The level of the IIA itself would be a matter of judgement. If it was too high there would be a risk of making some projects that were <u>uneconomic</u> pre-tax, economic post-tax; and to the extent that there was any deadweight cost this, too, would be greater the higher the level of the IIA. On the other hand, if it was set too low, it might have little or no effect.

IIA: ECONOMIC APPRAISAL

40. D/Energy have identified five fields as coming within the target range at present - ie where the development area is or may become significantly smaller than the PRT area. The situation as regards prospective development projects outside the development area - but within the field - in these cases is as follows

- Ninian: the Ninian Terraces, including Columba (see paragraph 14 above).

- Brent: potential in the Southern part of the field (blocks 3/4A), where the Northern part of the Strathspey discovery falls within the Brent PRT boundary as currently determined.

- Heather: Heather West accumulation.

- Beryl: Tay accumulation. The PRT boundary is expected to be redrawn to include this, and the development area boundary, which currently bisects Tay, is likely to be redrawn before Budget day to exclude it.

- Claymore: West Claymore accumulation currently outside PRT area but may be brought within it.

41. In our detailed analysis we concentrated mainly on Columba(Ninian) and Strathspey(Brent), partly because the developments in question are fairly clearly defined and reasonably firm information is available, but also because in the case of Columba this is the one as yet firm example where, according to the companies, tax is acting as a deterrent to the project going ahead. Also, these two projects are the most important in terms of size. Together, they would involve capex of some £730m (1988 prices), whereas the other projects mentioned above might together involve only about £130m in total.

42. There are however important caveats in the case of Strathspey. Only the northern part of Strathspey falls into the Brent PRT area and the southern part may be determined as a separate field anyway. Moreover, the major part of this project is shared by BP and Texaco who were not active participators in the Brent field. Unless the field was unitised, therefore, they would qualify for uplift and safeguard in relation to any development of Strathspey in which they ultimately share. In either of these scenarios Strathspey would, therefore, be less of an incremental problem and might not figure in the analysis of need for an IIA nor as deadweight cost.

43. Heather is unlikely to give rise to a tax problem because it will not pay PRT and the incremental projects are likely to be small and will not therefore push them into PRT. It is probable that Tay would go ahead in any event, while in the case of West Claymore it is too early to say whether it would qualify.

44. In our economic analysis of the effect of an IIA we assumed a real oil price that rises gently from $15 a barrel in 1988 to $25 in the year 2000 and $30 in 2010. We also assumed that the IIA would become available immediately against PRT liabilities of the parent field (where there are any) and that it would not, therefore, have to be carried forward against future income from the projects. The analysis also assumes that none of the incremental capital expenditure involved would qualify for uplift at present - the IIA would, of course, only be of use to companies already participating in the main field.

45. The results for Columba and Strathspey are set out in the table below, in terms of both the effect on IRRs and NPVs. For purposes of comparison, the table also shows the post-tax IRR and NPV under present rules (with a further distinction between the position as regards participators with an interest in the main field and those with no such interest - the latter qualifying for uplift and safeguard); a royalty refund; and separate field status. The IIA figures relate to existing main field participators, for the reason mentioned above.

	COLUMBA		STRATHSPEY	
	IRR(%)	NPV(10%)	IRR(%)	NPV(10%)
PRE-TAX	30.1	79	21.5	167
POST-TAX				
Incremental - "existing" participators	12.5	3	9.8	-1
Incremental - "new" participators	19	27	14.1	44
Royalty Refund	15	5	15	16
IIA				
- 10%	24	12	14.8	17
- 15%	31.3	17	17.7	26
- 20%	39.1	22	20.9	35
Separate Field	28.1	54	17.2	74

£m, 1988 prices

46. As will be seen, in the base case Columba would have a post-tax rate of return of 12½% and Strathspey just under 10%. An IIA of 10% would raise Columba's return to over 20% and Strathspey's to just under 15%, and an IIA of 15% would raise these returns to over 30% and 17½% respectively. On the other hand, an IIA of 15% would - just - make Columba's post-tax return higher than the pre-tax return, while a 20% IIA would result in a post-tax return significantly higher than the pre-tax rate. It should also be noted that with an IIA of 15% or higher the IRR on both Columba and Strathspey would be higher than with separate field status.

47. As noted earlier, the absolute level of profit is also relevant to the investment decision and, as the table shows, this would still be much lower with an IIA than with separate field status (though it would be very much more than with a royalty refund, which the Columba partners have turned down), notwithstanding the marked improvement to IRR resulting from the IIA.

48. The post-tax figures for Strathspey in the table assume that it is all treated as part of Brent for PRT purposes, but as noted earlier other scenarios are possible. It is also worth stressing that "new" participators in Strathspey would with an IIA in the assumed range be worse off in NPV terms than under the existing regime. There would be an improvement in terms of IRRs for new participators, reflecting the longer term benefits to them of uplift and safeguard related to payback of the incremental project.

Effect on Government Revenue

49. We cannot say for certain what minimum return would guarantee the development of Columba and Strathspey. But the Columba partners have already turned down the prospect of a 15% real rate of return which is at the top of the range we generally use. We do not know whether this was because of genuine worries about the absolute level of profit or because they judged that in the bargaining situation they were in the government would concede more. On the first of these possibilities, at least, a 10% IIA should be enough to secure Columba. Strathspey may also go ahead with a 10% IIA even if it was all treated as part of Brent but it would be marginal at a cost of capital of 15% real. We assume below that Columba would need a 10% IIA to go ahead and Strathspey a 15% one.

50. Below these levels of IIA there would - on this assumption - be no Government revenue from these projects; but revenue from the remaining projects

eligible for the allowance, which we have assumed would be developed anyway, would be higher.

51. On these assumptions, total net yield at the various levels of IIA would be:-

£m, 1988 prices, discounted at 10%

	No IIA	10% IIA	15% IIA	20% IIA
Columba	-	66	62	57
Strathspey	-	-	141	132
W Heather	25	25	25	25
Beryl:Tay	100	99	99	98
W Claymore	34	33	32	32
	159	223	359	344

52. The table above can be expressed in terms of costs and benefits (to the Exchequer):-

	Cost	Benefit	Net Benefit (+)
Net benefit from 10% IIA	2	66	64
Additional benefit 10 to 15% IIA	5	141	136
Cost of moving from 15 to 20% IIA	15	-	-15

53. On this basis a 15% IIA would be justified. Moreover the net cost of moving to a 20% IIA would not be large and this would give a significant proportionate increase in the post-tax NPV of Columba and Strathspey and thus increase the likelihood of their being developed. As noted, however, at this level of allowance Columba's rate of return would be higher post-tax (39%) than pre-tax (30%) and Strathspey's would be about the same post-tax as pre-tax. (A 20% uplift broadly puts the discounted rate of relief on expenditure equal to the discounted rate of tax on the resulting income. This is more favourable treatment than other sectors get where corporation tax taxes revenues faster than it relieves capital costs - the reason for the "tax wedge" discussed in paragraph 8).

54. In undiscounted terms, and assuming that Strathspey would go ahead anyway and/or that part of it would get separate field status (see paragraph 42 above), the annual cost/yield to the Government over the next few years would be

(£m, money of the day)

1989/90	1990/91	1991/92	1992/93	1993/94
-41	-34	+44	+15	+28

These are net figures. On the receipts side, and given the assumption about Strathspey, these comprise the additional Royalty, CT and PRT yield as a result of Columba going ahead. On the cost side, this comprises the cost of Royalty, CT and PRT relief for all Columba expenditure plus the additional cost of relief for a 15% IIA for capital expenditure on all five incremental projects.

Sensitivity

55. The above results are not all that sensitive to factors such as changes in the real oil price. Moreover, in the case of Columba much would also depend on appraisal of the initial stages of this phased development - if they proved negative, the project as a whole might still not go ahead even with a big IIA but of course there would then be no cost to the Exchequer in respect of Columba.

56. If Strathspey is not an incremental problem as a result of one or other of the scenarios described in paragraph 42 above (ie it does not figure either in the benefits or the deadweight costs) then the overall picture for revenue, costs and benefits changes somewhat. With a 15% IIA the total aggregate revenue from the projects drops from £359m to £218m and with a 20% IIA from £344m to £212m. This would result in the incurring of a net cost of £5m in moving from a 10% IIA to a 15% IIA rather than the £136m benefit assumed if Strathspey is counted among the problem incremental projects. On this basis only a 10% IIA would be justified.

57. We have also examined the economic merits of an IIA on the unlikely assumption that Strathspey was included in the "deadweight" costs - ie that this project was a "problem incremental" but that it went ahead without the concession. On this assumption it would appear still to be in the Exchequer's interest to introduce a 10 per cent IIA. The Exchequer would apparently gain in present value terms £66m for Columba and incur deadweight cost of £22m on Strathspey, W Heather etc, giving an overall net benefit of £44m. But on the same basis, increasing the IIA above 10 per cent would not be justified.

58. There may be one or two projects other than those mentioned in paragraphs 40 and 51 on which we do not have information yet, but these are likely to be small and

would not affect the cost very much, even if they fell into the deadweight category. It is also too early to say whether some of the accumulations of oil around Piper are separate fields, or likely to qualify for an IIA.

59. It is also possible, in the case of Columba, that the project might go ahead anyway without some kind of additional concession, but at a later date. This might occur, for example, if oil prices were to rise significantly, or new, more cost effective ways of developing the project were to emerge. However, D/Energy consider this to be unlikely. Oil prices are expected to remain weak over the next several years and, having spent £3m in appraising the project, the Operators have no further engineering studies in hand.

Practicability

60. Three main aspects would need to be considered here.

61. First, the intention would be for IIA to apply to expenditure which satisfied a purpose test relating to the winning, transporting and initial treatment/storage of production from wells which, whilst within the boundary of the PRT field area are drilled outside the original field development area. However, there is at present no definition of development area in the tax statutes and it would be necessary to ensure that such an area could be defined with sufficient clarity.(see paragraph 31 above)

62. Second, the IIA would be restricted to expenditure incurred on assets to be used wholly and exclusively for the purpose of winning etc oil from outside the original field development area. Expenditure incurred on shared assets, in particular those to be used on the existing development, would not qualify for the IIA at all.

63. However, this kind of "wholly and exclusively" test is not one which applies to expenditure generally under the terms of the current PRT legislation, where the approach is to prescribe relief for particular classes of expenditure and insofar as expenditure partly qualifies and partly does not, to allow the proportion which does qualify. On the other hand, provisions governing abortive and exploration and appraisal expenditure do impose a "wholly and exclusively" test, but in conjunction with a closely circumscribed set of admitted purposes.

64. The adoption of such a test would not, therefore, be entirely unprecedented but a clear definition of qualifying purposes(s) would be essential in order to avoid practical difficulties in applying the test. It

should be noted that such a "wholly and exclusively" test applies generally in relation to expenditure claimed for deduction in arriving at trading profits liable to income tax or corporation tax, and has in that context given rise to a great deal of litigation.

65. Third, the suggestion is that the IIA should be restricted to capital expenditure. Again, however, current PRT legislation makes no distinction between capital and revenue expenditure and this would therefore represent a fundamental change.

66. There is no statutory definition of capital expenditure but there is plenty of evidence in other areas of taxation where there is a need to make the capital/revenue distinction to suggest that problems could well arise with the operation of an IIA for capex alone unless the particular heads of expenditure attracting the relief were to be specifically described. One possibility would be to prescribe relief by reference to the Capital Allowances code, but this would need careful thought - in particular, would relief be given for overheads which may not strictly fall within the capital allowances provisions? Another aspect for consideration would be how, on a 'capital only' basis expenditure on drilling costs currently enjoying the "New Brunswick" treatment would be brought within the qualifying net.

67. As an alternative to prescribing relief for capital expenditure only, it is for consideration whether it might be appropriate to introduce a limitation on the lines of the present PRT 'supplement' provisions. For instance, expenditure otherwise satisfying the criteria for IIA (for example expenditure which does not qualify for supplement) might be allowed to the extent that it was incurred wholly and exclusively for one on the following purposes

(a) bringing about the commencement of the winning of oil from that part of the field which is outside the development area;

(b) bringing about the commencement of transportation of such oil to the UK;

(c) substantially improving the rate at which such oil can be won or transported to the UK.

This would avoid the need to introduce a new distinction for PRT between capital and revenue expenditure. By setting this kind of fairly narrow and specific qualifying purposes it should also help with the "wholly and exclusively" aspect mentioned above. Purposes

defined in this way would also contain their own inherent time limit - eg "bringing about the commencement of" - and so might serve to put a time limit on the availability of IIA as well. However, these might not be very effective with phased developments and it would be for consideration whether some kind of explicit time limit, analogous to the one for uplift, could be devised to exclude from IIA expenditure occurring late in the life of the incremental project.

IMPLICATIONS FOR OTHER RELIEFS

68. In the past Treasury Ministers have said that if they reviewed incremental reliefs they would also want to review the "New Brunswick" treatment of drilling costs (see paragraph 8(a) above). Clearly if a general solution were being proposed which gave extra relief to all incremental expenditure, there would be a good case for considering removal of the special benefit that this practice gives drilling expenditure. However, all that is being examined here is a limited relief covering a small category of incremental expenditure and only overlapping in a small way with "New Brunswick" drilling. In these circumstances we do not think it appropriate to disturb the present CT treatment of drilling, though this is another argument for not being too generous on the size of the IIA as drilling expenditure qualifying for both "New Brunswick" and an IIA would be receiving a very high rate of relief; some 89% for a 15% IIA.

69. Another question which this proposal raises is whether the existing field determination system is too generous in some circumstances as well as being too harsh in the circumstances affecting this relief. There are occasions where a single development area covers more than one PRT field because they are close together. In future this may also arise where different geological structures are stacked one on top of the other in a vertical direction: PRT field determinations can be three dimensional whereas development areas are not (and indeed little extra expenditure may be necessary when two fields can be reached from the same platform). Several of these small clusters are highly profitable but pay little or no PRT because of the oil allowances.

70. However, there is no obvious "symmetrical" approach to reducing relief in these cases to mirror the IIA in cases where the development area is smaller than the PRT field. The overall level of the North Sea fiscal regime and whether it is over-encouraging development (eg because of PRT relief for exploration and appraisal relief on fields which pay no tax because of the oil allowance and contribute little or no tax on tariffs they

pay because of the tariff receipts allowance) will need to be kept under review. But we do not think that introduction of an IIA would provide a suitable opportunity for addressing these issues nor that they are sufficiently urgent to justify deferring consideration of an IIA.

CONCLUSION

71. The potentially distortionary impact of the tax system on incremental projects has been reviewed regularly in recent years, but on each occasion no changes were made partly because there was no real evidence generally of difficulty in practice, and partly because of difficulties in devising a relief which would target the investment at risk without either incurring unacceptable deadweight costs or giving a tax subsidy to projects that were uneconomic before tax. We now have firm evidence of at least one actual project - Columba - where there is a problem, and there may be one or two others though the evidence there is less firm. The scale of the problem is still relatively small, but is not insignificant. Prima facie, therefore, there is now a case for action. Moreover, because with Columba the development is dependent on using the Ninian collection facilities if it is to go ahead, a decision on whether to take action is needed soon; with the passage of time the economics of the project deteriorate and once Ninian has been abandoned the opportunity will be lost.

72. Various solutions considered previously by the Working Party all faltered on grounds of inadequate targeting and the problem of deadweight cost. We have, therefore, tried to devise a relief that would be targetted very narrowly on these particular kinds of problem incremental project - discrete accumulations that are outside an existing development area but still within the PRT field as a whole. The relief itself - an Incremental Investment Allowance - would take the form of a proportionate enhancement of qualifying capital expenditure that is allowable for PRT purposes. It would be confined to incremental projects in pre-1982 fields that are off-shore and outside the Southern Basin.

73. We cannot say what minimum IRR would guarantee development of the Columba project or, assuming it is a problem incremental, Strathspey. Having regard to IRRs only (ie ignoring NPVs) an IIA of 10% should be sufficient for Columba (though probably not for Strathspey), while an IIA of anything above 15% would give Columba a <u>higher</u> IRR post-tax than pre-tax.

74. There are a number of considerations Ministers will wish to weigh in deciding whether or not to go ahead with

introduction of this entirely new allowance, bearing in mind also that PRT is already a very complex tax.

75. First, this proposal is targetted at a particular and limited set of circumstances: at the moment only Columba appears likely to benefit from it though of course any other 'discrete peripheral accumulations' in a similar position which we have not yet identified or studied in detail could also benefit. This fine degree of targeting is the strength of the proposal in terms of limiting deadweight cost. But it is also its weakness in the sense that targeting the allowance so narrowly may also mean that problems for other incremental projects which do not fall within this definition may arise in future and result in Ministers having to consider further ad hoc measures. It is likely that there will be complaints from the industry that such a narrowly targetted measure excludes other cases, whether deserving or undeserving, and that in general it excludes onshore and Southern Basin fields. Particular cases that may be raised are:

a) N W Hutton, where an incremental project requires assistance to go ahead, but falls within the Development Area. Amoco may argue that they are being penalised for earlier optimism about the extent of the DA. D/Energy is currently considering the Annex B, and the boundaries may be changed.

b) Wytch Farm, currently regarded as an onshore field, with appraisal suggesting a significant offshore extension. D/Energy do not have any evidence that assistance is necessary, and will review the case if new evidence is put forward.

c) Maureen and Brae, involve undeveloped reserves which lie under the main reservoir, but which are not eligible because the Development Area is defined horizontally but not vertically.

76. Second, there is a risk that Colomba might not go ahead even with an IIA of 15%. As noted, it seems probable that the companies also want a minimum level of absolute profits (ie NPV) and not just IRR. So, even a 15% IIA, which would give very healthy IRRs, would still not give them anywhere near as much in NPV terms as, for example, separate field status.

77. Linked to this, there is the risk of considerable embarrassment for the Government if the allowance was introduced but the project did not then go ahead. There is also the risk that the companies themselves might be

strongly tempted in that situation simply to hold back and press for more. On the other hand, if Colomba did not go ahead it might be because the economics were less good than our own calculations suggested, in which case the economic loss would be correspondingly lower.

78. One result of confining the allowance to expenditure on projects outside development areas as defined on Budget Day would be to ensure that companies could not simply adjust their behaviour in order to get the benefit of the IIA - ie by deliberately understating their development plans. By the same token, however, the concession could then never be applied to fields determined after 1982. Moreover, while companies at present generally have every incentive to include all worthwhile reserves in their initial development plans, there may be cases in which companies would regard the exclusion of developments within their existing development area as arbitrary and unfair.

79. Finally, this would introduce further complexity to PRT and administrative burdens. Though not insuperable, there would also be difficulties in making some of the distinctions that would be needed (eg between capital expenditure and other expenditure, and between assets used wholly and exclusively for the purposes of the incremental project and assets used partly for other purposes), none of which are necessary to PRT at present.

80. D/Energy accept that these difficulties and risks do exist, and that there could not be complete certainty that Columba would go ahead with a 15% IIA. They believe, however, that it is worth accepting these difficulties in the interests of securing a 50 mbl North Sea development worth £80m in pre-tax profits (present valued, at 10%), and any other DPAs in a similar position that might arise in future, which would otherwise have been frustrated by tax. They fully recognise that wider problems relating to incremental investment could arise in the future not restricted to peripheral accumulations, which would not be covered by this measure, and that the IIA may be criticised by the industry as arbitrary or inadequate. But this is inherent to any tax change which is well targetted, and the only other way of securing the benefit of these particular DPAs through fiscal change would be a much more broadly based and therefore costly tax change.

81. The Treasury also believe that there is a good case in principle for such an allowance and they recommend proceeding as well. However, they are concerned about the risk of possible embarrassment to the Government if Columba did not go ahead, or if the companies concerned tried holding out for more. The Treasury believe,

therefore, that it would be essential having announced an IIA for Ministers to stick at that and to make it absolutely clear that nothing more (either a higher rate for the IIA, or separate field status, or whatever) was on offer. The companies might otherwise be led to believe, following their campaign on Southern Basin restructuring, that Budget changes were always negotiable. For these reasons, the Treasury would favour an IIA of 15%, even though on the normal criterion that would appear on the generous side.

82. The Inland Revenue likewise recognises that tax can introduce economic distortions and that the proposed allowance would be targetted effectively on the particular distortion in cases such as Columba. They are, however, concerned that we would in effect be grafting onto an already complex regime an entirely new relief that was in practice directed (for the moment at least) at just one particular project, and in a situation where having done so there could be no guarantee that the project would in fact go ahead. The Revenue recognise that the offer of a discretionary refund of royalty large enough to provide sufficient incentive for Columba to go ahead might be difficult to justify - eg by comparison the normal criteria for government grants to industry. They feel, however, that the same arguments rather tell against introducing the complexity of a wholly new relief that would for the moment be for essentially the same single project, though of course the tax route would offer certainty to companies and avoid the use of discretion. Given these concerns and risks, and also the pressure for space in Finance Bills, the Revenue therefore doubt whether this proposal is of sufficiently high priority to justify proceeding with it.

REVIEW OF FIELD PROFITABILITY

1. Most of the Working Party's efforts this year have been devoted to the review of abandonment and, to a lesser extent, to the report on incrementals. We normally also undertake an assessment of the overall impact of the fiscal regime on the field of profitability, but because of the other demands this year it was possible only to undertake a quick review of the profitability of existing and future free-standing fields based on the databases set up for the abandonment work.

2. As on previous occasions, we have looked both at IIRs (calculated from the start of the year field in question) and at remaining (ie from 1988) NPVs. We used the same three "base", "low" and "high" price cases as in our work on abandonment and incrementals. The figures are on a slightly different basis from our report last year in that abandonment expenditure is now included; also, Brent gas (which is exempt from PRT) is now included with the Brent field.

3. The results are shown in Tables 1-3 attached.

4. Table 1 gives the results for Wytch Farm and 24 offshore fields approved before 1 April 1982. The Piper field is omitted. The IRRs for most of these mature fields really only reflect what has already happened. Changes in future oil prices have relatively little effect, and the only fields where there is a more than 1% difference between the "low" and "base" pre-tax IRRs are Brae, Hutton and Tartan which have not reached payback, and South Cormorant.

5. The remaining NPVs (latter part of table) are more important and, apart from Argyll, where abandonment is likely in the near future, the only fields with negative remaining NPVs are Auk and Heather, at low prices, and even these results are mostly due to the CT payment lag in that the remaining NPV cashflow series includes CT due on past production, but not the profits from that production.

6. There have been numerous changes to the data for these fields from last year. Reserves for some fields, such as Tartan, have been upgraded substantially and new projects such as Forties artificial lift, Central Brae and Beryl gas are included this year. Allowing for Brent, Wytch Farm (excluded last year) and Piper, total remaining NPV (10%, base) is about £700m (1988 prices) higher than last year, despite the abandonment costs and the slightly lower prices assumed in this years' review.

7. Table 2 shows IRRs and NPVs for the 21 oil fields given Annex B approval since 1 April 1982.

8. This covers a very wide variety of developments from small subsea projects such as Ness, which is very profitable indeed, to a field like Balmoral where development started in 1984 when oil prices were expected to be high, but is unlikely to earn a reasonable return on the investment because production only started in 1986 after prices had fallen.

9. Apart from Duncan (abandonment within the next 1-2 years), Miller (low price, 15% discount rate only) and Don, all of the fields have positive remaining post-tax NPVs. As with existing fields, the NPVs are in general higher than in last year's review.

10. None of these fields pay Royalty, and only North Alwyn and Miller pay significant amounts of PRT under base prices, so in most cases the gap between pre and post-tax rates of return ("tax wedges") are small. Some of the earlier fields do not have a CT wedge at all because they were developed before the 1984 CT reforms took effect, and those approved after 17 March 1987 get Cross Field Allowance which effectively reduces the CT wedge by about 2%.

11. Table 3 gives similar results for 19 Southern Basin gas fields approved after 1 April 1987.

12. As will be seen, the only gas fields with negative remaining NPVs are Ravenspurn (low prices) and Barque/Clipper (low prices and base at 15%).

CONCLUSION

13. We have this year been able to undertake only a brief review of field profitability. Overall, however, profitability seems in general to be slightly higher than our review last year. Certainly, we have found nothing to suggest that there are at this stage any major causes of concern as regards to the impact of the regime on field profitability generally.

CONFIDENTIAL

FIELD PROFITABILITY

TABLE 1. Oil fields approved before 1 April 1982

CT on field basis

	Oil/NGL production (mt)	Gas production (mtherms)	IRR (%) Base prices		Remaining post-tax NPV from 1988 (£m 1988 prices)					
					10% real			15% real		
			Pre-tax	Post-tax	Low	Base	High	Low	Base	High
Argyll	9.3	0	34.6	22.8	-9	-7	-1	-8	-6	-1
Auk	12.2	0	37.7	25.6	-7	4	24	-3	4	24
Beatrice	18.1	0	14.0	5.3	11	40	104	15	45	99
Beryl	103.7	11586	35.6	18.2	244	369	603	204	301	482
Brae	78.6	12192	13.3	8.4	647	1102	1729	530	873	1389
Brent	259.6	25362	26.0	13.1	868	1051	1359	750	909	1181
Buchan	10.5	0	24.6	12.2	13	18	35	13	18	34
Claymore	60.9	0	38.3	18.9	65	96	148	65	93	141
N Cormorant	73.8	520	21.0	11.7	374	463	619	350	422	549
S Cormorant	7.1	55	8.6	3.1	12	39	90	12	33	72
Dunlin	44.4	0	39.2	18.7	35	57	93	35	56	88
Forties	337.5	438	55.2	33.6	404	554	822	357	489	720
Fulmar	63.9	1464	49.8	25.3	206	265	361	198	251	338
Heather	12.8	0	7.5	-0.2	-10	2	25	-6	7	28
Hutton	25.6	0	4.0	0.7	310	395	549	292	363	492
Magnus	89.9	2890	27.6	14.9	438	566	802	398	507	705
Maureen	26.7	0	19.6	10.2	122	153	212	121	151	203
Montrose	14.4	0	26.5	16.3	9	37	88	9	31	70
Murchison	37.0	466	41.7	18.5	14	58	113	16	53	101
Ninian	146.7	149	33.5	13.8	59	137	280	55	121	238
NW Hutton	21.9	107	14.1	7.6	116	183	278	108	160	235
Statfjord	69.6	3693	36.2	20.5	288	383	555	259	339	485
Tartan	17.9	660	8.2	3.7	157	216	319	146	196	282
Thistle	51.4	53	28.4	11.5	25	55	105	30	57	98
Wytch Farm	32.5	256	64.8	51.2	198	277	419	147	210	320
Total	1625.8	59891			4590	6513	9732	4092	5681	8371
Average IRR weighted by production			34.3	18.7						

Table 2. Oil fields approved after 1 April 1982

Field		Oil/NGL production (mt)	Gas production (mtherms)	IRRs excluding all E & A expenditure (percentages): Low prices Pre-tax	Low prices Post-tax Field	Low prices Post-tax Immed	Base prices Pre-tax	Base prices Post-tax Field	Base prices Post-tax Immed	High prices Pre-tax	High prices Post-tax Field	High prices Post-tax Immed	Remaining post-tax NPV from 1988 CT on immediate basis (£ million 1988 prices): 10% real Low	10% real Base	10% real High	15% real Low	15% real Base	15% real High
N Alwyn	p	38.5	10322	14.3	9.5	13.0	17.6	11.3	15.0	22.1	13.9	17.8	1392	1541	1794	1238	1371	1583
Tern		23.8	0	9.8	7.1	9.3	15.1	12.0	14.5	21.7	16.7	19.5	333	504	740	253	384	564
Clyde	p	20.7	415	11.7	8.3	12.4	16.3	12.6	16.9	22.0	16.5	20.9	401	529	688	361	467	596
Balmoral	p	9.1	0	-ve	-ve	-ve	-ve	-ve	-ve	1.1	-ve	2.4	91	126	201	88	120	185
Eider	p	11.7	0	5.1	0.1	3.5	14.9	10.7	12.7	25.2	19.7	22.0	157	246	390	132	206	325
Highlander	p	7.5	0	195.4	175.7	195.0	195.7	176.1	195.3	196.1	176.6	195.7	38	54	85	38	54	82
Scapa	p	8.1	0	138.3	113.8	116.6	144.3	120.2	123.0	152.5	128.8	131.5	140	180	246	133	169	227
Cyrus		1.2	0	-ve	-ve	-ve	-ve	-ve	-ve	-ve	-ve	-ve	26	35	50	21	29	43
Ivanhoe		5.4	60	29.9	23.3	25.2	40.6	33.2	35.3	54.9	46.4	48.7	100	141	213	84	120	182
Rob Roy		6.8	328	10.2	6.5	7.5	19.4	14.6	0.2	31.6	25.6	27.5	93	149	248	71	119	203
Duncan	p	2.1	0	439.5	421.8	475.5	439.5	421.8	475.5	439.5	421.8	475.5	-8	-7	-4	-8	-7	-4
Deveron	p	1.9	0	107.7	90.6	109.3	110.6	94.3	112.4	116.0	100.9	117.8	7	10	23	7	10	21
Innes	p	0.8	0	41.3	33.7	46.2	42.9	35.3	47.8	45.0	37.5	49.8	2	3	4	2	3	4
Petronella	p	2.0	38	199.0	179.4	188.5	202.1	183.0	191.9	206.4	187.8	195.6	15	20	30	15	20	29
Arbroath	c	13.3	0	33.9	31.2	32.5	48.4	45.1	46.7	70.0	65.7	67.8	117	216	402	74	147	284
Don	c	3.0	0	-ve	-ve	-ve	5.9	5.8	6.0	30.5	26.8	27.5	-30	-14	36	-33	-7	21
Ness	c	2.8	0	all Ness IRRs calculated at over 1000%									68	80	99	66	77	95
Glamis	c	2.8	0	68.3	63.9	64.8	94.4	90.2	91.2	134.1	130.5	131.8	38	59	99	30	48	81
Osprey	c	5.5	0	49.0	44.7	45.4	70.1	65.6	66.5	101.4	96.4	97.7	29	106	188	21	81	146
Kittiwake	c	10.5	80	14.9	12.8	13.7	24.4	21.4	22.5	37.5	33.4	34.6	38	117	265	3	63	174
Miller	c	46.9	4435	18.0	13.9	14.9	25.3	18.0	18.7	36.2	24.7	25.9	172	333	633	-4	117	337
Total		224.1	15678										3216	4429	6431	2593	3591	5176
Average IRR weighted by production (Ness excluded)				30.8	25.5	28.9	37.2	30.7	33.6	46.4	37.9	41.6						

p = already in production

c = approved after 17 March 1987 and given immediate CFA relief

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TABLE 3. Southern Basin fields approved after 1 April 1982

(excluding peak shaver fields and 3 Camelot PRT areas)

	Gas production (mtherms)	IRRs excluding all E&A expenditure (percentages): Low prices Pre-tax	Low prices Post-tax Field	Low prices Post-tax Immed	Base prices Pre-tax	Base prices Post-tax Field	Base prices Post-tax Immed	High prices Pre-tax	High prices Post-tax Field	High prices Post-tax Immed	Remaining post-tax NPV from 1988 CT on immediate basis (£ million 1988 prices): 10% real Low	10% real Base	10% real High	15% real Low	15% real Base	15% real High
Victor	9305	283.6	212.2	229.3	283.7	212.2	229.3	283.7	212.2	229.3	169	180	200	149	157	172
Esmond	2987	30.8	21.2	29.2	31.1	21.4	29.4	31.6	21.9	29.8	126	129	138	118	121	128
Forbes	722	4.1	0.7	5.9	4.8	1.4	6.5	5.8	2.8	7.8	33	35	38	32	33	36
Gordon	1169	20.8	14.9	21.4	21.2	15.4	21.8	21.9	16.2	22.6	70	73	77	66	68	72
Thames	2194	92.2	60.8	68.4	92.5	61.3	68.8	93.0	61.9	69.4	80	85	91	75	80	84
Bure	518	18.3	12.3	15.5	19.3	13.3	16.6	20.9	15.1	18.4	40	42	46	37	39	42
Yare	299	-ve	-ve	-ve	-ve	-ve	-ve	-ve	-ve	-ve	22	22	23	21	21	22
Vulcan	10633	39.5	30.6	33.2	40.9	31.4	34.0	43.2	32.7	35.3	551	571	610	450	465	493
Vanguard	2100	26.8	21.9	23.6	28.6	23.5	25.3	31.5	25.8	27.7	97	105	121	77	83	94
N Valiant	4134	29.2	21.3	23.3	31.2	22.5	24.5	34.4	24.6	26.6	167	176	196	137	144	159
S Valiant	1775	17.8	14.6	16.2	19.6	16.3	18.0	22.6	19.0	20.8	80	89	106	62	68	80
Audrey	9808	109.2	75.0	78.3	112.8	77.8	81.1	118.7	82.4	85.7	181	198	229	155	167	192
Cleeton	2699	15.4	11.6	12.7	20.6	16.2	17.6	27.4	21.6	23.0	74	95	123	61	77	99
Ravenspurn	21380	2.4	-ve	1.5	9.2	6.8	7.9	16.7	12.6	13.9	-2	182	452	-89	40	243
Amethyst E	6312	42.3	29.9	31.4	50.3	35.4	37.0	62.4	44.1	45.7	90	119	176	53	75	115
Amethyst W	2008	44.8	36.3	37.9	54.8	47.7	46.9	71.2	59.4	61.2	38	53	83	20	31	49
Barque	3727	10.5	7.8	9.1	15.6	12.2	13.6	22.9	16.8	18.3	-6	28	69	-32	-9	21
Clipper	5082	11.9	9.0	10.3	17.2	12.9	14.4	24.7	17.4	19.0	3	40	86	-31	-4	30
Della	414	97.9	87.3	91.8	105.2	94.7	99.1	115.7	105.2	109.6	15	18	24	13	15	20
Total	87266										1825	2240	2887	1373	1671	2152
Average IRR weighted by production		46.3	33.6	36.4	46.8	33.9	36.7	47.5	34.5	37.3						

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Inland Revenue

Savings and
Investment Division
Somerset House

FROM: MR C STEWART
EXTN: 7414
DATE: 4 NOVEMBER 1988

1. MR CORLETT
2. MR ISAAC
3. FINANCIAL SECRETARY

CHARITIES - COVENANTED MEMBERSHIP SUBSCRIPTIONS - NATIONAL TRUST
(STARTER 151)

1. During the summer, you authorised us to explore with the National Trust the possibility of framing legislation to permit tax relief for membership covenants (Mr Isaac's minute of 28 July and Miss Feest's minute of 1 August). The Trust have since sent us a draft Clause. We see some problems with the particular approach they suggest, and have been considering whether we can devise a more satisfactory alternative.

2. The purpose of this minute is to report progress so far, and seek your authority to discuss with the Trust the alternative approach we have in mind.

---

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins

Mr Isaac
Mr Corlett
Mr Bush
Mr Calder
Mr Johnston
Mr Davenport
Mr McManus
Mr Keelty
Mr Rodger
Mr Boyce
Miss Dougherty
Mrs Fletcher
Mr Stewart
PS/IR

CS.5

Background

3. Where a covenant is used to make a donation to a charity, there is no problem about the tax relief. But where the covenantor gets significant benefits in return for his payments, the covenant payments may well be disqualified from relief. The present legislation does not lay down a precise test; it is a matter of case law. But as you explained in the Standing Committee debate, our practice for ordinary small subscriptions to charities is to ignore the benefits available to a member if they are worth less than 25% of the subscription. But in the case of the National Trust (and the National Trust for Scotland), our legal advice is that the benefit of free entry for members to Trust properties does disqualify the covenant payments. The two Trusts do not seem disposed to challenge this through the appeals system, but are making proposals instead for a change in the law to permit relief.

4. The approach in the draft Clause they have sent us is that for certain charities (including themselves), certain benefits would be ignored in deciding whether the covenant payments qualified for relief.

5. This raises three main issues about the shape of any new legislation -

a. which types of charity should qualify?

b. which types of benefit to members should be ignored?

c. what other conditions should be attached to any new relief?

Types of charity

6. The Trust propose that the relief should apply to "national" charities specified in a list in the Inheritance

Tax Act, excluding universities. A copy of the IHT list is attached (Annex 1). Originally, its effect was to give a wider exemption from capital transfer tax to certain "public" bodies than was available for the general run of charities. The two National Trusts are included by name.

7. The list does not provide a very satisfactory basis for a new relief. It would exclude some types of body which have complained about the present rules and seem to have as good a case for relief as the National Trust - for example, the wildfowl preservation bodies (which allow members free entry to their sites) and museums run by charitable trusts or supported by a separate "Friends" organisation whose members get free entry to the museum. Among museums, the IHT list includes only local authority and university museums, plus a few "national" museums. There would be constant pressure to amend the list to bring in other charities - whether national or local - who felt that their aims and membership schemes were similar to the National Trust's. There was also some criticism in the Standing Committee debate of the idea that there should be a list of "favoured" charities, and you expressed some sympathy with that criticism (7 June, columns 292 and 294)

8. We conclude therefore that the IHT list is not a satisfactory basis for a relief for membership subscriptions, and that a separate general definition will be needed.

9. That definition might cover -

a. charities whose sole or main purpose is to preserve property for the public benefit. This would cover "National Heritage" bodies like the Trust, and also museums preserving collections for the public;

b. charities whose sole or main purpose is conservation of animals. These are a slightly separate category; they may well own land, but their real aim is to preserve animals (or birds) rather

than the land itself. Zoos run by charitable trusts would also qualify under this head.

c. charities whose sole purpose is to give financial support to one or more of these charities. This would cover, for example, Friends of museums. It may often be a matter of chance whether the members join the museum itself or a separate Friends organisation. But the free entry privileges may be much the same either way.

10. These charities would be distinguished from others on the grounds that they are concerned with the permanent preservation of something for the public benefit and are allowing members free entry merely to view the property etc being preserved.

Type of benefits to be ignored

11. The benefit which causes the problem in the National Trust case is the members' right of unlimited free entry to the Trust property. Members also receive a magazine and an annual handbook, but on their own these would not be enough to disqualify the covenant payments from relief.

12. In their draft Clause, the Trust propose that benefits should disqualify the covenant if they can be converted into money and are not small in comparison to the covenant payment (ie the subscription). Thus they want free entry and literature to be disregarded altogether, but they accept that people should not be able to covenant (say) £20 per year in return for £20 worth of goods from the charity's shop.

13. Our practice based on present case law already ignores benefits if they are small in total. The main problem is the right of free entry, since an enthusiastic member can save his subscription many times over in that way. The best approach may therefore be to say simply that free entry to the charity's premises would be ignored, provided that the right

of entry was non-transferable and could not be converted into money by the member. Other benefits would continue to be dealt with on the present basis.

14. If the relief is targeted on preservation/conservation bodies, the benefit of free entry to see the property being preserved etc is an apt one to focus on.

15. There may well be some complaints from other types of charity that other kinds of benefit should be ignored as well - for example, a right to free or cheap publications (eg from a literary charity) or a right to a discount on tickets for musical or artistic performances (eg if the Friends of Covent Garden were to offer cheap opera tickets to covenanting members). The main purpose of the legislation is however to enable the National Trust to continue to enjoy tax repayments on membership covenants although the covenantors will enjoy the right of free entry to the Trust property; and to permit similar charities to claim tax repayments on the same basis. The legislation would not be intended to extend the relief to enable the Trust (or any other charity) to obtain tax repayments or covenants made in return for the general provision of substantial benefits in the form of goods or services.

Other conditions

16. We have set out in Annex 2 other possible conditions which might be imposed on any new relief to ensure that there is no scope for abuse - for example, so that the relief cannot be used for "exclusive" arrangements which are of no benefit to the public as a whole. On balance we think that some of the conditions may be unnecessary and others may cause some practical problems. It would be sensible to discuss these with the National Trust before a decision is taken (though obviously we should be very happy if you wished to give us any provisional "political" steer at this stage).

Next steps

17. If you agree, the next step would be for us to have another discussion with the National Trust about the problems we see in their particular approach, and an alternative test on the lines described above. We could check that the kind of test we have in mind would in fact cover their case, and discuss any practical problems they see in the more detailed conditions we might build in.

18. We would have to make it clear to the Trust in any discussion that at this stage there was no commitment by Ministers to introduce legislation; we would simply be exploring what kind of provisions the Trust's proposal would require in order to work satisfactorily.

CS

C STEWART

INHERITANCE TAX

BODIES QUALIFYING FOR THE NATIONAL PURPOSES ETC EXEMPTION

The National Gallery.

The British Museum.

The National Museums of Scotland.

The National Museum of Wales.

The Ulster Museum.

Any other similar national institution which exists wholly or mainly purpose of preserving for the public benefit a collection of scientific, his artistic interest and which is approved by the Commissioners of Inland R for the purposes of IHTA Sch 3.

Any museum or art gallery in the United Kingdom which exists wholly or for that purpose and is maintained by a local authority or university in the Kingdom.

Any library the main function of which is to serve the needs of teach research at a university in the United Kingdom.

The Historic Buildings and Monuments Commission for England.

The National Trust for Places of Historic Interest or Natural Beauty.

The National Trust for Scotland for Places of Historic Interest or Natural Be

The National Art Collections Fund.

The Trustees of the National Heritage Memorial Fund.

The Friends of the National Libraries.

The Historic Churches Preservation Trust.

The Nature Conservancy Council.

Any local authority*.

Any Government department (including the National Debt Commissioner

Any university or university college in the United Kingdom.

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*This includes National Park Authorities.

Annex 2

Possible additional conditions for relief

The possible conditions we have in mind are that -

a. the covenanted payment is in return for annual membership of the charity. (This condition may be unnecessary, so long as we are concerned only with covenants which must be capable of running for more than 3 years.)

b. membership of the charity should be open to the general public. (This looks a reasonable condition to impose. On the other hand, charities need to have a clear "public benefit" element anyway and that is not easy to reconcile with refusing membership for the public at large.)

c. the property is open to the general public as well as to members. (Again this looks a reasonable condition in general. On the other hand, it may cause some problems - if you wish to permit relief in the case where the charity wishes to have an occasional opening for members only, or to set aside a particular room as a coffee room for members only.)

d. Fees charged to members of the public for viewing the property should be small in relation to the membership subscription. (This is a test suggested by the National Trust themselves. It would mean that a covenant representing the price of a single entry would not qualify. "Small" might have to be defined in practice in a fairly arbitrary way, and there could possibly be problems where the charity has different subscription rates for individuals and families.

Ch/ I don't think you can do more at this stage than indicate whether you want the option of reducing the ceiling kept in play. Do you? 11/11

Inland Revenue

Savings and Investment Division
Somerset House

SECRET AND PERSONAL

Yes, but tho' unlikely, option of £25k or under option.

A decision on this does not have to be made now, but any steer would be helpful. The very limited circulation of the note, and its classification, follows from the instructions given to us in the summer when the Chancellor mooted the possibility of reducing the limit. 10/11

FROM : B O'CONNOR
10 November 1988

1. MR CORLETT
2. MR ISAAC 10.11
3. FINANCIAL SECRETARY

MORTGAGE INTEREST RELIEF : STARTER NO.117

1. The mortgage interest relief limit needs to be renewed every year. Following the changes made in the last Budget, it applies now only to loans used for the purchase of the only or main residence. The limit which applies to home annuity loans to elderly people has always been the same as the mortgage limit. This too must be renewed every year.

2. Following the introduction in this year's Finance Act of the residence basis, two mortgage interest limits now apply depending on whether or not the qualifying loan is "protected" under the transitional provisions:

a. The £30,000 per residence basis applies (i) to all loans made on or after 1 August 1988 and (ii) to loans, whenever made, to married couples not sharing with another person and to single persons.

b. The lesser of £30,000 or the amount on which interest was payable immediately prior to 1 August applies per borrower to loans, made before 1 August, to unmarried sharers and to married couples sharing with another person.

cc. Chancellor
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Jenkins (Parliamentary Counsel)
Mr Battishill
Mr Isaac
Mr Corlett
Mr Bush
Mr I Stewart
Mr O'Connor

OPTIONS FOR 1989-90

Renew limit at £30,000

3. Since the limit was introduced in 1974, at £25,000, there has been only one change. In 1983 it was raised to £30,000 where it has remained. However the introduction this year of the residence basis effectively cut the relief available to unmarried sharers. But, for the overwhelming majority of home purchasers - married couples and single non-sharers - the residence basis has made no difference.

4. The cost of mortgage interest relief continues to rise because house price inflation means that more borrowers are taking loans of £30,000 or more and thus qualifying for the maximum available relief. As table 2 in the Annex shows, the average building society advance in Q2 1988 was £32,900 (UK as a whole), £54,900 (London) and £44,500 (SE England excluding London). For banks, the UK average advance was £40,800. No regional breakdown figures are available. On the assumption that the mortgage interest rate remains at 12.75 per cent for the rest of this year, the estimated cost of relief for 1988-89 is £5.25 billion. The cost in 1989-90 of an unchanged limit will depend on tax rates and interest rates prevailing as well as any further increases in the number of advances presently less than £30,000.

Increase limit

5. On the assumption that an increase in the limit of, say, £5,000 or £10,000 would apply only to residence basis loans (paragraph 2a), and that protected loans (paragraph 2b) would remain frozen at present levels, the costs are estimated as follows:-

SECRET AND PERSONAL

	1988-89	1990-91
£35,000 limit	£ million	
assuming present tax rates and mortgage interest rate continuing at 12.75 per cent with no behavioural changes	-320	-400
estimated behavioural effects	- 20	- 50
total cost	-340	-450
£40,000		
assuming present tax rates and mortgage interest rate continuing at 12.75 per cent with no behavioural changes	-530	-690
estimated behavioural effects	- 40	-110
total cost	-570	-800

6. The figures quoted for behavioural effects are very tentative. They assume that a few people who otherwise would not have changed house might do so and that the significant number of borrowers, about 80,000 per year, who take out mortgages of exactly £30,000, would be likely to move up to the new limit.

Reduce limit to £25,000

7. The Chancellor asked (Miss Wallace's note of 23 August) that this option should be kept in play. Mr Johns' notes of 9 and 25 August covered two possible approaches.

8. The simpler approach would be to reduce the limit for all loans so that residence basis loans (paragraph 2a) would become £25,000 per residence and protected loans (paragraph 2b) would become, per borrower, the lesser of £25,000 or the amount on which interest was payable immediately prior to 1 August 1988.

Counting married couples as one tax unit we estimate that there would be 3.6 million losers. At the current mortgage rate of 12.75 per cent, the maximum loss for a non-taxpayer or basic rate taxpayer would be £159, and £255 for a higher rate taxpayer. The yield on this basis, at present tax rates and assuming the mortgage rate of 12.75 per cent continues, is estimated at £500 million in 1989-90 and £580 million in 1990-91.

9. An alternative approach (and that preferred by the Chancellor - Mr Allan 6 September) would be to restrict the reduction to new loans. If this were to be the only change there should be no great administrative problem with a 6 April or even Budget day start. However you might feel that protection should be extended to people already in the pipeline. The yield on this approach, with no pipeline protection, at present tax rates and assuming the mortgage interest rate of 12.75 per cent continues, is estimated at £80 million in 1989-90 and £240 million in 1990-91. Pipeline protection, if tightly drawn, would have a negligible effect on these figures.

10. This approach would of course mean that three different limits would be running - 2a and 2b above, and a new £25,000 one. Some of the consequences would be seen as anomalous. For example, it might be particularly awkward to defend a regime under which a married couple taking out a new loan were restricted to £25,000, whereas an unmarried couple with a pre-August 1988 loan continued to enjoy relief on up to £60,000.

11. There would be some second-order decisions to make. For example, at present, an unmarried couple enjoying a protected loan of up to £60,000 come down to £30,000 if they marry. Under a £25,000 new loan regime we should have to decide whether they should come down to £25,000. A possible variation on this approach would be also to reduce the per borrower protected loan limit to £25,000 as well as the residence basis limit for new loans. Only existing residence basis loans would retain the £30,000 limit.

12. So far as behavioural effects are concerned, an across the board reduction to £25,000 would have minimal impact because it would be unlikely to deter either first-time buyers or people who, in any event, intended to move. A reduction for new loans only might lead to some locking in, but this is likely to be small.

CONCLUSION

13. Renewing the limit at £30,000, increasing it for residence basis loans or reducing it across the board are all straightforward. If, however, a decision is to be delayed until nearer the Budget, it would be helpful to have an indication of whether the option of a reduction for new loans only is to be kept in play. If so, we shall need to do some more work on the detail. You might also wish to consider whether, on this approach, a reduction should also be made in the protected loan, per borrower limit (see paragraphs 10 and 11).

14. On home annuities we assume that the limit is to be kept in line with the mortgage interest limit.

B O'CONNOR

Annex 2

MORTGAGE INTEREST RELIEF: BACKGROUND FIGURES

1. Cost of Mortgage Interest Relief: 1978-79 to 1988-89

	COST OF MORTGAGE INTEREST RELIEF	COST OF RELIEF AT EXCESS OVER BASIC RATE
	£ million	£ million
1978-79	1110	100
1979-80	1450	90
1980-81	1960	130
1981-82	2050	190
1982-83	2150	170
1983-84	2780	160
1984-85	3580	200
1985-86	4750	260
1986-87	4750	290
1987-88	4850	370
1988-89	5250	320

The estimate for 1988-89 is based on the assumption that mortgage interest rates will remain at 12.75 per cent from 1 October 1988.

2. Average advances for house purchase

	Building Societies			Banks
	South East (excl London)	London	UK	UK
1987 Q1	£33,550	£41,550	£25,800	£34,500
Q2	£35,250	£42,850	£27,100	£36,600
Q3	£36,800	£45,800	£27,900	£37,100
Q4	£39,400	£47,400	£29,000	£37,300
1988 Q1	£41,100	£49,100	£30,100	£37,700
Q2	£44,500	£54,900	£32,900	£40,800

3. Percentage of new advances for house purchase above £30,000

	Building Societies			Banks
	South East (excl London)	London	UK	UK
1987 Q1	54%	73%	27%	45%
Q2	59%	75%	31%	50%
Q3	64%	79%	33%	50%
Q4	69%	76%	36%	49%
1988 Q1	70%	80%	39%	51%
Q2	76%	85%	45%	56%

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS
EXTN: 6371
DATE: 21 OCTOBER 1988

FINANCIAL SECRETARY

ELECTRICITY PRIVATISATION: EMPLOYEE SHARE SCHEMES

1. Once again you (and we) seem to have been placed in an almost impossible position over the employee share scheme aspects of a proposed privatisation.

2. First approaches to us have come midweek with Department of Energy officials asking us to agree instructions to Parliamentary Counsel - <u>by today</u> - to make significant alterations to the approved employee share scheme legislation. The underlying privatisation proposals are not only complex and unusual, but, so far as we can tell, still very far from finality.

3. Mr Farmer's note attached gives our preliminary views. So far as we can tell at this stage, there are two main issues.

---

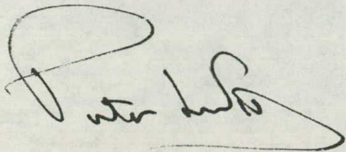
cc.		
	Chancellor	Mr Isaac
	Mr Moore	Mr Painter
	Mrs Lomax	Mr Bush
	Mr Culpin	Mr Lewis
	Mrs Brown	Mr Ridd
	Mr M Williams	Mr German
	Mr Gilhooly	Mr Farmer
	Mr Jenkins OPC	Mr Reed
		Mr Fletcher
		Mrs Majer
		Mr Williams
		PS/IR

4. First, it would be necessary to relax the definition of consortium shares which can be used in approved share schemes. This looks relatively straightforward technically if you agree, as a matter of general employee share scheme policy, that the change should be made. I say as a matter of general employee share scheme policy since, if such a change were to be made, it is difficult to see why it should not apply generally rather than just to the electricity industry. It would thus be a matter for the Finance Bill rather than the Privatisation Bill.

5. Second - and at first sight more difficult on policy grounds and much more complex technically - special provision would need to be made to bring the "units" to be used in the privatisation within the scope of the approved employee share legislation and to adapt it accordingly wherever necessary. Any such change - if feasible and you wish to make it - looks more appropriate to the Privatisation Bill since it would relate solely to the circumstances of the electricity privatisation.

6. We will, of course, work with the Department of Energy to give you more considered advice as soon as possible. But, bearing in mind experience with British Steel, I am concerned at the possibility that your freedom of action may be constrained by statements by the Department of Energy to the industry or advisers implying, without any qualification, that tax relief will be available for the arrangements presently envisaged. It might help to reduce the chance of that happening if you wrote to Energy Ministers indicating that while you have every sympathy with the employee participation aspects of the electricity privatisation, it is essential for them and their officials to avoid any commitments on the tax implications until such time as it has been clearly established that tax relief is either due under the present provisions or you have agreed to the introduction of legislative changes making such relief possible.

7. If you agree, we will let you have a draft letter accordingly on Monday.



P LEWIS

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

From: J D FARMER
Date: 21 October 1988

1. MR LEWIS
2. FINANCIAL SECRETARY

ELECTRICITY PRIVATISATION: EMPLOYEE SHARE SCHEMES

1. The Department of Energy wrote to us three days ago seeking agreement to their instructing Parliamentary Counsel - by close today - to draft provisions for the Electricity Bill which would substantially alter the approved employee share scheme legislation. The purpose would be to ensure that, in the as yet undecided but probably very unusual circumstances of the later privatisation, employees of the electricity industry can be offered share benefits on a fair and equitable basis - and that they can be assured straightaway that this will be the case.

2. This raises a variety of problems, of which you will wish to be aware. As on other recent occasions, it is a matter of regret that the Revenue was not consulted and brought into the picture at a very much earlier stage.

Background

3. We are given to understand that present thoughts as to the privatised industry's structure contemplate that the operation of the national grid and other central functions will be the business of new service companies (eg "Gridco" and "Central Services") which will be jointly owned by the 12 area boards. It is the latter which will be privatised as separate and independent electricity distribution companies. While details of the reorganisation to be effected under powers

sought in the Electricity Bill have not yet been settled, the Department of Energy seek to ensure now (in the Electricity Bill which is, we understand, to go to Legislation Committee in less than a month's time) maximum flexibility in relation to possible share benefits with tax relief under approved employee share schemes (ESS).

4. It remains to be decided, we understand, in particular whether eventual privatisation should take the form of the sale:-

i. of actual shares in the dozen distribution companies; or

ii. of units each comprising one share in each distribution company (such units might be convertible at some future date into whichever shares, in whichever distribution companies, the holder wished; but units as such might possibly continue to be held, and to be traded for some considerable time).

5. In this very uncertain context, the Department of Energy say they wish to arrange for the employee offers made at the time of privatisation to employees in the distribution companies to relate to actual shares in those individual companies. However, they may instead want these offers to relate to units of the kind which may be offered to the public. As to the employees of the two or three service companies which will be jointly owned suppliers of the distribution companies, however, they wish to be able to offer either the units which may be sold to the public or baskets of shares in the companies' parents (ie the consortium of distribution companies). The reason for this is that shares in the service companies will not be quoted, and the companies may be required to operate in a way that serves the distribution companies or meets regulatory requirements, rather than maximises their own profits. Their employees would not see as fair an offer which consisted of shares in their own employing company; and it would give these employees the wrong signals if they received shares or interests in shares of only one or some of the parent companies.

6. We advise below on the extent to which the Department of Energy's demands for change (in the interests of flexibility in structuring employee offers) might be met under existing ESS legislation; on which legislative changes might conceivably be made and which would be undesirable; and on what seems to be, from our standpoint, the best way - and timing - for making any changes. We are not aware, and have not addressed below, what other ways may have been explored for dealing with the problems foreseen - those relating to the possible flotation by means of units rather than shares, and to the need to equate the privatisation offers for employees of the companies being floated and for other electricity employees. But as to the latter, there may be alternatives which might not encounter the difficulties described below.

Possibilities under existing legislation

7. There appear to be three particular facilities which the Department of Energy need to provide them with the flexibility they seek. These, and their admissability under the present employee share scheme legislation are:-

a. the capacity of a company's approved scheme to use as scheme shares the shares of a member of a consortium which owns the company. At present this is permitted if the consortium owns 75 per cent or more of the company, and in respect of a member of the consortium which individually owns 15 per cent or more. This, however, would not go far enough in electricity circumstances, where the prospect is of service companies wholly and equally owned by a consortium of 12 distribution companies (each therefore holding only 8 per cent or so of the shares);

b. the capacity of a company's approved scheme to use as scheme shares the various shares of all or several of the members of a consortium which owns it. At present this is acceptable:-

i. if each of the consortium members the shares of which are to be used owns the 15 per cent referred to above; and

ii. if the scheme is drawn up with sufficient care to avoid difficulties over complying with requirements as to such events as take-over of the company, the roll-over of share options etc.

c. the capacity of a company's approved scheme to use <u>units</u> representing collections of different shares in different companies, which may or may not be related in some way to the company with the scheme in question. This is not <u>at present</u> permitted.

<u>Changes sought by Department of Energy</u>

8. Following from the above, two significant changes would seem to be needed to meet the Department of Energy's ambitions:-

i. a company's approved scheme should be permitted to use as scheme shares the shares of any member company of a consortium owning it, if that member company has 8 per cent or so of the shares (rather than the present 15 per cent).

We have been unable in the time available to discover precisely why the present 15 per cent minimum was fixed, and on the face of it this could conceivably be reduced without serious danger of abuse, although it would mean some further distancing between the share benefit obtained by the employee and his capacity to contribute to that benefit. For some other unrelated purposes in fact a 5 per cent limit is accepted, but whether this or any other reduced limit would prove adequate in the electricity circumstances we do not know.

eg group loss relief passed to members of a consortium

ii. a company's approved scheme should be permitted to use units representing a miscellany of shares in different companies, rather than the present permitted kinds of shares.

We find serious difficulties with this proposal.

9. The most important of these difficulties is that what the approved scheme legislation with its associated tax reliefs aims for is the association of the employee participant with the company for which he works, and its prosperity. The shares which present legislation permits to be used in approved schemes are, of course, carefully defined to match this purpose. If "units" of the ill-defined kind now in question could be used, the essential character and purpose of the approved scheme could be lost. The employee of a distribution company appropriated such a unit could convert it wholly or partly into shares in companies quite unrelated to his own. The employee of a service company could convert it wholly or partly into shares of just one of the 12 of his parent companies, which would distort his loyalties. If in time the floated distribution companies came to be taken over by other private sector businesses, employees could end up with what would amount to a unit trust holding in a variety of companies of only very remote interest to their own employment.

10. Other difficulties would be practical and technical. If the final Department of Energy ambition is to provide distribution company employees only with shares in their own companies, or with units convertible only into these shares - which would best align benefit and reward with individual employee motivation and loyalty - the provision to the public and to service company employees of units convertible into baskets of different distribution company shares would mean both that different employees of the electricity industry were treated differently (which it is the Department of Energy's anxiety to avoid), and that two different kinds of units carrying different conversion rights were to be issued, and

traded. In any event, technical difficulties would arise in reconciling the use of units in approved schemes with present provisions affecting the use of restricted shares, providing for roll-over of options in the event of take-overs etc.

Possible legislation

11. The conclusion to be drawn from the foregoing is that a relaxation in the present employee share scheme legislation might conceivably permit the use as scheme shares of the shares of "smaller" members of a consortium owning the company in question; but that to permit the use of "units" in place of shares would be both undesirable and complicated.

12. If the limited change indicated were to be acceptable on its own to the Department of Energy, the question arises whether it could and should be included in the forthcoming Electricity Bill and made effective only for that industry, or whether it would be preferable to give it general effect, and include legislation instead in the 1989 Finance Bill. Parliamentary Counsel has confirmed that the matter could technically be included in the Electricity Bill if desired, if its effect was confined to that industry. Otherwise our recommendation would be that it was given general effect by inclusion in the Finance Bill.

Conclusion

13. We regret the necessity to alert you to and invite your decision on this matter at such short notice. We suggested recently the updating and reissue of the Treasury's 1985 advice to Departments sponsoring privatisations to contact the Revenue at as early a stage as possible about contemplated employee share offers, and we hope this might prevent the further recurrence of emergencies of the present kind.

14. In the present instance you will wish immediately to be aware of these new problems, because of their apparent urgency. In the absence of any very clear decisions as to the nature of the eventual electricity privatisation, the Department of Energy's belated request is for significant relaxations in the present approved employee share scheme legislation, to give them maximum flexibility in designing employee share offers when privatisation comes. Our first reaction to these proposed relaxations is that, even if confined to the electricity industry and included in that Bill, they encounter objections - related both to the basic principles of the share scheme legislation and in terms of their technical complexity.

15. Subject to your views, however, we will prepare further advice as soon as possible.

J D FARMER

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BP

NOTES OF A MEETING HELD IN THE FINANCIAL SECRETARY'S OFFICE ON FRIDAY 11TH NOVEMBER 1988 AT 10.45AM

Those present:-

The Financial Secretary
Mr C Corlett - IR
Mr C Stewart - IR
Miss M Hay

CHARITIES STARTERS 150 AND 151

A. MR CORLETT'S MINUTE OF 21 OCTOBER 1988 to the Chancellor on charities - New Tax Reliefs.

The Financial Secretary asked Mr Corlett to explain the ideas presently being aired.

Mr Corlett explained that the idea of tax relief for one-off charitable donations was used in the USA. Relief for donations could be claimed via the taxpayer's yearly self-assessment return, providing that evidence of payment was supplied.

The problem with applying this system in the UK was that only 20% of PAYE taxpayers get income tax returns. It would be possible to target the relief at those who were more likely to receive returns, by setting a minimum limit for donations; but this would have political overtones as it would appear to penalise the taxpayer who couldn't afford a large donation.

Mr Corlett said that further work was being done on the question of a one-off donation relief for donors. The other main possibility was a Miras - type scheme which would pay the relief direct to the Charity. He said that the Revenue were in the process of analysing about 500 charities' accounts to see what the effects would be.

The Financial Secretary asked whether the work on one-off donations was based on replacing the covenant system?

Mr Corlett said that this was what the Chancellor's had in mind earlier this year. But he knew that the charities world would expect any new type of relief to be in addition to the covenants scheme. Adam Ridley at a recent CAF conference had suggested one-off donation relief as a response to a gap in the "donation market" (ie between covenants and payroll giving). Mr Corlett explained that the Revenue were trying to estimate what a revenue neutral rate of relief for a Miras scheme would be if it replaced the present covenant scheme. It had been suggested at the CAF conference that at present personal donations to Charities amounted to £3 billion a year whilst covenanted donations totalled well below £1 billion a year. It looked as if the Revenue's calculations might suggest that revenue neutrality would allow a Miras rate of only about 5p or 6p in the pound; which was obviously not much of an incentive.

Mr Corlett explained that the problem with a Miras scheme of that sort would be that some charities would suffer through loss of their charitable covenants (ie Churches). A Miras scheme would also run risks of abuse and there would be some extra administrative costs because the Revenue would have to deal with more charities than they do now. On the whole though, Mr Corlett felt that a Miras - type scheme was preferable to end of year assessments.

He pointed out that further work was being completed on the alternatives and a submission would come forward shortly. At this stage, he thought it was fair to point out that Charities weren't expecting another new relief so soon. Obviously decisions would depend on whether the Chancellor wished to abolish charitable covenants as a further simplification. Mr Corlett said that the Revenue were also considering other ways in which the Covenant system could be simplified without legislation.

b. **STARTER 151** - Membership Covenants

The Financial Secretary referred to Mr Stewart's minute of 4 November 1988 and agreed that it would be better to define those charities allowed tax relief for membership covenants by a set of conditions rather than a list of the charities.

Mr Corlett pointed out that the draft conditions were designed to relate to charities offering free admission and not those providing other benefits (such as reduced price theatre tickets etc). In fact these sort of small benefits were often already covered by the 25% rule.

Mr Corlett said that the proposed package should be acceptable to the National Trust and to other charities of a similar nature.

The Financial Secretary said he was content for the Revenue to continue their discussions with the National Trust in order to confirm that the Revenue's proposals would be suitable.

c. IHT - Bodies Qualifying for Exemption

The Financial Secretary referred to annex 1 of Mr Stewart's minute which gave the list of bodies qualifying for the national purposes exemption on IHT. He wondered whether this list was still relevant and if so whether other conservation bodies could be added to it.

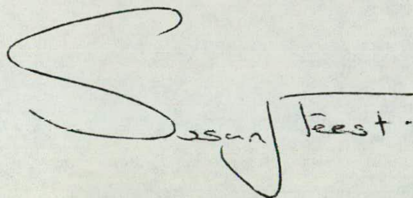
The Financial Secretary's request was prompted by the fact that he remembered there had been an amendment which had been put down by a Conservative Back Bencher some years ago which asked that Land gifted to nature reserves should be relieved of tax. The answer had indicated that it would be impossible to compile a list of such reserves. He couldn't see why all such nature reserves couldn't be covered in the original list.

He therefore asked for a note on the current purpose of the list.

Mr Corlett said he would ask his colleagues dealing with IHT to look into the matter.

Mr Stewart pointed out that the list might well have been largely overtaken by the legislation allowing exempting all charitable gifts from IHT.

cc 2 PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Miss Hay
Mr Michie
Mrs Chaplin
Mr Tyrie
Mr Jenkins OPC
Mr Isaac - IR
Mr Corlett - IR
Mr Stewart - IR
PS/IR.



SUSAN FEEST
14 November 1988

RS111FST42

CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 11 November 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mr Macpherson
Mrs Chaplin
Mr Jenkins (OPC)

Mr Pitts - IR
Mr Cayley - IR
PS/IR

Ch/ Agree with FST's conclusion that we: (i) abolish the general gifts relief but; (ii) answer "yes" to the exemptions (+ other points) suggested in Mr Cayley's para 44? 11/11

OK - I do not agree that there is an unfair 'notion of "unavoidable tax" ... N.

STARTER 252: ABOLISHING CGT GIFT RELIEF

The answers to the questions raised at the end of Mr Cayley's minute of 24 October about the scope and mechanics of the withdrawal of the CGT relief for gifts seem reasonably straightforward. We might have to look (in the context of our review of the employee share scheme legislation) at the requirement that gifts to employee trusts only attract relief if the trust holds more than 50% of the company; and we shall need to redraft the definition of "business assets". But basically the answer to all of them is yes. The retention of the relief for gifts into trust for a political party can be justified on the grounds of parity with charities (you will remember that Keith Joseph was interested in this).

However, this all assumes that we want to abolish the general relief, for which the arguments are not clear cut. If we went ahead, it might be seen as being directly contrary to the policy of encouraging lifetime giving which underlay the 1986 IHT reforms. Many would wonder why we were doing it in 1989 if we judged it not to be right (or necessary) in 1986. And it would be resented by those who had to bear an unavoidable tax without having the cash resources to pay it.

Against that, there is a strong logical case for abolition, which has already been widely canvassed by the IFS, Professor King and others. The relief was introduced in 1980 to remove the double CGT/CTT charge on lifetime gifts; now that the second of those charges has gone, it seems questionable to retain the relief for the first. Furthermore, if lifetime gifts were meant to be exempt from CGT, then we should have exempted them completely (as we do on death) rather than merely defer the gain. But that in turn opens up the prospect of capital escaping a charge to tax indefinitely, a possibility which is already being exploited by some under the present rules.

In the end, it becomes a political judgement. You have personally laid a lot of emphasis on "a nation of inheritors" and the encouragement of lifetime giving. This change at this time would be contrary to those themes. At present, Inheritance Tax is an avoidable tax; we would now be putting in place an unavoidable tax on lifetime giving. However, the retention of the relief for business assets would both placate the most likely opponents of abolition and help those most affected by the problem of illiquidity. On balance, therefore, I would be prepared to go ahead and defend a change of this kind.

Robert [illegible]

pp **NORMAN LAMONT**

(Approved by the Financial Secretary and signed in his absence)

CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: L E JAUNDOO
DATE: 14 NOVEMBER 1988

1. MR PITTS ✓ I have added a note at the end. [initials] 14/11.
2. FINANCIAL SECRETARY

INHERITANCE TAX - INSTRUMENTS OF VARIATION

1. You asked for a note on the use of instruments of variation (IOVs) for Inheritance Tax (IHT) purposes. This note reviews the background to the present arrangements and their operation in practice.

Summary

2. When a person dies provisions in the IHT code enable those who are entitled to the estate to rearrange within two years of the death the beneficial interests in a way that suits them, without incurring a tax charge, and often securing a tax advantage. The provisions now provide tax planners with considerable avoidance opportunities.

---

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mrs Chaplin
Mr Tyrie

Mr Isaac
Mr Painter
Mr Pitts
Mr Bush
Mr Thompson
Mr McKean
Mr Draper
Mr Gonzalez
Mr Jaundoo
Mr Fletcher
PS/IR

Since 1975 when complete exemption for transfers to spouses was introduced the provisions have been used increasingly to eliminate the death charge while ensuring that the property nevertheless passes to a chargeable beneficiary. The abolition of the immediate lifetime charge under IHT has increased the scope for tax avoidance. There is a good case for withdrawing the provisions.

The present arrangements

3. When a person dies the IHT liability on his estate depends primarily on

- the extent to which it devolves on exempt beneficiaries (mainly spouses and charities) and the availability of reliefs (mainly business and agricultural property reliefs); and

- whether the value of the estate inherited by chargeable beneficiaries together with any other chargeable transfers made or deemed to be made within 7 years before the death exceeds the IHT threshold (currently £110,000).

4. Under the general law the devolution of a person's estate on death is determined primarily by the terms of the Will and/or the rules of intestate succession. However, various statutes since 1938 culminating in the present Inheritance (Provisions for Family and Dependants) Act 1975 have given the Courts powers to override the deceased's Will where inadequate provision has been made for the dependants. Moreover an Order made under the 1975 Inheritance Act in relation to any property forming part of an estate on death is treated automatically for IHT purposes as if the deceased had disposed of the property in the way ordered by the Court.

5. The IHT code also extends similar treatment, but only at the parties' election, to rearrangements made by the beneficiaries

without a Court Order. The provision allows written variations (IOVs) to the devolution of an estate made by the beneficiaries within two years of the deceased's death to be treated for IHT purposes as if they had been made by the deceased.

6. The variation will take effect even if it increases the tax liability of persons without their consent. For example:

> A has a life interest under X's Will. On A's death the property (£90,000 net) goes to Y. A leaves all of his own estate (£100,000) to his widow.
> IHT liability - NIL on A's own estate because the bequest to the widow is wholly exempt. NIL on the settled property because it is below the IHT threshold (£110,000).
>
> By an IOV A's own estate is divided equally between his widow and child.
> Revised IHT liability - NIL - on the half share of A's estate to widow. £12,000 tax payable pro rata on the settled property taken by Y and the half share of A's estate to the child.

7. However in the main IOVs are used to enable the family to rewrite the terms of the deceased's Will without tax penalty and, frequently, with a tax advantage. For example:

> A died in April 1988 survived by a widow and two children having bequeathed his entire estate (£300,000 net) to his widow.
> IHT liability - NIL since bequest to widow is wholly exempt.
>
> In October 1988, the widow varied the bequest under her husband's Will giving legacies of £55,000 to each of her children.
> Revised IHT liability - NIL - reduced bequest to widow still exempt but the legacies to the children equal the IHT threshold of £110,000.

In this case there is no immediate tax advantage. But by using the occasion of her husband's death to make tax free transfers of £110,000 to her children (transfers would otherwise have been PETs) she has enabled a potential liability, should she die within seven years, to be avoided. There would have been an immediate tax advantage if the estate had been left to the children and the IOV used to redirect it to the widow (see illustration 1 - Example i. in the Annex).

Background

8. A provision allowing the redirection of assets in an estate after death to be effective for tax - in this case capital gains tax (CGT) - without the need for a Court Order first appeared in 1965 when that tax was introduced. The provision treated a deed of family arrangement (DFA) or similar instrument made within two years of the deceased's death, which redirected assets of which the deceased was competent to dispose, as having been effected by the deceased ie like a transfer in the normal way from executors to beneficiary. As a result any CGT that would otherwise have been charged on any gain that may have arisen between the date of death and the date of the rearrangement was not levied at that stage. However, whether there was a redirection or not, the beneficiary took the death value as his acquisition cost. The provision still exists in (broadly) its original form. Its effect, as in the case of the original, is not to exempt a proportion of the gain but to roll it over to the next disposal. It eliminates the inconvenience (for taxpayer and the Revenue) of large numbers of small gains realised over a short period of up to two years.

9. A similar provision was introduced into estate duty (ED) in 1972 at the same time as provisions exempting from ED bequests of up to £15,000 to surviving spouses and up to £50,000 to charities. Like the CGT provision, any rearrangement by a DFA within two years of death was treated, for the purpose of calculating the new spouse and charities exemptions, as having been made by the deceased. However, unlike the CGT exemption, the effect of ED provision was to exempt a part of the estate from the tax charge.

10. When capital transfer tax (CTT) replaced ED in 1975, the provision was carried forward to preserve the benefit of re-writing the Will retrospectively.

The rationale for the provision

11. The evolution of the provision up to 1975 was influenced by three considerations. First under the Inheritance (Family Provision) Act 1938 the Courts were given powers to make an order overriding a deceased's Will where inadequate provision had been made for the surviving spouse or the children to the marriage. So it was thought reasonable where a Will needed to be altered in order to make adequate provision for the deceased's family - something which was public policy and a matter of law to achieve - then that alteration should be effective for tax also; otherwise, the desired result might not be fully achieved. Accordingly, the 1938 Inheritance Act provided that Orders made thereunder should be effective for estate duty purposes. This public policy consideration was reinforced by the 1975 Inheritance Act which gave the Courts powers in relation to a wider category of dependants and provided for the CTT charge to take account of the Order.

12. Secondly in 1972 it was felt reasonable that families should be able to redirect property without a tax penalty to a surviving spouse so that advantage could be taken of the new surviving spouse exemption of £15,000.

13. Thirdly it was at first assumed (wrongly) that the term "deed of family arrangement" only covered variations of a Will in which there was a genuine element of compromise (where each of the participants gave up a legal right). In other words, the original assumption was that DFAs would be restricted to out-of-Court settlements of matters such as disputes between the beneficiaries as to the interpretation of the Will, or claims of family honour; and it was considered reasonable that where a DFA as so defined redirected property in favour of a surviving spouse, such redirection should be recognised in determining the tax liability of the testator's estate. However, it was realised subsequently

that if this narrow view of the scope of DFAs were maintained, families would not have been able to redirect property to the surviving spouse easily. So, during the Committee Stage of the 1975 Finance Act the (then) Chief Secretary gave an assurance that the term would be interpreted "very liberally".

The use of the provision

14. Prior to the introduction of CTT in 1975 DFAs were seldom used. Over the period 1975-78 they became a central feature of tax planning, instead of a rarity. Their attractions had been enhanced considerably by two features of the CTT code. First the introduction of the immediate lifetime charge increased the need for tax planning. Secondly the removal of the £15,000 limit on the spouse exemption increased the size of the potential savings. So DFAs were commonly used to redirect property away from the spouse towards the children (ie posthumous equalisation of estates). They were also used widely to redirect property to the spouse although, under CTT, any subsequent lifetime gift from the spouse to the children or grandchildren was subject to an immediate charge and tax would be payable once the nil rate band had been exceeded.

15. A parallel development was the realisation that, even when strictly construed, the scope of DFAs was considerably wider than we had originally assumed (paragraph 13). Indeed the legal advice was that the correct interpretation was in most respects even wider than the Official practice which had grown up under the concession to interpret DFAs liberally. So, the use of the term "deed of family arrangement" in this context was abandoned in the Finance Act 1978 and since then any written instrument may be used to rearrange the beneficial interests in the deceased's estate.

16. The change to IHT with the corresponding abolition of an immediate charge on lifetime transfers has removed a further impediment to tax free posthumous transfers; property may now be transferred to the children or grandchildren via the surviving spouse (to obtain the spouse exemption on the death) and,

provided the spouse survives seven years, without incurring a tax charge.

17. As a result, we are seeing an increasing number of cases where property is redirected to the surviving spouse followed by PETs from spouse to chargeable beneficiaries ie the position under the Will is soon restored. There is then a potential liability to IHT if the spouse does not live another seven years, but if he/she does, property is passed from one generation to the next without paying tax. Subject to the lottery of death, the spouse exemption becomes a child exemption. Several of these cases involve amounts in the region of £1m in each case.

18. Furthermore, we are also seeing cases resurrecting an avoidance device similar to one tackled in 1978. For example:

> A leaves his whole estate of £1m to his widow. The children claim that the Will makes insufficient provision for their maintenance and claim against the estate. The widow pays the children £500,000 out of her own resources, taking care not to use any part of the deceased's estate.

The payment of £500,000 does not restrict the extent of spouse relief (because the whole of the deceased's estate does in fact go to the widow) so the whole estate stays exempt. Furthermore, because the agreement is a compromise there is no gift, for IHT purposes, by the widow to the children. Accordingly she is not even regarded as making a PET of £500,000.

19. However, if a similar payment of £500,000 had been made by Court Order under the 1975 Inheritance Act then, for IHT purposes, that sum would have been treated as devolving to the children under A's Will and as such, subject to an immediate tax charge. As a result, care is taken <u>not</u> to obtain such an Order when, as in the example, the spouse's benefits are decreased (thus preserving spouse relief even though property is being redirected from her).

20. Illustrations of the range of the more common cases of IOVs to reduce the tax liability are given in the Annex.

Case for reform

21. This rests broadly on the argument that the original purpose of the arrangements has been distorted by legislative changes since 1972. The contention here is that a provision intended to allow the family, without the Court's assistance, to redirect tax free up to £15,000 of a testator's estate to a widow for whom inadequate provision had been made, may now be used to avoid the once per generation death charge altogether.

22. The critical development was the 1986 change from CTT to IHT which combined for the first time, complete exemption for transfers to spouses with tax-free lifetime transfers to chargeable beneficiaries. This allows, in effect, taxpayers to retain the benefit of spouse exemption on death for bequests to chargeable beneficiaries (paragraph 17).

23. The latter application runs counter to the presentation of IHT as a tax designed to encourage lifetime giving (through the abolition of the immediate charge on outright gifts) while preserving the death charge (through the seven-year protective period against deathbed transfers and the retention of the charge on gifts with reservation). It is also an unproductive use of an increasingly scarce staff resources to have to revise IHT assessments because of IOVs (see 34 below).

Case for retention

24. The original public policy justification for the provisions remains unimpaired (paragraph 11). Since 1938 the rule that a rearrangement ordered by the Courts of beneficial interests in an estate to provide for dependants should also be effective for tax has been a matter of general - not simply tax - law. It still seems reasonable to allow beneficiaries to achieve the same objectives and tax consequences if they get a Court Order and so

also if they achieve the same effect without the need to resort to the Courts.

25. One can argue that it is not the provisions themselves but rather the other rules, eg spouse exemption, which confer tax advantages directly. If there were little or no difference in the tax liability on estates inherited by different classes of beneficiaries, the effect of the provisions would be broadly neutral. So given the existence of the exemptions, and the public policy considerations referred to in the previous paragraph, there is a reasonable argument for allowing beneficiaries to escape tax which others with the benefit of differently drafted Wills have legitimately avoided, ie not to change the present rules.

26. If the provisions were withdrawn, the well-advised would continue to confer the benefits of the spouse and charity exemptions on their heirs through appropriate dispositions in their Wills. If the rules are changed the main losers would almost certainly be the beneficiaries of the ill-informed with relatively modest tax-paying estates.

27. The arrangements have been in place for 16 years and have become an accepted feature of the Capital Taxes landscape. The business, farming and heritage representative bodies and their professional advisers may be expected to lobby hard to resist any wholesale withdrawal of the facility. And, unless you are prepared to remove the IHT effect of Court Orders for making adequate provision for dependants, (a decision about which you would need to consult the Lord Chancellor), it may be difficult to frame a more limited acceptable provision (see 29 below).

Discussion

28. The underlying policy issue could be framed as follows: should tax be levied in circumstances where taxpayers have failed to take advantage of the available exemptions and reliefs and have not ordered their affairs to the best advantage?

If the answer were an unqualified "no", it would be at odds with much of our existing tax legislation because our tax codes do not generally allow such retrospective tax planning. The reality is that dividing lines, reflecting judgements about chargeable and exempt circumstances, are drawn and sign-posted and thereafter the taxable consequences follow. On this basis, the IHT code appears to treat the position at death as an important dividing line, the effect of which is being undermined by the use of IOVs.

29. On the other hand, it could be argued that the latter conclusion rests on giving less weight unjustifiably to the public policy considerations underlying the treatment of IOVs than to policy considerations in favour of encouraging lifetime gifts. This argument might be accommodated by limiting the scope of the present arrangements. For example

a. Limiting rearrangements to those ordered by the Court

This would severely restrict the present tax planning opportunities and return the arrangements to their original intention of allowing provision to be made for dependants without tax penalty. It would be criticised for encouraging unnecessary and costly resort to the Courts in circumstances where the parties are able to reach agreement among themselves. Therefore we would need to consult the Lord Chancellor's Department at an early stage about the likely effects on the workload of the Courts.

b. As at a. plus rearrangements between the parties but restricted to provisions for dependants which the Courts could have sanctioned

This would meet the criticism about discouraging private rearrangements while limiting the scope for tax avoidance by, for example, closing the "loopholes" in paragraphs 18 and 19. It would allow the parties to retain the tax advantages where they have reached bona fide compromises without resorting to the Courts for

either a formal Order or a "Consent Order" (described below). There would be some argument over the dividing line between rearrangements that could and could not be sanctioned by the Courts, but this is already a feature of the existing rules involving Court Orders. At present many applications made to the Courts for relief under the 1975 Inheritance Act are settled by consent among the beneficiaries themselves before the Court has adjudicated upon the matter. In those circumstances and when there are tax advantages the parties would ask for their agreement to be embodied in a Court Order, commonly referred to as a "Consent Order".

However, the terms of that Consent Order may include provisions, eg for persons who could not have claimed under the Act, and which accordingly could not have been included in a formal Order by the Court. So the IHT code only allows those provisions of a Consent Order that could have been included in a formal Order of the Court to be treated for IHT purposes in the same way as a formal Order. In other words, a judgement has to be made about the extent to which the Consent Order reflects a compromise of genuine claims.

c. Limit the relief to redirection of property to an exempt beneficiary

This would be a return broadly to the 1972 Estate Duty position. It would negate some of the "objectionable" uses made of IOVs eg that in paragraph 7, but leave intact what is perhaps the most blatant - redirection of the entire estate above the threshold on death to the surviving spouse who would then make PETs to chargeable beneficiaries.

30. The foregoing options, particularly that at 29(b), would curtail some of the more indefensive exploitations of IOVs. But if the primary objective is to reduce substantially the scale of

the tax planning benefits from using IOVs it would not be sufficient to rely on any of them alone because the abolition in 1986 of the immediate charge on lifetime transfers made it possible for the surviving spouse to channel property of unlimited value to chargeable beneficiaries without tax penalty. This suggests that the IOV arrangements should have been abolished when IHT was introduced.

31. Against this, it might be argued that the IOV arrangements were retained for CGT after the abolition of the death charge on gains. However the situations are not analogous because the removal of the CGT death charge did not remove the practical justification of cutting out a lot of work on small gains (paragraph 8). Moreover the CGT provision offers considerably less scope for tax avoidance: its effect is to defer the tax liability, not to give exemption from an occasion of charge.

Cost

32. The Revenue cost of the arrangements are not readily estimated directly. While transfers between spouses remain wholly exempt, the likely tax yield from the abolition of the IOV provisions will be considerably less than the cost of the spouse exemption. In the short term, taxpayers will be able to achieve broadly similar results as under the IOV provisions by making death-bed transactions between spouses including alterations of Wills. In the longer term, tax planners will advise husbands and wives to make Wills leaving everything over the threshold to the surviving spouse on the understanding that whoever survives will make PETs to the children and grandchildren.

33. The circumstances which offer the most scope at present for reducing the tax bill under the IOV provisions are estates left to chargeable beneficiaries where there is a surviving spouse. It is more likely that IOVs will be executed where the chargeable beneficiaries are the children or grandchildren. If, for example, all such bequests were channelled via the spouse, the potential annual tax advantage to the parties, and hence the

"loss" to the Exchequer, might be around £50 million. But the actual savings and corresponding Exchequer loss will almost certainly be less. Not everyone will take advantage of the device. Even where it is used, some spouses will not live long enough to make the "subsequent transfer" exempt (paragraph 17).

Staff effects

34. The abolition of the IOV provisions would mean that the staff in the CTOs would not have to examine IOVs. They are even encountered in sub threshold cases which would not otherwise be examined, where a wealthy beneficiary takes the opportunity to hand on his inheritance to the next generation. Often this work is undertaken against time pressures being imposed by the parties anxious to see how a valuation of the estate (eg on unquoted shares) affects the tax position before deciding on the shape of their IOV. So while the staff savings from the change are difficult to quantify, there would be a definite work saving which will be useful in the present difficult workstate situation.

Conclusion

35. The present arrangements are a charter for retrospective tax planning to subvert the death charge. As such, they are at odds with the provisions in the IHT code designed to encourage life-time giving and to protect the death charge. Yet their repeal would probably be portrayed as robbing the little man of a chance to achieve the same end result as the rich and well-advised would continue to achieve in any event. The latter point would have carried greater weight if the spouse and charity exemptions were limited to modest amounts. Moreover the evidence is that the arrangements are used by the rich and are more likely to involve blatant attempts at tax avoidance. This supports the view that the present arrangements in the context of the IHT code are over-generous. Complete withdrawal would involve removing the IHT effect of all Court Orders making provision for dependants (a matter requiring the Lord Chancellor's agreement). But it would

be possible to make partial changes which were nevertheless sufficient to enable some of the more indefensible of the avoidance opportunities to be removed.

Point for decision

36. We seek your decision

a. whether to legislate in this area and, if so,

b. whether to do so as in subparagraphs 29(a), (b) or (c).

[signature]

L E JAUNDOO

I think you will clearly want to retain the IHT effect of a Court Order to make adequate provision for dependants, and so also of out-of-Court arrangements to the same end (Mr Jaundoo's 29 a) and b)).

It is almost as clear that the spouse exemption has been around long enough for people to get their Wills sorted out to take account of that if they so wish. They no longer, for this reason, need a provision which gives their heirs a second bite (29 c)).

Is it needed for any other reason (13)? If not, abolishing the provision would not prevent estates for ever passing so without incurring a tax charge, but it would remove the chance to achieve that if the Will had failed to do so (and end what for us is an administrative nuisance). [signature]

ANNEX

ILLUSTRATIONS OF THE COMMON USAGE OF INSTRUMENTS OF VARIATION FOR TAX PLANNING PURPOSES

1. Use of Exemptions

Example i.

A dies leaving all his property (£200,000) to his children.
IHT liability - £36,000 on the £90,000 of the estate above the threshold.

By an IOV the children redirect the whole of the estate, apart from £110,000, to their mother.
Revised IHT liability - NIL - the property redirected to widow is covered by the spouse exemption and the legacies to the children equal the IHT threshold.

Example ii.

A dies leaving all his property (£300,000) to his children.
IHT liability - £76,000 on the £190,000 of the estate above the threshold.

By an IOV the children give the widow a short term income interest sufficient to extend beyond the 2-year period, with remainder to themselves.
Revised IHT liability - NIL on the death since the property is now covered by the spouse exemption.

Note: We have seen cases where the IOV is executed near the end of the two-year period giving the widow an income interest for a few months only - so very little actual benefit is conferred on the widow.

2. Use of Reliefs

The object is to ensure that property qualifying for relief, ie mainly business and agricultural property reliefs, is not wasted because the property passes to the widow.

Example

A leaves his farm worth £400,000 to his widow, and the rest of his estate worth £400,000 to his son.
IHT liability - £116,000 on the part of the £400,000 chargeable estate in excess of the threshold.

By an IOV the farm is redirected to the son with the rest of the estate to the widow. The farm is sold shortly thereafter.
Revised IHT liability - £36,000 - the farm qualifies for agricultural property relief at 50 per cent thereby reducing the chargeable amount to £200,000. So the value of the son's inheritance has been increased without prejudicing the widow's.

3. Use Where there is a Foreign Element

Example i.

A dies domiciled abroad, leaving his foreign property to his son B, who is domiciled here.
IHT liability - NIL because of A's domicile at his death, and the fact that he does not own any property situate here.

The foreign property inherited by B is now within the scope of inheritance tax in connection with transfers made by him. B enters into an IOV by which the property is held upon discretionary trusts or interest in possession trusts for the benefit of himself and his family.
Revised IHT liability - NIL on A's death because of his domicile. Moreover, because of the IOV A, not B, is regarded as settlor and as long as the property remains settled and abroad it will be immune from IHT whether in connection with B or otherwise.

Example ii.

A domiciled abroad leaves his English estate (£200,000) to his daughter and his foreign estate (£200,000) to his wife. His daughter is in the USA.
IHT liability - £36,000 on the part of the English estate which exceeds the threshold. Nil on the foreign estate because it is outside the scope of IHT.

By IOV the English estate is redirected to his spouse and the foreign property to the daughter.
Revised IHT liability - NIL because the foreign estate is outside the scope of IHT and the English estate is covered by spouse exemption.

Example iii.

A man dies domiciled abroad leaves his estate to his son, including English assets (£300,000).
IHT liability - £76,000 on English assets in excess of threshold.

By IOV the English assets are redirected to A's spouse.
Revised IHT liability - NIL - the foreign assets are exempt because the deceased is domiciled overseas and the English assets are covered by spouse exemption.

4. Circumventing the Gift with Reservation Rules

Example

X dies leaving his house to Y.
IHT liability - liability arises on the value of the house in excess of the threshold.

Y enters into an IOV under which the house is re-routed to his son Z, but Y continues to live in the house.
Revised IHT liability - there is still liability on X's death on the value of the house in excess of the threshold. But the value of the house is excluded from Y's estate. The gift to Z is regarded as having been made by X not Y, with the result that the house cannot be regarded as being property subject to a reservation. This is also an example of generation skipping. Y has managed to give property to his son without incurring any additional tax charge ie other than the tax payable on X's death.

5. Use where the Estate Increases in Value After the Death

Example

A's death estate is valued at £200,000 including unquoted shares valued at £100,000 and by Will it passes wholly to his spouse.
IHT liability - NIL because of spouse exemption.

Within the 2-year period the company is floated on the Stock Exchange and the deceased's shares are now worth £500,000. By IOV the widow provides for a specific legacy to herself of £200,000 with residue passing to her daughter, who then takes £400,000.
Revised IHT liability - NIL but the widow has ensured that the £400,000 does not form part of her own estate.

6. Use of Variations by Personal Representatives

Example

H dies leaving his £110,000 estate to his widow. Eighteen months later the widow dies with an estate of £220,000, including the £110,000 inherited from her husband and under her Will her estate passes to her children.
IHT liability - £44,000 on widow's estate in excess of threshold.

The children enter into an IOV giving their father's estate directly to themselves. The £110,000 is taken out of their mother's estate.
Revised IHT liability - NIL - both estates are equal to the threshold.

CAYLEY 16/11

[SECRET] AND PERSONAL

bf. 18/11

Inland Revenue

Capital and Valuation Division
Somerset House

NBA @ Bud

FROM: M F CAYLEY

DATE: 16 November 1988

1. MR PITTS

2. MR PAINTER *

3. CHANCELLOR

The estimated impact on house prices, even if reliable, is too little to justify the tax change discussed in this minute. But in June, you wanted us to consider it as a structural reform. As such, it is justified in principle - there is no reason, other than social and political, to leave these assets out of the CGT system. But the various costs of bringing them in seem pretty daunting. DP 16/11.

STARTER 250 - CGT MAIN RESIDENCE EXEMPTION

1. At the meeting in your room on 15 June, it was agreed that the possibility of bringing homes within the CGT charge would be considered as a possible starter for 1989.

2. The paper attached seeks to pull the threads together. It has been delayed because it has taken a bit longer than we had hoped to do more statistical work. (We have had to develop new modelling techniques.) The Treasury are submitting a separate note setting out their assessment of the more general context. Were legislation to proceed, we would need to come back to Ministers on some detailed, more technical, points.

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cc. Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Riley
Mrs Chaplin
Mr Tyrie

Chairman
Mr Isaac
Mr Painter
Mr Bush
Mr Pitts
Mr Calder
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Weeden
Mr G Coe (VO)
Mr Boyce
Mr C Gordon
Mr Quinn
PS/IR

* Inevitably this reads like a catalogue of practical difficulties. But they are real (particularly the resource/valuation problems) and we have been driven to propose a raft of more or less arbitrary expedients which would add up to a pretty distinctive tax régime for a pretty small proportion of owner-occupiers. It therefore looks difficult to present as essentially a structural reform. Yet given the constraints, the alternative, economic, justification also appears rather weak.

16.11

3. If this is to remain a viable option for 1989, we shall need early authority to bring in Parliamentary Counsel: the drafting of legislation would be fairly tricky. We would also need soon to ask our colleagues on the operational side to start thinking in more detail about organisational arrangements.

4. Annexed to this cover note is a summary of what we think a possible scheme might look like. This is fairly close to the scheme that was on the table in June, but with some variations to take account of ministerial reactions then and our own further thinking, and with some alternative options spotlighted.

5. The basic question that arises is whether the controversy of introducing a CGT charge would be worth facing, given that

(i) the effect on house prices would be small (and many people are anyway now forecasting relative low price increases in the immediate future) unless those active in the housing market misinterpret the new charge as more of a threat than it actually is;

(ii) the tax take from those with liable gains would build up very slowly and be small in the early years;

(iii) in the first few years, the change would, unless there is a sudden surge in house prices, be likely to give a lot of people capital losses, probably running into hundreds of millions (particularly as the costs of sale - typically 2% plus - would be allowed as a deduction). Many would have no taxable gains above the annual exemption against which to set their losses: but some would. Estimates in this field are very uncertain, but in the short term, unless the new charge is ring-fenced, it is conceivable that the change could even lead to a net cost to the Exchequer - a risk touched on by Sir Peter Middleton at the meeting on 15 June (see paragraph 5 of Mr Taylor's record). The

possibility of this would be increased if - as some people anticipate - over much of the country house prices rise by less than inflation over the next year or two;

(iv) the legislation would be complex and impose sizeable compliance and administrative costs; indeed, in the initial years, because most homes over the threshold might well show either tax losses or no tax liability, compliance and administrative costs would be likely to come close to or exceed the yield;

(v) there would be at least some economic drawbacks (eg implications for labour mobility; incentive for the elderly to hang on to accommodation too large for them until death, when there would be no CGT).

6. If the answer to this basic question is yes, then the main structural issues are:-

(i) should there be rollover (in the summer, the view was that there should not)?

(ii) is it confirmed that there should be a special threshold for homes, set in terms of disposal proceeds, below which exemption would continue, with special provisions to prevent a cliff-face in liability for homes just over the threshold? If so, what sort of level should the threshold be?

(iii) should (as envisaged in the summer) only half of any gain be taxed?

(iv) in addition to the threshold at (ii), should there be a separate exemption available, in lieu of the normal annual exemption and of relief for at least most improvement expenditure? If so, should this be at a flat rate of, say, £5,000 (equal to the normal annual exemption) or £10,000; or should it be cumulative (£X of gains per year of ownership) with a minimum of £5,000?

(v) if only half the gain were taxed and/or there was a special exemption on the lines of (iv), should all improvement expenditure be disallowed, or would one give some allowance for big expenditure in a particular year?

(vi) is it agreed that the charge should be confined to increases in value from [Royal Assent] 1989? If so, how does one deal with the practical problems of getting 1989 valuations? Is time-apportionment or some other arbitrary approach a possibility? Is it confirmed that there should be no "kink test"?

(vii) should gains and losses on the home be ring-fenced, or should losses and gains on other assets be offsettable?

(viii) where homes are jointly owned, should the threshold at (ii) and any <u>cumulative</u> special exemption [see (iv)] be shared between the owners pro rata to their respective interests?

(ix) should husband and wife joint owners be regarded as owning equal shares of the home unless they claim and establish otherwise?

(x) should the change extend to homes for dependent relatives (where CGT exemption has been preserved for existing cases)?

(xi) what should be the start date? Disposals on or after Royal Assent to the 1989 Bill?

Michael Cayley

M F CAYLEY

<u>AA</u>
I am horrified @ the large circulation of this submission, given all I have said about the classification. PSt moments ago than Mr Cayley! & saying that I agree with Mr Parker that this particular (game) isn't worth the candle.
N.

SUMMARY OF POSSIBLE SCHEME

A Rollover

There would be no rollover.

B Threshold

Present rules continue - ie generally total exemption - for disposals of homes for less than [£110,000]. Where proceeds exceed this, the CGT base cost for the new charge would (to avoid a cliff-face in liability) be a minimum of [£110,000]. Where there are joint owners, the [£110,000] is apportioned between them. Where there was a disposal of only part of a home, only an appropriate proportion of the threshold would be available.

C The New charge

The charge is on [half] the indexed gain from the commencement date. Only [half] of any losses would be allowable.

There is a special exemption, which is available only against gains on the home, and which is given instead of the normal CGT exemption (which is available in full against other gains). [This exemption is £X,000 for each year of ownership from the commencement date, with a minimum of £5,000 (equal to the normal annual exemption) in total. It would be in lieu of a deduction for at least some improvement expenditure (see below). Where there were joint owners, the cumulative exemption would be apportioned between them, but each would have a minimum £5,000. So someone with no other gains would have a minimum special exemption equal to the ordinary annual exemption.]

OR

[This exemption is equal to the CGT annual exemption. It would be in lieu of a deduction for at least some improvement expenditure.]

The resulting gains and losses are not ring-fenced: they can be set against gains and losses on other assets in the normal way.

D Improvement Expenditure

[No deduction would be given for improvement expenditure on the grounds that a rough-and-ready allowance was given by halving the gain and giving a special exemption.]

OR

[Improvement expenditure would be allowable only to the extent that, in any year, it exceeded [twice] the special exemption.]

E Homes Jointly Owned by Married Couples

Gains and losses would be split equally between husband and wife unless they claimed, and established, a different division.

F Dependent Relatives

The charge would extend to homes for dependent relatives.

G Commencement

Disposals from Royal Assent with a Royal Assent base: earlier increases in value would be exempt. No kink test.

STARTER 250: CGT AND HOMES

1. Under present law, the main home is normally exempt from CGT. There is only a small minority of cases where part of the gain on a home can come into tax. The main examples are where some rooms are reserved for business use (eg let as self-contained accommodation - if a lodger lives en famille the exemption is unaffected; or used as a doctor's surgery, a workshop or retail premises); and where there is a sizeable part of the period of ownership during which the dwelling was not used as the owner's main home. But the overwhelming majority of homeowners have no need to think about CGT when they move house.

2. The number of owner-occupiers is currently some 15 million, counting married couples as one. There is some uncertainty about the figures for the number of land conveyances which relate to lifetime disposals by owner-occupiers; but our best estimate is that the figure is probably currently about 1.2 million a year. About three-quarters of these sales are by married couples, which means that, with independent taxation, some 2 million individuals are involved in any year: and most owner-occupiers are likely to make a sale at least once in their lifetime. Only a small proportion of those concerned - including only a minority of those selling more expensive properties - will have any contact with CGT at the moment. The 1.2 million estimate compares with some 150,000 CGT taxpayers under present law. Whereas there is currently a sizeable proportion of CGT payers who are regularly liable (and hence are familiar with the system) or who routinely get an accountant to help in their tax affairs, most owner-occupiers caught by the new charge would be liable only occasionally, and - even with a high threshold - would currently not use an accountant.

3. It follows that, if CGT were extended to the home, even with a high threshold most of those affected would be additional CGT payers with whom we have currently no dealings on gains. Many would be people with whom we have little dealing at all - eg because they are currently basic rate taxpayers with earned income taxed under PAYE and any investment income taxed at source. Some would be elderly and unsophisticated people on fairly low incomes who, because of the way house prices had moved, happened to be living in a now valuable house or sitting on large gains, and who would find it difficult to understand the concepts of CGT.

4. This background underlies much of the discussion that follows on how homes might be brought within CGT. It suggests that it would be even more important than usual to keep the rules as simple as possible, in order to ease compliance and keep down administrative costs: and all the more so if there is not a high threshold. It also suggests that - especially for those with whom we currently have few dealings - it is likely to be vital for both taxpayers and ourselves to have an easy means of identifying those cases where the sale of the home might generate a CGT liability.

5. The shape of any tax rules would also be affected by the objectives and how they were to be presented. For example, is the main purpose to dampen down house price inflation (and this note discusses later on how far a CGT charge might do this)? Is it to remedy a structural anomaly - the exemption of what should in theory be a chargeable asset? Is the intended target houses at the upper end of the market? Would one want to bring most owner-occupiers within CGT or (for political or other reasons) only a minority? And so on.

6. With all this in mind, there are two very general issues which need to be addressed before looking at more detailed - but still very important - aspects:

(i) should there be rollover?

(ii) what threshold should there be, and what form should the threshold take?

ROLLOVER?

How rollover might operate

7. The principle would be that chargeable gains would be deferred to the extent that the proceeds of the sale of a home were reinvested in another home, and taxed only on a later disposal. There would be a time period - running from perhaps two years before the sale to three years after - during which qualifying reinvestment could take place. At the simplest, if I sell one home for £150,000 and buy another for £170,000, there would be no immediate tax - any gain would be deferred; but if my new home cost only £120,000, some or all of the gain on my old home would come immediately into CGT.

8. As with deferral on business assets, the rollover would have to be claimed on each occasion. (Depending on the precise rules, a claim might have to be made even where the disposal price was less than the threshold.) We could not tell taxpayers that they need have no dealings with us if they reinvested all the proceeds - but should report their gains if they thought full rollover might not be due. Among the reasons for this are:-

(i) we would be expected (by NAO/PAC) to have an adequate system for policing whether rollover was due. There would be likely to be substantial criticism if we relied entirely on taxpayers' honesty and understanding of the law;

(ii) as mentioned above, some of those affected would be unsophisticated and would have trouble understanding how the rollover rule worked;

(iii) if our first contact with taxpayers was when they thought tax might actually be payable, it would be unrealistic to expect all of them - especially if they had moved a number of times - to have kept all the records needed to compute the gains that had been deferred on all their previous homes;

(iv) where the reinvestment was towards the end of the qualifying period, tax might already have been paid, and we would need to make a repayment;

(v) we would need to sort out how far there was an immediate tax charge in those cases where some tax is payable under existing law; or the new home and its grounds would not be fully exempt under existing law. (The rules for this would be likely to be complex, both legislatively and in their application in practice.)

9. An important question is whether taxpayers should be required to rollover losses which they realised on selling their old home. Symmetry would suggest that they should be compelled to do so; and if they were not, the Exchequer would (unless the losses were ring-fenced and available only against later gains on their new home) be giving immediate relief for losses, but deferring tax on gains: and this could involve a significant cost to the Exchequer. Against this, rollover on replacing business assets applies only to gains: businesses get immediate relief for losses. The rationale for business rollover is, though, different, and to deny immediate relief for losses on the sale of business assets would be seen as detrimental to the business (as well as involving considerable technical and practical difficulties). Despite the business precedent, we think that, if rollover of gains were to be a feature of the

charge on homes, Ministers would want to consider requiring losses to be rolled over. We would need to give further thought to the details of how this might be achieved.

10. If rollover were given, there would be pressure for special concessionary rules where the marital home was sold in the course of the break-up of a marriage. People would press for rollover to be available insofar as proceeds were reinvested by either spouse, irrespective of which spouse owned the property, or how ownership was - or was deemed to be - split between them.

11. In theory there would be an argument for making an adjustment for changes in the level of borrowing. Thus, to give a very simple example, if the outstanding mortgage on my old home was £40,000 and, when I buy my new home, I borrow a further £20,000, that £20,000 would be deducted from my qualifying reinvestment. Without such an adjustment I could obtain an advantage by increasing my borrowing for the new home in order to release part of the proceeds of my sale for other purposes.

12. In practice any adjustment of this kind would run into major problems:-

(i) it would be ill understood by some taxpayers and almost certainly a source of complaint;

(ii) if one does an adjustment of this kind, one should arguably - on the same lines of argument - treat a taxpayer as realising part of the value of the house if eg he takes out a second mortgage or uses his home to secure an annuity (in both cases there is a release of some of the equity represented by the home for other purposes). This would be complex, and involve charging gains people would say they had not made at times when they would often be strapped for cash;

(iii) there could be substantial anomalies because of the different types of mortgage. Thus if I take out a £40,000 endowment mortgage, there is no capital repayment until the end of the mortgage's term. So if I sell the home after ten years, I still owe the lender £40,000. If I take out a repayment mortgage of the same amount, and sell the home after ten years, I will have repaid some of the capital I borrowed, so the outstanding loan at that point will be less than £40,000. If my loan for the new home is £40,000, then in the first case I would have kept my borrowing constant and there would be no adjustment to the amount of reinvestment; in the second case, I would have increased the capital amount of my borrowing and an adjustment would be made. Such a difference of treatment would be hard to explain. In practice special rules would probably be needed to avoid it - an added complication;

(iv) there would be other anomalies. For example, people who wanted to improve or refurbish their new home, and needed to borrow more to do so, would trigger the adjustment if the extra borrowing involved took the form of an increased mortgage at the time of purchasing the new home, but (depending on the precise rules and the form of the loan) might well not do so if they negotiated a separate loan a little later (since the extra loan would not be for house purchase). People with a second home (already CGT-liable) would have more scope for borrowing in ways which did not trigger the adjustment (by securing loans on their second home rather than their main residence) than people with only one home. And so on;

(v) complex provisions would be needed to prevent people dressing up borrowing for house purchase as something else. Given the fungibility of finance, these provisions could not be wholly effective;

(vi) in principle, the case for an adjustment of this kind would be no greater for rollover on homes than it is for rollover on business assets financed by borrowing. Such an adjustment is not made, and would be virtually impossible to devise, for business assets.

13. For these reasons, we doubt that an adjustment for changes in the level of borrowing would be a viable option.

<u>The argument for rollover</u>

14. The arguments for allowing rollover are relatively straightforward. Without it a CGT charge on the home would be a deterrent to labour mobility in particular, and house moves in general, especially where tax was payable at 40%. And those compelled to move house for eg job reasons would see themselves as unfairly penalised, if an immediate CGT charge made it more difficult for them to purchase an equivalent new home, especially on a move from a low to a high cost area.

<u>The arguments against</u>

15. There are however strong arguments against rollover.

16. It would be a big complication. It would involve taxpayers and ourselves in computing gains on a huge number of occasions when no tax was due, and mean a large staff cost for no immediate revenue.

17. In the absence of a CGT charge on death, rollover would for most people be tantamount to exemption (but by a much more cumbersome method): as long as people did not trade down in their lifetimes, no CGT would be payable. It follows that, if rollover was part of the system, the extension of CGT to the home would bring in next to no tax and have virtually no effect on house prices. (Even with a

charge on death, rollover would generally defer any tax liability until death, and hence substantially postpone the point at which the new charge began to bite on any significant scale.)

Conclusion on Rollover

18. For reasons such as these, you decided in June that rollover would not be appropriate. In our view the arguments against rollover remain very strong.

THRESHOLD

A highish threshold?

19. The scheme we drew up in June postulated a fairly high threshold, so that CGT on homes would be confined to a minority of owner-occupiers with between 10 and 15 per cent of disposals in a year being over the threshold.

20. A key factor is the desired target. Do you want to bring in most or all owner-occupiers making real gains on their homes? Major considerations here are:-

(i) the obvious political dimension (and press comment in the summer, when there were a number of stories about possible new taxes on homes, recorded strong opposition to the possibility of any CGT charge which applied to a high proportion of home-owners)

(ii) economic. Would a tax effectively confined to more expensive properties meet the desired economic objectives? Would it have the "knock-on" effect of reducing the prices of less expensive homes?

(iii) geographical. With a high threshold, any tax charge is likely to weigh more heavily on London and the South-East than on other regions.

(iv) compliance and administration. Without a high threshold, millions more people would at least at some point in their lives have to be involved in the complications of CGT, and there would be staff costs running into thousands. And on many of the smaller disposals any CGT charge would be small.

(v) the scale of the valuation problem (see below) would be multiplied unless there was a high threshold.

21. Ministers concluded in the summer that it would be preferable to have a high threshold.

<u>What form should the threshold take?</u>

22. In principle the threshold could be expressed in terms of gains or of disposal proceeds. (In the latter event special provision would be needed to avoid a cliff-face in liability just above the threshold.)

23. A threshold in terms of gains looks more logical for a tax on gains. It means that if I make a gain of £60,000 my CGT position is the same whether I sell the property for £90,000 or £300,000.

24. A highish threshold expressed in terms of gains could mean that, in the first few years (assuming a 1989 base), only a tiny number of disposals would be caught. But (assuming the trend continues to be for homes to appreciate by more than the RPI), as time goes on the numbers affected would rapidly increase unless the threshold was regularly increased to keep the taxpaying population constant. So the prospect would be of a tax charge which had negligible effect in the early years but gradually brought in a significant proportion of owner-occupiers.

25. Such a threshold would have important drawbacks:-

(i) people would find it much more complex. They would have to form an estimate of the gains (allowing for indexation etc.) before deciding whether to report a disposal to us. The difficulties would be particularly acute for existing homes, since people would need to form a view of the 1989 value in order to gauge the probable gain, and there will often be room for widely divergent opinions about this.

(ii) the new charge would tend to weigh more heavily on people who seldom moved house (and hence, on any single disposal, might have a large gain) than on those who moved often (and so, on individual disposals, tended to have smaller gains which might well be within the exemption). A threshold expressed in gains might therefore encourage people to move home more often.

(iii) at our end we would have no means of identifying potentially liable cases from Stamp Duty particulars, which record only proceeds.

There could thus be significant extra compliance, administrative and policing difficulties with a threshold expressed in gains, as well as a distorting effect on how long people stayed in one home.

26. Factors such as these led us to suggest in the summer that a threshold in terms of disposal proceeds would be preferable. This would enable everyone to see at a glance whether they were potentially within the new rules, and enable us to draw on Stamp Duty information. It would therefore reduce compliance and administrative costs. If the desire is not to extend the new charge beyond homes at the upper end of the market, then a threshold in terms of disposal proceeds is the obvious way to achieve it. It is however open to the criticism that a person below the threshold will escape CGT even if he makes a large gain, while someone above the threshold who makes a more modest gain may face a tax charge.

27. For working purposes, we have assumed that the threshold would be set in terms of disposal proceeds.

Level of Threshold

28. Taxpayer numbers, and our staffing costs, would be critically dependent on the level at which the threshold was set. In June, a figure of £110,000 was suggested. As explained later on, our estimates of taxpayer numbers are very uncertain, but the following table shows our best guesstimates of likely numbers at illustrative threshold levels. (The section on yield and taxpayer numbers below explains the very considerable uncertainties attaching to any figures of this kind.) The table assumes a 2% real growth in house prices and that the threshold would be frozen for the next few years (we would need more time to build in the effect of eg revalorisation by reference to the RPI).

Year	Number of sales over threshold (thousands)	Number of sales generating tax (thousands)
(a) £75,000 threshold		
1989-90	450	50
1990-91	500	40
1991-92	545	75
1992-93	580	100
(b) £90,000 threshold		
1989-90	300	45
1990-91	350	40
1991-92	390	65
1992-93	430	85

Year	Number of sales over threshold (thousands)	Number of sales generating tax (thousands)
(c) £110,000 threshold		
1989-90	185	35
1990-91	215	60
1991-92	250	85
1992-93	280	100
(d) £125,000 threshold		
1989-90	135	30
1990-91	160	30
1991-92	180	40
1992-93	200	50
(e) £150,000 threshold		
1989-90	85	20
1990-91	100	25
1991-92	110	30
1992-93	125	35

Annexed to this note is a bar chart showing estimates of the breakdown of disposals in 1989-90 by value of disposal proceeds. An important point to note is that, from 1990 (when independent taxation comes in) the number of taxpayers involved might be up to one and three-quarter times the figures quoted: it is estimated that about 75% of owner-occupied homes belong to married couples, and are generally owned jointly.

29. This table suggests that, as the threshold is reduced below £100,000, the number of disposals potentially affected increases fast. One would start to bring in a lot of

relatively modest dwellings in London and the South-East. If the aim is to confine the charge to the upper end of the market, this points to a threshold of over £100,000. Wherever the threshold was set it would have a disparate effect in different parts of the country and, within regions, in different liabilities.

30. If large numbers of extra taxpayers were not to be brought in over time, with a corresponding increase in our staff need, the threshold would need to be kept under constant review. A particular difficulty here is that an unpredicted surge in house prices could suddenly bring a lot more people into charge in a year for which the threshold had already been set. We return to this in the section on staffing below.

<u>Part Disposals</u>

31. Where there was a part disposal (for example where part of a house was converted into a self-contained flat which was then sold), only an appropriate proportion of the threshold would be available, with a corresponding adjustment to the threshold allowed on a later disposal of the remainder of the dwelling.

<u>Preventing a cliff-face in liability</u>

32. With a threshold set in terms of disposal proceeds, it would be necessary to have a special provision to prevent a cliff-face in liability for homes just over the threshold.

33. In the summer, we envisaged this taking the form of a marginal relief under which the gain taxed under the new rules would be limited to half the excess of disposal proceeds over the threshold. (This was on the assumption that the general policy was to tax only half of the indexed gain on the home.) Thus if the home were sold for £120,000 and the threshold were £110,000, the gain we tax would never

exceed £5,000 (half of the difference between £120,000 and £110,000).

34. Our experience with marginal reliefs is that many taxpayers find them difficult to understand. So we have considered whether there is a simpler alternative approach.

35. We think we have found one which will give a very similar result and be easier for both taxpayers and ourselves to apply. This is to stipulate that the taxpayer's base cost for the new charge shall never be less than the threshold. So if the indexed acquisition cost or 1989 value is less than the threshold, the taxpayer would be treated as having a CGT base cost equal to the threshold. If gains on the home are generally halved, then this would limit the charge to half the difference between the threshold and the disposal proceeds.

EXAMPLE

Assume threshold £110,000 and that gains are generally halved.

Indexed acquisition cost £80,000

Sale proceeds £120,000.

The taxpayer would be treated as having a base cost of £110,000. On that basis the full gain would be £10,000, which would then be halved.

BASE DATE AND COMMENCEMENT

36. We assume that, to avoid retrospection, gains and losses would be measured from a current base date rather than from 1982 or acquisition if later; and that this base date would correspond to the day from which the new charge applied.

37. We would suggest that this day should be the day the Finance Bill receives Royal Assent, rather than Budget Day or 6 April. This has a number of advantages:-

(i) until the Finance Bill is through, people could not be absolutely certain of what the details of the law would be - and hence how much they needed to set aside, when selling their home, to meet any CGT liability. With a Budget Day start some people might even feel constrained to hold up sales until they were certain what the rules would be.

(ii) the date of disposal for CGT is not the day of completion but the date of exchange of contracts (missives in Scotland). But people are well advanced in the process of house purchase before this. A Royal Assent start would give many people who have made or accepted an offer, or are near doing so, by Budget Day a chance to see things through to disposal before the new rules come in. Even so some pressure for transitional relief for people in the pipeline might remain, and we would need to minute Ministers further on whether something should be done for them.

(iii) it would give us time after Budget Day to prepare and issue public guidance and instructions to our offices. With a Budget Day or 6 April start, we would have to have work on this well in hand before the public announcement on Budget Day, and that would mean substantially increasing the circle of knowledge - which on a topic as sensitive as this we suspect you would prefer to avoid.

38. If the charge is limited to future increases in value, and there is a highish threshold, the risk of a lot of people rushing to sell before the deadline is small.

Should there be a kink test?

39. For 1982 rebasing, we built in a kink test to prevent people being taxed, because of rebasing, on more gains than they had made, or given relief for more losses than they had realised; but at Report Stage taxpayers were given the right to elect out of the kink test for all their assets.

40. A similar kink test for the 1989 base for homes would be a sizeable complication. Given the way house prices have been moving, its main application would be to deny relief for losses if house prices fell, or increased by less than the RPI, after the commencement date. If (as with rebasing) taxpayers could elect out of the kink test, even this effect would be lost. At the practical level, there could be difficulties in some cases in establishing what the taxpayer's actual gain is, and hence in operating a kink test. For example, where they were given the home, there might be some difficulties now in establishing its value at the date of gift in the condition it was then in. And if you felt obliged to allow the cost of some or all improvements (an issue we discuss below), there might well be problems in establishing what improvement expenditure had been incurred between 1982 and 1989. On balance we would recommend against importing a kink test.

41. If, because of the valuation difficulties discussed in the next few paragraphs, 1989 values were determined by time-apportionment or some other arbitrary method, the question of a kink test would not arise.

1989 VALUATIONS

42. In principle, the base for the new charge should be, for existing homes, the open market value of the home on the commencement date. Over the year, as people acquire new homes, the number of cases where 1989 values are required will diminish: but they will be needed in a high proportion of cases for some years. This raises substantial practical issues.

43. As you know, our Valuation Offices are already extremely hard-pressed. They do not have the resources to undertake or check 1989 valuations on any significant scale. You are already having to press the Secretary of State for the Environment hard to introduce an unpopular restriction of current Rating Proposal/Appeal rights in order to prevent unacceptable consequences for the non-domestic revaluation and other Government programmes. Although the extra CGT work would not start significantly until 1990/91, after the non-domestic list has been completed, the Valuation Office valuers are likely still to be under-staffed to cope with the appeals against the list, and all the more so if agreement had not been reached to restrict the now current Proposal/Appeal rights.

44. The resource difficulties would increase because of the new charge. Valuers are scarce nationally. If work on 1989 valuations were undertaken (whether at the taxpayer's expense or ours) by the private sector, it would be inevitable that more of our Valuation staff would leave for the private sector. Even if initial work on 1989 valuations is undertaken by us, the private sector will still want more Valuers because some taxpayers will seek their own valuation advice and will want to dispute our figures.

45. Moreover, in many cases, particularly for more expensive properties, there can be room for substantial differences of view (tens of thousands) about market value. In the first month or two this point would be of less relevance, because the sale date would be close to the base date. But after that the room for dispute would rapidly escalate.

46. The options available are

(i) for the Valuation Offices to do all the 1989 valuation work ourselves. As explained, that runs into acute resource difficulties.

(ii) to accept the taxpayer's estimate, subject to a small sample check. But - especially as time goes on - taxpayers' estimates are likely to be very unreliable (and err very much in their favour); less sophisticated taxpayers might have little idea how to form a view; and the risk of criticism on grounds of public accountability must be high.

(iii) to require taxpayers to supply an expert valuation (the cost of this being deductible in computing the gain), which might be subject to a small sample check. Again, especially given the room for substantial divergences on valuations, there would be criticism if we checked no more than a small sample. But we would not have the resources to do more. The private sector would probably have its own resource problems in meeting the demand for 1989 valuations, and our own existing staffing difficulties would be exacerbated by an outflow of Valuers to the private sector.

47. These problems would, in the short term, be multiplied if large numbers of people decided to get an early estimate of the 1989 value of their home which they could produce on a later sale. Experience from the introduction of CGT in 1965 suggests that a lot of people would want to do this.

48. It will be clear from this that our further thinking since the summer has produced no ready answer to the practical problems of 1989 valuations.

49. Against this background, we have asked ourselves whether it is worth considering an alternative, more arbitrary approach. One possibility would be to use time-apportionment from the date of acquisition to arrive at 1989 values. This would have to be compulsory if the valuation problems are to be avoided. To illustrate how time-apportionment would work, take the case of a house bought in 1979 (ten years before the base date) for £50,000

and sold fifteen years later in 1994 for £200,000. The 1989 value would be deemed to be £150,000: ten-fifteenths of the difference between the acquisition price and the disposal proceeds would be attributed to the period before 1989.

50. Time-apportionment is open to obvious objections. By definition, it ignores the actual time-pattern of movements in a dwelling's value. If the true annual increase in value before 1989 is greater than after, then time-apportionment will bring too much gain into charge. Thus this would be the case if, in the example given, the true 1989 value was £175,000. With the rate of house price inflation now slowing down, time-apportionment will in the foreseeable future commonly bring too much gain into charge. With a Royal Assent start, this could lead to forestalling. And time-apportionment would mean that two identical and neighbouring houses could be deemed to have different 1989 values, depending on when they were acquired.

51. Another possibility might be to use a national house price index. At the simplest one would inflate the acquisition cost by the percentage increase in house prices between acquisition and 1989. This could create capital losses where a home appreciated by less than the national average - losses which the taxpayer had not really made. A more sophisticated approach would be to use some form of interpolation. For example, if the national house price index was 100 at the date of acquisition, 150 in 1989 and 200 at the date of sale, one would deem half the taxpayer's nominal gain on the house to be attributable to the pre-89 period. If he had bought for £100,000 and sold for £180,000, this would give a deemed 1989 value of £140,000.

52. We think many taxpayers would have great trouble understanding an interpolation provision of this kind. It would be necessary to go through the steps of computing the nominal gain, then applying the interpolation formula to arrive at 1989 values, and then operating indexation - a fairly laborious process. More generally, use of a national index in some form or other would have one advantage over

time-apportionment: it would mean that the arbitrary approach to 1989 values would take account of the recent steep rise in house prices. It would, though, share many of the disadvantages of time-apportionment: it would by definition be arbitrary; involve taxing some people on what were really pre-89 gains while leaving some post-89 gains untaxed in the hands of others; and, like time-apportionment, would mean that identical, neighbouring houses could be deemed to have very different 1989 values depending on when they were acquired. And there is one technical difficulty: we are not sure there is a reliable and consistent national index going back far enough to cover homes acquired 50, 60 or more years in the past: so we might well have to devise an arbitrary means of extrapolating an existing index back in time.

53. In principle, a refinement on the use of a national house price index would be to use regional indices. But there can still be very large divergences in house price movements within a region - at times as great as divergences from a national index. And the use of regional indices runs into some practical problems:-

(i) we do not think there are existing regional indices which go back far enough, so we might well have to construct our own - that would be a major task;

(ii) it would be important to ensure that regional boundaries did not change over the period covered by the indices: otherwise there would be problems in dealing with a home which was in one region in one period, and in another later on. Over the years, local government reorganisations have altered administrative boundaries: so this would be difficult. And, even if it were possible, the boundaries would need to be drawn very precisely to avoid disputes as to what region an isolated dwelling or outlying hamlet belonged to;

(iii) there would be an extra resource cost, particularly for more remote dwellings, in establishing just where the regional boundary fell; and

(iv) regional indices could produce very different 1989 values for similar dwellings which were very close to each other but fell on different sides of a regional boundary.

54. An arbitrary approach which starts from acquisition costs will run into difficulties where such costs are not available. For example, where the home was acquired by gift or inheritance, a valuation at the time of acquisition would be required. And while, where there is a Land Registry record, this should include the dates of, and amounts paid on, purchases of homes, that information is incomplete, particularly for homes bought some time in the past.

55. We would need to do more work to establish what might be the best means of establishing 1989 values on an arbitrary basis. But some such approach seems the only way of sidestepping the valuation difficulties. If Ministers would be prepared to accept the inevitable consequences of an arbitrary approach, we can consider further what the precise formula might be.

HOW MUCH OF THE GAIN SHOULD BE CHARGED?

56. In the summer, you indicated that you would want to tax only a proportion of the indexed gain. As we said then, if this is so then, given that there is no magic in any particular proportion, the obvious course would be tax only half the indexed gain. The corollary would be that only half of any loss would be allowable. Losses would not be allowable where disposal proceeds were below the threshold, just as gains on each disposals would be exempt.

57. If only half any gain is taxed, the economic effect of the new charge will clearly be reduced. But the decision here would have to be political. For the moment we have assumed, in our figuring, that gains and losses on disposals over the threshold would be halved.

THE CGT ANNUAL EXEMPTION

58. If the normal CGT annual exemption is available against the home, this would mean that people who made taxable gains when they moved home would be brought within the complexities of CGT for any other gains, however small, they made in that year: to determine the total CGT liability, it would be necessary to compute the gains on both the home and any other disposals.

59. Administratively, and in compliance terms, there would be substantial advantage in reserving the normal annual exemption for disposals other than of the home in order to avoid having to deal with trivial disposals of shares etc in a year when someone moves home. This would mean having a separate, special exemption for gains on the home. To this we now turn.

FORM OF A SPECIAL EXEMPTION

60. At a minimum, everyone would have to be given an exemption for the home equal to the normal annual exemption. Otherwise someone who just disposed of a home could, for instance, end up paying tax where he would have been exempt had he made an equivalent gain on, say, shares.

61. In the summer we suggested having a special cumulative exemption of £X,000 per year of occupation (starting from 1989), with a minimum equal to the normal annual exemption. This was because of the problem of improvement expenditure (discussed in the next section). At the meeting on 15 June,

Ministers expressed some hesitation about this, partly on the grounds that it would set an undesirable precedent for making the normal annual exemption cumulative (ie allowing people who had not used it up in any year to carry forward the balance and add it to the exemption in the next year, and so on). We recognise that this is a serious drawback.

62. A cumulative exemption would reduce the impact of the new charge. In addition it would also be a significant complication - both operationally and legislatively. The complication would become acute if - as was suggested at the 15 June meeting - where there were joint owners the cumulative exemption were split between them: the rules for determining the appropriate split would be exceedingly complex - and difficult to apply - for joint owners who acquired and sold their interests at different times. But without such a split - in other words, if joint owners each had a full cumulative exemption - there would be inconsistency with the residence basis for mortgage relief.

63. On reflection we therefore think the balance of argument may point towards allowing each tax payer a flat rate exemption of the first £X,000 of gains. This exemption would have to be at least equal to the normal CGT annual exemption (currently £5,000): otherwise someone disposing of just a home could be worse off than someone making an equivalent gain on other assets. The difficulty of improvement expenditure might be reduced if the exemption was higher than £5,000 - say, double the normal annual exemption, or £10,000 on current figures - but this would substantially reduce the yield in the early years. For immediate working purposes, we have assumed an exemption of £5,000.

64. The exemption would be available in full to each taxpayer. This would mean that two people who jointly owned a house (including from 1990 married couple joint owners) would have £10,000 of tax-free gains. Arguably this might appear inconsistent with the residence basis for the

mortgage relief limit; but for CGT the position would be the same as for joint owners of shares or other assets, who each have a separate annual exemption. If only half of gains on the home are taxed, the exemption would be applied before the halving.

IMPROVEMENT EXPENDITURE

65. We were led into proposing a cumulative exemption by the practical problems of expenditure on improving the home:-

(i) when someone comes to sell, the records may not be there to establish what expenditure on improvements has been incurred and when (especially now that relief for borrowing for home improvement is no longer available);

(ii) under normal CGT rules, we would give a deduction for improvements but not for expenditure on repairs and renewals. But the borderline between the two can be difficult to establish - especially (possibly long) after the event when the home was sold. This could lead to a lot of correspondence and argument;

(iii) indexation would be given on improvement expenditure from the date it was incurred, as a separate calculation. This would be a substantial complication of some computations, particularly where there was a series of improvements.

66. We think therefore it would be a necessary simplification to find a way of ignoring most or all improvement expenditure. If only half the gain is brought into tax, it might be possible to argue that this was a sufficient proxy for allowing for improvements (without also introducing a cumulative exemption) - and all the more so if Ministers agree that taxpayers should have a separate flat rate exemption on the home, leaving the normal annual exemption for other assets.

67. There would though be complaints from people who had undertaken major improvements, for example by adding a large extension or making habitable a dilapidated property. If Ministers wanted to go further, one possibility would be to disallow the first £X,000 of improvement expenditure in any year, and where expenditure was greater allow only the excess. X would have to be fairly large - perhaps £10,000 - since the cost of more routine improvements such as putting in central heating or double glazing can run to several thousand pounds. A figure of £10,000 would be easier to justify if the flat-rate exemption was set at the same level.

SHOULD GAINS AND LOSSES BE RING-FENCED?

68. The question here is whether gains and losses on the home, as computed under these rules, should be available for set-off against losses and gains on other assets, or whether there should be ring-fencing.

69. The arguments against ring-fencing are essentially:-

(i) with all the other special rules for the home, it would make the new charge look too much like a completely separate tax on homes instead of bringing them within an existing tax.

(ii) if someone makes a large loss on some other asset and a gain on the home, or vice versa, it looks unfair not to allow set-off.

70. There are, though, some arguments in favour of ring-fencing:-

(i) without ring-fencing, there may be an incentive for people to bed-and-breakfast a large loss on a shareholding in a year when they have a large gain on the home.

(ii) as explained below, we anticipate that, in the early years, one effect of bringing homes into charge would be to give a lot of people capital losses. Some would have gains above the annual exemption against which to set these losses. So there is a risk that, in the immediate future at least, the CGT yield could actually fall unless there was ring-fencing.

71. The conclusion in the summer was that there should be no ring-fencing.

MARRIED COUPLE JOINT OWNERS

72. Where a married couple jointly own a home it can be very difficult to establish how ownership is divided between them. (Indeed, under one common form of joint ownership they each in law have a simultaneous 100% interest in the property.)

73. The issues here are very similar to those which Ministers considered for the treatment of investment income on joint accounts under independent taxation: and the solution needs to be the same. We should deem ownership to be split equally between the spouses unless they claim, and establish, a different division.

DEPENDENT RELATIVES

74. CGT exemption extends to homes provided for dependent relatives before 6 April 1988, and it was said explicitly when the exemption was withdrawn for new cases that it would continue for existing ones.

75. Legislatively it would be complex not to bring these existing dependent relative homes within the new rules; and it would appear odd to charge tax on someone's own home but not to withdraw exemption for a home they had been providing for their aged mother.

76. We would therefore recommend that dependent relative homes which currently attract exemption should come within the new rules.

INCIDENTAL COSTS

77. The incidental costs of acquisition and disposal - Stamp Duty, estate agents' commissions, lawyers' fees - would be allowable in the normal way, as for any other asset. This has significant implications for the yield, particularly in the early years. The incidental costs of selling a home probably average 2 per cent plus of the gross proceeds, and this means that, with CGT indexation, the value of a home would have to go up by over 2 per cent in real terms from the base date before the new charge began to bite. The costs of buying a home could often add a further 2 per cent to this for homes acquired after the base date.

FIXTURES, FITTINGS AND CHATTELS

78. Where carpets, curtains, furniture and so on are sold with the home, there would be more incentive for people to enter them as a separate item in the sale agreement, at an inflated value, in order to reduce the amount of proceeds attributable to the home itself (and hence subject to the new charge) and to take advantage of the CGT chattels exemption (which will exempt chattels sold for less than £5,000 - see Starter 256). It would frequently be difficult and time-consuming for us to check the values attached to chattels etc. In principle one solution might be to treat the proceeds of their sale as part of the sale proceeds of the home itself, but we would then have to add their cost to the cost of the home - and the records for this would often be missing: so this does not look a viable option. So in practice we think we would have to accept some tax leakage through people attaching over-high values to fixtures, fittings and chattels - and this would also cause a small reduction in the Stamp Duty yield.

ADVANCE GUIDANCE

79. At least some taxpayers would press us to give an advance indication of how much CGT they were likely to have to pay, so that they know what resources they had free to reinvest in a new home. We would not have the resources to comply, but would anticipate complaints about this.

EXCHEQUER EFFECTS AND TAXPAYER NUMBERS

80. Exchequer effects and taxpayer numbers of a scheme on the lines we envisage would depend critically on not only the level of threshold but also what happens to house prices: and a major influence would be <u>local</u> movements in values. (Even at a time of relatively static house prices, there are likely to be particular localities where prices are moving up.) House price movements and turnover are hard to predict, and all the more so at the local level, and this makes it very difficult to forecast yield or taxpayer numbers with any confidence. For example, an unexpected surge in prices or the number of transactions could produce an unexpected increase in yield and taxpayer numbers: and the effect would be proportionately very much greater for a tax on <u>gains</u> than for IHT, which is a tax on values. Thus Table One attached illustrates how an extra 2% on real house price increases might easily double the number of cases.

81. Our approach to the costings has been discussed with the official Treasury. We have attempted to allow for regional variations in current prices, and for a dispersion of local movements in house prices around a national average. The number of possible permutations of assumptions here is very large, and we have inevitably had to limit our work. Our working assumption has been that on average prices will increase by 2% to 4% a year in real terms over the next few years. This is above some outsiders' estimates for the immediate future. We have attempted to allow for behavioural reactions, on a basis suggested by the Treasury, though these must be essentially a matter of judgment.

Given all the uncertainties, the figures we give should be taken as no more than an indication of possible magnitudes.

82. In considering the yield it needs to be remembered that, with a 1989 base, a slow build-up is inevitable: all the more so because the costs of sale would be a deductible expense.

83. We have taken five illustrative levels of threshold - £75,000; £90,000; £110,000; and £125,000 and £150,000 - and have assumed these would be frozen for the next few years. (We could - with a bit more time - build in the effects of revalorisation by reference to the RPI.) For all five levels, we have produced figures assuming a 2% annual rise in real prices; for £110,000, we have also given figures for a 4% real increase a year.

84. The full figures are contained in the tables at the end of this note. The general picture that emerges is of a modest, slowly rising yield from people with taxable gains, but sizeable tax losses, reducing over time, on other disposals over the threshold. These losses reflect inter alia:-

(i) the fact that the costs of sale will be a deduction for CGT purposes;

(ii) the dispersion of house price moves around the average. Even if on average house prices rise by, say, 2% in real terms, many will rise by less than this, and some by less than the rate of inflation (and hence the rate at which indexation relief builds up). At the present time, when some people are estimating a national average nominal increase in house prices equivalent to around 10 per cent a year, there are parts of London and the South-East where prices are if anything falling.

Most people having these losses would probably have no gains above the exemption against which they could be set: but some would be able to use the losses, and so there would be some reduction - to which we cannot easily put figures - in the yield on other assets.

85. As far as taxpayer numbers are concerned, among the main things to emerge are

- the sharp increase in numbers as the threshold is reduced;

- the fact that, in the early years, only a minority of disposals over the threshold would generate tax for the Exchequer: but we would still often have to look at other cases to establish non-liability, and to quantify losses which could be set against gains on other assets or carried forward for use against gains on the new home;

- the effect of independent taxation, which will very substantially increase the number of people with whom we would have to deal.

STAFFING EFFECTS

86. The staffing effects would also be critically dependent on decisions on the details of the scheme. If this Starter were to proceed, we would need to undertake proper costings in the light of those decisions.

87. At this stage, all we can say is that our preliminary view is that, with a threshold of something over £100,000 and a £5,000 special gains exemption, we would be talking of some hundreds of staff. We have no PES provision for these.

88. We have discussed above the special resource problems on 1989 valuations. But a charge of this kind presents another particular problem. This is that (as explained

above) the unpredictability of house price movements and turnover mean that we might suddenly find ourselves with a large influx of taxpayers for which we could not be prepared in advance. (And an important point here is that the caseload will be determined largely by what happens to prices at the very local level, rather than by the average movement nationally.)

COMPLIANCE COSTS AND COST/YIELD RATIO

89. In the first years, the figuring we have done suggests that only a minority of disposals over the threshold (wherever that was pitched) would generate tax liability. But both taxpayers and the Revenue would incur costs in establishing non-liability, or quantifying losses, in the remaining majority of cases.

90. Our statistical work would suggest that, as a result, taxpayers' compliance costs and the Revenue's administrative costs could, in the early years, come close to or exceed the tax yield on homes on which, at the end of the day, tax was payable. For example, if the threshold were set at £125,000 and, over the next year, the real rate of price increase averaged 2 per cent, tax of some £m25 might be payable on some 30,000 sales in 1989/90. But to establish this it could well be necessary to consider some 135,000 disposals over the threshold. Spread over all these, the yield would equate to less than £200 per home over the threshold. Compliance and administrative costs (including the establishment of 1989 values) might well total more than that figure. The lower the threshold, the more likely this is to be so: thus with a £90,000 threshold, the yield, on the same basis, would equate to only around £100 per home over the threshold. While these figures - like all our estimates in this paper - are necessarily very uncertain, they illustrate the probable high relativity of costs to yield.

ECONOMIC EFFECTS

91. The Treasury will doubtless want to comment further on the economic effects.

92. The main issues are the effects on house prices and turnover. Prices of relatively expensive houses caught by the charge may tend to fall relative to the market as a whole. In highly responsive financial markets this fall would take place immediately, but prices in the housing market are likely to react more sluggishly. However, our economists' view is that a scheme of this kind would have no more than a marginal effect on prices. For example, for a £500,000 house the effect might only of the order of two per cent depending on the precise scheme implemented and the future course of house prices. Over the whole range of houses over the threshold, the average effect on prices might be in the range of 1 to 2 per cent.

93. The size of the effect on price depends partly on potential buyers' expectations about the future and their degree of understanding of the new regime. If the new charge is mistakenly regarded as being more onerous than it actually is and/or it is regarded as the thin end of a wedge (to be opened up further by later Governments) then house prices will fall more than might otherwise be expected - given the scheme outlined here.

94. It is conceivable that the price effects will not always be one way. For example, some sellers may endeavour, and succeed, in passing on the CGT charge through an increased selling price. To the extent that this happened, the new charge might actually increase some house prices. And there could also be an upward effect on prices if the new charge locked people in existing homes to the point where the available supply of more expensive housing was reduced by more than the demand for such housing.

95. Turnover (and labour mobility) in the longer term may tend to decline because of the "lock in" effect of CGT - in future there may be a greater reluctance to crystallise gains, especially if equity withdrawal can be achieved by increased borrowing, such as second mortgages. If this happened, it would become more difficult for people to trade up, because the volume of more expensive homes on the market would be less: and this in turn might reduce somewhat the availability of suitable housing for new first-time buyers. People above the threshold and caught by the new charge might find it even harder than now to finance a move to a more expensive area. Because of the difference in house prices, it is already difficult to persuade staff to transfer to, for example, London, even without a CGT liability on their out-of-London home.

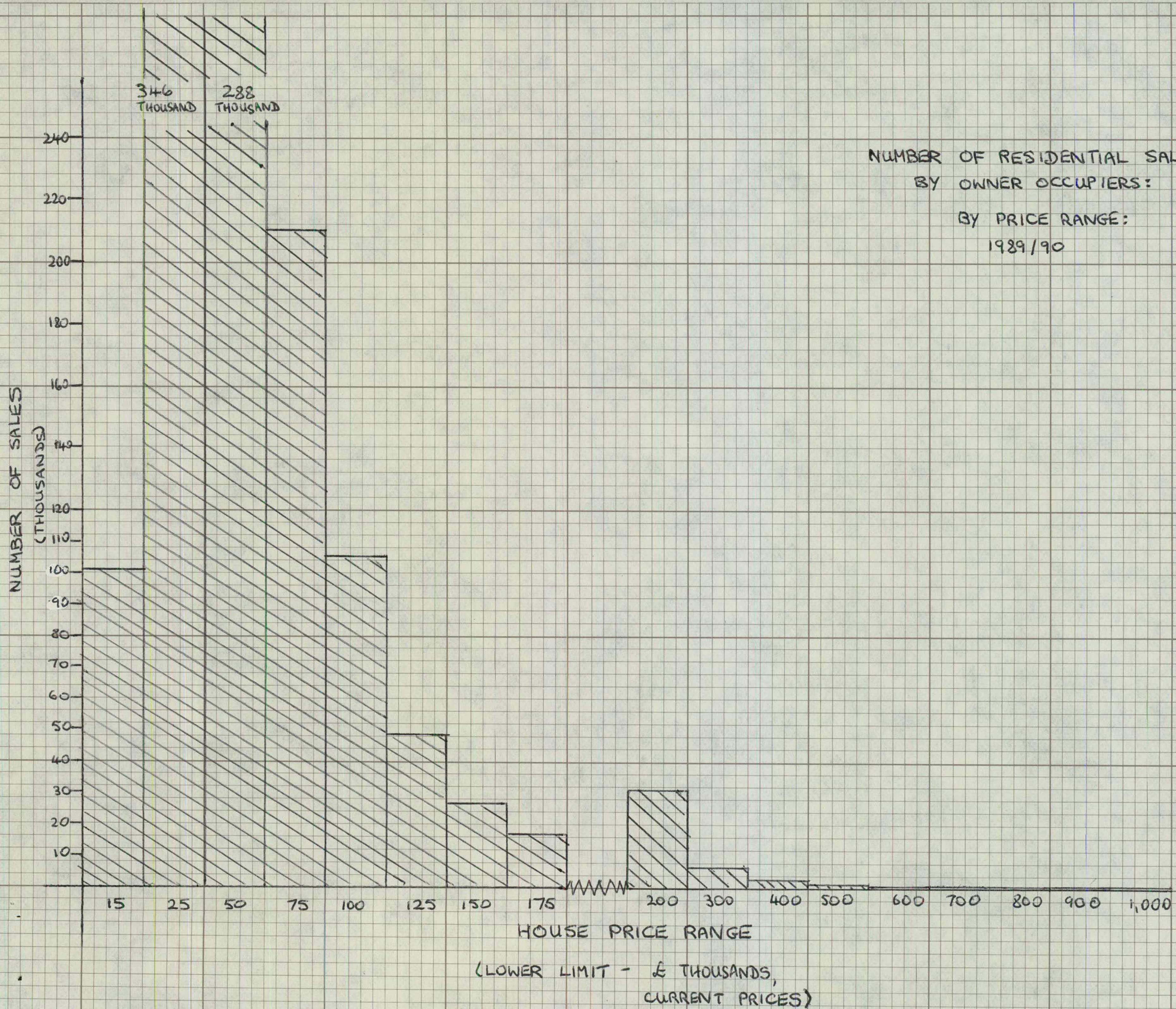
96. In the shorter term it is possible that turnover might be somewhat increased. On the supply side, sellers may wish to crystallise gains before the new regime bites fully (particularly if 1989 valuations are uncertain) or, generally, to switch wealth into other assets with more attractive returns. On the demand side potential buyers from the less expensive (untaxed) sector may in the short term find it easier to move into the more expensive sector because of a relative fall in house prices. The size and duration of any such effect is of course very uncertain.

LENGTH OF LEGISLATION

97. This would again depend critically on detailed decisions; but our present guess that, allowing for transitional provisions for the interaction with the existing rules, the legislation would probably run to at least ten pages - and possibly quite a bit more.

RESOLUTION

98. A ways and means Resolution would of course be required.



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SECRET AND PERSONAL

TABLE ONE: THRESHOLD £110,000 (BY YEAR OF SALE)

Year	Sales (tax units) over threshold	Sales (tax units) with taxable gain	CGT payable	Losses on other sales over threshold
	'000	'000	£m	£m
(1)	(2)	(3)	(4)	(5)
Real growth of 2% a year in house prices				
89-90	185 (185)	35(35)	25	450
90-91	215 (375)	35(60)	30	290
91-92	250 (435)	50(85)	70	210
92-93	280 (490)	60(100)	125	260
Real growth of 4% a year in house prices				
89-90	190 (190)	45(45)	35	375
90-91	235 (410)	70(120)	90	125
91-92	270 (470)	110(190)	210	60
92-93	315 (550)	135(235)	350	75

TABLE TWO: THRESHOLD £75,000 (BY YEAR OF SALE)

(Assumed real growth in house prices 2% a year)

Year	Sales (tax units) over threshold '000	Sales (tax units) with taxable gain '000	CGT payable £m	Losses on other sales over threshold £m
(1)	(2)	(3)	(4)	(5)
89-90	450(450)	50(50)	30	750
90-91	500(875)	40(70)	35	475
91-92	545(950)	75(130)	80	340
92-93	580(1010)	100(175)	150	400

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TABLE THREE: THRESHOLD £90,000 (BY YEAR OF SALE)

(Assumed real growth in house prices 2% a year)

Year (1)	Sales (tax units) over threshold '000 (2)	Sales (tax units) with taxable gain '000 (3)	CGT payable £m (4)	Losses on other sales over threshold £m (5)
89-90	300(300)	45(45)	30	600
90-91	350(610)	40(70)	35	390
91-92	390(680)	65(110)	80	275
92-93	430(750)	85(150)	140	340

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TABLE FOUR: THRESHOLD £125,000 (BY YEAR OF SALE)

(Assumed real growth in house prices 2% a year)

Year	Sales (tax units) over threshold '000	Sales (tax units) with taxable gain '000	CGT payable £m	Losses on other sales over threshold £m
(1)	(2)	(3)	(4)	(5)
89-90	135(135)	30(30)	25	360
90-91	160(280)	30(50)	30	225
91-92	180(310)	40(70)	65	175
92-93	200(350)	50(85)	110	210

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TABLE FIVE: THRESHOLD £150,000 (BY YEAR OF SALE)

(Assumed real growth in house prices 2% a year)

Year	Sales (tax units) over threshold '000	Sales (tax units) with taxable gain '000	CGT payable £m	Losses on other sales over threshold £m
(1)	(2)	(3)	(4)	(5)
89-90	85(85)	20(20)	20	275
90-91	100(175)	25(40)	30	175
91-92	110(190)	30(50)	60	125
92-93	125(215)	35(60)	95	160

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CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS
EXT: 6371
DATE: 18 NOVEMBER 1988

Ch/ Questions for decision summarised in para 95. FST to advise, in first instance?
18/11

Yes pse.

CHANCELLOR

CARS: STARTER NO 104

1. This note reviews four separate topics included under this starter number

- the car benefit scales
- mileage allowances
- the car fuel scales
- "expensive" cars, including the special capital allowance rules for them

Preliminary

2. There are two points to clear out of the way at the start.

3. First, our working assumption has been that the P11D threshold will continue to be £8,500 for 1989/90. Ministers considered the P11D threshold in some detail at various times

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cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Monck
Mr Culpin
Mr Gilhooly
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)
Mr Walton (Customs)

Mr Battishill
Mr Isaac
Mr Painter
Mr Lewis
Mr McGivern
Mr Bush
Mr Massingale
Mr Keith
Mr Northend
Mr Hodgson
Mr Boyce
Mr Evershed
Mr I Stewart
PS/IR

last year, both as a topic in its own right, and in connection with the doubling of the car benefit scales; but they concluded that they wished to continue with the present "withering on the vine" policy. We are not planning a separate submission this year on the P11D threshold.

4. Second, car tax. At one point last year Ministers considered briefly the possibility of linking a substantial increase in the car scales with some reduction in the rate of car tax. This would fit in well with the policy of reducing the fiscal advantages of company cars since a reduction in car tax would reduce the cost of running a car to the private motorist while increasing the effectiveness of any given level of scale charge (since the value of the benefit would be reduced to reflect the reduction in car tax). And a reduction in car tax could offset any fall in demand from increasing the company car scales. But we have not explored this linkage further since we understand that you have already considered, and decided against, any reduction in the car tax.

CAR SCALES: BACKGROUND

5. Last year you

- doubled the car scales

- applied that increase to the year immediately following the Budget (rather than the year after that as previously)

- indicated that hitherto cars had only been taxed at about a quarter of their true value and that the scale of under-taxation was so great that it could not be put right in a single year.

In a number of important respects this has changed the background against which possible car scale changes have to be considered.

a. <u>Inter-play with the main personal tax package</u>

6. Under the old arrangements, car scales were announced two years in advance, so there was no direct comparison of gainers and losers which could be made since the personal tax regime for the second year was not due for announcement for another 12 months. This year we shall again be fixing the scales for the following year, and we assume that you will again wish to defer any final decisions until the main personal tax changes in prospect are reasonably clear. (Mr Mace will be sending you shortly a note discussing the background to next year's decisions on income tax rates and allowances.)

7. Our working assumption has been that, at present, there seems little prospect of a personal tax package of the kind we had last year which enabled substantial car scale increases to be made on virtually a "no losers" basis. But, despite the less favourable Budget outlook, we describe a full range of options as you may feel that this is a field in which the process of reform should continue to be carried forward in the 1989 Budget - for example, having regard to rising real incomes - even if it involved some losers.

b. Legislation

8. Last year you decided, partly for procedural reasons and partly because of the size of the increase, that it should be made by Finance Bill legislation rather than the order-making power. Leaving aside any question of whether next year's changes should also be in the Finance Bill on account of their size, it is probably sensible, at this stage, to plan for Finance Bill legislation because there would be very little time for making an order and bringing it into effect if the changes are not announced until the Budget on 14 March.

c. Expectations

9. Everyone is expecting a very substantial increase again this year (in some quarters your words have been interpreted as implying a further doubling of the scales next year). And the expectation of further large increases has probably already been largely discounted in forecasts of the market for company cars. So if you continue to attach importance to moving towards more realistic scales, and believe the industrial and wider economic implications are acceptable, there is a special opportunity for further substantial increases this year.

d. Car scale system

10. As we have always anticipated, the very simple structure of the present system, with 3 main scales and 2 ranges for expensive cars, is beginning to come under criticism as unfair now that the car scales are being pushed to a higher level. Any single band covers a wide range of cars so that for any particular scale charge cheaper cars will be relatively over- taxed while the more expensive ones will be under-taxed. For example, the cost of cars in the middle engine band (1400 to 2000 cc) ranges from about £6,000 to £7,000 right up to (and beyond) the £19,250 point where the first expensive car band begins. Possible structural changes are discussed later, but for a variety of reasons they are for the longer term, preferably following consultation with the industry, and not for announcement in the Budget to take effect for 1989/90.

e. Staff cost of car benefit taxation

11. The present system although crude in terms of the number of scales, is nevertheless fairly costly in staff usage (about 500 for car and car fuel benefits). This partly reflects the number of company cars and the relative frequency with which they are changed; and the fact that there are a number of other important rules - such as the 50% surcharge for "perk" cars and the 50% discount for heavy business users which complicate the system. It is already becoming more staff intensive as we move towards higher scale charges because the simplest way of collecting the tax due, by way of a coding adjustment, is not fully effective for the increasing number of cases where the net coding allowances available are less than the scale benefit. We are considering the possibility of a new type of PAYE code to help with these cases. Any refinement of the present system, or change to a new system, to meet the criticisms about the fairness of the present charge is likely to lead to an extra layer of staff costs.

f. Mileage allowances

12. At the levels of car scale we are now considering, there is a link across to the tax treatment of mileage allowances because as the car scales increase there will, under the current treatment of mileage allowances, be an increasing incentive for some motorists to chose mileage allowances for business use rather than a company car. This note also raises the question of whether the treatment of mileage allowances should be brought more into line with the car scales to avoid fiscal distortions of this kind, and, whether or not that is done, whether a more efficient system for taxing mileage allowances might be introduced.

CAR SCALES: THE ISSUES

a. Calculation of car benefits: the underlying figures

13. After the last Budget the SMMT questioned whether it was right to base the car scales on AA figures, and suggested that if

the scales were doubled again (as the Budget Statement had implied) the benefit of a company car would be over-taxed.

14. We have discussed the figures with the SMMT, and resolved these points. They had a number of detailed points about the AA figures (such as the fact that their insurance cost takes no account of no claims discount) but we had already anticipated them and made adjustments accordingly in the figures we have previously presented to Ministers.

15. The only point remaining (on which we could not comment) was that the SMMT had some doubts about the rigour of the method by which the AA collect their figures, and whether they are fully representative. They suggested that we might look instead at contract hire figures to arrive at the cost figures underlying the car scales.

16. We have considered contract hire figures in some detail, and discussed them with the British Vehicle Rental and Leasing Association whose members are responsible for most contract hire. Our broad conclusion is that there is very little to chose between the contract hire figures and the adjusted AA figures we have hitherto been using - if anything the contract hire figures turn out to be somewhat higher. In this submission, therefore, we continue to base the calculations on the adjusted AA figures. But the work on contract hire has been useful as a cross-check on the AA figures, and it will allow us to lean less heavily on them in public presentation in the future.

b. <u>Valuation of car benefit to the employee</u>

17. Underlying the second point which the SMMT have raised - that, contrary to what you said in the Budget, there is not scope for doubling the car scales again - lies a major conceptual question about the proper way to value car benefit. It was discussed with Ministers last year but not resolved because there was no need to resolve it at that point.

18. The SMMT say there is not scope for doubling the car scales because they believe that only the 7% or so of "perk" cars which are liable to the 50% surcharge should be taxed on the full value of the benefit. They believe there should continue to be discounts for business mileage so that - maintaining the present relativities - the main scale would never rise above two thirds of the charge for perk cars and cars which travel more than 18,000 business miles (some 18% of all company cars) would never be charged on more than one third of the full value.

19. In contrast, the Budget Statement was referring to the main scale which applies to cars doing 2,500 to 18,000 business miles, 75% of the total. Broadly speaking that would need to be doubled to bring it up to a full charge, but that would clearly be excessive if you believe the cars which do more than 2,500 business miles should get a one third discount from the full charge. So the SMMT's difference of view stems from concepts, not figures.

20. The SMMT view reflects the old-fashioned way of looking at car benefit. It looks at the cost of the provision to the employer, and apportions the costs between business and private use on the basis of mileage. The private proportion is regarded as the measure of the benefit to the employee. If the private mileage is roughly the same for all motorists, the private proportion of costs falls as business mileage rises.

21. That is how the Schedule E rules used to work (or more correctly, in practice, not work) until 1976; it is how the rules for taxing mileage allowances still work (discussed below); and it is how the rules for the self-employed work. But the question for the self employed is rather different. What has to be determined there is how much of the expenditure incurred by the owner of the car was for business purposes, and how much was for private purposes. For the company and the employee that question does not arise because the whole cost of the company car is allowable for the company in calculating its taxable profits whether it relates to business use, or to private use because the latter is simply part of the cost of remunerating the employee.

22. The alternative, and we believe better, conceptual approach to car benefits is to look to the value of the benefit to the employee. The question then is "How much would it have cost the employee to provide himself with the same car for using privately?" In the context of the present scale system for taxing company cars, that means looking at the whole of the standing charges and the running costs for the average private mileage (now closer to 9,000 than to 8,000 for company car holders) - business mileage is not relevant. This approach

- underlies the present system of car scales introduced in 1976 which has no regard to actual private mileage (although illogically the concept of business mileage was "bolted on" during the passage of the Finance Bill, in part as a transitional matter)

- is clearly the right approach if Ministers' objective remains fiscal neutrality between benefits and cash pay (even on this approach there remains, of course, the very large NIC advantages of benefits)

- seems to have been adopted in a number of leading countries which have modernised their systems for taxing company cars in recent years in the sense that, though not using the UK system as such, they charge a figure of broadly the same order as would be produced by this approach. (Annex A outlines the rules in some other countries, and makes a quantitative comparison of their effect)

23. If you are contemplating a significant increase in the car scales this year, it may be necessary to take a view on which of these two approaches is right. We are beginning to get beyond the point where it is possible to have significant increases across the board in the present system, to present the reasons for them convincingly, and to give an indication of the trend of future policy without having a clear view on what the ultimate shape of the system should be.

24. If you believe the "employee value" approach is the right one, we should be aiming for, eventually, a single scale of charges reflecting 100% standing costs and operating costs for average private mileage. Very roughly, this would mean an increase of 50% for "perk" cars; 100% for "main scale" cars; and 400% for cars doing over 18,000 business miles.

25. Alternatively, you may decide that the car scales should continue to be reduced, to some extent at least, to reflect business mileage ie that the concept of the business/private mileage apportionment is right and should continue to be recognised through the mileage discounts. In that event, it seems better to do it solely through the present 3-tier approach (relativities can, of course, be adjusted) rather than attempt to reflect business use in the underlying scale charges by, for example, not including the full amount of standing charges. There is clearly an element of double counting if the underlying figures we discuss with Ministers are adjusted to take account of business use and then on top of that there is also a discount from those figures reflecting business use.

26. Accordingly, the options discussed in this note are all compared with a valuation of the employee benefit which includes the whole of the standing charges. If you adopt the "employee value" approach that figure is the (theoretical) target. If you think that the scales should be reduced for business use, the (theoretical) target is that figure less whatever reduction is made for business use.

c. Use of business or private mileage in relation to the car scales

27. One of the reasons for introducing the scale system in 1976 was the difficulty of getting a large number of employees to keep proper records to show their business and private mileage.

28. The present system is much simpler, and entails only a record of business mileage to determine whether it is less than 2,500 or more than 18,000 miles. But there are some signs emerging that, as the importance to the employee of reaching

these business mileage targets increases with the rising car scales, the break-points are becoming increasingly abused. They have always been one of the clearest fiscal disortions, encouraging honest taxpayers to do extra business journeys to get over the appropriate limit. The signs are that there may also be a fall in the level of honesty in reporting business mileage. For example, estimates made by the Department of Transport from the latest national travel survey - which should be regarded as no more than broad orders of magnitude - suggest that we should have perhaps fives times as many people in the under 2,500 business miles category as show up in our survey of actual tax returns. Similarly, our figure for those doing over 18,000 business miles (18% of cars) is half as much again as the Department of Transport estimates.

29. This problem would, of course, disappear if Ministers go for the "employee value" approach - at least in the longer term because there would clearly need to be some phasing out of the present business mileage rules.

CAR SCALES: THE OPTIONS

30. The following paragraphs look at 4 specific options for 1989/90

Increase	Yield in 1989/90 (Receipts) £m	Yield in 1990/91 (Receipts) £m
10%	45	55
25%	120	140
50%	230	280
100%*	410	530

* with withdrawal of "perk" car supplement

These figures take no account of possible behavioural changes.

31. Briefly, the rationale for these options (details of the scales below) might be

50% increase

This would be the leading candidate in line with last year's policy (subject, of course, to budgetary, industry, and wider economic considerations). The actual amount of the increase in the scales would be exactly the same as last year. It would be another major step towards getting the scales to a realistic basis. It is probably the minimum the industry and car users are expecting*. It is just about the largest increase that could be accommodated without making any change to the present system.

100% increase

This would double the scales, as last year. It is what some people in the industry seem to be expecting. It would bring the main scale charge to almost the right level; and the 50% addition for perk cars would have to be shaded back sharply or abolished to avoid an excessive charge for some bands. Even so, most increases would be double those made last year.

25% increase

This would be a half way house if you felt that budgetary and other economic considerations prevented you from going for 50%. The actual increases would be half those of last year. That would still be a significant increase (second only to last year's) but it would look much more like a reversion to previous policy (there were 20% increases in 1981/82, 1982/83 and 1983/84) than the continuation of last year's policy.

* Not, of course, what they are lobbying for. The SMMT accept that there should be an increase of 40 to 50% for "perk" cars. But on an apportionment of business/private mileage they suggest only a 5% increase for the other two scales. Figures derived from the national travel survey suggest that the split between business and private mileage is different from that given by the SMMT, and that there is scope for increases of perhaps 15% to 25% even on a broad apportionment basis.

10% increase

We assume you would only wish to consider an increase this small if all the budgetary and economic lights were firmly at red. It would represent little more than an offset to inflation, and would be in line with the lowest previous level of increases, 10% in 1985/86, 1986/87 and in 1987/88. (There were no increases at all in 1979/80 and 1980/81).

32. The following tables summarise the present scales, for cars less than 4 years old, and what they would become under these options.

Present Scales

	Approx Proportion of cars in each engine size band	Main Scale	"Perk Car"	Over 18,000 business miles	Total weekly tax (main scale/basic rate taxpayer)
Up to 1400cc	17%	1050	1575	525	£ 5.05
1400-2000cc	62%	1400	2100	700	£ 6.73
Over 2000cc	18%	2200	3300	1100	£10.58
Original cost £19,250-£29,000	2%	2900	4350	1450	£13.94
Original cost Over £29,000	less than 1%	4600	6900	2300	£22.12
Proportion of all cars		75%	7%	18%	

50% increase

	Main Scale	"Perk Car"	Over 18,000 business miles car	100% AA Standing Charges	Extra weekly tax (main scale/ basic rate taxpayer)
Up to 1400cc	1575	2360	790	2554	£ 2.52
1401-2000cc	2100	3150	1050	3158	£ 3.37
Over 2000cc	3300	4950	1650	4798	£ 5.29
£19,250-£29,000	4350	6525	2175	7333	£ 6.97
Over £29,000	6900	10350	3450	11567	£ 11.06

100% increase

	Main Scale and perk cars*	Over 18,000 business miles car	100% AA Standing Charges	Extra weekly tax (main scale/basic rate taxpayer)
Up to 1400cc	2100	1050	2554	£ 5.05
1401-2000cc	2800	1400	3158	£ 6.73
Over 2000cc	4400	2200	4793	£ 10.58
£19,250-£29,000	5800	2900	7333	£ 13.94
Over £29,000	9200	4600	11567	£ 22.12

* This table assumes that the 50% surcharge for perk cars would disappear, since the main scale charge for some bands, in particular the three engine size bands would be close to the full charge. It would be possible to retain a reduced surcharge for expensive cars to bring them up closer to the full charge also.

25% increase

	Main Scale	"Perk Car"	Over 18,000 business miles car	100% AA Standing Charges	Extra weekly tax (main scale/basic rate taxpayer)
Up to1400cc	1310	1965	655	2554	£ 1.25
1401-2000cc	1750	2625	875	3158	£ 1.68
Over 2000cc	2750	4125	1375	4798	£ 2.64
£19,250-£29,000	3625	5440	1810	7333	£ 3.49
Over £29,000	5750	8625	2875	11567	£ 5.53

10% increase

	Main Scale	"Perk Car"	Over 18,000 business miles car	100% AA Standing Charges	Extra weekly tax (main scale/basic rate taxpayer)
Up to 1400cc	1155	1730	575	2554	£ 0.50
1401-2000cc	1540	2310	770	3158	£ 0.67
Over 2000cc	2420	3630	1210	4798	£ 1.06
£19,250-£29,000	3190	4785	1595	7333	£ 1.39
Over £29,000	5060	7590	2530	11567	£ 2.21

33. Where people with company cars are just below the P11D threshold at present, they may, as a result of an increase in the scale charge, be pulled over the threshold. In such cases there is an exceptionally large increase in the tax bill, because they have to start paying tax not only on the increase, but on the old scale charge as well. Broad estimates of the number of people who might be in this position are -

Increase in Car Scales	Number brought over P11D threshold
10%	less than 10,000
25%	20,000
50%	30,000
100%	50,000

34. Increases in the car scales entail ongoing extra staff costs, because of the extra numbers brought over the P11D threshold, and the increased work involved in the extra cases where coding allowances are not sufficient to cover the increased scale benefit. For the options above the position is broadly:-

Increase in Car Scales	Staff Requirement
10%	+ 5
25%	+15
50%	+25
100%	+60

There would also be some extra staff costs relating to 1989/90 if we had to put company car drivers on non-cumulative PAYE codes because - unlike this year - Budget tax reductions did not generally offset the car scale increase. This can only be evaluated fully when the whole Budget package is reasonably clear.

Treatment of business mileage

35. The tables above generally assume that the present system of a 50% surcharge for perk cars and a 50% discount for heavy

business users would continue. Thus, implicitly, they are aiming for the following system

Business mileage	Benefits charge (as proportion of full value to employee)
Under 2,500	100%
2,500 - 18,000	66 2/3%
Over 18,000	33 1/3%

36. If you decided that the present relativites between the three classes were right, then straight increases of up to 50% give the right result. But in the case of the 100% increase table, the main scale would be above two thirds of the proper charge, and the heavy business user more than one third of it, so the increases would need to be reduced.

37. If, on the other hand, you decided that the aim should be to phase out the business mileage variations as inappropriate to the "employee value" approach, we could consider how that could best be done. There is no problem with the 50% surcharge. That could be scaled down automatically as the main scale charge came up to the right level. The effect would simply be that perk cars got on to the right charge sooner. With the heavy business user cars a fairly gradual phasing out would probably be necessary. For example, if you increased the scale charge next year by 50%, and shaded back the heavy business user discount from 50% to 40%, that would mean an overall increase of some 80%. At the 1988/89 level of the car scales the cost of the discount for heavy business users is about £60m; but of course it increases every time the car scales go up.

38. Phasing out the heavy business user discount would be likely to be controversial. People who use their cars a lot for business have been among those most critical of this year's increases. They tend to regard their cars as necessary or essential for businesses purposes (tool of the trade) and to assume that they cannot, therefore, be a "perk" even though they are allowed to use them privately. The travel survey suggests

that the private mileage of cars which do a high business mileage is, on average, no smaller than the private use of other business cars. On that basis, since the scales tax the value of the private use of the car, it is difficult to see much justification for this discount.

Wider Economic Considerations for 1989/90

39. We have noted above that car industry forecasts have probably already largely discounted a further substantial rise in the car scales. Nevertheless, the outlook for the industry is less buoyant than last year, and there are balance of payments considerations. We assume you will want advice from Treasury (IAE) once the range of options to be considered further has been narrowed down.

CAR SCALES: A DIFFERENT SYSTEM FOR THE LONGER TERM?

a. <u>Criticisms of the present scale charge system</u>

40. As mentioned above, the doubling of the car scales last year has given rise to criticism of the fairness of the present simple system of car scales.

41. Some critics want extra reliefs related to business mileage. But, as indicated above, the present business mileage relief is misconceived. The other criticisms all boil down to one essential point, namely that each scale band covers a very wide variety of cars with a wide price spectrum and that it is unfair to levy the same charge on the man whose car costs, say, £6,000 as on someone whose car costs £18,000.

42. A variation of the same theme is that diesel cars should have a separate scale because, commonly, they have larger engines than the petrol versions of similar quality and performance, which may take them into a higher charge band.

43. These drawbacks are, of course, inherent in any scale system because it must be based on averages. But they become more acute as the scales go higher. And the engine size system is probably rather less satisfactory than it was when introduced because it is less the case nowadays that size is equated with quality, and therefore cost; so using engine size as a broad indicator of cost is perhaps becoming an even more broad brush system than it once was.

44. In short, these criticisms highlight the classic conflict in any tax system between equity and simplicity.

45. If Ministers were concerned about such criticisms, we could for the longer term consider structural changes to the system. We think this is not something for next year because

- consultation with the industry would be desirable to ensure that any new system avoided any unnecessary difficulties for them

- the industry would probably welcome some notice of significant tax changes to give them a period for adjustment

- 1989/90 looks a bad year for tax offices to have to change the system because they will be particularly busy with preparatory work for independent taxation.

A possible timetable would be announcement of change/consultation in 1989, legislation 1990, implementation 1991.

b. Refining the Present Scale System

46. In the longer term there seem to be two main possibilities. First, the present scale system could be retained but refined. That would mean making the bands cover a smaller range of cars. The original proposals in the 1976 Finance Bill did in fact envisage many more bands than we have at present*, but the system was simplified during the passage of the Finance Bill, mainly because of car industry representations about the distortions in production they would cause.

47. The main draw back with this possibility is that, however many bands were introduced, you would mitigate but not solve the problem. For example, if you take even a single engine size (1598cc) and look at the Austin Rover range, the prices go from £7,969 up to £11,279. Similarly, if you look at the Ford range cars with 1993cc engines go from £9,645 to £16,520. So the scope for dealing with criticism by this route looks limited; and it seems doubtful whether it would be worth the upheaval.

* There were 5 engine size bands for cars with an original market value up to £5,000 (under 1000cc, 1000-1500cc, 1500-2000cc, 2000-3000cc, and 3000cc and over); and 9 cost bands for cars costing over £5,000, the top one for cars costing over £30,000.

c. Charge based on the cost of the car

48. Another possibility - but a much more substantial change - would be to link the charge directly to the cost of the car. The logic of this approach is that a large part of the benefit reflects costs (such as depreciation and financing costs) which are directly linked to the cost of the car and that other costs such as insurance and maintenance also tend to reflect, though perhaps not so closely, the purchase price. So - at its simplest - taking a straight percentage of cost gives a reasonable valuation of the benefit. This is the route which a number of overseas countries take for collecting tax on company cars (see Annex A).

49. The disadvantage of this approach is that it is more complicated both at the technical level and operational level. For example, you would need to have rules to deal with cars which were acquired under leases and contract hire where the employer would not necessarily know the price paid. There would need to be rules to cover sales not made at market price, for example within a group. Identical cars would have a different benefits value if employers obtain different discounts. And you would need rules to ensure that the charge could not be avoided on "extras" by having them fitted a week after delivery.

50. At the operational level, every car would have a different value for benefits purposes. And every change of car would have tax consequences, whereas under the present system the employee can change his car as often as he likes and provided he is within the same engine band there are no tax consequences. Even with the benefit of COP, it seems likely that a system of this kind would carry with it a significant staff cost. There would also almost certainly be additional employer compliance costs. (A system of cost "bands" as in the United States might help operationally. But unless they were kept fairly narrow, the system would begin to become liable to the same kind of criticism as the present scales; and if they were narrow, cost would still need to be calculated fairly precisely, reducing the savings).

51. The question here is whether, having regard to the sort of increases in car benefit taxation you would like to make next year, and in the medium term, you regard the present system as likely to remain viable; or whether it is necessary or desirable to look at other possible systems for the longer term. Any new system would undoubtedly carry a staff cost since the present system, in essentials, is so very simple - and it covers a large and increasing number of cases, presently some 1.4 million. If you would like us to do work of this kind we would need, given other commitments for the next Budget, to discuss the timing with you.

MILEAGE ALLOWANCES

52. This is an important subject in its own right. But as indicated above there is also a link across to the car scales because, as the level of the car benefit charge rises, the option for the employee of having his own car and claiming mileage allowances from his employer may begin to look more attractive.

Company car verses mileage allowances - break even points

53. We have tried to identify the situations in which, at present, an employee and employer might prefer increased salary and mileage allowances to a company car. The calculations are necessarily rather complex because they depend on the type of car, the scale charge, the rate of mileage allowance assumed and the tax and NIC status of the employee and employer.

54. In each case there are three distinct mileage ranges. In the lowest mileage range, because of the tax and NIC advantages of a company car, the employee can always receive for any given cost to the employer, a greater effective salary through the provision of a company car. In the middle range the value of mileage allowances and additional salary to the employee, at a cost equivalent to the employer of providing a company car, become more attractive to the employee. Finally, in the highest range, when the mileage becomes greater still, while the employee would continue to prefer mileage allowances and additional salary, the employer does not. This is because it is cheaper for him to provide a company car (assuming that he does not reduce the mileage allowance to compensate).

55. So this analysis identifies two turning points. The first is the point at which it suits the employee to have mileage allowances and it is cheaper for the employer to provide them; and the second one is where the employer's cost rises so that he is no longer prepared to accommodate the employee's preference.

56. The sort of figures which come out of this analysis are that if you are a basic rate taxpayer (above the UEL) and

- you have the typical company car in the range 1400 to 2000 cc, and

- mileage allowances are paid at the maximum "tax free" rate

there is a business mileage band from about 8,500 to 13,000 in which theoretically you would now be better off with mileage allowances than a company car. If the car scales were increased, for example, by 50%, that band in which mileage allowances are preferable, increases to about 6,000 to 13,000 miles.

57. For a higher rate taxpayer in the same circumstances the band is somewhat broader; for a basic rate taxpayer below the UEL it is somewhat narrower.

58. We would not wish to put too much weight on this analysis. For one thing, it necessarily depends on various assumptions eg about the rate of allowance paid and the similarity of the company car to the car the employee would buy. For another, the gains near the first turning point are not very large; and to take advantage of the position companies would have to be able to do the same sort of calculation themselves and to identify reasonable numbers of employees as falling within the relevant mileage bands, and to persuade them that dropping the company car would suit them both. An important factor for many employees would be raising the cash, for the replacement car.

59. Nevertheless, it is rather worrying that a fairly broad band of business mileage seems to be opening up in which it is theoretically advantageous to have allowances rather than a car. The starting point is already at a fairly modest business mileage level and it will get progressively lower, as the car scales increase. There are a number of possible points for concern

- a significant move towards mileage allowances might be seen as to some extent undermining the Government's policy of taxing company cars properly

- it would be attributed, no doubt, to differences in the tax rules as between the company car and mileage allowances

- to the extent that new cars purchased privately had a greater import content, the industrial and balance of payments effects would be adverse

- at a practical level, handling individual mileage claims, instead of company car cases, could increase our staff requirement where, under the present system, more taxable mileage allowances were paid.

Taxation of Mileage Allowances - other reasons for considering changes to tax rules

60. There are two other reasons for considering changes to the present rules for taxing mileage allowances

- the present statutory rules are over-generous, if you consider that "employee value" is the right approach to the car scales, because they work on the business use/private use apportionment. The right approach, consistent with the "employee value" view of the car scales, is to treat the business use of the employee's car as the marginal use, and to allow only the extra costs arising from business mileage

- in practice, because of the large number of cases involved, we at present have to administer the rules on a very broad brush basis. The result is that many people get more - sometimes considerably more - relief than would strictly be due if each case were handled individually with all the necessary information available.

Present Rules

61. As mentioned above, relief is given under the present rules for allowable expenses in respect of the running costs applicable to business mileage and for the business proportion of standing charges. But the Schedule E rules would, strictly, exclude any relief for depreciation and financing costs for the majority of employees.

62. Where an employer pays a mileage allowance for business use, the mileage allowance paid may exceed the allowable expenses actually incurred by the employee. In such cases tax is levied on the excess.

63. In practice these cases are often dealt with on a broad brush basis employer by employer under what is known as the "fixed profit car scheme". Under this we calculate for each employee - using mileage information provided by the employer - a taxable amount equal to the difference between the mileage rate paid by the employer and a fairly generous estimate of the mileage rate allowable under the expenses rules. Using this estimate - which varies with engine size - we can readily calculate the amount which should be assessable on each employee, without the need for individual expenses claims.

64. Employees can always make a claim by reference to their actual expenditure if they wish to do so; but because the estimate of the allowable "tax free" rate is fixed at a generous level - for example, it includes depreciation so that everyone under this scheme gets relief for depreciation whether or not strictly entitled to it - few in practice do so. The fixed profit scheme saves us work as compared with getting individual expenses claims from everyone; but it is still rather laborious because it requires a coding adjustment or assessment for each individual employee.

65. Thus, at the moment, we have a situation in which

- the statutory measure of relief is arguably over generous because it works on the private/business mileage proportion basis rather than by reference to the extra costs actually incurred through business use

- it is made the more so by the "fixed profit car scheme", where it applies, because the "tax free" mileage rates it uses take account of depreciation which would often not strictly be due; the generous rate applies however many business miles are travelled; and there are various roundings in the system

- while a marked improvement on handling individual expenses claims, the fixed profit car scheme is still relatively cumbersome to operate.

Outline Proposals

66. Against that background, the question is whether you would like to consider possible changes to the amount of relief for mileage allowances and also the way in which it is given.

(a) System of Relief

67. Looking first at the system by which relief is given, the question is whether we could move to a more efficient system, on the lines of the fixed car and car fuel scales, whereby statutory "tax free" mileage rates for various engine sizes would be prescribed before the beginning of the tax year. Like the car and car fuel scales, the "tax free" mileage rates would be calculated by reference to the relevant average costs (for which tax relief was available) and would fix the amount concerned for tax purposes finally - it would not be possible for the employee to claim that his actual expenditure was higher, and he should therefore be given further relief. Any employer paying at or below such rates for business journeys could do so in the confident knowledge that there would be no tax complications. An employer wishing to pay in excess of those rates would automatically treat the excess as pay for PAYE and NIC purposes.

68. It would be possible to introduce such a scheme leaving the level of relief broadly* as it is. In effect that would be putting something akin to the fixed profit car scheme on to a statutory basis, making it apply universally, and operating it (much more efficiently) directly through PAYE rather than through coding adjustments and assessments.

(b) Amount of Relief

69. This would give us a more efficient system, but it would not put the level of relief right. On the contrary, it would entrench some aspects of the excessive relief given under the fixed profit car scheme. In particular, because some employees are entitled at present to depreciation, it would be necessary to continue to include it in calculating the mileage rate applicable to everyone - and depreciation accounts for a large part of the mileage rate, generally some 40 to 50%. So there would continue to be an incentive, in certain circumstances, to switch from company cars to mileage allowances. If you wished to reduce this effect, and to put the rules for mileage allowances on a basis more consistent with the calculation of the car scales, it would be necessary to restrict the relief available as closely as practicable to the extra costs applicable to the use of the vehicle for business purposes.

70. Under a statutory "tax free" mileage allowance system, it would be a question of which costs should be taken into account in prescribing the appropriate rate each year, in the same way as we consider the car scales. Running costs attributable to business use - such as petrol and oil - should clearly be allowed in full. For some other operating costs such as repairs and maintenance, an apportionment is probably correct. But there

* I say broadly because we must in any event review certain aspects of the fixed profit car scheme, for example, the absence of an upper limit on the mileage to which the full rate applies which can produce excessively generous relief for drivers with a high business mileage

should be no relief for the road fund license or for insurance except to the extent that extra costs are involved in insuring the car for business use. So far as other fixed costs are concerned there would be no relief for financing charges (as now); and depreciation should only be allowed to the extent that the car depreciates faster because it has done a higher mileage through business use (even at the very highest mileages, that is generally only about 25 to 50% of the depreciation of a car doing a normal mileage). A tax-free mileage allowance constructed in this way would of course be significantly lower than the rates currently allowed under the fixed profit car scheme. Transitional arrangements would need to be considered.

(c) Employers

71. It is not clear how employers would react to a system of statutory mileage allowances (leaving aside for the moment any question of the level of relief). On the one hand, they would probably welcome the certainty of the scheme since the amount which could be paid tax free would be given in a statutory rule rather than be a matter for negotiation in all the circumstances with the tax office. And employers would save P11D work and work on operating the fixed profit car scheme. On the other hand, those who paid taxable mileage allowances would have the extra work of putting the taxable part of them through their PAYE system.

72. Employers would not, of course, be pleased with some additional part of their mileage allowances being reclassified as taxable because of the effect on employees' net pay; and there might also be NIC consequences. On the other hand, some employers might endeavour to reduce their costs by moving, over time, to a similar marginal cost approach in calculating the allowances they would pay.

73. You will recall that a fixed profit car scheme is operating for Civil Service mileage allowances which exceed the fixed profit car scheme "tax free" rates. We are sending the Financial Secretary separately a note looking at the position of the

mileage allowances paid to MPs. We will need to decide with Ministers the way forward there having regard to whether or not there is a possibility of moving to a new statutory regime.

74. We have not, so far, been able to work this idea up in any detail. But it seems clear that there would be some yield, even if the rules for relief were kept broadly the same as now, since at the moment the "broad brush" approach means that tax is lost with the roundings in the system, and in some cases tax offices probably do not know that mileage allowances are being paid. A statutory system should lead to a more efficient and clear cut system for tax offices to operate. There would be some staff savings but, in advance of detailed work, our expectation would be that the benefits would be more in improved handling of this kind of case rather than significant staff savings.

75. Any new system could not take effect before April 1990 at earliest, because we would have to have the new rates prescribed before the start of the tax year, and allow employers sufficient time to make any necessary adjustments to their payroll systems.

76. The question at this stage, therefore, is whether you see sufficient attractions in a system of this kind to make it worthwhile doing further work on it for possible inclusion in the 1989 Bill.

C FUEL SCALES (SCHEDULE E AND VAT)

77. There is very little to report in respect of the fuel scales. Petrol prices have risen somewhat since last year, but as the fuel scales were on the high side for 1988/89 the current level of prices suggests that no change is needed for 1989/90.

78. More generally, there seems little point in attempting to fine-tune the fuel scales while the car benefit scales are still significantly below a full charge. Not everyone with a company car gets free fuel for private use, but it is becoming more widespread.

79. No legislation (or Treasury Order) is needed for the fuel scales if they remain at the current level for 1989/90.

80. Annex B (by Angela Marshall, agreed with Customs) explains the background and discusses the position in a little more detail.

D EXPENSIVE CARS

a. Car scales

81. There is a case for extra taxation of luxury cars because - as the options for the car scales show - the degree of under-taxation is greatest there. And the top band covers a very wide range of prices, from £29,000 up to £100,000 and beyond.

82. But, because the numbers are small, there is not much revenue in constructing another band for expensive cars, and it would be difficult to do so without adverse effects on some small British manufacturers. Ministers considered this possibility last year and decided that, even in the context of last year's Budget, they did not wish to introduce an extra expensive car scale. Having regard to that, we have not done any further work this year on this possibility.

b. Capital allowances

(This section is by Mr Keith, Business Taxation Division).

Capital allowances for "expensive" cars

83. There are special rules for cars costing over £8,000 which restrict the 25% annual writing-down allowance to a maximum of £2,000. There is no permanent loss of relief: the allowances are brought into line with the actual depreciation when the car is sold. But there is a cash flow effect.

84. This concept of an annual capital allowance ceiling was introduced in 1961 on the principle that expenditure on luxury cars reflects an element of personal choice as well as business needs and that it is appropriate therefore to limit the amount of the Exchequer contribution by way of tax relief. For leased cars costing over £8,000 there are corresponding restrictions of lease rentals. Annex C contains a fuller note on the restrictions and discusses the case for repeal or uplift of the ceiling.

85. These rules are a continuing source of representations from the main representative bodies. In part these reflect concerns about the cash flow effect and about the corresponding restrictions of lease rentals. But they claim that their main concern is the compliance burden of keeping separate records for an increasing number of business cars. One case has been cited to us where a company has at least 5,000 cars over the limit, each requiring a separate record. We estimate that around 550,000 new cars purchased in 1989/90 would be affected if the £8,000 ceiling were retained, the vast majority of which will not be in the luxury class. And clearly the burden for companies will grow as the £8,000 ceiling continues to bite on a greater number of cars.

86. In the past Ministers have taken the view that the present rules should remain until the car scale charges for employees were put on a proper basis. During the run-up to this year's Budget you decided - against the background of the doubling of scale charges - not to make any changes largely on grounds of cost and value for money. We assume, however, that you will wish to review the rules again, particularly if you are considering a further substantial increase in the scale charges.

87. If the restrictions were abolished for all new expenditure on cars for 1989/90 onwards the costs, at today's prices, would be:-

1989/90	1990/91	1991/92	1992/93	1993/94	then falling
negligible	£80m	£170m	£200m	£190m	to £70m

If existing cars were also relieved (so as to remove the compliance problem immediately), the costs would be brought forward with a figure of £180m in 1990/91 and a peak of £250m in 1991/92.

88. The costs, at today's prices, of raising the ceiling for new expenditure to (a) £16,000 or (b) £20,000 (£20,000 would be broadly in line with the threshold for expensive cars under the

benefit rules and is the level proposed by Philip Hardman in his recent shopping list of simplification measures) would be:-

	1989/90	1990/91	1991/92	1992/93	1993/94
(a) £16,000	negligible	£70m	£130m	£160m	£150m
(b) £20,000	negligible	£70m	£150m	£180m	£160m

89. Annex C shows comparative figures at other levels. An increase to £10,000 only would halve the cost of doubling the limit to £16,000 but it would have much less deregulatory impact. On the basis that about 550,000 new cars would be affected by the restrictions if the ceiling remained at £8,000, an increase to £10,000 would remove the need to keep separate records for about 55% of them. This contrasts with 90% or 95% if the limit were raised to £16,000 or £20,000.

90. It is unlikely that a £10,000 limit, although resulting in a substantial saving of compliance costs, would be seen as a satisfactory solution by Industry and the representative bodies. On the last occasion that the limit was raised (1979) it was by 60% (£3,000) and anything less would run the risk of being seen as derisory, particularly if the context was a further substantial increase in scale charges.

91. From the compliance angle, abolition of the restriction seems more attractive than a substantial increase of the £8,000 ceiling, because the latter would involve most of the costs of outright abolition without securing the full deregulatory impact. But at one of the overview meetings earlier this year, you thought that raising the ceiling was a stronger runner, mainly because of the large extra relief in the first year which abolition would provide for the very expensive cars. The example taken was the £100,000 Rolls Royce, for which the allowance in the first year after abolition would be £25,000 instead of £2,000. Subsequent work showed that the DCF value of the acceleration of the tax relief is very much less than the difference in the relief available in the first year; but nevertheless at the top end of the market the amounts are significant, particularly where the car is held for a long time.

92. A different approach, aimed at achieving the compliance savings without the high costs of outright repeal of the restrictions or raising the limit, would be to pool all expenditure on cars costing over £8,000 (ie without restriction of the annual allowance on individual cars) and give allowances at a lower rate than 25%. The broadly revenue neutral rate would be 18%, which would allow the cost of a car to be written off in effect over some 12 years instead of the 8 year period which a 25% rate provides.

93. Such an approach would remove the need for separate record keeping and it would also be possible to get rid of the rental restrictions for leased cars. But there are a number of serious objections. It would entail a major step back from the present simple system of a single 25% rate for all machinery and plant, towards the system that existed before 1971. More fundamentally it would result in a redistribution of relief - admittedly in timing only - in favour of the most expensive cars, for which a 12 year write-off instead of the present £2,000 per annum maximum allowance would be very generous. On the other hand Industry would regard the longer write-off period as unreasonable for the general run of business cars and a high price to pay for removal of the compliance burden.

94. One variation of this approach would be to raise the limit to say £10,000 and apply a lower rate of allowance for cars costing more than that amount. In that case the revenue neutral rate would be 14%. This would avoid the worst effects at the bottom end of the range but would remain generous for the most expensive cars; and again it would be a move away from the present simple single rate system for machinery and plant.

F POINTS FOR DECISION

95. It would be helpful to have Ministers' guidance on the following points

P11D threshold

i. Is the threshold to remain at £8,500 for 1989/90?

Car tax

ii. Is any further work required in this context?

Car scales

iii. Are there any preliminary views on the size of the increase for next year?

iv. Would you like any further work done on any of the options for 1989/90 discussed in this note; or work on other options?

v. Should the concept underlying the car scales be a business/private mileage apportionment, or the value of the car to the employee? Accordingly, should the business mileage discount continue; or should we consider the steps by which it might be reduced or phased out?

vi. Should we consider structural changes to the car scales for the longer term? If so, do Ministers have any initial views on the choice between refining the present system further, or an entirely new scheme, eg one based on cost? Or on consultation/timetable?

Mileage allowances

vii. Should we consider further the possibility of introducing a streamlined statutory basis for taxing mileage allowances, on the lines of the car and car fuel scales?

viii. If so, should we consider targetting relief more closely on the extra costs of using a car for business purposes?

Fuel scales

ix. Should the present fuel scales continue for 1989/90?

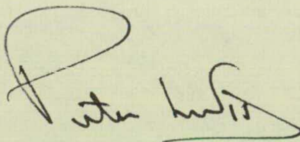
Expensive cars

x. Is any further work required on the possibility of an extra benefits band for luxury cars?

xi. Do Ministers favour any of the options on the special capital allowance rules applying to cars costing over £8,000?

Finance Bill/Treasury Order

xii. Do Ministers wish to include the 1989/90 car benefits scales in the Finance Bill, or should we consider further the possibility of a Treasury Order made immediately after the Budget?



P LEWIS

ANNEX A

ANNEX A

TAXATION OF COMPANY CARS IN OTHER COUNTRIES : AND COMPARISON WITH UK

1. This annex takes a brief look at the taxation of company cars in a number of other countries. It should be regarded as no more than a broad guide.

2. The rules vary widely from country to country. It seems clear that a number of countries have been tightening up their rules in recent years, and that some charge an amount which is broadly equivalent to the AA's full standing charges figures which are used as a standard or comparsion in this note (see table attached).

3. Some countries still use (in principle at least) a private/business use apportionment of actual total costs to arrive at the benefit. But of those countries which have moved over to a more formalised system of scales/tables, so far as we can see only Ireland and the UK take account of business use. In Ireland there is no business use discount if the business use is less than 10,000 miles. But after that there is a progressive reduction in the charge until it reduces to nil at 25,000 business miles.

UNITED STATES

4. There are four main rules under the present system.

a. General rule

5. The general rule is that the employee must include in his income the fair market value of the availability of an employer provided vehicle. Such valuation must be determined by reference to an arms length leasing cost.

6. There are then three optional special valuation rules. The employee can only use a special valuation rule if the employer

also uses it for employment tax purposes (broadly equivalent to employers' and employees' NIC).

b. Lease valuation rule

7. This is a table of annual lease values related to the fair market value of the car at the date when first made available. The car is only revalued for this purpose every four years.

8. The basic rule is to take 25% of the fair market value of the car and add $500. So, for a car which had a fair market value between $10,000 and $10,999 when first made available for private use, the employee would need to include in his income, under this option, the sum of $3,100. This figure covers maintenance and insurance, but not the value of free fuel.

c. Vehicle cents per mile valuation rule

9. This rule only applies where either the car is regularly used for the employer's business or does more than 10,000 miles in the year, and is relatively cheap (maximum price - in 1985 - $12,800).

10. The amount to be included in income is then calculated on the private mileage at 21 cents per mile for the first 15,000 miles and 11 cents per mile for all miles over 15,000.

d. Commuting valuation rule

11. There is a special rule which applies where the employer requires the employee to bring the car to work but it cannot be used for any other personal purposes. The daily amount included in income is $3.

CANADA

12. Under the Canadian system there is a charge based on the cost of the car to the employer, and a separate charge on all operating costs such as licences, insurance, repair and maintenance and fuel.

13. If the employee has the use of the car for a full year, he is charged on 24% of the cost of the car to the employer. Where the vehicle is leased, the employee includes 2/3rds of the total leasing charges (which may also include mileage charges and charges for repairs and maintenance) in his income.

14. He is also charged on the proportion of all operating costs which relate to private use.

15. Until recently the "stand-by charge" relating to the cost or lease rental of a car (paragraph 13) could be scaled down if private use was less than 7,500 miles per year. But this reduction is now only available where more than 90% of the use of the car is for business purposes.

WEST GERMANY

16. Information is rather sketchy. As we understand it the Germans still use an apportionment of the total expenditure between private and business use, and charge the private proportion. If the taxpayer fails to provide detailed evidence of private use, a minimum of 20% - 25% of expenditure is regarded as private, and in some cases a higher figure is taken, for example where the taxpayer has a second home or the car is used by members of his family.

NETHERLANDS

17. The benefit of a company car is at present chargeable only if the employee also have non-employment income. Then 20% of the list price is included in the employee's income. Proposals now before the Dutch Parliament would extend this basis of taxation to all employees with company cars from 1990.

SWEDEN

18. Following changes in 1986, the basic rules is to take 18% of the new car price (for the closest equivalent model, if the

actual car has been discontinued) plus extras above a de minimis limit. For cars in use for more than 3 years the figure is 14%. An extra 4% is added if free fuel is provided.

COMPARISON OF UK AND OVERSEAS CAR BENEFIT CHARGES

Average cost of car in each engine size band (AA figures)	US (General Rule/ Lease Valuation Table)	US (Cents Per Mile Rate) (1)	CANADA	GERMANY	NETHERLANDS	UK 1988/89 Main Scale	UK 1988/89 +50% (Main scale)	UK AA (100% Standing charges)
£7,960	2275	1074	1910 (3)	Insufficient information available, but likely to be significantly smaller than US/Canada where substantial business mileage	1592	1050	1575	2554
£10,197	2834	N/A (2)	2447 (3)		2039	1400	2100	3158
£16,294	4358	N/A (2)	3910 (3)		3259	2200	3300	4798

This table shows the average cost of a car in each of the three scale bands according to the AA's latest figures (1987/88 +5%), and what the benefits charge would be for it if the rules in force in other countries applied.

(1) Private mileage assumed to be 9,000 (UK average). Not certain this alternative rule would be available for a car costing this amount - it exceeds the latest upper limit (1985) we have.

(2) Not applicable because cost of car exceeds the limit to which this rule can apply.

(3) Since under the Canadian system there is an additional charge on the private proportion of operating costs the ultimate figures would probably be similar to the US charge.

ANNEX B

ANNEX B

CAR FUEL SCALE CHARGES - SCHEDULE E AND VAT

[This note has been agreed with Customs and Excise]

1. Until 1986/87 the car fuel scale was the same as the car benefit scale and it was increased by whatever percentage increase was decided for car benefits. Unlike the car benefit scale, however, the level of the car fuel scale was by 1986/87 becoming close to (and in some cases even exceeded) the true measure of the average benefit of free fuel provided for private motoring.

2. With effect from 6 April 1987 the car fuel benefit scale charge has applied for the purposes of assessing VAT on petrol purchased by businesses but used for private motoring. This replaced an arrangement whereby an apportionment of petrol expenses had to be agreed between the local VAT officer and the business. The scale charge approach is a simpler and more efficient way of doing this and also yields more tax because, due to the lack of evidence about the extent of private use, apportionments under the old system were generally far too low.

3. Though there are differences between the populations to which the Schedule E and VAT scales respectively apply

these scales are being used to measure essentially the same thing - the benefit of free fuel for private motoring.

Scale charge for 1988/89

4. The car fuel benefit scale currently in force is as follows:

Size of Car	Scale charge (£)
1400 cc or less	480
1401-2000 cc	600
Over 2000 cc	900

By 1986/87 the car fuel benefit scale was getting a bit on the high side, having regard to the actual cost of fuel for standard amounts of private motoring and petrol prices had fallen rather than risen in 1986, Ministers decided to peg the 1988/89 charge at the 1987/88 level. The standard mileage on which these calculations were based is 8,000 miles a year; but the most recent national travel survey suggests that average private employee mileage is now nearer 9,000 miles per annum. On the VAT side, where the scales apply to many self-employed people, average private mileage is lower.

Scale charge for 1989/90

5. In the past, the car fuel scale, like the car scale was announced a year in advance. However for car fuel, as for cars, the scale rate to apply for 1989/90 was not fixed in the last Budget. The arguments, however are little changed from last year. They are - given that the present scale charge is broadly at (or a little above) the true measure of the benefit, and that it applies for VAT as well as Schedule E, it is right in principle that any changes should mainly reflect changes in the price of fuel. It is also a condition of the EC derogation authorising the scale charge arrangement for VAT purposes that the scale should be adjusted in line with the cost of fuel (though the Commission have agreed that there need be no adjustment when there are only minimal petrol price changes).

6. The price of four star petrol has remained reasonably steady over the last 12 months at around £1.70 a gallon. The price of fuel would have to go well beyond £2 per gallon to justify an increase in the scale charges while they continue to be calculated, as previously on 8,000 private miles. No increase seems required unless, by the Budget, prices have risen to significantly more than £2 per gallon.

7. The question is, rather, whether there is any case for a decrease, given that the scales are at the moment a little on the high side. On the Schedule E side we see no need for this. There have been virtually no complaints that the level of the scale charge is too high. There may be several reasons for this

- the average private mileage on which the scales are based is now probably on the low side

- even at its present rate, the actual cost to the employee (the scale charge at his marginal rate of tax) is much less than the cost of buying petrol from taxed income

- if the employee feels the charges are too high they can be avoided by reimbursing the employer the full cost of petrol provided for <u>all</u> his private motoring

8. You will recall that in view of some of the complaints about the level of the scales for VAT we looked at the possibility of coupling a 10% decrease in the fuel scales with a higher than usual increase in the car scales. In the event Ministers decided to double the car scale while leaving the fuel scale unchanged.

Nothing has happened to change the picture since then. There have been no complaints on the Schedule E side despite the significant increase in the car scales while on the Customs side the level of complaints about the VAT scales has now significantly reduced. This may be because the benefits for businesses of the full deduction of input tax incurred on repairs, maintenance and leasing charges are beginning to be felt.

9. We recommend that the current scale charges should continue to apply in 1989/90.

ANNEX C

ANNEX C

CAPITAL ALLOWANCES: EXPENSIVE CARS

Background

1. For a business car costing over £8,000 (other than one used for short term hire) the writing-down allowance is restricted to £2,000 for any year in which the normal 25% allowance would exceed that figure. No permanent loss of relief is involved: an unrestricted balancing adjustment is made when the car is sold to bring allowances into line with actual depreciation. But the restriction does of course have a cash flow effect.

2. In order to make the restriction the computation of allowances has to be kept separate from that on other business machinery or plant. This means that separate records have to be maintained for each car costing over the limit.

3. To prevent the capital allowance rule being circumvented by the leasing of business cars, there is a corresponding restriction of the allowable lease rental (ie the tax deduction which may be claimed by the lessee) for a car costing over £8,000. The full rental is reduced in the proportion which £8,000 plus half the excess bears to the price of the car. In this case the "lost" rental deductions cannot be recovered.

4. The concept of an annual capital allowance ceiling was introduced in 1961 when tax rates were much higher and it was considered appropriate to limit the Exchequer contribution by way of tax relief towards expenditure on luxury cars which reflected an element of personal choice as well as business needs. To some extent the restriction has been seen as compensating for the inadequacy of car benefit scale charges and Ministers have taken the line that the present ceiling should be retained until more realistic scale charges are set.

5. On the basis of published car prices we estimate that the number of business cars costing over £8,000 purchased in 1988 could be in the range 550,000-600,000. Taking account of company discounts on the one hand and price increases on the other, 550,000 may be a realistic estimate of the number of car purchases in 1989/90 which would be affected by the restrictions if the present ceiling were retained.

Present level of the ceiling

6. Inflation has whittled the ceiling away since it was fixed at its present level in 1979. The April 1988 equivalent figure (using RPI) would be around £16,000. This has had the effect of extending the restriction to more and more middle-priced cars in just the sort of range in which the British motor industry usually argues it is strong and where potential purchasers ought not to be discouraged.

7. The vast majority of the business cars purchased each year which are now affected by the restrictions are not in the luxury class. Only 25,000 fall into the over £19,250 category to which the higher benefit scale charges apply.

Abolition of restrictions

8. Abolition of the restrictions would have a helpful deregulation impact, by removing from businesses the need to keep separate detailed records of individual cars. This administrative burden for an increasing number of cars is the main thrust of the case presented by representative bodies when calling for abolition or a substantial uplift of the ceiling in their annual budget representations. Abolition would save a handful of Revenue staff and remove a page or so of legislation.

9. Abolition would also deal with the double restriction which occurs at present when an "expensive" car is leased, ie both the lessor's capital allowances and relief for the lessee's rental payments are restricted. The CBI, SMMT and most other

representative bodies see this as unfair. There is no simple solution to this problem within the existing arrangements.

10. At today's prices the cost of removing the restrictions for <u>new capital expenditure</u> for 1989/90 onwards would be as follows:

1989/90	1990/91	1991/92	1992/93	1993/94	1994/95
negligible	£80m	£170m	£200m	£190m	£150m

falling away thereafter.

11. If <u>existing</u> cars were also released from the restrictions the cost would be:

1989/90	1990/91	1991/92	1992/93	1993/94	1994/95
negligible	£180m	£250m	£210m	£160m	£90m

again falling away thereafter.

<u>Raising the ceiling</u>

12. A substantial uplift of the ceiling would involve much of the Exchequer cost of abolition without securing all of its advantages. The following tables set out the cost at current prices of raising the ceiling to various levels for new expenditure and the estimated numbers of cars which would remain affected by the restrictions at those revised levels.

<u>Costs</u>

Ceiling		1989/90	1990/91	1991/92	1992/93	1993/94
£10,000	-	negligible	£30m	£ 60m	£ 80m	£ 70m
£12,000	-	negligible	£50m	£100m	£120m	£110m
£14,000	-	negligible	£60m	£120m	£150m	£130m
£16,000	-	negligible	£70m	£130m	£160m	£150m
£20,000	-	negligible	£70m	£150m	£180m	£160m

Cars affected	No. of cars	Percentage of total business cars above current £8,000 limit
£10,000	250,000	45
£12,000	160,000	30
£14,000	100,000	20
£16,000	60,000	10
£20,000	25,000	5

Impact on unincorporated businesses

13. It would clearly not be appropriate to confine any changes to expensive cars provided for employees, where there is a read across to the car benefit scales. The self-employed also suffer the present restriction and abolition or uplift of the ceiling would therefore be of particular advantage to them as they would gain from the accelerated relief without any offsetting benefits charge. Their capital allowances would still need to be restricted to take account of private mileage and in some cases personal choice (eg where a farmer bought a Rolls Royce which he claimed to use partially for business purposes).

RS139FST42 18.11.88

CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 21 November 1988

CHANCELLOR

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

Mr McGivern - IR
Mr Elliott - IR
PS/IR

Ch/ It seems sensible for FST to see Sir E Griffiths (however, I would not be surprised if Sir EG nonetheless insisted on tabling another amendment in the '89 FB

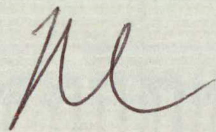
STARTER 214: TAX EXEMPTION FOR SPORTS BODIES

You will recall that Sir Eldon Griffiths tabled an amendment at Report Stage of ~~last~~ this year's Finance Bill, which would have given tax relief for both income and capital gains to the governing bodies of "Sports Associations", as well as a tax relief for donations to such bodies. I have no doubt we would have had a very substantial vote against us on the floor if I had not agreed during the debate to look at this question further. Accordingly, the Revenue have re-examined the issue as Budget Starter 214.

Having discussed Mr Elliott's submission of 8 November with officials, I am against making a new relief. But this is a somewhat muddy area. Sports bodies are already not taxable on subscriptions, income from activities open only to members, and gratis donations from both individuals and companies. They are taxable on investment income and on trading income from activities outside the circle of their own members, including sponsorship income (for which the donor gets an equivalent tax relief, if trading). But any relief in these areas would put sports bodies in a similar position to (and in certain respects a more privileged position than) charities, which would be both difficult to defend in principle and might well direct money to sports

bodies at charities' expense. Moreover, it would be difficult to restrict the definition of "sports" in order to exclude more recreational activities such as chess and darts.

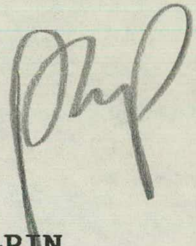
Rather surprisingly, the supporters of the amendment have not come back to me. But I suspect that they will during next year's Finance Bill. I therefore propose to ask Eldon Griffiths to see me, making it clear that I am consulting, but am sceptical about his proposals. I shall try to ensure it is a low-key meeting (though Eldon Griffiths may try to raise the profile). That way we should be able to put this issue to bed before this year's Budget, and so avoid the sports lobby's introducing amendments to the Finance Bill.



NORMAN LAMONT

culpin/23.11.02

CONFIDENTIAL



FROM: ROBERT CULPIN
DATE: 23 November 1988

FINANCIAL SECRETARY

cc: Chancellor
Chief Secretary
Sir Peter Middleton
Mr Scholar
Mr Monck
Mr Gilhooly
Mr Riley
Mr Macpherson
Mrs Chaplin
Mr Tyrie

Mr Battishill)
Mr Painter)
Mr Lewis)
Mr Bush) Inland
Mr Massingale) Revenue
Mr Mace)

CARS

I have read Mr Lewis' very interesting paper of 18 November. It may help to concentrate discussion if I set out my own provisional conclusions, for what they are worth.

(a) We should leave the structure alone: keep the P11D threshold at £8,500, keep the present bands, the present rules for mileage allowances, capital allowances and so on.

(b) We should raise the car scales as much as we can without imposing unreasonable losses.

(c) We should not decide now how far that is, but consider it together with income tax rates and allowances.

(d) The main test, though not of course the only one, should be the net gains/losses for the "typical" car owner. He or she has a bit more than average earnings, pays basic rate tax, and has a car in the Sierra/Cavalier range (1.4-2 litres).

(e) A reasonable starting point would be to look at increases in the car scales which would leave the "typical" car owner roughly breaking even on the Budget, with no significant cash gain or loss. (He gained in 1988.)

(f) If allowances are indexed, this would give approximately the following tariff:

Reduction in basic rate	% increase in car scales
0	15
1p	45
2p	75

(g) Broadly speaking, people with smaller cars would gain, with larger cars lose.

(h) The increases would affect nearly 1½ million taxpayers with company cars:

900,000 in the Sierra/Cavalier range

300,000 smaller

300,000 larger

(all figures rounded).

(i) The case for a substantial increase is that people are expecting it and have had two years of very fast growth in real take-home pay.

(j) The case for caution is that real take-home pay should grow much less fast next year, and people already face steep increases in mortgage payments.

(k) The maximum increase we should consider is the same cash rise as in 1988 - a 50% increase.

2. All we really need to know now is whether you agree with a-c. In other words, we should try to settle the structure for next year soon, so that the only policy question on car scales is how much to raise them.

ROBERT CULPIN

Robert/6.23.11.88min

CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 24 November 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Culpin
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Pitts - IR
Mr Cayley - IR
PS/IR

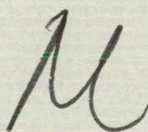
STARTER 254: CGT - UK BRANCHES OF OVERSEAS BUSINESSES

I have discussed Mr Cayley's minute of 9 November with officials.

I believe that we should go ahead with this starter and amend the legislation dealing with the chargeable gains of UK branches. The change is needed in order to protect the exit charge on accrued gains for companies migrating outside the UK tax net (and, in particular, to deal with the case where a migrating company keeps UK assets in a branch, but then ceases to trade here shortly afterwards), which we introduced as part of the 1988 changes to company residence. Ideally we would have included this starter in the 1988 Bill as well. However, the link with this year's changes will allow us to portray this measure as essentially a completion/ tidying-up exercise. And since the accrued gains charge will only bite if and when the branch's trading activity ceases, it should not be controversial.

I also agree with all of Mr Cayley's subsidiary and technical recommendations. One point which may become sensitive is the proposed extension of the charge to cover the UK branches of foreign professions and vocations. But it is inequitable that they should be taxed less heavily than the UK branches of foreign traders, particularly when the distinction between "trade" and "profession" is increasingly blurred.

I have considered, as part of my review of starters generally, whether this one could be deferred until the 1990 Bill. Officials agree that it is not the most important issue around at the moment, and that we could therefore leave it for a year. But it would only be at the cost of some (unquantifiable) loss of yield, since exploitation of the current loopholes is extremely easy in practice and those loopholes will became increasingly well-known during the next few years. Subject to any imminent review of the length of the Bill as a whole, therefore, I recommend we keep this starter in.



NORMAN LAMONT

Robert 9.24.11.88 **CONFIDENTIAL**

FROM: FINANCIAL SECRETARY
DATE: 24 November 1988

CHANCELLOR

cc
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Burgner
Mr Culpin
Mrs Lomax
Mr Moore
Mr Ilett
Miss Hay
Mr Sharples
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr McGivern - IR
Mr Reed - IR
PS/IR

Ch/ Agree FST? 25/11

Thanks. Agreed.

STARTER 202: COMPANIES' PURCHASE OF OWN SHARES (POS)

You will recall that I looked at the question of whether changes should be made in the tax treatment of a POS before the last Budget. My view then was that there was no case for a relaxation of the general rule that a POS should be treated in the same way as a distribution of profits, and hence subject to ACT. Having now discussed Mr Reed's minute of 28 October with officials, I remain unconvinced. Such a relaxation would be a major breach of the imputation system and would create the distortion that companies with surplus ACT would pay less tax if they distributed profits through a POS rather than through a dividend. It would appear very odd if we introduced tax measures which actively encouraged the diminution of equity in this way at a time when most commentators are bemoaning such practices in the US. (For unquoted trading companies, we do of course already offer a limited relief for a POS. But that is only to recognise the special problems for these companies in buying out dissident shareholders or settling IHT bills.)

David Young raised a subsidiary point about removing the ACT for a POS from a market maker only. The exemption would then mirror the special case whereby (for anti-avoidance reasons) the market maker does not receive a tax credit on the sale of the shares to the company even though the company has paid ACT on the POS. I have spoken to David about this. His main reason is to try to maintain market stability when prices fall sharply. Quite apart from the likely effectiveness of such a proposal (and in particular the fact that the distortion I referred to above would still apply, albeit only for POS through a market maker), I think attempts to buck the market are a very bad reason for introducing a new tax relief. Moreover, we could not introduce it without at least considering complementary changes to the regulatory aspects of POS. DTI have not yet got around to looking at these.

I have also looked to see whether a relaxation of the POS rules would help ease Burmah's ACT problem. However, that is more a question of the distribution of the company's earnings between the UK and abroad. And since the 97% of their shareholders who are UK resident get relief for the ACT through the associated tax credit on their dividends (and many of the remaining 3% get partial relief through double taxation agreements), it does not seem to be much of a problem in practice.

One issue that has been drawn to my attention is a possible loss of yield in the present system through a tax avoidance scheme which theoretically enables companies with surplus ACT to repurchase their shares from companies with capital gains, who then use the capital loss created through the purchase to reduce their tax liability. Amending the POS rules would protect this potential loophole; but only at the cost of opening up others. On balance, therefore, I would prefer to monitor this particular situation carefully and only introduce specific anti-avoidance measures to combat it if a serious problem materialises.

R.C.M.J.

pp NORMAN LAMONT

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: C W CORLETT
FAX No. 438 6766
EXTN. 6614
25 November 1988

1. MR ISAAC

2. FINANCIAL SECRETARY

TRUSTS (Starters 118 and 119)

1. The attached paper by Mr Golding examines a number of important issues concerning the taxation of trusts - a specialist subject, but one of considerable interest to a wide range of professional advisers and their representative bodies. The paper brings together not only the income tax aspects (which are the responsibility of my Division and Mr Lewis') but also the capital gains tax aspects (Mr Pitts' Division) and the treatment of non-resident trusts (Mr Houghton's Division). This is

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins - Parliamentary Counsel

Mr Battishill
Mr Isaac
Mr Painter
Mr Bush
Mr Houghton
Mr Lewis
Mr Pitts
Mr Johnston
Mr Calder
Mr Davenport
Mr Hamilton
Mr Phalp
Mr Bryce
Mr Mace
Mr Stewart
Mr H Thompson
Mr Gerrie
Mr Reeves
Mr Ko
Mr Boyce
Mr Golding
PS/IR
Mr Corlett

necessary because of the interactions. I am afraid, therefore, that the paper is inevitably rather long (but, I hope, nonetheless readable).

OBJECTIVES

2. We do not seek detailed Ministerial decisions at this stage. Rather, the purpose is to explain where we have got to having completed the first stage of the review, to take stock particularly for the coming Finance Bill and to seek guidance on how you want work to proceed.

3. The questions we have been addressing so far include:

a. This year's tax changes may alter the perspective of trusts. On the one hand the reduction of income tax rates may reduce the attractiveness of trusts as shelters for income. On the other hand, the taxation of capital gains at income tax rates makes non-resident and some resident trusts more attractive as tax shelters. The reduction and alignment of rates may offer scope for reform, particularly rationalisation and simplification. Are there options here worth pursuing?

b. If reforms (both income tax and capital gains tax) do look a real possibility, could they be done in the coming Finance Bill, or would they have to wait for 1990? And what about consultation?

c. Quite apart from optional rationalisation, some essential action may be needed, mainly as a consequence of reforms in this year's Finance Act. What changes exactly are needed? And should they be in the coming Finance Bill, or could some or all of them be held over until a more general reform package in 1990?

d. Is any action required to present the proposals in the consultative document on residence being

side-stepped through the use of non-resident trusts? And quite independently of this, avoidance through non-resident trusts is a cause of increasing concern. How can it best be tackled in the context of the wider options for trust reform?

CONCLUSIONS

Resident trusts: income tax simplification

4. Our provisional conclusions here are as follows:

a. The possibility for reforming the treatment of resident trusts looks promising. There are alternative limited and more radical approaches. You might like to refer to these in paragraphs 17-32 of Mr Golding's paper to see whether, as sketched out there, they are potentially attractive enough to be worth exploring further. (It is perhaps just worth cautioning that, while the more radical approach has much attraction, there is a downside, particularly since some people will see themselves as worse off. So it is not an easy option, and will need a lot of working up before a decision can be made to float it publicly.)

b. There is just a possibility that some income tax tidying up (but less than even the limited reform referred to above) could be managed in time for 1989 - see paragraph 21 of the paper - depending on what other trust work needs to be done (see below) and the pressures on Parliamentary Counsel.

c. Any major reform could not be done until 1990, but that would allow time for a consultative document next summer.

Resident trusts: capital gains tax simplification

5. Our conclusions here are:

a. The scope for a radical capital gains tax reform of the treatment of resident trusts looks even more promising. It is less difficult technically than the income tax aspects. So it would probably be possible to introduce it in full in 1989. You might like to look at paragraphs 35-41 of the paper to see if you are broadly attracted by what is on offer. There is probably an expectation that the reform begun this year will be concluded next year.

b. On the other hand, a 1989 package would:

i. rule out prior consultation on CGT (if consultation were thought desirable)

ii. lose the presentational attraction of a wide-ranging income tax/CGT reform package (which could only be for 1990)

iii. attract criticism if in 1990 it proved feasible to introduce a trust reform integrating income tax and CGT on different lines.

Non-resident trusts

6. Considerably more work needs to be done in this area, but the (very) provisional conclusions are:

a. imposing a more effective charge on non-resident trusts (see paragraphs 44-47) must be consistent with action on the domestic front. We do not see this element of the package as a Starter for 1989;

b. nevertheless, some buttressing of the present charge on non-resident trusts may be necessary in 1989 to prevent any particularly blatant side-stepping of the proposals put forward in the consultative document on residence to change the basis of liability. If,

however, any changes were to be limited to the residence rules themselves, no action would be needed on non-resident trusts on that account;

c. in view of the considerable opportunities for pre-empting any changes, this is not an area in which consultation would be appropriate.

Matters for essential action

7. Wider reform apart, you cannot defer too long some statement about the progress, if not the result, of the review of trust taxation you have announced. And there are some matters on which we already know we would recommend action:

a. Opportunities for circumventing this year's covenant reform need to be blocked off (see paragraphs 53-54).

b. There are the commitments you gave on Independent Taxation (see paragraphs 55-58 of the paper). These go hand in hand with the measures at (a). Ideally they should be dealt with in 1989 to give the outside world as much advance notice as possible.

c. As a result of a recent adverse decision in the Courts (known as the Dawson case) there is a gaping avoidance loophole where arrangements are made for at least one trustee to be resident abroad (see paragraphs 59-63). We are appealing to the House of Lords. But because of the risk of loss of tax, we need to prepare legislation on a contingency basis. It may well prove necessary to legislate on this in 1989 rather than wait until 1990.

d. Some action may well be needed in 1989 to prevent the changes arising on the residence side from being sidestepped.

8. If the general CGT reform (paragraph 5 above) does not go ahead, there will be a need to remove what are arguably defects, both against and in favour of the taxpayer, in the CGT rules. But this could wait beyond 1989.

OPTIONS

9. Drawing all this together, the immediate questions are:

a. What should be worked on for 1989?

b. What should be worked on for 1990?

10. The main options seem to be:

a. Do as much as possible in 1989 and probably nothing more in 1990 This would imply aiming to do in 1989

i. the essentials in paragraph 7 above

ii. a bit of income tax tidying up (if there is time)

iii. the full capital gains tax reform.

There could be no effective consultation. And the possibility of fundamental income tax reform would almost certainly have to be abandoned, for the time being at least. If it proved necessary to take action on non-resident trusts in 1990, that could be done as a separate exercise.

b. Do some reform in both 1989 and 1990 This would imply aiming in 1989 to do

i. the capital gains tax reform

ii. some of the more urgent paragraph 7 essentials

The income tax reform, the non-resident trusts and the remaining essentials would be left for 1990.

c. Do the minimum in 1989 and aim for a full reform package in 1990 This would imply:

i. only doing in 1989 such of the paragraph 7 essentials as you conclude are absolutely urgent

ii. leaving for 1990 (a) the income tax and the CGT reforms (or possibly an integrated reform), (b) the non-resident aspects and (c) the remaining essentials.

11. The decision as between these options may depend to some extent on your attitude to prior consultation. If there is to be effective consultation, there would have to be a consultative document (possibly with draft clauses) in the summer of 1989, in time for legislation in 1990. Anything to be done in 1989 cannot realistically be the subject of proper prior consultation.

12. This year's CGT changes (like the 1984 corporation tax reforms) were introduced without consultation, thereby avoiding the hassle and trouble that come from giving proposals a full public airing. That has certain attractions.

13. On the other hand, the balance of considerations affecting the tax treatment of trusts is not the same as that affecting the main stream of income tax and CGT. In both cases big money is at stake in individual cases. But trusts are dominated to a far greater extent by the general legal (as well as specific tax) technicalities. And any reform must touch the heart of the "private client business"

of the big law firms. They could - if they are prepared to co-operate - have something to offer in devising a scheme that is genuinely simple for all to operate. And certainly there would be widespread criticism from the practitioners if major proposals for restructuring were not floated in advance.

14. Furthermore, there is clearly an awkwardness if doing the CGT reform in 1989 were seen to be pre-empting the scope for income tax reform, particularly for aligning income tax and CGT.

NEXT STEPS

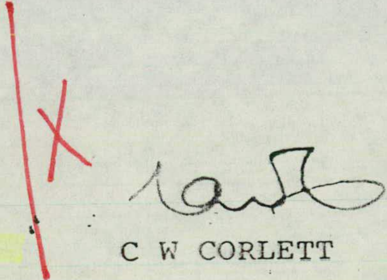
15. Ministers will have their own views on the tactics, and therefore on the choice between the three options in paragraph 10. Our own preference is for option c. - primarily because of the importance we attach to consultation and the opportunity afforded, by the extra time, to get this tricky part of the tax system on a sound and sustainable basis for the foreseeable future.

16. Once we have a decision, we shall:

a. prepare separate notes as a basis for deciding which of the essential measures should be done in 1989, and settling the detail;

b. get ahead with work on the longer-term reform proposals (assuming you see them as possible candidates for inclusion in the 1990 Finance Bill), with a view to seeking a further Ministerial steer in the New Year on the contents of a consultative document (which presumably would be foreshadowed in the Budget).

This is, if you find it attractive, a possible major contribution to a 'simplification' theme in the Budget & Finance Bill. As mentioned earlier this morning, both Dr. Painter and I strongly recommend option 10(c): only the essentials this year, but a Budget announcement and consultation about radical reform. To legislate without consultation would invite trouble, for many reasons.



C W CORLETT

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: R GOLDING
EXT: 7509
DATE: 25 NOVEMBER 1988

1. MR STEWART
2. MR CORLETT
3. MR ISAAC
4. FINANCIAL SECRETARY

REVIEW OF TRUST TAXATION (BUDGET STARTERS 118 AND 119)

1. In the Finance Bill Standing Committee this year you announced the intention of examining a number of aspects of the income tax and capital gains tax regimes for trusts (copy attached). This note reports on progress with the Review, as promised by Mr Stewart on 14 July and 7 October.

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cc Chancellor of the Exchequer	Mr Battishill
Chief Secretary	Mr Isaac
Paymaster General	Mr Painter
Economic Secretary	Mr Corlett
Sir P Middleton	Mr Bush
Mr Scholar	Mr Houghton
Mr Culpin	Mr Lewis
Mr Gilhooly	Mr Pitts
Mrs Chaplin	Mr Johnston
Mr Tyrie	Mr Calder
Mr Jenkins (Parliamentary Counsel)	Mr Davenport
	Mr Hamilton
	Mr Phalp
	Mr Bryce
	Mr Mace
	Mr Stewart
	Mr H Thompson
	Mr Gerrie
	Mr Reeves
	Mr Ko
	Mr Boyce
	Mr Golding
	PS/IR

2. This is a very wide-ranging subject. There are some aspects on which legislation in 1989 is recommended. Others need to be looked at over a longer period. The purpose of this note is to explain the issues briefly, so that you can consider the priorities and timescale for further work.

3. The paper is in five sections:-

A. Background information.

B. The possibilities for reforming the income tax regime for resident trusts (which could not realistically lead to significant legislation before 1990).

C. A proposal to reform the CGT regime for resident trusts to simplify it and simultaneously mitigate various injustices and inadequacies.

D. An examination of the question of non-resident trusts (which has some links with the recent proposals on the residence of individuals).

E. Various matters on which action is essential in the near future (whatever is decided about further work on major reform).

A. BACKGROUND

Reasons for the Review

4. The taxation of trusts needs to be considered for a variety of reasons.

- Many stem from the radical changes in this year's Finance Act. The simplification of the higher rate structure, the new interface between income tax and capital gains tax, and the reduction of the higher rates of tax themselves may well permit

the present old and complex legislation to be rationalised and simplified. The target here would be much shorter legislation, and administrative arrangements which saved costs both for the Revenue and for trustees and beneficiaries.

- A number of changes are needed to handle the consequences of the covenant reform, Independent Taxation and the new capital gains tax (as you explained in your announcement).

- A recent Court of Appeal decision - Dawson v CIR - has undermined certain fundamental aspects of current practice.

- The changes proposed in the Consultative Document on the Residence of Individuals affect trusts indirectly and the Introduction to the Document said that the tax treatment of trusts was being considered separately.

5. All these issues need to be considered alongside each other, to see how they interrelate, to examine whether common solutions exist and to avoid the risk of inconsistency if they were tackled independently.

Trusts

6. Some introductory explanation of what trusts are - and which of them we are concerned with here - may help.

7. A trust is a legal obligation which binds a person - the trustee - to deal with property or income in a particular way, or for the benefit of another person or class of persons - the beneficiaries. A trust normally has more than one trustee. The person who provided the original funds for the trust - the settlor - may be a trustee or a beneficiary or both.

8. Trusts can be set up for many different reasons. They are often used for specific benevolent or commercial purposes. Examples are charities, superannuation funds, employee trusts and unit trusts. The review is not aimed at such trusts, and it will be necessary to ensure that any changes do not inadvertently affect them. The position of the personal representatives of deceased persons will also be borne in mind.

9. The review is primarily concerned with ordinary family trusts - where the beneficiaries are mainly individuals who are members of the settlor's family. Such trusts can be divided roughly into four categories:-

a. UK resident trusts where the trustees have some discretion regarding the payment or retention of the trust income. These are known as discretionary and accumulation trusts. There are about 55,000 such trusts, with total assets over £8bn. They have an annual income of £250m to £300m and capital gains of about £350m. Most are comparatively small. Around 9,000 have income in excess of £4,000 and only 1,400 (3per cent) have income over £25,000. But the top 3per cent receive nearly half the total income. Similarly, half the gains are made by a small number of trusts, each with gains in excess of £250,000. The majority (75per cent) are created during the settlor's lifetime. This includes nearly all (95per cent) of the largest trusts. The remaining trusts are established by the settlor's will or under an intestacy.

b. UK resident trusts where all the income belongs to one or more beneficiaries as it arises. These are interest in possession trusts. There are about 115,000 of these with annual capital gains of about £350m. Little is known about their wealth or income. At a rough guess the totals involved

will be of the same order of magnitude as for discretionary and accumulation trusts.

c. UK resident trusts dealt with under the so called "special arrangement". These are trusts of the same types as those described in a. and b. above, but they have major corporations (such as banks and insurance companies) as trustee. Because each trustee acts for so many trusts they are all effectively assessed as a single trust. This simplifies the administration. About 90,000 are handled in this way. The majority are small, interest in possession trusts.

d. Non-resident trusts. These are mainly of interest if they have UK settlors or beneficiaries. About 8,000 are known to the Revenue but there are probably many more. Information about their income and gains is necessarily very limited as it is often not disclosed to us. But the assets controlled by such trusts are probably worth several billion pounds. They must therefore have substantial income and gains but only suffer UK taxation on a very small proportion of them.

How trusts are treated for income tax

10. The income of UK resident trusts is taxed in four different ways, depending on the terms of the trust and what the trustees do with the income:-

a. "Caught" income. If the settlor or his wife or his minor child benefits from the trust or he has kept control of it, some or all of the trust income is treated as his for tax purposes. The relevant provisions are known as the Settlements Legislation. Some of the provisions depend on the terms of the trust when it is set up, but others are triggered by events during the life of the

trust. The legislation is not limited to trusts. It also covers gifts, covenants and other forms of agreement or arrangement which result in the gratuitous transfer of capital or income. The Settlements Legislation overrides b - d below.

b. Interests in possession. If a beneficiary is entitled to trust income as it arises, the trustees normally pay tax at the basic rate on any income received gross. The beneficiary is given credit for the tax suffered by the trustees. He may be liable at the higher rate or be able to claim a repayment - depending on his own tax position.

c. Income distributed at discretion. If income does not belong to a beneficiary as it arises, the trustees will usually have some discretion as to what to do with it. They pay tax at the basic and additional rates - currently 35per cent (25per cent plus 10per cent) - on all such income. A beneficiary with a discretionary interest is only assessed on income which the trustees choose to distribute to him. He is taxed in the year in which the distribution is made, but receives credit for tax at the basic and additional rates for that year. He may have to pay tax at the 5per cent currently needed to bring those rates up to the higher rate (40per cent), or he may be entitled to a repayment if he is not liable to tax or is only liable at the basic rate.

d. Accumulated income. If trustees do not distribute income over which they have some discretion, they may choose to accumulate it instead. That income is also taxed at the basic and additional rates. If the trustees make payments out of accumulated income to a beneficiary, he normally receives them as capital. He gets no credit for the tax paid by

the trustees but has no further liability if he is a top rate taxpayer.

11. If the trustees are non-resident the rules are somewhat different. The trustees are only taxable on UK income. However, there are anti-avoidance provisions which apply if the trust has been funded by assets transferred abroad to avoid income tax. They operate if a beneficiary living in the UK receives a non-income benefit from such a trust. He is then taxed on the benefit as if it were income to the extent that the trustees have access to income which could be paid to him instead. The provisions also operate when the settlor retains the power to enjoy the assets held in trust. In that event, the settlor is taxed on any income arising to the trustees or to any company owned by the trustees.

How trusts are treated for Capital gains tax

12. As a result of the changes in this year's Finance Act, the capital gains of UK resident trusts are taxed in three different ways:-

a. Settlor trusts. If the settlor or his spouse retains an interest in the trust any gains are taxed on him at his marginal income tax rate. He can set his annual exempt amount against them. This rule does not apply to as many trusts as the income tax Settlements Legislation. It overrides b and c below.

b. Interest in possession trusts. If the whole of the trust income belongs to beneficiaries as it arises - so that the trustees only pay income tax at the basic rate - the trustees are taxed on the trust's capital gains at the basic rate. They receive a special annual exempt amount. This is

usually half the allowance given to individuals; but it is further reduced if the settlor has made more than one trust - the anti-fragmentation rule. Beneficiaries are not taxed on the trust gains and can never claim repayment of the tax paid by the trustees.

c. Discretionary and accumulation trusts. If the trustees are liable to pay tax at the additional rate on any part of the trust income they are taxed on any capital gains at the sum of the basic and additional rates. They are entitled to the special annual exempt amount as in b above. Again, beneficiaries are not taxed on the trust gains and can never claim repayment.

13. The capital gains of non-resident trusts are treated very differently. The settlor trust rules (paragraph 12a) never apply. The trustees are rarely taxed on gains, but UK resident beneficiaries sometimes are. They can be liable on the trust's gains if they receive capital payments from the trust - but only if the settlor was living and domiciled in the UK when he made the trust or when the gains arose.

Objectives

14. We suggest that, in examining the scope for reform, proposals should be judged against the following criteria:-

a. Simplicity: the income tax and CGT regimes for trusts should be (so far as possible) easy for trustees and the Revenue to understand and administer, and should impose the minimum necessary burdens on business.

b. Certainty: the legislation should be comprehensive and unambiguous, and provide for effective policing by the Revenue.

c. Consistency: with Government policy in other areas of taxation; with general trust law; and with our international obligations.

d. Parity: ensuring so far as is practicable that trust income and gains are taxed neither more heavily nor more lightly than they would be in the hands of an individual.

e. Equity: the system should be fair, and any anti-avoidance provisions should be effective but operate no more harshly than is necessary to counter the mischief at which they are directed.

B. INCOME TAX REFORM - RESIDENT TRUSTS

15. The matters mentioned in your announcement of the review do not require any major changes so far as the income tax regime for resident trusts is concerned. But the restructuring of the higher rates and other recent changes raise the question whether the door is now open for a major reform. There are a number of options.

16. To begin with we have examined whether it would be possible to structure the trust rules so that trust income was never treated as belonging to a beneficiary for income tax purposes. There could then be a simple non-repayable tax charge on the trustees which they would have to pay whatever they did with the income. That would undoubtedly be a dramatic simplification. But we have concluded that it would be going altogether too far. Much trust income belongs to beneficiaries as it arises. A good proportion of the rest is paid out shortly after it arises, because the trustees make discretionary payments to beneficiaries. Currently, any beneficiary who receives such income gets a credit for the tax suffered by the trustees (unless the income is caught by the Settlements Legislation). If he is

liable at a lower marginal rate he can claim a repayment. However, with a non-repayable charge, the income would be taxed at the rate imposed on the trustees even if the beneficiary was not liable to tax. That would adversely affect the position of too many beneficiaries, including quite a few hard cases (such as widows, orphans and the disabled).

17. There are however two other - and more promising - possibilities for simplification: -

a. overhauling the Settlements Legislation (limited reform), or

b. replacing the additional rate regime by a non-repayable charge on undistributed income only (radical reform), which would permit much greater simplification of the Settlements Legislation.

Limited reform

18. This approach would merely look at the 22 pages of Settlements Legislation. There are 12 different sets of circumstances which can trigger the legislation, and there are nearly as many different consequences which can follow. It should be possible to simplify matters considerably.

19. There are prospects for simplification in the following areas:-

a. Merging four Sections which currently overlap into a single provision. This would depend on action to prevent trusts from being used to get round this year's covenant reforms (see paragraphs 53-54).

b. Abolishing a couple of Sections which may not be needed following the covenant reforms.

c. Rationalising the various explanatory and supplementary provisions.

d. Deleting any of the obscurer provisions which are no longer needed.

20. There would also be opportunities to clarify some ambiguities in the present law and to relax it at the margins. The changes could halve the length of the legislation and make it more understandable. The tax consequences of a new trust would be easier to determine and there should be a small saving in the specialist staff engaged on that work. This option would not however significantly reduce the work involved in administering a trust from day to day.

21. It might be possible to achieve a small part of this reform in the coming Finance Bill. But there is not time for prior consultation. And we could not hope to work through all the possible candidates for simplification. Moreover, there would be no point in limited simplification in 1989 if the radical approach described below is regarded as worthy of further study - because much of the work done in 1989 might be made obsolete by changes in 1990.

Radical reform

22. Under this approach trust income would be taxed in one of two ways, depending on how the trustees dealt with it.

23. Income distributed before a specified cut off date after the end of each year of assessment would be the beneficiary's income for tax purposes as at present. He might have to pay higher rate tax or be able to claim a repayment. Those parts of the Settlements Legislation which

affect distributed income could be replaced by a simple provision stopping taxpayers from gaining an advantage by transferring income within the family. Income which belonged to a beneficiary as it arose - an interest in possession - would automatically be treated as distributed before the cut-off date. This would stop such beneficiaries from being adversely affected by the reform.

24. Income which was accumulated or which was retained by the trustees for possible distribution after the cut-off date would be taxed only in the trustees' hands. When it eventually passed to a beneficiary it would be received as capital. The beneficiary would have no further liability and would be unable to claim a repayment. There could be an operational de minimis limit below which we would not assess untaxed income.

25. In order to abolish those provisions in the Settlements Legislation which apply to undistributed income, most or all of that income would have to be taxed at the higher rate (currently 40 per cent). Without wanting at this stage to get into too much detail, the question then would be whether to:-

a. Tax it all at the higher rate (which might appear too severe in small cases).

b. Give the trustees a narrow basic rate band (which would give the wealthy a new tax advantage. The width of the band would have to be fixed so that the effort and expense of creating a trust generally outweighed the potential tax saving. For example, the maximum benefit per taxpayer with a band of £2,000 would be £300).

26. Careful thought would also have to be given to the choice of cut off date. For example:-

a. 5 April would be the easiest to administer, but trustees would complain that it gave them no time to decide how much of the year's income they should distribute.

b. 30 September would make it impossible to keep to the present timetable for assessing trusts; so that they would become a means of delaying the assessment of investment income.

c. 5 July or 30 June might be a suitable compromise.

27. This radical approach would simplify the treatment of trusts in several ways:-

- The additional rate would be abolished. Large numbers of trustees would no longer need to be assessed. This could save up to 30,000 assessments annually (the precise number would depend on decisions about any basic rate band). Some small repayments to beneficiaries would be eliminated.

- The Settlements Legislation would also largely be abolished and staff would be saved.

- The assessment of beneficiaries would be put on a clear statutory footing, leading to greater certainty all round.

- It might even be possible to move eventually to a "pay and file" system for those trustees still assessable.

28. There would be useful administrative savings here. The Law Society have been representing for some years that the present rules add up to a heavy compliance burden on their members. They are also quite costly for us.

29. The radical approach might be criticised on the following grounds:-

a. A trust basic rate band would give the wealthy a new opportunity to reduce their tax bills. But the advantage would be very limited if any band was sufficiently narrow.

b. Some beneficiaries would be worse off (because they can currently claim repayments in respect of trust income but would no longer be able to do so). On the other hand the people affected would be the minority who receive distributions of income after the cut off date. Further work would need to be done to estimate the numbers involved. In any case, the trustees would often be able to prevent any loss by making distributions before the cut off date.

c. Some trusts would pay more tax than at present, because their marginal rate would increase from 35per cent (the sum of the basic and additional rates) to 40per cent (the higher rate). But this would be limited to the small minority of discretionary trusts which receive substantial income but distribute very little. They would tend to belong to the wealthier families. Increased liability for that minority can be defended as an acceptable consequence in the context of a reform which would ease the administrative burden generally and (if there was a basic rate band) also reduce the tax liability of the smaller accumulating trusts.

d. Any cut off date will be a compromise and there would be pressure to have it fixed more favourably.

e. Putting the assessment of beneficiaries on a statutory footing would require new legislation. But it should be a lot simpler than the existing Settlements Legislation; should be welcomed by professionals; and ought to be much shorter than the current 20 pages.

30. On balance - and at this preliminary stage of our work - the benefits of simplification seem likely to outweigh the drawbacks.

31. The Exchequer yield or cost of the radical option would depend on the decisions made as the proposal was developed. It should have a negligible overall revenue effect so far as existing trusts are concerned. The aim would be to frame the details so that the risks of new avoidance using trusts were kept to an acceptable minimum.

32. There is no realistic possibility of introducing the radical option in the coming Finance Bill. A number of important aspects need a considerable amount of further thought, before a workable package could be constructed.

C. CAPITAL GAINS TAX REFORM - RESIDENT TRUSTS

33. The present CGT rules are arguably defective. A number of aspects of the regime introduced this year were criticised at the time. Your announcement committed Ministers to considering some of them. The best way of resolving these difficulties is to restructure and simplify the regime.

Drawbacks of present system

34. The objections to the present rules are that:-

a. Taxing gains in 3 different ways is unnecessarily complicated.

b. The system lacks parity and equity. It is wrong in principle to consider income rights when taxing capital gains, since the gains seldom belong to the beneficiaries entitled to the income.

c. Charging the gains of an interest in possession trust at the basic rate only, gives an unreasonable tax advantage to the larger trusts. The tax take is possibly some £50m less than it would be if comparable gains were made by individuals.

d. The non-repayable charge at the sum of the basic and additional rates - currently 35per cent - is inadequate where the capital beneficiaries are higher rate taxpayers and too high where the beneficiaries' personal tax rates are lower. Netted off, the tax take is possibly some £15m lower than it would be if comparable gains were made by individuals.

e. There is perceived inequity in relation to mixed trusts. They are trusts where some of the income is payable at the trustees' discretion and some is subject to an interest in possession. All the gains of such a trust are taxed at the rate for discretionary trusts (currently 35per cent). But if the different income interests arose under separate trusts, any gains on the assets in the interest in possession part would only be taxed at 25per cent. This is an issue which Ministers specifically undertook to consider.

f. The settlor trust rules may also be too harsh where the settlor has little or no interest in the trust capital or where the anti-fragmentation rule applies unnecessarily. They may be open to abuse in other cases because - unlike the income tax

provisions - they do not apply where the settlor's minor child benefits from the trust or where the trustees are non-resident. Moreover, certain technical devices could be readily used to circumvent the rules.

<u>New approach</u>

35. Some of these difficulties could be tackled piecemeal. This would involve:-

a. Reviewing the use of the basic rate only in taxing the gains of interest in possession trusts.

b. Introducing rules for the (arbitrary) apportionment of the gains of mixed trusts.

c. Refining the settlor trust rules in several ways; to reduce the scope for abuse and to relieve the harshness of the anti-fragmentation rule.

But all that would be complicated and unlikely to deal satisfactorily with all the criticisms.

36. An alternative approach would be to simplify radically the present law and mitigate those difficulties along the way. Under the simplified regime all gains of UK resident trusts would be assessed on the trustees. They would get:-

- an exempt amount, as at present, and

- a basic rate band.

Beyond that gains would be taxed at the higher rate. The basic rate band would probably need to be narrower than that for individuals. This system would be much simpler to

operate because it would be entirely independent of any individual's liability and because all trusts would be treated in the same way.

37. The CGT proposal can be much simpler than the radical income tax option because capital gains - as such - never belong to a particular beneficiary. And since it is not normally possible to identify the ultimate capital beneficiary at the time a gain arises, there is little or no scope for directly attributing capital gains to beneficiaries.

38. On the other hand, capital can be distributed. It may be said that this is effectively a proxy for distributing gains. On that view it could be argued that the simplified regime should recognise the gains element in such distributions. That element would then be taxed as if it had arisen to the beneficiary and not to the trustees. (This is already the law for non-resident trusts, but there it is needed to prevent the avoidance of tax.) That would reduce the tax payable in some cases - for example, if the beneficiary had no gains of his own - but increase it in others. Taking CGT in isolation, attributing gains to beneficiaries in this way would be an artificial complication. But it might be worth considering as part of an integrated income tax and CGT reform.

39. In structuring the system the aim would be to bring the yield up to that on corresponding gains by individuals and so recover the current shortfall of some £65m mentioned in paragraphs 35 c and d. The precise Exchequer yield could be more or less than that amount. It would depend on the size of the exempt and basic rate bands given to trustees and on any behavioural changes.

Timing

40. There ought to be time to work up the simplification suggestion for legislation in 1989. The proposal is clear and relatively straightforward. It deals - in a broad way - with a number of the areas which Ministers have promised to consider. Early legislation would complete the 1988 reforms before further criticism arises or more tax is lost. But a decision would have to be made fairly soon and there would be no time for outside consultation.

41. On the other hand, if Ministers wanted further work done on the radical income tax option, it might be sensible to delay any CGT legislation and continue to review the two aspects in tandem. The reasons are that:-

a. Gains are now taxed at income tax rates.

b. Aspects of the income tax Settlements Legislation have been adopted for CGT. It needs to be considered whether the two taxes should be brought further into line in this area.

c. The proposal for simplifying the CGT regime and the radical income tax option have a lot in common. Both head in the direction of basing tax liability on the amount received by the trust, without taking into account the personal tax position of the beneficiaries. On present thinking that approach would apply to all capital gains but only to income which was not speedily distributed. But the difference does not rule out a common approach on some of the detail. Moreover, on further investigation it might be possible to devise a more integrated solution. For example, there could be a single basic rate band covering income and gains. At the very

least, it could be awkward to take one view of an issue in relation to CGT and the opposite view in relation to income tax.

D. NON-RESIDENT TRUSTS

42. The other area - in addition to simplification - which would merit a wider review is the use of non-resident trusts for tax avoidance. You specifically mentioned such trusts in your announcement.

43. The income and gains of resident trusts are taxed as they arise. For non-resident trusts, however, there is normally no liability until payments are made to a resident beneficiary. This difference is frequently exploited to reduce the tax liability of UK residents. Income and gains which will ultimately benefit such taxpayers are diverted to a non-resident trust. There is no UK taxation when the trustees receive the income and gains. If they wait several years before making payments to a UK beneficiary, tax is deferred for as long as they choose to wait. Alternatively, they can delay payment until the beneficiary has become non-resident and so avoid liability altogether. Schemes which do this in a way which gets round the existing anti-avoidance legislation are actively marketed. In addition, trusts of this sort are already being canvassed as a means by which multinational groups can avoid the controlled foreign company legislation.

Possible changes

44. The present position defeats the objective of parity with the treatment of individuals and is an open invitation to avoidance. There is a good case for restricting this abuse where the non-resident trust has a strong UK connection. The definition of a "strong UK connection" would need careful thought. Factors to be taken into account would be the residence of the settlor and beneficiaries and the location of the trust assets.

45. There would be two main ways in which the abuse could be combated:-

a. Where the settlor was resident in the UK he could be taxed on the whole (or at least some) of the trust's worldwide income and gains as they arose.

b. In other cases, liability would only arise - as at present - when a UK resident beneficiary received a payment. But the advantages of deferment could be reduced by charging interest on the tax due. Interest would run from the time when the trustees received the income or gains used to fund the payment.

46. There would need to be transitional provisions for existing trusts. A regime on these lines would not be harsh by comparison with those of many major countries.

47. There are other possible changes which would also justify careful examination such as:-

- introducing a CGT exit charge for trusts emigrating from the UK

- tightening up the existing provisions which apply when a UK resident beneficiary receives a capital payment from a non-resident trust, and

- clarifying the effect of the existing legislation on foreign entities similar to trusts.

Timing

48. It would not be possible to examine these issues properly in time for legislation in 1989. Some changes in the taxation of non-resident trusts may be introduced as a

consequence of the consultative document on residence, if it is decided to remove the concepts of domicile and ordinary residence. Firm conclusions on other aspects of their taxation cannot be reached until decisions have been taken on:-

a. The taxation of individuals following the consultative document, and

b. The taxation of UK resident trusts.

49. Moreover, any new system will - like the current one - be subjected to sophisticated attempts to get round it. The issues are complex and careful study will be needed to ensure that any changes are worthwhile and effective.

50. If it was decided to change the tax liability of non-domiciled UK residents, non-resident trusts might be used to get round the new basis. Short term measures might then be needed to protect the position while a full review was carried out. However, if any legislation in 1989 was limited to changes to the residence rules themselves, no action on non-resident trusts would be required solely on that account.

E. ESSENTIAL CHANGES

51. There are three areas in which we advise that more limited action is urgently needed - either to complete the 1988 reforms or to resolve the problems caused by the Dawson decision mentioned in paragraph 4. These are described briefly in the following paragraphs. In each case, legislation in the coming Finance Bill would be desirable. Outsiders will want to know what is proposed as soon as possible. Delay could result in complaints that inequities were being allowed to continue or in a loss of tax.

52. In some cases, however, legislation in 1989 might be made redundant or need to be revised in the light of wider changes brought forward in a later year. There is, therefore, a question of whether - despite the pressure for early resolution - all action should be deferred in order to produce a unified package of reforms in 1990. We indicate why, on balance, we consider action on these items is preferable in 1989, whatever Ministers decide about a continuing review of other matters.

Consequences of the covenant reform

53. The tax advantages of non-charitable covenants and similar transfers of income were removed in this year's Finance Act. However, the wealthy can get round that reform by using trusts to transfer income to their spouses, student children etc whilst retaining control of the capital for themselves. The tax at risk is not large but the existence of the loophole has already attracted adverse comment in the press. The Settlements Legislation needs to be tightened up a little. Your announcement specifically warned that this area was being looked at, and promised that any changes would be brought forward in time for the introduction of Independent Taxation.

54. Delaying legislation until 1990 would give taxpayers a lot of opportunity to make settlements that exploited this weakness. And the tax loss would continue for many years unless any new legislation applied to the future income of existing settlements. Although Parliamentary Counsel has not yet been consulted, it may be possible to solve the problem by a small amendment to the Settlements Legislation. We recommend that that should be done in 1989. This would let taxpayers and their advisers know where they stand at the earliest opportunity and leave no doubt that your promise had been fulfilled. If there was to be a continuing review, the change could be accompanied by a commitment to further action in 1990 - to simplify the Settlements

Legislation and, if possible, to identify categories of trust which should be excluded from its scope altogether. The aim would be to take out trusts where they was only a remote possibility of the settlor benefiting - but any major relaxation is unlikely.

Independent Taxation.

55. You announced to the Standing Committee that it was the Government's objective that an outright gift of assets between husband and wife should be recognised for tax purposes (so that the recipient and not the donor would be taxed on the income from the assets). The Settlements Legislation will have to be amended to put that into effect.

56. There is a further, very limited, situation where an amendment to the Settlements Legislation may be needed as a result of Independent Taxation. Certain statutory pension schemes (such as the Principal Civil Service Pension Scheme) allow, say, a husband to allocate part of his pension to his wife. She can then start to receive a pension during his lifetime. The law needs to be changed so that her pension is not taxed as the income of the husband.

57. Generally we are looking at the opportunities for husband and wife to gain a tax advantage under Independent Taxation. This is another aspect of the review that you specifically announced in Standing Committee. We have not yet identified any areas where we think urgent legislation is needed (apart from the abuse of trusts described in paragraph 53 above). But if we do so in the next few weeks we might need to come back to you with further proposals.

58. It would be undesirable for any legislation or further announcement on these matters to precede the corresponding action on paragraph 53. If it did, there would be problems because people would then want to know what was being done

about the use of trusts to transfer income from husband to wife. However, if you agree that action on trusts is needed in 1989, any legislation on these other topics should be brought forward at the same time. That would not prejudice other aspects of the review.

The Dawson case

59. There is no statutory test for deciding whether trustees are resident in the UK for income tax purposes. The taxation of mixed residence trustees - where at least one trustee is resident in the UK and at least one is not resident - is now wide open to abuse. This is because the Court of Appeal has decided (in the Dawson case) that mixed residence trustees are neither resident nor non-resident. This means that much of their income falls outside all UK tax legislation. We are appealing to the House of Lords, but the appeal is unlikely to be heard before the 1989 Finance Bill and our chances of success seem poor. Legislation is needed to resolve the position.

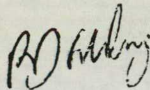
60. The Dawson decision has also highlighted the fact that the current practice for assessing trustees - including ones who are wholly resident - is wrong in law. That practice should be given statutory backing.

61. There could be a considerable loss of tax if swift action is not taken on the residence status of trusts. We cannot quantify the tax at risk precisely because we do not know to what extent people would be prepared to make the kinds of investment needed to exploit the opportunities provided by the Dawson case. But the tax lost could easily exceed £10m and the maximum potential loss is considerably more.

62. Legislation on the assessing procedures for trustees is not quite so urgent, but we suggest that both aspects should be tackled at the same time. This is because both problems

have a common source and need a similar approach to their solution.

63. Legislation in the coming Finance Bill is unlikely to prejudice other aspects of the Review. The topics are fairly self-contained and legislation would be designed to restore the position to substantially what it was thought to be before Dawson. Moreover, such action is unlikely to be rendered obsolete by wider changes in 1990, because any new regime will almost certainly require a definition of the residence status of trusts and provisions for assessing trustees.



R GOLDING

Question proposed, That the clause, as amended, stand part of the Bill.

Mr. Arbuthnot: The clause has one unfortunate effect, and my concern is shared by my hon. Friend the Member for Taunton (Mr. Nicholson). If all the income of a trust is subject to an interest in possession, the additional rate will not apply. If all the income is to be applied at the discretion of the trustees, the additional rate will apply, which is right and proper. The trouble is that if some of the income is discretionary, or if the income is discretionary for only a part of the year, under the clause the additional rate will apply to all of the income for all of the year, despite the fact that there is an interest in possession in the rest of the income. There may be an interest in possession in the majority of the income.

My fear is that that effect will cause people to set up a large number of different settlements. Such fragmentation would be a pity and would not be particularly sensible. I ask the Financial Secretary to look at the problem which has been raised by a number of different bodies to see whether an answer can be found.

Dr. Marek: One of the problems is that if there is to be a pro rata division in a trust depending upon whether it is discretionary, a lot more accountants may be employed and may make things very difficult by trying to enlarge one part of a trust at the expense of another. Although I see the sense of the argument I wonder whether it is practical.

Mr. Lamont: I do not think that I need dwell on the general purpose of the clause. My hon. Friend the Member for Wanstead and Woodford (Mr. Arbuthnot) has asked about mixed settlements. I believe that he is complaining not that the provisions are unfair but that they will create an incentive for the fragmentation of trusts, which he thinks will be an undesirable and expensive development.

We have also received a large number of representations about the way in which the additional rate is to apply to all the gains of mixed settlements.

Concern has also been expressed about mixed settlements for children in which older children may be non-discretionary beneficiaries and younger children discretionary beneficiaries. This is a very complicated subject, as my hon. Friend the Member for Wanstead and Woodford will know from his professional experience. I am afraid that it is not possible to make changes this year, but because we have received so many representations about the matter, we shall certainly look into it in the coming year.

We shall be looking at a number of aspects of the tax regime for trusts in the light of the Budget changes. On the capital gains anti-settlor provisions, we shall look at both the potential for avoiding the higher rate charge on gains of settlements set up for the settlor's children and, as a separate matter, gains of non-resident settlements which are outside the scope of the new clause and schedule. This will be as part of a considered wider review of trusts over the coming year which will include the capital gains treatment of mixed settlements with discretionary and non-discretionary beneficiaries.

Other representations have asked about the effect under independent taxation of existing legislation that applies to the income arising from trusts and other settlements in certain circumstances when the person making the settlement—the "settlor"—or the settlor's husband or wife retains an interest in the settlement. A particular question which we have been asked and which may interest the hon. Member for Wrexham is whether, under independent taxation, income from outright gifts of assets between husband and wife could be affected by these provisions. There is also a wider issue of how these "settlements provisions" now fit in with the changes that we have made this year to end tax relief on transfers of income between individuals, generally by means of covenants.

Looking at the special position of husband and wife, where one partner in a married couple makes an outright gift of assets to the other, our objective is that that should be recognised for tax purposes, and that the recipient and not the donor should be taxed on any income that arises from the assets after the transfer has occurred. But the position is different where arrangements fall short of an outright transfer of both income and capital from one partner to the other. Where, for example, a husband seeks to divide his income from the underlying capital and to transfer only income to his wife, while retaining control over the capital, we see no reason why couples should enjoy a tax advantage from arrangements of that kind.

As hon. Members may understand, the major changes that we have made this year, both in the taxation of husband and wife and in the ending of tax relief for covenants, have fundamental implications for the highly complex existing provisions which are designed to ensure that individuals cannot obtain a tax advantage by arrangements designed to transfer income to others. It may be that, as some have suggested, there are some aspects where the present law is now too wide, and others where it may be too narrow. We shall also therefore be looking at the law in this area to see whether it achieves our objectives. If any changes are found to be necessary, we shall bring them forward in time for the introduction of independent taxation. I hope that those affected will bear that possibility in mind when considering how the existing law applies.

We shall, therefore, be standing back and looking at a number of aspects of the income and capital gains tax regime for settlements. I think that I have answered a number of the points that the hon. Member for Wrexham raised earlier.

Question put and agreed to.

Clause 94, as amended, ordered to stand part of the Bill.

Clause 95

UNDERWRITERS

Question proposed, That the clause stand part of the Bill.