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PART B

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PART. B.

1989 BUDGET
STARTER.

THIS FOLDER HAS BEEN
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REGISTRY SYSTEM

CLOSED

SF62FST.42 CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 28 November 1988

CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mrs Chaplin
Mr Tyrie
Mr Pitts - IR
Mr Jaundoo -IR
PS/IR

Ch./
Agree FST that there should be legislation?
29/11

Agreed.

INHERITANCE TAX - INSTRUMENTS OF VARIATION

I have discussed Mr Jaundoo's minute of 14 November with officials.

I believe that we should legislate in this area. The present arrangements whereby beneficiaries of a death estate can rearrange their affairs within two years of the death so as to secure a tax advantage is an unnecessary loophole in the tax system. And as a result of the abolition in 1986 of an immediate charge on lifetime transfers, this loophole is increasingly being exploited. We should take steps to block it now.

The provisions would still apply for rearrangements either ordered by the Court in order to make adequate provision for dependents, or made out-of-Court but to the same end (Mr Jaundoo's paragraphs 29(a) and (b)). This would relieve genuine situations of hardship for the surviving spouse.

NORMAN LAMONT

chex.ps/jmt/40 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 30 November 1988

PS/FINANCIAL SECRETARY

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

Mr Pitts - IR
Mr Jaundoo - IR
PS/IR

INHERITANCE TAX - INSTRUMENTS OF VARIATION

The Chancellor has seen the Financial Secretary's note of 28 November. He agrees with the Financial Secretary's conclusion that there should be legislation in this area.

J M G TAYLOR

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: J D HINTON
DATE: 1 DECEMBER 1988

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

This is the first paper foreshadowed by my submission yesterday to the Chancellor. The second (on personal pensions) should follow tomorrow. JK 1/12

Indexation of the cap is dealt with in paras 13-18. That was written before your enquiry today about the 20 year effect. We shall let you have a separate note on that. But at first sight, the proposal for price indexation plus an override looks a reasonable solution. GWb 1/12

STARTER 153: OCCUPATIONAL PENSION SCHEMES

1. This note deals with the main issues arising from the proposals relating to occupational schemes. In particular:

   i. it considers the operation of the earnings cap on benefits;

   ii. it looks at some possible simplifications of the tax regime; and

   iii. it puts forward options on transitional issues.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir T Burns
Dame Anne Mueller
Mr Scholar
Mr Culpin
Mr Luce
Mr Riley
Mr Gilhooly
Mr Dixon
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Loades - GAD
Mr Jenkins - Parliamentary Counsel
Mr Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Cayley
Mr Newstead
Mr Lusk
Mr Eason
Mr Kuczys
Miss Dougharty
Mr Hinton
Mr Gilbert
PS/IR

The earnings cap

2. The main features of the core package for pensions will be to remove the link between tax privilege and total pensions and to define the limits of tax privilege. There will be two constraints on tax privileged pensions, as follows:

   i. their accrual will be governed by the present 20 year accelerated accrual rules; and

   ii. a tough cap (£60,000) will be imposed on pensionable earnings.

3. The first question for decision is how the earnings cap should work. In particular, should it apply across the board to all employments (a global cap) or should it operate by reference to particular employments?

4. A precedent for an earnings cap on benefits is the £150,000 ceiling on lump sums introduced last year. That legislation applies the ceiling to the benefits under a particular occupational scheme. It does not apply globally. This does not, however, mean that a person can get a series of £150,000 lump sums because the accelerated accrual rules require the scheme to take account of benefits from previous jobs - thus keeping the aggregate lump sums within 1.5 times final salary.

5. The accelerated accrual rules for pensions operate in the same way. This limits the maximum tax privileged pension to two thirds of final salary. If the total pension from previous jobs and with the final employer would exceed two-thirds, the last employer must cut back on what his scheme may provide (although it is not normally necessary to cut back below a pension accrual rate of 1/60 final salary). The tax rules for occupational pensions - unlike the personal pensions rules - therefore have an in-built control on total benefits.

6. On the other hand a global cap, although logical, would raise practical problems. In particular:

i. A cap which covered all employments might mean that a later employer could give no tax privileged benefits at all. For example, where accelerated accrual benefits had been given in a previous job on the basis of £60,000 earnings. (At present the final employer can always give benefits of 1/60 final salary for each year of service).

ii. It would also be difficult to enforce as employers would not generally know the exact benefits a previous or concurrent employer was providing. This would produce a similar problem for occupational schemes as now applies with the personal pensions lump sum cap - which for practical purposes can only bite on a "per arrangement" basis.

7. Whatever earnings cap is adopted for pensions will automatically set the ceiling on lump sum benefits. If the earnings ceiling is set at £60,000 the maximum lump sum will become £90,000 (compared to the present £150,000). Here again, it will be sensible to follow - as a matter of consistency - the approach taken last year and apply the new cap to earnings from a particular employment.

8. The rules would have to relate the cap to the aggregate benefits from schemes of "associated" employers. This will be needed to prevent people from getting round the cap through a series of artificial employments with, say, different companies within a group.

9. Subject to that reservation, the practical difficulties of a global cap, together with the precedent set in 1987 in relation to the earnings cap for lump sum benefits, point to

a pensions cap related to particular employments as being the best approach.

Level of the cap

10. At the meeting of 26 October the Chancellor was inclined towards a tough cap which would limit tax privileged pensions to earnings up to £60,000. At this level it would affect some 50,000 people. This figure has been derived from the pay of those sampled in the Survey of Personal Incomes in 1985-86 projected forward to the current year using Department of Employment figures for the growth in earnings and Treasury projections of earnings for 1988-89. Pay excludes fringe benefits and expenses but includes the annual salary received by directors. Clearly the projection process includes some margin of error, but we would expect the numbers of people affected to be accurate to within 10,000.

11. Alternative earnings ceilings could be £90,000 or £100,000. But these would affect only 15,000 and 10,000 people respectively. Consequently the higher the limit the more marginal the impact will be on tax privileged pensions.

12. A decision on where the cap should be set is a matter for Ministers' judgement. But the decision to allow non-tax privileged topping up strengthens the case for a relatively tough limit on tax privilege. A tough cap could also pave the way (without opening the doors to abuse of the tax rules) for simplifying the present occupational pensions regime - possible simplifications are considered at paragraphs 17-35. For this reason we would recommend an earnings cap of £60,000.
AWK

Indexing the cap

13. With a cap on the lump sum alone (ie the present position) it has been possible to leave the question of uprating to be decided from year to year, as and when. This is because any reduction in the real value of the

lump sum part of the benefits would increase the size of the pension. But this will no longer necessarily be the case when pension benefits themselves are capped. It will therefore be necessary to make some provision for indexation.

14. There are a number of options. The first (Option A) would follow present convention for personal allowances and round up year by year in line with rises in the cost of living, perhaps to the nearest £1000. But the disadvantage with this approach is that it applies the inflation adjustment to the previous year's rounded up ceiling. This produces an "upward creep" which would, over time, lead to the increase in the cap outstripping the rise in the RPI.

15. An alternative (Option B) would be to index by reference to increases in prices since 1989 (again rounded up to the nearest £1000). As the base for each year's indexation would be the original ceiling of say, £60,000, increases would be broadly kept in line with movements in prices since 1989. This option avoids the problem of actual increases being well above price inflation - which is a feature of the conventional year by year system.

16. One effect of automatic prices indexation is that the earnings cap would soon result in the maximum benefits becoming awkward amounts. For example, with an earnings cap of £67,000, the maximum pension would be £44,666.66. If it was felt desirable to avoid this, the solution would be to round to the nearest £3000 (Option C). Under this option, if it operated by reference to the cumulative increase in prices, the cap would increase each year unless the rate of inflation was less than 2.5 per cent. An illustration of the effect of each option is at Annex A.

17. Mr Culpin has suggested a further option - indexing the pension cap but not the lump sum cap. This could be done, if Ministers wanted the tax free lump sum to wither away over time - which would not be consistent with the assurances you gave during the debates on the 1987 package.

Moreover capping each type of benefit separately is not so straightforward as capping earnings. (It would also give the wrong result for public service schemes. Because they give separate pension and lump sum benefits a £40,000 cap on pensions (excluding the lump sum) would be too high in comparison with a £40,000 cap on pension before commutation, which is what a £60,000 ceiling on earnings implies.) Because of these factors we could not recommend this approach.

18. Whatever option is decided upon it will be best to keep in reserve a power to override the automatic indexation of the ceiling. This will enable either the ceiling to be kept at the previous year's level (if in any year that seemed appropriate) or to rebase the ceiling at some new (higher) level. Indexation on Options B or C would then, of course, operate from the new base.

Simplifying the tax regime

19. The present Revenue rules for pension schemes have developed over time. They now form a complex code which is applied by the Superannuation Funds Office through discretionary powers conferred by the present legislation. Although this creates scope for argument it has generally operated well and enabled the Revenue to respond flexibly to developments in pension provision. But with the introduction of non-tax privileged pensions (providing benefits in excess of normal limits) it will be necessary for all concerned to know the exact parameters of tax privilege. It will, therefore, no longer be appropriate for maximum (tax privileged) benefits to continue being a matter for the Revenue's discretion.

20. A tough (£60,000) earnings cap will restrict the scope for manipulation of the present tax rules. This could pave the way for some general simplifications in the present benefit limits. But it will still be possible for controlling directors and some senior executives to dictate their benefit package. There is, for this reason, no case

for simplification which would lead to a general relaxation of the present rules. But there are some areas where changes could be made. These are considered below.

- pension benefits

21. There is little pressure for improving the overall two-thirds benefit limit at the normal retirement age chosen by the scheme. Most employers are content with them, and would not want to pay more for the pensions of most of their employees. In addition the present limit (and the twenty year accelerated accrual rules) are easy to comprehend. But if an employer did wish to go beyond the limits, the move to decouple tax controls from maximum pensions will allow them to do so (without tax privileges).

22. Where benefit limits do commonly come under pressure is at the intermediate stages - for example, early retirements and early leavers. (An outline of these limits is at Annex B). As that Annex shows, on early retirement the normal two thirds limit is proportionately reduced. This tends to give rise to much dissatisfaction as the restriction is often thought of as unfair and arbitrary by those it affects. For example, a person who retires early after completing 20 out of a possible 21 years service will have his benefits cut back. But his colleague who completes the same 20 year service at normal retirement age could have a full two thirds benefit.

23. As part of the 1987 package of measures, the Budget Day Press Release announced that we would be looking for ways to relax the present rules on early retirement pension benefits. With Ministers' agreement a discussion paper was circulated to the pensions industry late last year. But further developments have been held up pending decisions, first on Mr Byatt's ideas and subsequently on the present reforms. The discussion paper put forward a number of options for easements to the present early retirement rules. But they did not propose simplifications.

24. With the protection of a tough cap, it would now be possible both to relax <u>and</u> to simplify the present intermediate limits. For pensions the effect would be that the maximum benefits at normal retirement age (ie a two thirds pension subject to completion of at least 20 years service with the final employer) would also apply at the intermediate stages. A more detailed outline of the proposal can be found at Annex C.

25. This simplification would mean no change for people who retire at the scheme's normal retirement age - for them the present rules will continue to apply. But the present proportionate cut back will be removed for people who retire early (whether voluntarily or due to redundancy). This change would meet the complaint against the present rules described at paragraph 21 above.

26. The change would also meet the point made to the Chancellor this year by the Group Managing Director of Next plc (who wanted to set a normal retirement age of 55 for their senior executives). In so doing it would distance the Revenue from imposing, through the tax rules, on employers like Next, behavioural patterns different from normal commercial considerations. But the weakening of the concept of a normal retirement age of 60 or more for men might increase pressure to make corresponding changes to the CGT retirement relief rules. Ministers decided against reducing the qualifying age in the run-up to the 1988 Budget. Nonetheless the proposal for simplification does not introduce a <u>new</u> option for retirement at age 50 or later; it just enhances the benefits that may be given.

27. It is difficult to estimate the number of people that this simplification will affect, or its cost. There are no statistics available to show the number of early retirements which are caught by the present rules. But as it has only a limited impact we believe that its cost would be negligible.

28. If you consider this change to be worthwhile, it could usefully be made an integral part of the Budget package.

For those affected it is a real relaxation and it will be welcomed by the pensions industry. But, as we only feel able to recommend this change in the context of a tough cap on tax privilege, we would recommend that it be available only to those affected by the new regime. In other words, people must take the changes as a whole, not pick & choose the bits that suit them

29. Some further work still needs doing on the fine detail of the proposal. And as, in so far as early leavers' benefits are concerned, it interacts with social security preservation legislation we would like, if you are content, to discuss the proposal in confidence with DSS officials - but without of course telling them about the rest of the package.

- lump sum benefits

30. In addition to a cap on the lump sum (which will follow that for pensions), the one last loophole for maximising the (tax free) lump sum at the expense of the taxable pension ought to be closed. We propose that this be done by requiring that the same definition of final salary be used for calculating both pension and lump sum benefits.

31. Although this connection between the lump sum and the pension should be straightforward for most final salary schemes, it becomes complicated if the member has paid AVCs or the scheme gives money purchase benefits. The point is illustrated in the following example:

Example

The member has completed 20 years service. The scheme provides a pension of 1/60 of basic salary for each year of service.

Basic salary at retirement	=	£6000
average gross earnings	=	£9000

Scale benefit 20/60 x £6000	=	£2000
AVC pension	=	£ 800
Total scheme pension	=	£2800
Revenue maximum pension (2/3 x £9000)	=	£6000

1. If the only benefits the member received was his scale pension, his lump sum would also be based on £6000.

2. As AVCs have been paid which enhance benefits above the scale pension but below the Revenue maximum pension, there is no clear earnings level on which benefits have been based.

32. This example shows the difficulty of requiring an earnings link in cases where AVCs have been paid. But the position is even more awkward where occupational schemes operate on money purchase principles. In these cases, final salary has no real meaning other than to establish the maximum benefit payable under the tax rules.

33. But an alternative way of achieving the aim will be to make the maximum lump sum a multiple of 2.25 times the pension before commutation. This would give a similar result to the present rules. But it is far simpler than the present rules for calculating lump sum benefits (see the formula at paragraph 2 of Annex D) and as the lump sum is tied to the amount of the pension, it cannot be manipulated.

34. There are, however, two points. First, some less generous schemes of long standing - such as for workers in the building industry - give only lump sum benefits, on the 3/80ths formula. And this approach does not tie in with the separate pension and lump sum schemes found in the public sector. We would therefore recommend that an underpinning lump sum of 3/80 final salary for each year's service continue to be allowed.

35. The second point is that where service is less than 20 years the accelerated accrual rules for lump sums are less generous than for pensions. For example, accelerated accrual does not commence until after 8 years service has been completed and does not equal the pensions rules until the 20th year. The options will be to leave the present accelerated accrual rules as they are (see Annex D) or to allow even accrual of the lump sum in line with accrual of the pension. The 2.25 times pension multiplier will then ensure an appropriate link between the two parts of the retirement benefit package.

36. To leave things as they stand would introduce a complexity to an otherwise simple formula. But to make a change would carry some cost as it would increase the value of the lump sum (at least for people with fairly short service). We recommend simplicity, despite the cost

Transitional matters

37. There are two broad choices for transitional measures for occupational pensions:

- to preserve entitlements to benefits at present salary levels; or

- to follow the 1987 precedent and apply the changed rules to new schemes/new members only

- i. Preserve present salary entitlements

38. The idea would be to shorten the transitional period by applying the new rules as and when people reach the earnings level limits in the future. But for those whose earnings already (at Budget Day) exceed the limit their protected entitlements would be frozen at that level. The following examples illustrate how it might work:

Example 1: Current salary £55,000. On Budget Day the employee would be unaffected by the change. It would be possible to pension through the tax privileged scheme further earnings until the £60,000 earnings figure is reached.

Example 2: Current salary £65,000. So long as the employee stays in the current scheme, earnings up to £65,000 can be pensioned with tax privileges (even though the normal limit is £60,000). But no additional tax privileged benefit can be gained from pay increases. And if the employee leaves to join another employer's scheme, the £60,000 limit will bite immediately.

39. The possibility of adverse job mobility effects from the situation shown in example 2 cannot be ruled out. Unless the individual on change of jobs could carry a "reserved right" to his new employment, he might feel reluctant to make a move. But reserved rights would be impossible to administer. Nonetheless, subject to this drawback, the approach has its attractions. No one will have their accrued pension rights diminished and it avoids lengthy transitional periods before the full effect of the changes comes through.

40. There are, however, some other serious drawbacks. In particular most people are members of final salary schemes and are promised benefits by reference to their earnings close to retirement. So, although they are protected on current earnings (or on earnings up to £60,000), to the extent that they had an expectation of a pension based on future earnings they will suffer a diminution of benefits. This option is not therefore immune from charges of retrospection.

41. It is also more complex, as the "protected" earnings will vary from person to person and not be set at a standard figure. This will complicate record keeping for pension schemes and increase the administrative burden of complying

with the tax rules. There will also be the question of determining what "earnings" means - for example is it actual earnings over a 12 month period or the current annual rate of pay? In addition, many people in this group will be in receipt of bonuses or commission which, although relating to the pre-Budget Day period cannot be quantified until sometime later.

42. There is then the question of how this approach will affect the lump sum entitlements. If the same approach is applied to lump sums as to pensions, it would catch people who in 1987 were given protected rights (and so not subject to the £150,000 limit). There is a risk that catching these people could lead to accusations of retrospection. Although only a small portion of the working population would be affected, they are likely to be the most articulate and vocal in protecting their existing rights. On the other hand, to have more generous transitional provisions for the lump sum than for pension benefits would look very odd indeed.

43. The problems connected with transitional arrangements which preserve entitlements to benefits at present salary levels make this option look very difficult. It might be a runner if the numbers affected by the proposed package were very small (perhaps, if only those earning over £100,000 were caught), and if Ministers were prepared to face down charges of retrospection. But with changes that bite at earnings of £60,000, the administrative burden on pension schemes of this approach would be significant. There is a real danger of the reception of the overall package being soured as a result.

- ii. 1987 approach

44. The alternative is to follow the 1987 precedent and apply the changes only to new schemes and new members of existing schemes. This will produce a "three tier" pension regime which would consist of:

a. pre-1987 members;

b. members who joined between 1987 and 1989; and

c. post-1989 members.

45. This too will have a complicating effect for pension scheme administrators which would have to be defended by reference to the alternative - to backdate the changes to 1987.

46. Although theoretically this three-tiered approach involves a very long transitional period of up to 40 years, we would in practice expect the majority of pension scheme members to become subject to the new rules much more quickly than that. This is because the measures which will be introduced should not have a serious impact on job mobility (because of decoupling). Moreover (again through decoupling) any senior executives who felt locked-in by the 1987 changes may no longer be so reluctant to change employers.

47. The proposed package does not have any significant impact at lower earnings levels and so it is reasonable to expect normal employment patterns to continue. In order to gauge the likely timescales, we have undertaken some work to estimate the effect of job changing on the transitional period. This suggest that if the transitional measures followed those of 1987, 25 per cent of those potentially caught will be subject to the new rules after 3-4 years, 50 per cent within 7 years and 75 per cent after 15 years.

48. This suggests that the Exchequer consequences of generous transitional measures are not so severe and that the longer period before the measures take effect is a price worth paying to prevent souring the whole package. And on balance, this is the approach we would recommend.

Conclusion

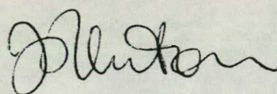
49. We should be grateful for your decision on:

- how the earnings cap should work (we recommend that it should be applied to employments, with related employments aggregated);

- how indexation should work (we recommend Option C: no "upward creep" and rounding to the nearest £3,000);

- whether the rules should be simplified as we suggest, for pensions and lump sums; and

- what form the transitional rules should take (we recommend the 1987 approach).



J D HINTON

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ANNEX A

INDEXATION OF THE EARNINGS CAP

1. The table below illustrates the impact of three possible options:

<u>Option A</u> involves rounding up (to the nearest £1000) year by year in line with increases in inflation. Each year's increase will be applied to the previous year's threshold.

<u>Option B</u> cumulatively applies the inflation increase to the original earnings cap (again by rounding up to the nearest £1000).

<u>Option C</u> is similar to Option B. But the threshold is rounded (up or down) to the <u>nearest</u> £3000. This avoids the "upward creep" inherent in option A and keeps the maximum tax privileged pension and lump sum at round figures. (ie At earnings of £69,000 a two thirds pension would be £46,000 and a 1.5 times final salary lump sum of £100,500).

2. The rise in the cost of living is assumed to be 5 per cent each year. The initial earnings cap is taken as £60,000.

Year	Option A	Option B	Option C
	£	£	£
1989	60,000	60,000	60,000
1990	63,000	63,000	63,000
1991	67,000	67,000	66,000
1992	71,000	70,000	69,000
1993	75,000	73,000	72,000
1994	79,000	77,000	75,000
1995	83,000	81,000	81,000
1996	88,000	85,000	84,000
1997	93,000	89,000	90,000
1998	98,000	94,000	93,000

ANNEX B

OUTLINE OF PRESENT BENEFIT LIMITS FOR OCCUPATIONAL PENSIONS

These limits are founded on the concept of a "normal retirement age". This is the age at which, under the rules of a particular scheme, the maximum approvable benefits may be paid. If benefits fall due before that age they are scaled down; if they come into payment after that age they may be increased. The normal limits are as follows:

A. At normal retirement age (ie 60-70 for men, 55-70 for women)

The better of:

i. A pension of 1/60 of final salary for each year of service with an employer, up to 40 years to count (ie a maximum of two-thirds). On this basis there is no need to take account of benefits from previous jobs; or

ii. A pension of 1/30 final salary for each year of service, up to 20 years (accelerated accrual). But then benefits from previous jobs must be taken into account and scheme benefits cut back to keep the total within the two thirds limit.

B. On early retirement (ie before normal retirement age)

The better of:

i. A pension of 1/60th final salary for each year of service, up to 40 years, or

ii. An amount calculated on the formula N/NS x P, where:

N is the number of actual years service completed at retirement;

NS is the number of potential years service to the normal retirement age for the scheme;

P is the maximum pension that could have been paid by reference to potential service. Any restriction for retained benefits from previous jobs must be taken into account.

C. Early leavers

The limits on an early leavers benefits are broadly the same as for early retirement. The position is a bit more complex because of the effects of DSS preservation legislation. Their (statutory) rules override the Revenue's (discretionary) ones, so in some cases - particularly money purchase schemes - preserved benefits may exceed the N/NS x P formula.

ANNEX C

OPTION FOR SIMPLIFICATION

OPTION

The Inland Revenue benefit limit for pensions should be the better of:

A. 1/60 final salary for each year of service, up to 40; or

B. the lesser of

i. 1/30 final salary for each year of service up to 20, and

ii. 2/3 final salary less retained benefits.

For lump sum benefits the limit would be the better of:

A. 3/80 final salary for each year of service, up to 40; or

B. 2.25 times the amount of pension before commutation.

Service

Would be service with the present employer.

Benefits at normal retirement age and on early retirement (aged at least 50)

These will be the better of A or B above. This gives benefits no worse than now and for early retirers the benefits will gain from the absence of an N/NS restriction.

Late retirement

The justification for late retirement enhancement is anomalous and would seem inappropriate following a move to more flexibility in retirement. This will need further thought, but for now the limit could still be the better of A or B above based on final salary at retirement.

Normal retirement age (nra)

This is still required as a funding target, but it could become anything in the range 50 to 70 (broadly as for personal pensions). As there will be no difference between early and normal retirement benefits the relevance, for tax purpose, of nra's will solely be for funding purposes. This would also help distance Revenue rules from what schemes have to do under the EC Equal Treatment Directive, ie a common retirement age for the sexes.

Final Salary

Present definitions would apply.

Early leavers

The limits at A or B would apply (increased to payment date in line with inflation). This should ease the strain between Revenue limits and preservation legislation.

Funding

Unlikely to be any simplification, but consistent with present surpluses legislation.

FSAVCs

Should increase the scope for contributions - make it easier to fund through AVCs for early retirement.

Cost

Difficult to estimate, but as only early retirements/early leavers get a better deal it is likely to be negligible.

Transition

Should be an integral part of the 1989 Budget package available only to new schemes/new members. Might help shorten transition period.

Rules

Should be left to schemes to choose to switch from old rules - especially if part of Budget package.

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ANNEX D

ACCELERATED ACCRUAL OF LUMP SUM BENEFITS

1. For employees who cannot complete 20 years service with their final employer, the maximum accelerated accrual lump sum which may be paid is derived from the following table:

Year of service	80ths of final salary
1 to 8	3 for each year
9	30
10	36
11	42
12	48
13	54
14	63
15	72
16	81
17	90
18	99
19	108
20 or more	120

2. For members who joined on or after 17 March 1987 the above table applies subject to the following formula where total benefits are less than the maximum:

$$\left[\frac{A - B}{C - B} \times (D - E)\right] + E \text{ where:-}$$

A. is the scheme pension payable before commutation or retained benefits.

B. is a pension of 1/60th of final salary for each year of service before any deductions as at A. above.

C. is a pension equivalent to 1/30th of final salary for each year of service, not exceeding 20 years, before any deductions as at A. above.

D. is a sum equivalent to the number of 80ths of final salary appropriate for the total years of service as shown above.

E. is a sum equivalent to 3/80ths of final salary for each year of service.

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: J D HINTON
DATE: 5 DECEMBER 1988

This is the third paper in Mr Hinton's series. The next will cover controlling directors

1. MR KUCZYS

2. MR CORLETT

3. FINANCIAL SECRETARY

STARTER 153: FREE STANDING AVCs

1. The Chancellor asked at the meeting on 26 October for further consideration to be given to the treatment of additional voluntary contributions (AVCs) in the light of the overall pensions package.

Background

2. Free-standing AVCs were introduced in October 1987 as part of last year's pension reform package. Their purpose is to give occupational pension scheme members a greater

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir T Burns
Dame Anne Mueller
Mr Scholar
Mr Culpin
Mr Luce
Mr Riley
Mr Gilhooly
Mr Dixon
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Loades - GAD
Mr Jenkins - Parliamentary Counsel

Mr Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Newstead
Mr Lusk
Mr Eason
Mr Kuczys
Mr Fraser
Mr M J Hodgson
Mr Toye
Mr Miles
Miss Dougharty
Mr Hinton
Mr Gilbert
PS/IR

choice in the investment of voluntary contributions. Hitherto, people had been restricted to whatever mode of investment was offered by their employer's pension scheme — if it offered any scope for AVCs.

3. But even though free-standing AVCs are taken out with an independent provider, they form an integral part of the member's occupational pension benefits. For this reason aggregate contributions by the member to the AVC arrangement and the occupational scheme have to be kept within the normal 15 per cent of earnings limit. And, at retirement, benefits from all sources have to be combined to check that the two thirds limit on occupational pensions is not exceeded. In other words free-standing AVCs are not, for tax purposes, personal pensions.

The problems

4. It has always been recognised that the administration of free-standing AVCs was likely to be a cause of difficulties - in particular the complications involved in bolting free-standing AVCs onto the existing occupational pensions tax regime.

5. The main difference between free-standing AVCs and the "in-scheme" arrangements previously on offer is the introduction of an independent provider. In other respects the initial checks and ongoing monitoring involved is little different from what occupational schemes have always had to do. But it is the bringing in of a third party - or a number of them if the member has more than one free-standing arrangement - that has made the position more complicated. In practice, these difficulties have been somewhat greater than had been presumed when this new pensions choice was being devised two years ago.

6. As a result, although some occupational schemes are co-operating fully with free-standing AVC providers others are not. In particular there have been a number of complaints from pension scheme members about difficulties

they are experiencing in taking out free-standing AVCs. The main obstacles created by employer's schemes are:

i. delay in providing the necessary information;

ii. high charges for information and confirming that a proposed contribution is acceptable; and

iii. in one case, outright refusal to provide information.

7. In order to get round these obstacles, we have encouraged free-standing AVC providers to standardise their information requests. We have also discussed with the Department of Social Security the possibility of some alterations to their disclosure of information Regulations so that scheme members will have a statutory right to information.

8. But although these steps should help, they do not deal with one of the fundamental issues which troubles employers' schemes. The one point above all others which rankles with them is the requirement that if the total benefits at retirement exceed tax approval limits, it is the benefits under the employer's scheme which must be cut back. Employers consider that this requirement puts them in an invidious position. At worst it could undo all the industrial relations benefits they believe they gain from running a pension scheme, at considerable expense.

Impact of the core package

9. The main features of the recommended core package of pension measures are:

i. the removal of the link between tax privilege and total benefits;

ii. the retention of the present 20 year accelerated accrual rules for maximum benefits; and

iii. the introduction of a tough (£60,000) earnings cap for tax privileged benefits.

10. These measures will have little direct bearing on the free-standing AVC problem. Generally, the free-standing AVC problem has affected ordinary scheme members rather than those very high earners at which the core package is directed. The problems are therefore likely to continue and a separate solution needs to be found.

Possible solutions

11. There are a number of possible approaches which could be followed. A minimalist approach would involve doing no more than preventing employers from blocking free-standing AVCs. This could be done by giving scheme members a statutory right to the information through Social Security legislation. But the DSS do not have enabling powers fully to reproduce the present tax requirements. And if any changes to the tax rules to fit in with Social Security legislation led to more lax controls, there will be a greater risk of excessive benefits emerging - with an increase in cases where occupational scheme benefits need cutting back.

12. There are, however, two more radical options. The first would involve allowing a certain level of contributions to be paid subject to minimal checks (such as whether they were within the statutory 15 per cent limit on contributions) and with no cut back if, at retirement, total benefits prove excessive. Under this approach contributions below, say, 5 per cent of salary or, alternatively, up to £1000 a year, would be excluded from the present procedures.

13. The advantage of this option is that smaller payments would be removed from the present procedures. (Less

information would be required for these payments and it should be possible to rely on statutory disclosure of information requirements). An employer could not therefore block these payments.

14. The disadvantage is that it could be used by the better off as a means to provide tax privileged savings on top of maximum occupational pensions. Although this could be minimised by use of a monetary rather than percentage ceiling, this option would remain open to misuse and does not go with the grain of the core package. It would also lead to a two tier administrative system for free-standing AVCs. One would be integrated with the main occupational tax regime but the other would not. This complication could further aggravate the administrative problems for employers. And by weakening the link with occupational pension benefit limits it could lead to renewed pressure for free-standing AVCs to be turned into personal pensions.

15. The second of the more radical solutions would not weaken the link with the occupational pensions tax regime, but would allow excess contributions to be returned to the member less a tax charge. In practice, for consistency, this solution could not be confined to free-standing AVCs but would also need to apply to surplus funds arising under employer sponsored AVC arrangements.

16. The original idea was for a flat rate 40 per cent tax charge on the refund of excessive investments. But when this idea was discussed Ministers considered that such a flat rate would be too rough and ready. Even though the free-standing AVC investment would have benefited from two tax reliefs - tax relief on contributions paid to the scheme and tax free build up of the AVC fund - a 40 per cent charge could be about as high as could be justified for basic rate taxpayers.

17. But, for higher rate taxpayers (who are already paying tax at 40 per cent on their income), there would be no clawback of the tax reliefs enjoyed on the fund build-up.

So, for this group, the tax treatment would still be more generous than for other forms of saving. The result could be that some higher rate taxpayers might be tempted to use free-standing AVCs as a tax efficient general savings scheme in the knowledge that excess funds would be returned. But the Chancellor would be reluctant to re-introduce a tax rate over 40 per cent anywhere in the tax code.

18. We have therefore looked for an alternative approach that would meet Ministers' concerns. Because of the many variables involved - the period of contributions, the investment return, tax rates and so on - it is not practical to impose a tax charge that exactly matches the tax reliefs enjoyed. This possibility was considered during the development stage of the 1986 pension fund surpluses legislation. It was rejected due to the complexities involved in fixing an "individualised" tax rate and because of the amount of extra record keeping that would be involved to ensure that the proper tax rate could be calculated.

19. An alternative would be to impose a special charge on the refund (say at 10 per cent) to broadly compensate for the advantages of the tax free-build up, on top of the individual's marginal rate. This would ensure that basic rate taxpayers were not unfairly penalised and mean that higher rate taxpayers would not use free-standing AVCs just as a tax efficient savings scheme.

20. Rough edges would remain. In particular, the extent to which a surcharge is justified depends on how long and at what rate the tax-free build-up has been taking place, and whether the refund is regarded as consisting of contributions paid many years ago (which will have benefited substantially from the build-up) or those perhaps paid only in the last year or so (which will scarcely have benefited at all). The former assumption might justify a surcharge of up to 15 per cent; the latter one of nil.

21. The recommendation of setting it at 10 per cent represents something of a (reasonable) compromise. But it achieves the purpose of not allowing the higher-rate taxpayer a one-way bet into a new tax shelter. And, in doing so, it follow the same pattern as the charge on refunded pension fund surpluses, which was introduced in 1986.

22. On mechanics, it would, as with the tax charge on refunded pension fund surpluses, be possible for the scheme administrator to deduct basic rate and the special rate tax from the refund. So, if the individual was a basic rate taxpayer, that would be the end of the story - unless it is thought necessary to provide for repayment of the basic rate charge to those not liable to tax at the refund date. If, however, the individual was chargeable at higher rates, the further liability on the refund would be handled by his tax office.

23. Even though this would minimise tax office involvement, some extra work would be generated in dealing with higher rate taxpayers. And because of other pressures on the tax office network - from independent taxation and other changes - whatever system is devised for handling higher rate cases must avoid adding any significant extra burden on them. But as AVCs are normally medium to long term investments, the impact on the network should not be large in the next four or five years.

24. An arrangement along these lines would retain the present concept of tax privileged limits. Benefits from all sources would need aggregation, and if in total they were excessive some cut back would be needed. But instead of the excess funds being lost to the employee altogether, they would be repaid (albeit less a tax charge). This should defuse one of the main employers' objections to co-operating over free-standing AVCs. It could also pave the way for a review of the information and liaison arrangements between employers and providers. But as employers are the only persons in a position to take on a co-ordinating role, the

best that can be aimed for is a reduced administrative burden: it cannot be removed altogether.

Conclusion

25. If Ministers consider that any of the options considered in this submission looks worth pursuit, further detailed work will be needed. We would need to involve the DSS as some aspects touch on matters for which they have responsibility. It would therefore be helpful to have Ministers' views on whether any of the approaches looks attractive:

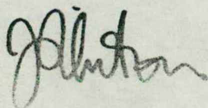
i. just preventing employers from blocking free-standing AVCs, but otherwise leaving the present administrative rules unchanged (paragraph 11); or

ii. allowing free-standing AVCs on-top, if they fall within certain limits; and, if so, relating the limit to earnings or to a fixed monetary sum, (paragraphs 12 to 14); or

iii. returning surplus AVC funds to the member less a tax charge, which is what we recommend, (paragraphs 15 to 24)

and to have

iv. authority to discuss the matter as necessary with DSS (while not, of course, making any reference to other aspects of the package).



J D HINTON

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS

12 DECEMBER 1988

1. MR CORLETT

2. FINANCIAL SECRETARY

STARTER 153: FREE-STANDING AVCs

1. In Mr Taylor's note of 9 December, the Chancellor asks what is proposed, under our recommended option, to deal with the problem of the unco-operative employer.

2. There are two ways (briefly mentioned in Mr Hinton's paragraph 24) in which the proposal would affect employers. First, employers like GEC say that one reason they oppose free-standing AVCs is that, if the AVC investments do better than expected - ie, are very successful - and as a result benefit limits are exceeded, then it is the employer's scheme benefits which have to be cut back. Employers say this puts them in an invidious position. Under the proposal that surplus AVC funds would be returned (less tax) to the member, there would be no need for cutting back main scheme benefits; so employers would no longer have this particular excuse.

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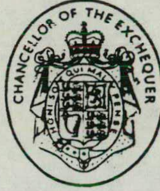
cc PS/Chancellor
Mr Scholar
Mr Culpin
Mr Luce
Mr McIntyre
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)
Mr Loades (GAD)
Mr Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Kuczys
Mr Hinton (o/r)
PS/IR

3. Second, if excessive benefits were refunded, rather than going to waste, we might not need to require quite such elaborate checks that "headroom" was available, before AVCs are paid. We could not remove altogether the need for employers to provide information. But it might be possible to reduce what was required to the point that DSS could give employees a right to the necessary information under their legislation. Then no employer could block an employee from taking out free-standing AVCs.

A W KUCZYS



FROM: J M G TAYLOR
DATE: 9 December 1988

PS/FINANCIAL SECRETARY

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Scholar
Mr Culpin
Mr Luce
Mr Riley
Mr Gilhooly
Mr Dixon
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Loades - GAD
Mr Jenkins - Parly Counsel

Mr Battishill - IR
Mr Isaac - IR
Mr Bush - IR
Mr Corlett - IR
Mr Kuczys - IR
Mr Hinton - IR

STARTER 153: FREE STANDING AVCs

The Chancellor has seen Mr Hinton's note of 5 December.

2. He has commented that the recommended option - returning surplus AVC funds to the member less a tax charge - is ingenious. He wonders, however, what is proposed under this scheme to deal with the problem of an uncooperative employer (cf paragraphs 6-8 of Mr Hinton's note).

J M G TAYLOR

CONFIDENTIAL

RS/12.12

FROM: FINANCIAL SECRETARY
DATE: 12 December 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Scholar
Mr Culpin
Mr Luce
Mr Dixon
Mr Gilhooly
Mr McIntyre
Mr Riley
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Loades (GAD)
Mr Jenkins (OPC)

Mr Corlett)
Mr Kuczys) IR
Mr Hinton)
PS/IR

STARTER 153: PENSIONS (OCCUPATIONAL PENSION SCHEMES AND PERSONAL PENSIONS)

I have discussed the first two of Mr Hinton's papers with officials.

Occupational Pension Schemes

I find the questions at the end of Mr Hinton's note of 1 December reasonably straightforward. I agree that the earnings cap should be applied to employments, with related employments aggregated; and that the rules should be simplified, as the Revenue have suggested, for both pensions and lump sums. I also recommend that the transitional rules should follow the 1987 approach so that the

new rules apply to new schemes/new members only. This is obviously easier politically; but it will also result in lower compliance costs for employers than the alternative approach of preserving entitlements to benefits at present salary levels.

Like you, I believe that the method of indexation of the earnings cap is the trickiest issue. Of the options, C (cumulative indexation of the earnings cap, rounded to the nearest £3,000) and your option AA (indexation each year plus rounding up to the nearest £600) seem best, since they always give round figures for the maximum tax privileged pension and lump sum. I have no strong view on this; but am marginally in favour of option C, since the round figures are round to the nearest £000 rather than to the nearest £00, which makes it easier for clerical staff in employers to calculate that part of the pension which is <u>not</u> tax privileged (i.e. the total less the cap).

I would also like to highlight the read-across to the public sector. Clearly much more work needs to be done here. But my initial view is that I am not readily persuaded of the logic of applying an earnings cap to a pay-as-you-go scheme such as that for the Civil Service.

<u>Personal Pensions</u>

I think it would be unthinkable not to have some limit for personal pensions. Judith Chaplin is concerned that it might be seen as "clobbering" personal pensions only a short while after we have set them up. But the key point is that it would be an earnings cap, <u>not</u> a benefits cap (ie. if the investments in the fund do well, then the beneficiary is not penalised or restricted). I would therefore support the Revenue's general approach, though I would like to explore further the level of the cap and the contribution limits. It is not self-evident that the £60,000 cap should be passed across without amendment; what matters is whether personal pensions offer the same opportunities as occupational schemes for people on comparable levels of earnings.

R.C.M.J.

pp **NORMAN LAMONT**

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

Ch/ Findings summarised on pages 21-23

FROM: S S WILCOX
DATE: 16 DECEMBER 1988

1. MR FRASER

2. MR LEWIS seen - approved in draft

3. FINANCIAL SECRETARY

TAX TREATMENT OF LUMP SUM TERMINATION PAYMENTS TO EMPLOYEES
(STARTER NO: 110)

1. When Ministers were considering in December last year what should be the proper tax treatment of the proposed severance payments to Ministers in the House of Commons (now expected to be introduced in the next session of Parliament) they asked for a review of the tax treatment of lump sum payments to employees on termination of employment. In particular, you asked us to look at whether the proposed severance payments should be exempt; and at the wider question of whether the general rules for lump sum payments should be changed so that only "genuine" redundancies received favourable tax treatment (Mr Heywood's minute of 21 December 1987 refers - attached, top copy only).

Chancellor	Chairman
Chief Secretary	Mr Painter
Paymaster General	Mr Isaac
Economic Secretary	Mr Lewis
Sir Peter Middleton	Mr Ridd
Mr Scholar	Mr Fraser
Mr Monk	Mr Kuczys
Mr Gilhooly	Mr Northend
Miss Hay	Mr O'Brien
Mr Knight - IAE	Mr Hodgson
Mr Ramsden - ST	Mr Boyce
Mr de Berker	Mr I Stewart
Mrs Chaplin	Mr Howland
Mr Tyrie	Mr Wilcox
Mr Jenkins OPC	PS/IR

2. This note examines these issues in relation to the present £30,000 tax exempt threshold available under the special rules applying to ex-gratia termination and redundancy payments. Annex A comments briefly on other tax reliefs and exemptions applying to certain lump sum termination payments.

BACKGROUND

The present law

3. An employee is chargeable to income tax under the general rules of Schedule E on all the pay he receives from his employment. The definition of "pay" is very wide, and includes a lump sum payment if it is derived "from" the employment.

4. For a lump sum payment to be taxable, entitlement to it does not need to be specified in a written contract of employment - although, if it is, that would be conclusive. A charge to tax under the general Schedule E rules can still arise if it can be demonstrated that payment of the lump sum was expected by the employee or that he had reasonable certainty of receiving it. Effectively, such an expectation forms an unwritten term of his contract of employment.

5. Many lump sum payments received on termination of employment are not contractual and nor are they "expected". Often they will be genuinely ex-gratia or will compensate the employee for the loss of some right - for instance, wrongful dismissal or the right to work out a period of notice.

Historical Background

6. Up until 1960, termination payments of this kind were not chargeable to tax because they did not satisfy the basic requirement of being "from" the employment. In 1955 the Royal Commission on the Taxation of Profits and Income recommended that "payments by way of compensation for loss of office should henceforth be treated as taxable income". The

reasoning behind this recommendation was that "the money received.. is not only a fruit of the office .. held, but is directly related to the income which would have accrued to [the employee] if he had rendered his services. Though on a larger scale it is comparable with a payment in lieu of notice, a receipt which should certainly be treated as taxable".

7. By 1960 "golden handshakes" - the term by which very large compensation payments to directors for loss of office on a takeover had become known - had become even more widespread. Moreover, there were signs that these payments were not genuine compensation payments but deferred remuneration or "sweeteners" to smooth through takeover bids. The Government of the day felt it objectionable that large payments of this kind - which were not available to the ordinary taxpayer - should escape tax entirely.

8. As a result, special rules were introduced in 1960 to bring these payments into tax. In line with the Royal Commission's recommendations the rules were cast very wide and brought into charge genuine ex-gratia termination payments. The rules also extended to payments arising from a change in the functions of an employee's duties or the commutation of future financial rights. These last two payments are usually chargeable as emoluments under the ordinary Schedule E rules. But the wide scope of the special rules was intended to ensure that all lump sum payments "not otherwise chargeable to tax" were caught.

9. It was decided, however, that the first £5,000 of a lump sum which was only taxable under these special rules would remain tax free. This was because one of the primary objectives of the rules was to tax large "golden handshakes" which were artificially dressed up as compensation payments, and it was recognised that a £5000 exempt threshold would keep out of tax most payments which genuinely compensated for the financial loss and hardship often suffered on termination of employment.

10. Statutory redundancy payments were introduced in 1965. Under the general Schedule E rules they would have been taxable in full because employees are entitled to them. But Finance Act 1966 limited taxation to the 1960 "golden handshake" rules. In practice, they are thus exempt from tax since the maximum payment is less than the tax exempt limit. In practice, redundancy payments paid under an employer's own (non-statutory) redundancy scheme are taxed in the same way as statutory payments provided various conditions are satisfied. These conditions - which are set out in Statement of Practice SP1/81 (attached as Annex B) - are intended to ensure that tax relief is only available to payments made under the employer's scheme in genuine redundancy situations.

11. The threshold has risen over the years. This year it was increased from £25,000 to £30,000 and at the same time the "top-slicing" relief provisions for larger lump sums was removed. The position now is that where an ex-gratia or redundancy lump sum termination payment exceeds £30,000, the whole of the excess is taxable in full.

Parliamentary severance payments

12. In paragraph 10 we noted that statutory redundancy payments are taxable only under the special lump sum rules (thus benefiting them the tax free threshold) because of specific statutory authority. There are two other payments which would also be taxable in full as emoluments because the recipients are entitled to them, but for similar legislation bringing them within the special lump sum rules. These are

- termination grants to MPs and MEPs, and
- severance payments to Ministers in the House of Lords

In these cases the payments are strictly not even paid on redundancy (because the office continues).

Number of lump sum payments taxable only under the special rules

13. Only incomplete information is available upon which to base any estimate of the number of lump sum termination payments made each year, the size in individual cases and the reason for the termination. Employers are under no obligation to make returns of payments which are less than £30,000. And where payments are greater than £30,000, the excess is simply included as part of the individual's ordinary pay and taxed accordingly. Unfortunately, the Department of Employment no longer have available the number and amount of statutory redundancy payments made each year. However, on the information available we tentatively estimate that the cost of the £30,000 exempt threshold might be as much as £0.5 billion annually. And taking account of the fact that the maximum statutory redundancy payment is currently £4920 it seems likely that well over 90 per cent of all lump sum payments are less than £30,000.

REVIEW OF PRESENT COVERAGE OF THRESHOLD

Payments on involuntary job loss

14. As indicated at paragraph 9 above, the original £5000 exemption limit was intended to safeguard the position of somebody who had lost his job prematurely through no fault of his own. As we have noted the threshold applies to payments on genuine redundancy and to other ex-gratia payments (which are neither expected nor due by contractual right) paid when a job is lost.

15. The rules, however, draw no distinction between the person who loses his job and finds another immediately or reasonably soon and someone who spends a considerable period unemployed. One extreme example of this recently was the reported case of Esso tanker drivers who lost their jobs, received £50,000 pay-offs, but found jobs with a new employer doing the same "hived-off" activity. The financial

consequences of a job loss will thus vary widely. But in general favourable tax treatment for genuine redundancy payments still seems to be justified because unemployment will frequently bring financial hardship.

16. There are a number of other situations in which payments qualify for relief which Ministers may see as less deserving. In general, these situations arise either because of the generosity of the employer or, more frequently, because the employee is in a senior or influential position and able to arrange or encourage the provision of an ex-gratia payment.

Retirement

17. It is not uncommon for a person to retire and receive both a termination payment taxable under these special rules and a tax free lump sum out of his pension scheme. The case for exempting any part of that compensation payment because of financial hardship is less strong where termination coincides with an event - such as retirement - where a drop in earning capacity had been planned for anyway.

Voluntary Terminations

18. No distinction is drawn between the employee who involuntarily loses his job and the individual who simply chooses to go. Voluntary termination does not necessarily mean that no termination payment is involved. There will be situations where the employer believes it right to make some kind of payment to the employee; there will also be situations (and this is developed more fully below) where the employee's position is sufficiently influential - for instance, he may be a director - that an "ex-gratia" payment is almost automatic and yet it will not be taxed in full because the circumstances are such that it is not possible to show that it was "expected".

Golden Handshakes

19. In a significant number of cases termination payments - or "golden handshakes" as they are commonly called - purport to be "ex-gratia". Yet in reality a "golden handshake" is often the natural - customary - consequence of the termination of a senior engagement or the ending of a close company directorship. Where, for instance, the minutes of a company's board meeting record the decision to award a director an ex-gratia payment it is usually extremely difficult to demonstrate that the payment was either an entitlement or expected. There will be no evidence available to support either suggestion. But it does not need much imagination to see the opportunities for people close to the centre of a company's business activities, and who are normally well advised in the tax breaks available to them, to ensure that one way or the other termination brings with it a lump sum payment part of which is covered by the tax exempt threshold. Mr Cropper might have put his finger close to the reality of the situation in his minute of 10 December 1987 in which he suggested - perhaps mischievously - that there is a tariff of golden handshakes for outgoing executives. But it is certainly no coincidence that termination payments in this sort of situation can normally be expected to be at least as generous as the prevailing tax exempt threshold.

20. There has been some press comment in recent months (see for example the Observer article attached at Annex C) which suggests that the practice of giving very large handshakes to directors and senior employees is undesirable. The criticism is directed at the general acceptability of such payments and whether they are based on sound commercial practice which shareholders would support. With payments of the size referred to in the article, it is perhaps unrealistic to suggest that the existence of tax relief is a significant factor. But it is possible that, if the trend were to

continue (and there is no reason to believe that it will stop), the present tax relief will become seen as an undesirable incentive for these kinds of payments and one inconsistent with this year's reduction in basic and higher rates of tax.

Frequency of payments

21. Another feature of the exemption limit which might be thought over generous is that there is no limit on the number of tax free lump sum payments and sometimes successive payments are received within a relatively short period. Exploitation of the £30,000 threshold is prevented in relation to termination payments from successive engagements with the same or associated employer. Effectively, all payments are aggregated together for the purpose of determining whether the £30,000 threshold is exceeded. However, there is no limitation of this kind where a person holds successive unconnected employments and receives a termination payment each time he moves on to a new job.

22. Arguably, this feature of the rules is unlikely to benefit more than a fairly limited group of people whose specialist skills and expertise are much in demand and who hold senior positions in companies, but move on after relatively short periods, for example "trouble shooter" senior executives or people employed by the financial institutions in the City. But it is these same people who are the most likely to receive the very large payments which on occasions are reported in the press and who, as suggested above, are probably in the best position to influence the granting of payments. For them, the failure of the rules to limit the availability of the tax free threshold in the same way as for payments from connected employments is probably the icing on the cake.

SUMMARY

23. Although the original justification for the threshold - to ease the financial hardship which unexpected and unavoidable unemployment may bring - still remains valid, the preceding paragraphs identify a number of circumstances in which the present relief may be thought to go too wide. These can be summarised as:

- in practice lump sums to senior employees and directors are often not purely ex-gratia, but part and parcel of the "customary" arrangements for job changes at this level

- some job losses are voluntary

- some job losses are quickly followed by a new job

- those with less specific contractual entitlements (generally people higher up the management chain) are in a position to enjoy more advantageous tax treatment because a payment is only taxed in full if contractual or "expected"

- successive lump sums from unconnected employments all enjoy their own individual £30,000 exemption.

OPTIONS FOR REFORM

24. We have considered 6 options which might achieve, or help towards, what you may consider to be the proper objectives of this favourable tax regime. We look at each of them generally first and then consider the implications of each for the Parliamentary payments. In paragraph 45 we also consider the relative advantages in terms of revenue yield, length of legislation and compliance cost.

Option 1 - limit £30,000 relief to payments made in defined circumstances

25. This option involves defining more narrowly the circumstances in which payments qualify for more favourable tax treatment. The alternatives we have considered are limiting relief to

- payments made on "genuine" redundancy
- payments made to compensate for involuntary "genuine" job loss
- payments to persons other than close company directors

Genuine redundancies

26. Limiting relief to "genuine" redundancies is the option you particularly asked us to consider and which has, more recently, been suggested by Philip Hardman in his taxation simplification proposals. A definition of the circumstances in which it can be accepted that job loss occurred because of redundancy already exists in the Employment Protection (Consolidation) Act 1978 under which statutory redundancy payments are made. (The relevant sections of the Act are reproduced at Annex D.) In brief, a redundancy is defined as a situation in which someone loses his job because the job itself disappears. It would be necessary, however, to ensure that relief was granted on a consistent basis for both statutory and non-statutory redundancy payments. Consideration would also need to be given to how much of the quite detailed EPCA legislation should be reflected in any tax legislation and what, if any, would be the implications if both sets of legislation did not largely mirror each other.

27. The EPCA definition of redundancy is a very narrow one. Under the EPCA rules payments would qualify for favourable tax treatment only when a job loss arose from a total or partial closure of, or a reduction in, an employer's business activities which results in the employee's job disappearing. (This would include employees entitled to a redundancy payment even if they volunteer to go as part of a redundancy programme). Directors would not be denied relief where an appointment was terminated in a way consistent with the EPCA, but it would be necessary to show that the end of a directorship was clearly linked to an event which satisfied the definition of a redundancy - for instance, the closing of a manufacturing process for which the director had executive responsibility. A boardroom reshuffle which, for instance, eased out a director whose face did not fit would generally mean that any "pay-off" did not qualify for relief. Payments made when a job ended for any reason other than redundancy would not qualify.

28. There are two main drawbacks to this approach one of principle, the other practical.

29. As a matter of principle, it would be difficult to justify limiting relief to a strict "redundancy" situation. It would exclude employees who were dismissed from jobs in other circumstances e.g. people dismissed with lump sums on health or inefficiency grounds; or people whose job had come to an end for other reasons. Whatever the circumstances in which someone loses his job, the financial consequences can be just as serious.

30. At a practical level, although the EPCA definition works in relation to the limited situation in which statutory redundancy payments are due, using this definition to enable payments to qualify for very favourable tax treatment would put much more pressure on its application. The EPCA legislation includes detailed provisions as to how, for instance, the offer of a new contract affects an employee's right to redundancy payments. There is also

reference to the employer's intention to cease trading: we understand that sometimes an employee is dismissed in contemplation of a future job loss, yet a temporary replacement can nevertheless be employed for a short period. There are no guidelines as to how long a lapse between dismissal and the cessation or reduction of trade can be; it is a matter for the employer's judgement. The EPCA legislation is backed by the employee's right to establish, before an industrial tribunal, entitlement to a payment. But if an employer makes a payment anyway, and the question is only whether tax relief is due, no one - except the Revenue - would have an interest in testing objectively whether a genuine redundancy situation had indeed arisen.

"Genuine" job loss

31. Given the limitations of the "redundancy" approach we have considered whether it might be possible to limit the relief to genuine job losses, not just those which occur on redundancy, by introducing a new test of involuntary dismissal. But there would be significant difficulties in finding a watertight means of defining this. We had thought that there might be a definition in the Social Security rules for the payment of unemployment benefit but those rules are very unwieldy and we understand they contain no definition of an involuntary job loss. This is something that DSS Adjudication Officers have to decide on the facts of each individual case. An approach of this kind would simply not work in relation to a tax relief. And it is difficult to envisage any rule which would successfully identify and exclude cases where, for instance, directors or senior employees had engineered a dismissal - and the necessary "ex-gratia" payment - to ensure qualification for the restricted relief.

Exclude close company directors

32. Another possibility would be to exclude close company directors and employees or directors with a material interest in the business for which they worked from the benefit of the

tax exempt threshold on the grounds that it is in this area that most of the current abuse goes on. But this would not eradicate the manipulation of "ex-gratia" payments entirely; and would be seen as very unfair by those in these categories whose remuneration payments were genuinely ex-gratia.

33. Of the three versions of this option, the first might (with difficulty) be feasible but there could be criticism of the narrowness of the definition of redundancy - it would exclude MPs, for example, because the office continues - which might well lead to pressure for the wider second version. But we doubt whether that is practicable. The third approach would be only a partial solution, and is very arbitrary.

Option 2 - remove the tax exempt threshold entirely

34. At first sight this might be seen as surprising following the increase in the threshold to £30,000 this year; but that increase was of course part of a structural change which reduced the overall relief available. The attractions would be:

- it would be the cleanest answer to all the objections set out above and would ensure that contractual, "expected" and ex-gratia payments were treated consistently

- the case for an exempt threshold is weaker now tax rates are lower

- it would be a significant simplification and could be presented as part of this year's proposed simplification measures

- it would save a few staff in tax offices

- the legislation would be very short.

35. On the other hand there are a number of significant disadvantages:

- removing the exempt threshold would increase the tax liability of recipients, in genuine job loss situations, of relatively small lump sums as well as those able to obtain large "golden handshakes". It might be seen as a case of everyone suffering for the wrongs of a few

- some people losing their jobs do experience genuine financial hardship which the exempt slice was originally intended to recognise. That remains as true today as in 1960

- both statutory and non-statutory redundancy payments would be brought fully into tax. Ministers would need to justify this to DE colleagues. Any compensatory increase in the size of statutory payments would lead to an increase in public expenditure

- reducing the resources of the unemployed through taxation of redundancy pay might lead to additional public expenditure on unemployment and income support benefits

- ex-gratia payments are not liable to NIC and it would be for consideration whether a change in the NIC rules should be introduced if, for tax purposes, they were to be treated as equivalent to ordinary pay. Ministers would need to consult DSS colleagues

- taxing redundancy pay may give the wrong signals in relation to the Government's wider policy of encouraging enterprise and self employment.

Option 3 - reduce or retain the threshold,but tax the whole of larger payments in full

36. If Ministers believe that an exempt threshold should be preserved, a further option might be either to retain or reduce the £30,000 threshold, but where payments exceeded the threshold the whole payment (including the first £30,000 or whatever) would be taxable in full. This would mean that weight could still be given to the argument of genuine financial hardship arising from ordinary unemployment and for the vast majority of lump sum payments there would, in practice, be no change of treatment. It could also be seen as a response to the criticism generated recently over the very large payments reported in the press.

37. However, unless the threshold were also reduced significantly, it seems unlikely that this measure would be a sufficient disincentive for, eg, close company directors from arranging for other family directors to vote them ex-gratia payments up to the amount of the threshold on termination. Moreover, in its simple form this proposal would entail an enormous leap in liability as the threshold was passed with the result that a higher rate taxpayer receiving more than £30,000 but less than £50,000 would be worse off than someone getting just £30,000.

38. Some marginal relief would clearly be essential. This might withdraw relief along the lines that age allowance is reduced once the income limit is exceeded. One possibility would be to reduce the £30,000 exempt threshold by £1 for every £1 by which the threshold was exceeded. Thus, if a payment of £45,000 was made, the threshold would be only £15,000 and £30,000 would be chargeable. Relief would be fully withdrawn for lump sums of £60,000 or more involving a maximum marginal rate of 80%.

39. This approach would be more complicated than the present simple relief. Where, for instance, a payment had to be aggregated with earlier payments from a linked employment, the employer could have difficulty in determining the right amount of tax to deduct. This could involve a greater compliance burden for both employers and us; it might also result in underpayments of tax which have to be collected later from the employee. But such cases will, of course, be comparatively rare.

Option 4 - Piecemeal restrictions in relief

40. As opposed to these more fundamental options, we have also considered whether it would be possible to restrict the application of the present £30,000 threshold in certain limited circumstances. For instance:

- limit relief only to those situations where the employee did not find a new job within a prescribed period

- prevent, as with connected employments, the £30,000 threshold applying on more than one occasion.

41. Since tax, if due, should be deducted under PAYE from taxable lump sums, it is important that the employer can easily establish when he is making the payments how much of the payment is taxable. Tinkering with the relief in this way would add to its complexity and make it more difficult for both employers and tax offices to administer. In addition, we think that any restriction linked to how soon a new job was obtained would be difficult to square with employment policies. It might persuade employees to stay unemployed longer.

42. If Ministers were loathe to make any other change to the threshold itself, limiting its availability to once only, while not removing the main abuse, would ensure that it was not repeated. But in practice there would be operational

difficulties - both for us and employers - in having anything other than a relatively short period in which relief was restricted in this way. This is because it would be necessary for us to keep a record of all lump sums received by an employee to ensure that the threshold had not been exceeded. This could mean that employers would have to check with the tax office the correct amount of tax to be deducted in each case - an unattractive extra burden for employers and tax offices.

Option 5 - Reduce the threshold

43. Another damage limitation change would be to reduce the threshold. This would increase the tax bill for some taxpayers with genuine ex-gratia payments or payments under an employer's redundancy scheme but could be pitched above the level at which statutory payments are made. It would reduce the value of the threshold to those who try to take advantage of it. Since the original threshold of £5,000 would in real terms now be worth in excess of £40,000 (if indexed by reference to prices) its value has already dropped over the years. A reduction would further reduce the real value of the original limit and would be a reversal of the increase from £25,000 to £30,000 in this year's Bill.

Option 6 - leave the threshold unchanged

44. Since we think most termination payments relate to genuine job losses and are significantly below £30,000 there is probably a good case for leaving the threshold at its present level. As noted, £30,000 is below the price indexed value of the original £5,000 threshold (now worth £75,000 indexed by reference to earnings) so a trend of allowing it to "wither on the vine" has already been established. Keeping the present threshold would mean that Ministers were keeping faith with the original objectives of the threshold, while ensuring in future that, in real terms, a smaller proportion of large payments remain untaxed.

Relative revenue yield, length of legislation and compliance effects

45. Ministers may find it helpful to have this broad outline of how the 6 options compare in terms of these factors.

- revenue yield: as already indicated in paragraph 13 any estimate of the current cost of relief is highly tentative. Moreover, with only incomplete information we cannot accurately cost all the options involving change. But for the purposes of comparison we think Option 2 (abolition) would yield up to £0.5 billion annually; Option 3 (withdrawing exemption for larger sums) around £50m (which might increase if, for instance, the level of City redundancies were to continue); the yield from Option 5 would depend on the level to which the threshold was reduced (a reduction to £20,000 might yield up to £100m annually, but could be reduced by behavioural effects). The yield for Option 4 (piecemeal restrictions) would probably be only very small. Option 1 (limiting relief to genuine redundancies) would produce some savings, depending on the variant chosen, but any estimate of yield could only be highly speculative.

- length of legislation: for Options 2 and 5 it would be very short (probably only a few lines). At the other extreme Option 1 could be quite complex and lengthy

- compliance effects: only Options 1,3 and 4 would have any significant impact for both employers and tax offices. And Option 1 would probably prove the most troublesome for employers to understand and implement.

SEVERANCE PAYMENTS TO MINISTERS, MPs AND MEPs

46. As noted above, Ministers were concerned that the introduction of severance payments next year for Ministers to the Commons would highlight the special treatment accorded to these "Parliamentary" payments. Ministers have expressed the view that the basis upon which Lords' Ministers payments are taxed should apply also to the new payments for Commons Ministers. But we also assume that the same parity of treatment would apply to MPs and MEPs termination grants which currently enjoy the same favourable treatment. Some of the options we have considered would mean that Ministers and MPs payments would become taxable in full. This adds a new dimension which Ministers will wish to take into account.

47. The implications of the various options for these "Parliamentary" payments are:

Option 1 - if the threshold were limited to payments in the genuine redundancy situation, all "Parliamentary" payments would cease to qualify for relief since the loss of office in each case would not satisfy the existing statutory definition of "redundancy". On the other hand, if it proved possible to limit relief to the wider concept of genuine job losses, Parliamentary payments should still qualify.

Option 2 - if the threshold were removed all the payments would become taxable in full.

Option 3 - if relief were withdrawn for payments over £30,000 the treatment of "Parliamentary" payments would be unaffected since the level of payment is currently well below £30,000 (The maximum payments intended

from 1 January 1989 are: severance payments for Lords Ministers: £10,499; MPs and MEPs resettlement grants: £24,107. If severance payments for Commons Ministers are introduced next year, as currently planned, the maximum amount will be £7,130).

Option 4 - if Ministers wished to prevent more than one £30,000 exempt threshold applying within a prescribed period "Parliamentary payments" could be affected, for example, in the case of an MP who lost his seat at a general election and then received a payment in relation to a subsequent job loss.

Option 5 - if the threshold was reduced, the effect on these payments would depend on the new level chosen.

Option 6 - leaving the threshold as it is would maintain the status quo.

48. Any change Ministers decided to introduce to the lump sum rules would follow for existing Parliamentary payments (to MPs, MEPs and Lords Ministers) unless Ministers took special action - but that could, of course, be controversial.

49. Subject to what changes, if any, Ministers decided to make to the lump sum rules, it might be possible to introduce severance payments for Commons' Ministers next year in a way which gave them the same treatment as at present applying to payments to Ministers in the Lords but without Finance Bill legislation. This would depend on whether the relevant Parliamentary Pensions Act 1984 provisions could be amended in a way consistent with the existing tax relief rules and if the

application of those rules to the payments could be confirmed in the same legislation. Treasury officials have already sounded out Parliamentary Counsel whose preliminary view is that this should be possible.

SUMMARY

50. In this review we have assumed that Ministers' main objective is to confine relief to genuine redundancies, and to deny it to those who in reality expect, and may be able to manipulate, golden handshakes. Against those objectives, the main features of the options seem to be:

- Option 1 (restrict relief to genuine redundancies or job losses). This is in principle the right approach, but it looks technically complex and operationally so awkward and liable to dispute that we doubt whether it is a practical starter.

- Option 2 (tax payments as income). This would achieve the objective of taxing those people who ought not to get relief, and would be straightforward (both for the legislation and operationally). But it would only achieve its simplicity by taxing in full people who were genuinely unemployed and who the original legislation was designed to protect. It might yield as much as £0.5 billion annually.

- Option 3 (Progressive withdrawal of relief for payments above the threshold). This would limit or remove the tax free element in the largest golden handshakes without affecting the great majority of genuine job losers. It would build on this year's changes (which withdrew the extra relief previously available for payments between £25,000 and £75,000)

but it would reintroduce a more complicated system. It would add to the compliance burden for both employers and tax offices, but there would be a yield of around £50m.

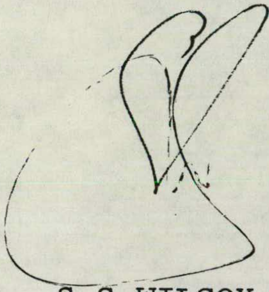
- Option 4 (restricting the availability of the exempt threshold to once within a prescribed period). While any favourable treatment of lump sums remains, those able to control their own remuneration will be tempted to make use of it as frequently as possible - this option would be designed to limit the number of times someone could have tax free lump sums. But it could affect people who were genuinely redundant more than once within the specified period; and the need to carry forward a record of the first lump sum paid in case another arose during the specified period would be troublesome operationally. There would be an additional compliance burden and any yield would probably be insignificant.

- Option 5 (Reduce £30,000 threshold). This would make the relief less attractive for those who manipulate it, but could also affect genuine redundancies. Although it could be presented as a further tightening of the regime for lump sums, it would seem like a reversal of last year's policy in which you raised the threshold from £25,000 to £30,000. The yield would depend on the level of the lower threshold chosen.

- Option 6 (leaving the £30,000 unchanged). The threshold is already less in real terms than it was in 1960, and - like the P11D threshold - it could be left to "wither on the vine" for quite a long time to diminish the tax attractions of golden handshakes without affecting most genuine redundancy payments which are usually fairly small.

51. The Parliamentary payments would be affected by Option 1 (if focused on genuine redundancies rather than genuine job losses) and Option 2; and could be affected by Options 4 and 5.

52. We would be happy to discuss these options with you.



S S WILCOX

ANNEX A

OTHER RELIEFS AND EXEMPTIONS AVAILABLE UNDER THE LUMP SUM RULES

1. In this Annex we set out briefly the other reliefs and exemptions available for employment lump sums. We think that Ministers need to be aware of these provisions. But - subject to any overlap with the proposals regarding pension lump sums (see paragraph 8 below) - there is no compelling need to change any of these arrangements. Most of the reliefs stand on their own merits irrespective of what decision Ministers make about the exempt threshold. We can, of course, expand on any particular point in which Ministers are interested.

Relief for lump sums related to work done abroad

2. There are special provisions which either wholly exempt or partially reduce the amount of a lump sum which is taxable where the lump sum relates to work done overseas. For the whole of a lump sum to be exempt the payment must relate to an employment which was predominantly performed overseas. The legislation defines what this means. In those situations where the employment was only partially performed overseas, the chargeable part of a lump sum (before the tax exempt threshold is applied) is reduced in the proportion which foreign service bears to the whole period of service.

Comment

3. The object of these reliefs was to align the treatment of lump sums with the treatment of earnings which arise from broadly the same period of service overseas. The reliefs recognise that the earnings of a UK resident who works for lengthy periods outside the UK, are not taxed. The reliefs were unaffected by the increase in the tax exempt threshold, and the removal of "top-slicing" relief rules, earlier this

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year. Clearly any change Ministers introduced to the availability of the tax exempt threshold would apply equally to lump sums paid partly for foreign service.

Payments exempt from tax under lump sum rules

Injury and Disability payments

4. Payments made in connection with the death of an employee or because an employment had ceased as a result of an injury to the employee, or a disability, are exempt from tax.

Comment

5. It has never been felt appropriate that ex-gratia compensation payments of this kind should be taxable.

Payments under restrictive covenants

6. This year action was taken to tax, as part of pay, payments to an employee under a restrictive covenant entered into with the employer. Previously payments were only taxable if the employee was liable at higher rates of tax. This exemption prevented such payments being also taxed under the special lump sum rules.

Comment

7. For technical reasons this exemption needs to be retained.

Payments under a retirements benefit scheme

8. Tax free lump sums paid under a statutory or approved pension scheme, or an unapproved scheme (provided the employee has already been charged on the benefit of

contributions into the scheme) are not taxed under the special lump sum rules.

Comment

9. This exemption is part of the overall pensions regime which Ministers have considered separately.

Terminal etc grants under Royal Warrants to members of Armed Forces

10. These payments are analogous to lump sums paid under statutory and approved pension schemes. The object of the exemption is to ensure that such payments enjoy the same exemption afforded to statutory and approved schemes as described at paragraph 8 above.

Payments to employees of governments of overseas territories in the Commonwealth

11. This exemption was introduced to ensure that in all cases, including instances where such an employee worked for part of the time in the UK, no tax charge would arise on payments under pension schemes administered by overseas governments in the Commonwealth, or on compensation payments to public employees of a Commonwealth territory who lose their jobs when a territory became independent.

Comment

12. Most such payments would be covered by the exemption (see paragraphs 2-3 in this Annex) applying to payments related to employments performed predominantly overseas. This "belt and braces" exemption responded to a Government commitment of long standing that these payments would not be taxable.

Other provisions

13. In addition to these statutory exemptions, Ministers should be aware of:

Statement of Practice SP2/81 - attached as Annex A (i)

14. The effect of this is that we permit the whole of a termination payment to be paid - without any charge arising under the special lump sum rules - into an approved scheme provided that in so doing the ensuing retirement benefits are within the rules of the scheme.

Comment

15. In practice this can have significant advantages for the employee. If for instance the lump sum is £35,000, he can take £30,000 tax free as covered by the tax exempt threshold, and pay the additional £5,000 into the pension fund. This can then be used to enhance the pension, and perhaps lump sum benefits, from that scheme. There is no evidence that only those with large "golden handshakes" are using their lump sums in this way. And in practice overall payments into and out of a pension scheme have to remain within prescribed limits.

Extra-statutory concession A10 attached as Annex A (ii)

16. If an employee has a contractual right to a payment from an overseas Provident Fund it is normally assessable under the general rules of Schedule E to the extent that it represents contributions into the fund by the employer. Where entitlement to a payment is discretionary a charge only arises under the special lump sum rules - but normally payments are not taxable either because it is exempt under the rules relating to foreign service (see paragraph 2-3 in this Annex) or because it is covered by the tax exempt threshold.

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17. The object of the concession is to ensure that contractual payments under overseas Provident Funds are also, in practice, not taxed.

Comment

18. We would want to consider the future of this concession if Ministers decided that the tax exempt threshold should be abolished or restricted.

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FROM: J J HEYWOOD
DATE: 21 December 1987

PS/PAYMASTER GENERAL

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr de Berker
Mr Cropper
Mr Tyrie
Mr Call
Mr Isaac IR
Mr Lewis IR
Miss Rhodes IR

TAXATION OF SEVERANCE PAYMENTS

The Financial Secretary and the Paymaster General have now discussed this issue with officials.

General Taxation Rules

2. As described in Miss Rhodes' minute of 20 November, the general rule is that a severance payment is:

(i) Taxable under Schedule E if an employee has a contractual entitlement to this payment or if he has an expectation that such a payment will be made (even if this is not written into his contract);

(ii) Taxable under special rules if this payment is unexpected or in general "ex gratia". (In practice this means, for example, that payments up to £25,000 are tax free).

Footballers

3. The Financial Secretary noted that it was now proposed

(Mr Wilcox's minute of 12 November) to treat termination payments received by football league players on transfer from one club to another, in general, as type (i) payments. In many cases, for example, the transferred footballer expected to get a percentage of the transfer fee. Each case would however be subject to appeal if the individual player felt that a type (ii) payment were more appropriate. The Financial Secretary thought the Revenue were right to take this line.

Commons Ministers

4. The most natural way to introduce a severance pay scheme for Commons Ministers would be to extend the existing Lords Ministers' scheme with a simple legislative amendment. If this were done, the tax treatment would automatically follow the treatment of severance payments to Lords Ministers (ie payments would be regarded as type (ii)).

5. If, however, the Commons scheme were established as a separate scheme, we would have to decide whether or not the tax treatment should be the same as for the Lords scheme (which would require a Finance Bill clause) or whether the severance payments should be taxed as income, with no exemption.

6. The Financial Secretary thought that the most logical treatment would be to tax the severance payments as income: any person taking up office as a Government Minister would know that sooner or later he would lose office and get a severance payment. Thus there would be an expectation of a severance payment although uncertainty as to when this would arrive. However, the same logic cast doubt on the tax exemption already given to payments for Lords Ministers.

7. The Paymaster pointed out that it would be easier to introduce a tightening up of the tax regime for Ministers if this were done in the context of a general tightening up of the tax regime. He saw little case for allowing ex gratia payments to be made tax-free if they were triggered by an employee voluntarily moving from one job to another (even if that move

were unexpected). On the other hand he did see a case for exempting unexpected severance payments from tax (up to a threshold) when an employee was sacked and had no job to move to.

8. This, however, would be a difficult distinction to draw in legislation, unless once could frame a definition of dismissal that was immune from abuse. It was possible that in the Social Security rules such a definition might exist.

Conclusion

9. The Financial Secretary said that unless the TSRB produced its recommendations before the Finance Bill there was no need to include a clause clarifying the tax treatment of severance payments for Commons Ministers (and indeed, as discussed in paragraph 5 above, a Finance Bill clause might not be necessary at all). But he did think it was worth looking further at whether severance payments to Government Ministers ought to be exempt from tax and at the wider question of whether the general rules should be changed so that only "genuine" redundancies received a favourable tax treatment.

J.H.

JEREMY HEYWOOD
Private Secretary

ANNEX A (i)

Statement of Practice

SP 2 / 81

Date 10 March 1981

INLAND REVENUE, SOMERSET HOUSE, LONDON

FURTHER COPIES OF THIS STATEMENT MAY BE OBTAINED BY CALLING AT OR WRITING TO THE PUBLIC ENQUIRY ROOM, NEW WING, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB.

CONTRIBUTIONS TO RETIREMENT BENEFIT SCHEMES ON TERMINATION OF EMPLOYMENT

1. Where, as part of an arrangement relating to the termination of an employment, an agreement is reached between the parties for the employer to make a special contribution into an approved retirement benefit scheme in order to provide benefits for the employee, the Inland Revenue will not seek to charge such a payment under Section 187 provided that the retirement benefits are within the limits and in the form prescribed by the rules of the scheme.

2. Similarly, they will not seek to charge the payment under Section 187 where the employer purchases an annuity for his former employee from a Life Office, so long as the transaction is approved under Chapter II, Part II, Finance Act 1970.

THIS STATEMENT HAS NO BINDING FORCE AND DOES NOT AFFECT A TAXPAYER'S RIGHTS OF APPEAL ON POINTS CONCERNING HIS LIABILITY TO TAX

Annex A (ii)

EXTRA-STATUTORY CONCESSION - A10

A10. Overseas provident fund balances

Income tax is not charged on lump sums referable to service overseas and receivable by employees from overseas provident funds (or under arrangements analogous to those of such a fund) on termination of employment overseas.

Annex B

Statement of Practice

SP 1 / 81

Date 10 March 1981

INLAND REVENUE,SOMERSET HOUSE,LONDON

FURTHER COPIES OF THIS STATEMENT MAY BE OBTAINED BY CALLING AT OR WRITING TO THE PUBLIC ENQUIRY ROOM, NEW WING, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB.

NON-STATUTORY REDUNDANCY PAYMENTS

1. Section 412, Income and Corporation Taxes Act 1970, provides that any statutory redundancy payment shall be exempt from liability under Schedule E, with the exception of any liability under Section 187 of the Taxes Act.

2. A payment made under a non-statutory redundancy scheme may in law be taxable in full under Schedule E if the scheme is part of the conditions under which the employees agree to give their services, or if there is an expectation of payment on their part. However, in practice the Inland Revenue accept that in the case of a genuine redundancy the only tax liability on lump sum payments made under redundancy schemes is under Section 187, even though the payment may be calculated by reference to the length of service or the amount of remuneration, or is conditional on continued service for a short period consistent with the reasonable needs of the employer's business.

3. As a general guide, redundancy is regarded as genuine for this purpose if -

a. payments are made only on account of redundancy as defined in Section 81 of the Employment Protection (Consolidation) Act 1978;

b. the employee has been continuously in the service of the employer for at least two years;

c. the payments are not made to selected employees only; and

d. they are not excessively large in relation to earnings and length of service.

The Revenue also accept that a scheme may be devised to meet a specific case of redundancy, for example the imminent closure of a particular factory, or couched in general terms to embrace redundancies as and when they arise.

4. This practice is designed to distinguish between payments which are made in cases of genuine redundancy and those which are no more than terminal bonuses given as a reward for services and which are taxable in full. It follows that each case must be considered in the light of its particular facts. Where an employer wishes to be satisfied in advance that a proposed scheme will fall within the Revenue guidelines Inspectors will be prepared to give an advance clearance on being informed of the full facts.

THIS STATEMENT HAS NO BINDING FORCE AND DOES NOT AFFECT A TAXPAYER'S RIGHTS OF APPEAL ON POINTS CONCERNING HIS LIABILITY TO TAX

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS
EXTN. 6487
16 December 1988

1. MR CORLETT

2. PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER (MR TAYLOR)

STARTER 153: PENSIONS (OCCUPATIONAL PENSION SCHEMES AND PERSONAL PENSIONS)

1. Your minute of 15 December.

2. I attach a table prepared by Mr Hinton. The column headed "Cap" is the extra column the Chancellor asked for. The further two columns, headed Maximum Pension and Maximum Lump, show how the maximum pension before commutation, and the maximum lump sum, are always whole multiples of £100 on this option.

3. Parliamentary Counsel will know that we had provisionally instructed him on the basis of the Financial Secretary's recommendation. Could I ask Counsel to hold up drafting on the indexation question until we have the Chancellor's decision. If necessary we will issue revised instructions.

A W KUCZYS

cc Financial Secretary
Mr Scholar
Mr Culpin
Mr Dixon
Mr Gilhooly
Mr McIntyre
Mrs Chaplin
Mr Tyrie
Mr Loades (GAD)
Mr Jenkins (OPC)
Mr Isaac
Mr Corlett
Mr Lusk
Mr Hinton (o/r)
PS/IR
Mr Kuczys

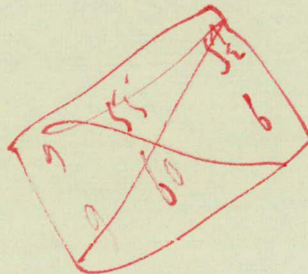
INDEXATION OF EARNINGS CAP

OPTION AA

The Cap is rounded up (to the nearest £600) year by year in line with increases in inflation. Each year's increase is applied to the previous year's threshold.

The following Table assumes rises in the cost of living of 5 per cent each year. The initial earnings cap is taken as £60,000.

Year	Cap	Maximum Pension	Maximum Lump
	£	£	£
1989	60,000	40,000	90,000
1990	63,000	42,000	94,500
1991	66,600	44,400	99,900
1992	70,200	46,800	105,300
1993	73,800	49,200	110,700
1994	78,000	52,000	117,000
1995	82,200	54,800	123,300
1996	86,400	57,600	129,600
1997	91,200	60,800	136,800
1998	96,000	64,000	144,000



Inland Revenue

Savings and
Investment Division
Somerset House

FROM: C W CORLETT
EXTN. 6614
FAX. 6766
21 December 1988

FINANCIAL SECRETARY

TRUSTS (STARTERS 118 AND 119)

1. At your meeting last week, you said you would welcome our inviting a couple of outside experts to help us - on a strictly confidential and personal basis - to examine the reform and simplification ideas which might feature in a consultative paper next summer.

2. I have approached John Avery Jones and John Dilger (a member of the Revenue Law Committee of the Law Society), and I am pleased to say that both have accepted the invitation. We have already had an initial discussion, and I shall be letting them have, for Christmas reading, a paper based on Mr Golding's of 25 November.

C W CORLETT

---

cc Chancellor of the Exchequer
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Isaac
Mr Painter
Mr Bush
Mr Houghton
Mr Pitts
Mr Johnston
Mr Stewart
Mr Davenport
Mr Golding
Mr H Thompson
Mr Bryce
Mr Corlett
PS/IR

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: M A HILL
DATE: 30 NOVEMBER 1988

1. MR CORLETT

2. FINANCIAL SECRETARY

STAMP DUTY ON HOUSES AND LAND: STARTER 300

1. At his 26 October meeting, the Chancellor said he was minded to abolish stamp duty on share transfers in his forthcoming Budget, but to leave the duty on property at 1%. But, within a framework of a basic 1% duty, there are several structural changes to the present charge on property which Ministers might want to consider: raising the present £30,000 threshold; converting that threshold into an exempt slice; or imposing a higher charge on more expensive property. These changes are the subject of this note.

2. Part I summarises the background to any consideration of structural changes to the duty on houses and land. Recent developments relevant to this issue form the substance of Part II. Finally Part III, together with the figures set out in the Appendix, considers the pros and cons of the various options for change.

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cc		
	Chancellor of the Exchequer	Mr Battishill
	Chief Secretary	Mr Isaac
	Paymaster General	Mr Corlett
	Economic Secretary	Mr Bush
	Mr Scholar	Mr Davenport
	Mr Culpin	Mr Pipc
	Mrs Lomax	Miss Shoosmith
	Mrs Chaplin	Mr Pape
	Mr Tyrie	Mr Adderley
	Mr Jenkins (Parliamentary Counsel)	PS/IR
		Miss Hill

I BACKGROUND

3. Stamp duty on transfers of houses and land is a highly profitable tax. With the charge being ad valorem, the Exchequer - like estate agents - has benefited automatically from the recent house price boom. Back in 1984/85 (the first year of the 1% rate) the yield was some £400 million; this year it is likely to be £1.5 billion. The current forecast yields for 1989/90 and 1990/91 are £1.8 billion and £1.9 billion respectively.

4. At the same time stamp duty is cheap to collect: it has a cost/yield ratio of 0.25% (as compared with 1.6% for PAYE income tax). In addition it is difficult to avoid, is generally understood, raises few problems on hardship or ability to pay grounds and gives rise to relatively few complaints (though see paragraphs 8 and 9 below on recent representations).

5. Nor does it seem to create any significant market distortions. Though in theory stamp duty on house purchases might be something of a hindrance to labour mobility, in practice people's decisions about when and where to move seem not generally to be influenced by stamp duty considerations. Likewise it is unlikely to have much impact on the relative levels of property prices across the country. On the other hand it probably does have some small effect on absolute price levels: a large part of any reduction in stamp duty might be expected to feed through into marginally higher property prices.

6. The changes this Government has made to the stamp duty on houses and land all came in the first 5 years. In 1979 the threshold was £15,000, with the duty being chargeable on properties above that level on a sliding scale from 0.5% to 2%. The threshold was increased in 1980 and again in 1982. In 1984 there was a more thoroughgoing reform with the sliding scale of duties being replaced by the present flat rate 1% charge, and the threshold increased by £5,000 to £30,000. There have been no changes since then.

II RECENT DEVELOPMENTS

7. Perhaps the most notable development in the last 12 months has been in the housing market itself. House prices in some areas have risen by nearly 50%. The average house price across the country as a whole has increased from £45,000 to £60,000. Very recently of course there have been signs of levelling off, at least in the south East.

8. Against the background of the steep increase in prices in early 1988/89, there have been rather more in the way of representations about the stamp duty charge on property. The Law Society, the Royal Institution of Chartered Surveyors and the Association of British Insurers, for example, all call for some overall reduction in the present charge on property. Each body has its own scheme for achieving this reduction, but a common thread is dissatisfaction with a threshold as low as £30,000 in the light of the current level of property prices. Also a number of representations have pointed to the forthcoming VAT charge on commercial property (see paragraph 11 below). However, in their regular discussions with the Deputy Chairmen on their Budget representations, the Law Society freely admitted that the housing market was not at present an obvious candidate for a significant fiscal stimulus.

9. In addition to these formal representations a number of members of the public have written to their MPs, or direct to Ministers, usually about the charge on residential property. But there have been no more such approaches this year than last, and overall the volume of criticism and complaint remains small in relation to that received on many other taxes.

10. The increasing volumes of property transfers affects the work burden both of our Stamp Offices and the Land Registry (each of which are involved, separately, in examining conveyances). It has thus given added impetus to the search for more efficient ways of collecting the duty. For some 12 months a joint Inland Revenue/Land Registry Working Party has

been reviewing the possibilities of streamlining current work practices, possibly by the Land Registry taking some additional responsibility for the stamp duty charge on property transfers. (Conveyances where the price is below the £30,000 threshold are already seen just by the Land Registry.) However more recent developments at the Land Registry - expansion; a computerisation programme; accommodating legislative change; and the possibility of agency status - mean there can be little likelihood of them taking on additional work in the imminent future. For the time being at least, it now looks as though Revenue Stamp Offices will need to continue to administer the duty on houses and land.

11. There is one development affecting commercial property which perhaps also deserves a mention here. That is the proposed legislation in the forthcoming Finance Bill, following a recent EC ruling, to extend VAT to sales of new commercial buildings and certain commercial lettings. Though in many cases the purchaser of a commercial property will not pay any extra VAT as a result, the new VAT charge seems to be widely perceived as an additional burden on sales etc of commercial property.

12. The provisional decision to abolish the duty on share transfers would of course be another relevant development here. In some quarters it will be represented as a give-away to the City. And the Opposition will no doubt seek to argue that this is unfair when first time buyers, already struggling to cope with high interest rates, were still having to pay 1% duty on the full purchase price of their homes.

13. Second, as recognised at the 26 October meeting, widening the differential between the duty on property and the duty on shares would increase the risk of securitisation. The incentive to dress up property transfers as transfers of shares would be that much greater. Following the October discussion, no specific action on securitisation is proposed

for this year, but the situation will be monitored closely. The Law Society in fact mentioned the risk of securitisation (arising from the present 1/2% differential) in this year's written Budget representations, but said in discussion that they were not aware of securitisation currently taking place purely for stamp duty reasons.

PART III OPTIONS FOR CHANGE

14. The developments discussed above do not necessarily point to legislation this year on the current stamp duty applying to houses and land. But, within the framework of a continuing 1% charge on property, the following possible changes could be considered:

- raising the present £30,000 threshold
- turning that threshold into an exempt slice
- imposing a higher rate on expensive property.

As illustrated by the figures in the Appendix, none would take up very much Finance Bill space or have significant compliance costs. On the other hand all would have a substantial impact both on total revenues and on stamp duty running costs.

(a) Raising the threshold

15. Unlike most thresholds in tax legislation, the £30,000 trigger for the stamp duty charge payable on houses and land etc is not indexed. Historically, as the attached graph shows, it has tended to keep more or less in step with average house prices. However the threshold was last raised in 1984 when the average house price was £28,000; the average is now approaching the £60,000 mark.

16. The result of a static threshold at a time when house prices have been increasing rapidly is to bring many more house purchases into duty. Some 70% of the total now attract

duty, including a substantial proportion of first time purchases. Put another way the number of dutiable property conveyances needing processing each year is now approaching the 2 million mark. This is reflected in the pressure under which Stamp Offices are now operating, as they struggle to maintain an efficient and rapid service for the public. Significant efficiency improvements have been made in recent years. Even so it could, depending on developments in the property market, become increasingly difficult to cope with the volume of conveyances within existing resources.

17. In order to indicate the range of possible changes, the Appendix sets out the revenue, and average staffing, consequences of a range of increases in the present £30,000 threshold:

- £40,000 - ie an increase in line with general inflation since 1984;

- £60,000 - a threshold around the present average house price for the country as a whole; and

- £70,000 - which would exempt virtually all first-time buyers even in London and the South East.

18. The Appendix shows that any of these increases in the threshold would have sizeable Exchequer costs: even a £10,000 increase would cost around £100 million a year. On the other hand all would remove significant numbers of purchases from the stamp duty net (and so affect stamp duty running costs as well).

19. One factor, which does not emerge from the various facts and figures in the Appendix but which may also be of relevance to the option of raising the stamp duty threshold, is the perceived link with the £30,000 mortgage interest limit. Such a link does not of course exist - as history shows. Arguably,

however, there could be a presentational awkwardness in raising the stamp duty threshold if at the same time the mortgage interest relief limit remains as it is. As against that, the perceived link may need to be broken sooner or late, if the stamp duty threshold is not to be left to wither on the vine.

(b) Turn the threshold into an exempt slice

20. The stamp duty "threshold" is not a nil rate band or and exemption: duty above the present £30,000 trigger is payable at 1% on the full amount.

21. Converting that threshold to an exempt slice would create a structure which would probably be seen as fairer. This suggestion has featured in a number of recent representations. It would have the effect of reducing the stamp duty bill of all purchasers of property over £30,000 by £300. On the other hand it leaves exactly the same number of people paying duty as before; actually increases Revenue and compliance costs; and is extremely costly in Exchequer terms - approaching £0.5 billion in 1989/90.

(c) A higher rate on more expensive property

22. Increasing the rate of duty on more expensive property could be a way of exerting downward pressure at the top of the market. The illustrative option analysed in the Appendix is a 2% stamp duty charge on all properties over £200,000, which would increase stamp duty take by around £500 million a year. It would be a relatively painless way of increasing taxation. In view, however, of recent developments in the property market (see paragraph 7) the housing policy argument is perhaps less compelling now than it may have been earlier in the year.

23. In practice most of the additional duty would fall on commercial rather than residential property. It might therefore be felt to be particularly onerous at a time when a

new VAT charge on such property (see paragraph 11) has been introduced. A 2% duty would also encourage securitisation, particularly if the duty on shares is now to go. And, as noted in our October paper on the charge on shares, it is in the commercial sector that we think the risks of tax loss through this means are at their greatest.

CONCLUSION

24. The purpose of this paper has been to indicate the range of options, rather than to make recommendations. Ministers will need to consider whether to pursue any of these possibilities, or to leave the duty as it is for the coming year.

Margaret Hill

M A HILL

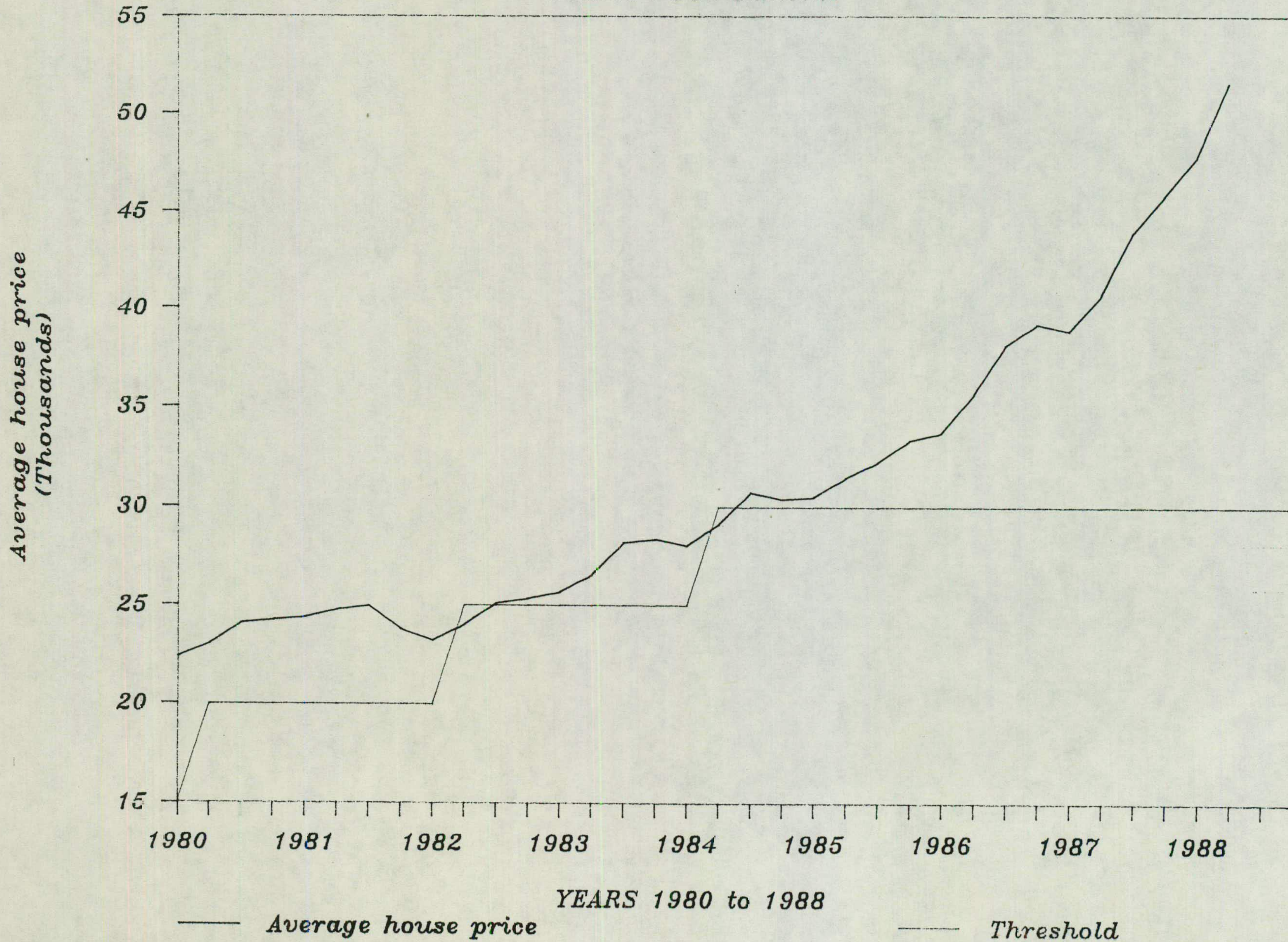
CONFIDENTIAL

APPENDIX

OPTIONS FOR CHANGE

	Exchequer costs (£m)			Staff effects	No of taxpayers affected	Compliance costs	Length of legislation
	1988/89	1989/90	Full year				
i. Increasing the threshold							
to £40,000	100	90	110	No change*	300,000	Nil)	
to £60,000	290	320	315	- 20*	650,000	Nil)	1/3 page
to £70,000	410	450	445	- 30*	850,000	Nil)	
ii. Turning £30,000 threshold into exempt slice	455	500	490	+ 15	1.6 million	Negligible	1 page
iii. a 2% duty on property above £200,000	+ 445	+ 520	+ 480	No change	75,000	Negligible	½ page

*These figures relate to Inland Revenue staff only. Because these options would result in more "below threshold" conveyances to process, there could be some small increase in the Land Registry staff requirement. Even so we would expect in each case a net saving as compared with the present threshold.


GROWTH IN UK AVERAGE HOUSE PRICES
Source : BSA Bulletin
Average house price (Thousands)
55
50
45
40
35
30
25
20
15
1980
1981
1982
1983
1984
1985
1986
1987
1988
YEARS 1980 to 1988
Average house price
Threshold

Robert 17.7.12.88

CONFIDENTIAL

FROM: **FINANCIAL SECRETARY**
DATE: **9 December 1988**

CHANCELLOR

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

Mr Painter) IR
Mr Lewis)
Mr Massingale)
PS/IR
Mr Walton - C&E

Ch. / Agree with FST's conclusions? 9/12

Agreed

CARS

I have discussed Mr Lewis' paper of 18 November with officials.

In general, I do not believe that this is the year for major structural change. We looked at many of these issues last year; there is also great pressure on the Finance Bill. I would therefore be inclined to leave the P11D threshold at £8,500 for 1989-90; and not to change the structure of the car scales. I can see the Revenue's argument that the present structure of car scales is seriously flawed. But equally there is in the Parliamentary Party a widespread and very strong gut feeling that it would be wrong to tax a rep using his car full-time for business on the same basis as the person using it only occasionally for work, even if their private use is identical. We saw just a little of this in last year's Finance Bill debates; it would be much more pronounced this year if we made major changes in a very different Budget context.

I am attracted to trying to improve the rules for mileage allowances. The present system does seem inappropriate (as the recent article in the Daily Mail highlights). Moreover, a change to a more streamlined system might lead to worthwhile staff savings and some yield. However,

the Revenue will be making improvements to the "fixed profit car scheme" which do not need legislation; and a statutory system which prohibited claims based on individual expenses would have a read-across to the other issue on mileage allowances on which I minuted you today. In any case, pressures on next year's Finance Bill effectively rule out any change for 1989-90; I suggest we pick it up again after the Budget.

Your Budget Statement last year has created a strong expectation of further large increases in car scales next year. With the car scales still rather less than half the full value of the benefit, the current rate of inflation implies an increase of about 15% just to ensure that the cash size of the untaxed benefit does not increase. But beyond that, I very much agree with Mr Culpin that we should make any decisions on car scale rates in the overall context of changes in income tax rates and allowances. I would be cautious about creating too many cash losers; so if there were no cut in the basic rate or increase in allowances over and above indexation, that implies an increase of only about 20%. Twenty per cent on the 1400-2000cc band (62% of all company cars are in that category) would mean an increase of £280. The indexation increase on the married man's allowance is likely to be very close to that amount, so it might be seen as a reasonable increase.

I recognise that this may well be lower than many people are expecting, given the tone of your Budget Statement. And, in connection with the Schedule E receipts basis, you have just asked me (Mr Taylor's note of 5 December) to look for something which brings some tax revenue forward in time. A 20 per cent increase in scales would produce £90 million in 1989-90, and £110 million in 1990-91, comfortably more than the transitional cost of the receipts basis in these two years (£60 million and £80 million). If immediate revenue yield will be an important factor this year, that is something we can reflect in final decisions on the car scales.

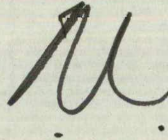
The capital allowances rules for expensive cars (which mean that each one costing over £8,000 has to have its own tax calculation and record) continue to attract much criticism from the representative bodies on compliance grounds. Getting rid of these rules would be an attractive part of a simplification package which included the Schedule E receipts

basis, residence, trusts and (possibly) close company apportionment. But abolition or raising the limit seems prohibitively expensive (unless you judged we could raise the car sales further as an offset). And the alternative possibility of setting a lower, revenue neutral rate for the allowance for expensive cars raises a number of difficulties. So unfortunately there seems no scope for action this year.

In summary, my answers to the questions at the end of Mr Lewis' note are:-

- leave the P11D threshold at £8,500 for 1989-90;
- no further work on car tax;
- increase the car scale rate in the context of the Budget arithmetic - but my preliminary view is to go for a rise of only about 20 per cent;
- no further work on the structure of car scales (either to phase out the business mileage discount, or to move to more engine size bands, or scales based on the cost of the car);
- look at the structure of mileage allowances after the Budget;
- leave the fuel scales unchanged (there has been little or no movement in fuel prices during the past twelve months);
- leave the expensive cars regime for both scale benefits and capital allowances unchanged (unless capital allowances can be changed as part of a package which increased the car scale rates);
- include the 1989-90 car benefits scales in the Finance Bill. (I have also considered, but do not recommend, going back to the old system of announcing the car scale changes a year in advance).

I have also commissioned a background note on the industry from Mr Monck for use nearer the time of the Budget.



NORMAN LAMONT

Inland Revenue

CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: MRS A C MAJER
DATE: 15 December 1988

1. MR FARMER

2. FINANCIAL SECRETARY

ELECTRICITY PRIVATISATION : EMPLOYEE SHARE OFFERS (STARTER No 455)

1. Mr Farmer's minute of 21 October reported the Department of Energy's last minute request that the Electricity Bill should include amendments to the approved employee share scheme legislation. They wish to ensure that, on privatisation, all employees of the electricity supply industry can be offered share benefits on a fair and equitable basis - and that they can quickly be assured of this. Although plans for the privatisation have still to firm up, the Department of Energy wish to press ahead with discussions with the industry on employee share benefits, and want to have the maximum flexibility in doing so. In particular, they wish to be sure that if it is decided to use the 'distribution share' (DS) route, this will not cause any difficulties.

2. You subsequently wrote to Michael Spicer MP, Parliamentary Under-Secretary of State at the Department of Energy, who replied on 31 October. You also asked Treasury and Revenue officials to get together with the Department of Energy people for further discussions, and to report back to

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c Chancellor
Mr Moore
Mrs Lomax
Mr Culpin
Mrs Brown
Mr Gilhooly
Mr M L Williams
Ms Hay
Mr Holgate
Mr Jenkins (OPC)

Mr Isaac
Mr Painter
Mr Bush
Mr Lewis
Mr Ridd
Mr Creed
Mr Farmer
Mr Reed
Mr Fletcher
Mrs Majer
Mr N Williams
PS/IR

you. And your PS's note of 2 November agreed Mr Williams' recommendation that any amendments to the employee share scheme legislation which might be agreed as technically suitable for the 1989 Finance Bill should be located there, though there might be no objection to DS-related provisions being included in the Electricity Bill at Committee Stage if it were decided to use the DS route.

3. This note reflects the outcome of our discussions with the Department of Energy and our consideration of a further letter from them supplying more - if still imprecise - information about what they regard as their requirements on the employee share scheme <u>and</u> employee priority fronts. It examines the extent to which these needs can be met under existing legislation and, where they cannot, what changes would be necessary to accommodate them and whether Ministers might find them acceptable. This submission has been agreed with the Treasury.

Background

4. The White Paper "Privatising Electricity" said that "there will be attractive provisions to ensure that [employees] can acquire shares [in the industry]". It has yet to be decided whether to extend to employees of the electricity supply industry all of the usual mix of preferential share offers made available to employees under previous privatisations. Such offers have comprised

i. a free offer of shares to a certain value, with or without an additional element based on length of service. These shares are tax free because they are lodged with the trustees of an approved profit-sharing scheme, and constitute appropriations under the scheme;

ii. a 'matching' offer, whereby employees purchase shares to a certain value and deposit them in the

approved scheme trust for a specified period as a condition of obtaining further free shares under the scheme;

iii. a priority offer, under which employees purchase shares in priority over members of the public, up to a set limit;

iv. a discount offer, under which employees are given a discount on the public offer price (with or without priority) on a limited number of shares.

The industry is said to be interested in setting up:

i. approved all-employee profit-sharing schemes (through which the free and 'matching' shares can be channelled);

ii. approved all-employee savings related share option schemes;

iii. an approved discretionary share option scheme (though such schemes are usually established only after privatisation).

5. You are familiar with the structure of the privatised electricity industry. On the <u>supply</u> side in England and Wales it will consist of

i. 12 distribution companies (successors to the present Area Boards);

ii. a company owning and operating the national grid ("Gridco") which either itself or through a holding company will be jointly owned by the distribution companies, in proportions yet to be determined;

iii. probably a further company (the "Central Services Company"), which will be owned by the distribution companies or, possibly, by "Gridco" or its holding company;

On the <u>generating</u> side, there will be

i. 2 generating companies, which will succeed to the generating assets of the Central Electricity Generating Board and, possibly,

ii. a generating services company, which will be jointly owned by the generating companies with, possibly, the distribution companies also having a stake.

6. Our discussions with the Department of Energy and their advisers have concentrated exclusively upon the supply side. We are told that the plans for the generating side - which is to be floated separately - will not throw up any additional problems.*

7. These discussions have not covered the plans for the privatisation of the Scottish electricity industry. However, the two present Boards - which each carry out supply and generating functions - will be privatised as separate companies. In addition there will be a nuclear generating company jointly owned by the two new companies. Department of Energy do not anticipate any difficulties.*

8. As you know, it has yet to be decided how the supply side in England and Wales will be floated. The alternatives are <u>either</u>

*We have asked Department of Energy to let us have details of their proposals on the generating side and for Scotland as soon as possible, so that we can check that, as they say, there are no tax problems.

i. separate simultaneous flotations of the 12 distribution companies, which will be individually priced and linked only by a common prospectus, or

ii. sale of instruments called "distribution shares" (DS) each comprising one share in each distribution company.

We understand that Mr Parkinson will be writing to the Chancellor in the near future to set out his proposals. However it is not clear when a decision will be made to proceed with one or the other of the flotation techniques. The Department of Energy are nevertheless pressing for an early response to their proposals on employee share issues, so that they can proceed with their discussions with the industry. This submission accordingly addresses both flotation techniques. In either event the DS is unlikely to be used in Scotland.

9. If DS are used, the intention is that they will be separately listed and traded on the Stock Exchange immediately after flotation and may have a life of up to 5 years or more . At any time after flotation holders may explode and convert them into the underlying shares in the distribution companies, or, alternatively, persons holding fewer than a prescribed number of DS will be entitled during a considerably shorter period to convert them directly into shares of just one of the distribution companies (only when dealings start will any of the underlying shares have a market value). Loyalty shares and/or bill vouchers may be offered, for example, to encourage individual investors to convert into the shares of their local distribution company; but again no decision has been made.

Main facilities sought by the Department of Energy

10. The main facilities sought by the Department of Energy to ensure the flexibility they seek are discussed below. They are:

a. the capacity of a company's approved scheme to use as scheme shares the shares of any member company of a consortium owning it where that member beneficially owns not less than 1/20 of its share capital;

b. confirmation that approved employee share schemes (ESS) can use shares in more than one company;

c. the capacity to use "distribution shares" in approved ESS;

d. in addition they also seek confirmation that employee priority allocations of DS will qualify for the income tax exemption provided by Section 68 Finance Act 1988 and specific assurances that none of the range of possible variations to the employee offer they have in mind will fail to qualify for that exemption or will breach the ESS legislation.

11. The aim of the facilities sought in a. and b. above and most of the variations referred to in d. is to ensure fair and equitable treatment of the approximately 6,000 employees of the jointly owned companies compared with the remainder of the approximately 130,000 employees in the industry as a whole.

a. **Amendment of the 'member of a consortium' rule**

12. A company's approved scheme can use as scheme shares those of a member of a consortium which owns the company so long as the consortium owns at least 3/4 of the company,

and the individual member at least 3/20. The Department of Energy are seeking an amendment of this 3/20 limit to 1/20. They believe this revised limit would be sufficient but have not consulted the electricity industry yet. The purpose is to allow employees of Gridco (and possibly the other jointly owned companies) to be offered baskets of shares in its parents (ie the distribution companies who form members of the consortium). They do not want to offer such employees shares in their own employing company because the jointly owned companies will not be quoted and may also be required to operate in a way that will not necessarily maximise their own profits). Since there will be 12 parent companies, the present 3/20 rule will preclude this, because the individual distribution companies cannot each own at least 3/20 of the jointly owned subsidiaries. We are told that relaxation of this limit to 1/20 would probably permit Gridco to offer approved share schemes involving shares in <u>at least 11</u> and possibly all of the distribution companies - and thus align its employees' interest with the success of the parent companies.

13. The rationale for the present 3/20 rule in the employee share scheme legislation is to ensure that share schemes of jointly owned subsidiary companies can use only those shares of a parent which has a significant stake in the subsidiary. First introduced in the 1972 share option legislation, it represents a strengthening - for employee share scheme purposes only - of the then (and current) provisions dealing with group income for corporation tax, which treat a company as owned by a consortium if 3/4 or more of the ordinary share capital is beneficially owned between them by UK resident companies, of which none owns less than 1/20. The ESS 3/20 rule has not up to now proved a problem. Reducing the present limit would not so far as we can see open up any avenue for abuse - but it would weaken what can already be a fairly tenuous connection between the company operating the scheme and the company whose shares are used in it.

14. Given the difficulties which the electricity supply industry may otherwise face in setting up approved schemes for the jointly owned companies, Ministers may be willing to see the limit reduced to 1/20, as the Department of Energy request. We see no problem in making this change, for general ESS purposes. However although the Department of Energy contemplate consulting the electricity industry about whether this figure will be adequate for the future (where the holding of individual distribution companies could fall below that level), we suggest that any limit which was even lower would not sit well with the other legislation referred to above, and it could hardly be claimed to be consistent with ESS policy which is intended to give employees interests in shares which will clearly reflect their own performances. So we suggest you should be prepared to agree that the present minimum holding should be reduced to 5% - but make it clear that it would not be possible to go any further.

b. Approved ESS to use shares in more than one company

15. As Mr Farmer's minute of 21 October explains, this is at present acceptable, provided that each company whose shares are to be used is a member of a consortium and owns the 3/20 (or 1/20) referred to above, and the scheme is carefully drawn up to satisfy other requirements of the legislation.

c. Use of "distribution shares" in approved ESS

16. If the flotation proceeds by the DS method, a variety of problems arise for the employee share offers. We address separately below the questions that would arise for employee priority, but as to the use of DS in approved ESS two questions arise.

17. First the Department of Energy and their advisers envisage that the free shares offered to employees via

approved schemes will be shares in the individual companies concerned - which is of course entirely consistent with the present legislation. But unlike other privatisations, this will mean that appropriations to employees will not be possible before dealings begin, because it is only at that point that shares in the individual companies become available (by conversion of the DS), and acquire a value. The way round this may be to arrange for the free shares to be appropriated to employees in the approved profit-sharing scheme as follows:

Distribution company employees

- Applications for DS (equating to the free share offer) and for contributed DS which qualify the applicant for additional free shares ('matching' shares), would be accompanied by an undertaking to convert the DS obtained immediately dealings start into shares of the company for which the applicant employee works.

- These shares would then be lodged in the approved profit-sharing scheme trust, and the matching free shares would then also be appropriated to the individuals concerned.

- The free shares - which matched the employee contributed shares - would be acquired and appropriated by the trust. These might either be the number of shares promised or the number of shares equivalent to a promised value.

Jointly owned companies' employees

- Applicants for DS here would follow the same route as above, save that conversion would be into the bundles of all the shares represented by the DS.

This approach needs further work to make sure it is viable, and that would fall to the Department of Energy and their advisers; but we would, if wished, lend our assistance.

18. The great advantage of this approach (if on further examination it proves to be practicable) is that there is no need for substantial and complex amendment - whether generally or for the electricity industry alone (and others later?) - to the FA 1978 scheme legislation, which would be needed to allow the use of DS in approved schemes. Quite apart from the technical complexity, such changes would appear particularly inappropriate, since distribution companies' approved schemes would then be appropriating to employees perhaps substantial interests in shares in companies with which the employees concerned had no conceivable link or involvement. The Department of Energy and their advisers have not yet given up the idea that DS might be used in approved schemes. But unless any unforeseen and insuperable objections are found with the approach outlined above, it seems to be very clearly the preferable course.

19. The second question arising again assumes that flotation adopts the DS technique, and that what is offered to employees via approved profit-sharing schemes is shares in the individual companies concerned. The method used for scheme appropriation would be that suggested in paragraph 17 - ie the appropriation to the employee is a promised number or value of shares. The question relates to the valuation of the shares for tax purposes.

20. Because the underlying shares in the distribution companies are not available at the date of the offer for sale, they cannot be appropriated to employees at that point (as in earlier privatisations). Appropriation must instead be deferred until the shares are separately listed, after flotation. Under the profit-sharing scheme legislation, the initial market value of scheme shares must be determined on

the date on which the shares are appropriated, or on such earlier date as the Revenue and the scheme trustees (in advance) agree. If the shares are valued at the date of appropriation, ie when dealings start, their value will of course include any appreciation before that date. Assuming the DS - and therefore the underlying shares - go to an early premium when dealings start, Department of Energy is concerned

- that employees might receive fewer shares, if their entitlement to free shares is a monetary amount (eg £70) rather than a specified number of shares, and

- that those shares will have a higher tax value and so will attract a higher income tax charge if disposed of by employees before the '5 years in trust' rule is observed. (But if the shares are kept for long enough to qualify for the income tax exemption, the higher initial tax value will become a lower CGT charge when they are eventually sold.)

21. Department of Energy propose to remove the first of these disadvantages, if the free shares are a specified amount rather than a specified number, by relating an average of the market value of each company's shares over a period of say 30 days following flotation to the initial offer price in such a way as to grant more shares to employees. The following example illustrates what they have in mind:

i. Assume 3 distribution companies, and offer for sale price of the distribution share (representing one share in each of the 3) is 150p.

ii. Assume over the 30 day period, the average market values of the shares are 75p, 60p and 40p (ie total premium 25p).

iii. Relating those figures back to the offer for sale price of 150p, the 'notional' prices of the

3 shares would be 64.28p, 51.43p and 34.29p, respectively.

iv. So, if the free offer is £70 worth of shares, employees of the above 3 companies would be allocated 108, 136 and 204 shares respectively (in place of the smaller number of shares which - in this example - they would be allocated if the shares were valued strictly as at the date of appropriation).

22. Department of Energy ask that if they do this the Revenue should accept the proportion of the offer for sale price, calculated as shown above, as the market value of the shares at date of appropriation. We cannot do so under the present legislation and we see no grounds for changing the tax rules to cover this point because:-

a. the offer to employees can be made in a way which does not raise the problem (see next paragraph);

b. the ESS is intended to encourage employees to hold their shares, not sell. The change proposed would reduce the tax charge for those who sold early and potentially increase it for those who held their shares for 5 years or more;

c. if the shares open at a discount, rather than a premium, the legislation would have the opposite effect to that sought by Department of Energy.

23. All in all it would seem preferable either

i. as indicated in paragraph 17 above - to base the employee free share offers on numbers of shares rather than a value of shares (ie given a DS with

a defined composition of underlying shares eg 1, 2 and 3 in the 3 distribution companies illustrated above, the free offer for employees of the 3 companies would be a multiple of 1, 2 and 3 shares respectively. A similar approach would seem viable for the matching offer: if this was 2 free for 1 DS purchased, the offer for the 3 different employees would be 2, 4 and 6 respectively. Employees of the jointly owned companies would in either case be offered multiple bundles of 1, 2 and 3 shares); or

ii. if Department of Energy prefer to base the free offer on value of shares rather than number, to take market value at the date of appropriation for all purposes, in the usual way. If Department of Energy felt that there might be complaints that employees believed they were losing out in comparison with those who benefited under earlier privatisations they could make the offer a larger one than previously.

Neither of these solutions would require amendment to the ESS legislation.

d. **Employee priority**

24. If the flotation used the DS technique, our legal advice is that the distribution share is merely a transparent mechanism and that the investors should be regarded as owning, at the outset, or as soon as the underlying shares are available, shares in all the Distribution Companies. On this basis, an offer comprising DS qualifies under the employee priority legislation in Section 68 of Finance Act 1988 as "an offer to the public of shares in a company at a fixed price". Therefore if the flotation consists of an offer of DS, priority enjoyed by employees will qualify for the exemption provided by Section 68, if the normal conditions are met.

25. <u>If the DS technique is not used</u> and the 12 distribution companies are floated separately, then the only problem is with the jointly owned companies. The proposal is that employees of the jointly owned companies will be granted priority rights over a basket of shares, comprising reduced allocations of shares in each of the 12 companies. If, for example, employees of the distribution companies are each offered priority rights over £2,400 worth of shares in their employing company, and if those 12 companies should chance to be of equal value, employees of the jointly owned companies will be granted priority rights over £200 worth of shares in each of the 12 companies.

26. The employee priority legislation, however, requires that all those entitled to priority allocations of shares are entitled to it on "similar terms". This requirement admits variation of individual offers of allocations by reference to level of salary or length of service, for example, but it would not cover the sort of variation proposed above. We suggest that, as in respect of employee share schemes for the jointly owned companies, Ministers may wish to bring employee priority offers involving such reduced allocations of baskets of shares within the scope of the legislation. This would entail legislative provisions specific to the electricity industry.

27. <u>As a further point on priority</u>, the Department of Energy are also asking for confirmation that should flotation take the form of a single public offer using DS, we would not regard the Section 68 "similar terms" requirement as breached if distribution company employees are required to convert their DS into shares of their employing company as a condition of obtaining a priority allocation, whilst employees of the jointly owned companies escape such a requirement. However we consider the imposition of such a condition would amount to a breach of the conditions laid down in the present legislation, and so would deny employees the priority tax exemption. Other

privatisation priority offers to employees have had no strings attached - but they have not involved DS. It might be considered consistent with the general aims of the legislation (of employee commitment to the company he works for) to impose such a condition on distribution company employees. We therefore suggest that if flotation is by means of the DS method, there should be a legislative provision confined to the electricity industry to allow a conversion requirement of the kind Department of Energy suggest.

Other points

28. As explained in paragraph 12 above, the Department of Energy are seeking an amendment to the legislation relating to the use of shares in companies which are members of consortia - the 3/20 amendment to 1/20 - but they have also raised two alternative possibilities. Both would seem to conflict with the policy objectives expressed in other contexts, of wanting to avoid giving the employees of the jointly owned companies interests in only one or a few of all their parent distribution companies. However we assume the Department of Energy wish to establish the extent of the room for manoeuvre in their discussions with the industry.

29. One is a wish to see the profit-sharing schemes of the jointly owned companies have freedom to use the shares of just one of the distribution companies. The present ESS legislation would accommodate this (assuming the revised consortium rule is set).

30. However, as a second point Department of Energy would wish the jointly owned companies to be free to appropriate, to each employee, the shares of the distribution company in whose area he lives or, alternatively, works. So, in the case of Gridco, for example, employee 1 would receive free shares in company A, employee 2 would receive free shares in company B, and so on. This proposal would not be acceptable

under the present legislation, which requires that all employees who participate in an approved profit-sharing scheme "actually do so on similar terms". Share allocations to individual employees may vary according to level of remuneration or length of service, but a scheme cannot offer them shares in different companies, as is requested here.

31. Amendment of the legislation to permit such a facility would allow schemes to discriminate between employees in the very way that the "similar terms" condition and other detailed provisions relating to scheme shares are designed to prevent. Any relaxation would therefore need to be confined to electricity. Having regard to this fact, and to our suggestion in paragraph 14 above for legislative changes to facilitate the preferred alternative of baskets of shares (3/20 to 1/20), which better serves the aims of the approved employee share scheme legislation (as well, we have understood, as the industry's own aims), Ministers may conclude that the concession of such a facility is not justified.

Conclusion

32. This submission examines those of the various employee share possibilities put to us by the Department of Energy which give rise to difficulties under present legislation. Having regard to the stipulation in your letter of 24 October to the Minister for Department of Energy that nothing should be said to the industry, advisers or publicly which implies that special tax relief or concessions will be made available, the Department of Energy have not consulted the industry yet about these proposals. They wish to do so as soon as possible.

33. We should be grateful to know if you are content that

i. the limit in the rule permitting the shares of a member of a consortium to be used in approved

schemes should be reduced from 3/20 to 1/20 (a general change for inclusion in the Finance Bill) (paragraphs 12 to 14);

ii. unless insuperable obstacles are encountered in further work on the approach described in paragraph 17, legislative changes should not be made to enable distribution shares to be used in profit-sharing schemes (paragraphs 16 to 18);

iii. a concession should not be granted as regards the calculation of market value of shares appropriated under profit-sharing schemes (paragraphs 19 to 23);

iv. if the DS method is not used, there should be legislative provisions confined to the electricity industry - and thus in the Electricity Bill, unless the Finance Bill is preferred - to enable priority allocations to employees of the jointly owned companies to comprise reduced allocations of shares in each of the 12 companies (paragraph 26);

v. if flotation is by means of the DS method, there should be legislative provisions again confined to the electricity industry - and thus in the Electricity Bill, unless the Finance Bill is preferred - to enable priority allocations to employees to be subject to the conditions referred to in paragraph 27;

vi. changes should not be made to the profit-sharing legislation to enable employees of the jointly owned companies to be allocated shares in the distribution company in whose area they live/work (paragraphs 28 to 31);

vii. the Department of Energy may be advised of your decision on these points.

34. Since the above package appears to meet Department of Energy's main concerns we think it likely that they would be prepared to open discussions with the industry on this basis. However we cannot rule out the possibility that in due course, Department of Energy officials, or Mr Spicer, may wish to come back on some of the above proposals; or with fresh proposals relating to the generating side or Scotland.

A C Majer

MRS A C MAJER

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FROM M C SCHOLAR
DATE 22 DECEMBER 1988

ECONOMIC SECRETARY

cc Chancellor
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Byatt
Mr Monck
Mr Culpin
Mr D J L Moore
Mr S Matthews
Mr M L Williams
Miss H Goodman
Miss Hay
Mr Chaplin

Mr Beighton - IR
Mr M A Johns - IR
Mr Prescott - IR
PS/IR

Clearly a starter for 1989.

NORTH SEA FISCAL REGIME - INCREMENTALS

I attach the second of the two reports by the Working Party on the North Sea Fiscal Regime. This concentrates on incrementals although it includes, for information, some updated figures on the profitability of free-standing fields.

2. The Chancellor promised in his 1986 Budget Speech 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". Up till now, while it has been possible to demonstrate theoretically that in some circumstances tax could depress returns on incremental investment quite substantially, there has been no evidence that is happening in practice. But the evidence does now suggest that there is a narrow category of cases which may be at risk where companies' development plans on old fields were drawn up in such a way that they did not make it possible to secure the oil from some of the outlying areas of the

PRT field. There is only one such case definitely identified - Columba -, which is equal in size to one good medium-sized field. There may be a few other cases but the total population must be quite small because for new fields, development plans are made for the whole of the PRT field.

3. The other problem which has hitherto prevented any action has been our inability to identify an instrument which would improve the profitability of projects at risk without carrying a very substantial deadweight cost. However, this year the Department of Energy have managed to devise a relief closely targeted on the problem area. This is a PRT Incremental Investment Allowance equal to 15 per cent of the cost of capital expenditure on getting oil out of parts of a PRT field not covered by a development consent. To target it more precisely, it would be restricted to pre-1982 offshore fields outside the Southern Basin.

4. All three departments (Treasury, Inland Revenue and Department of Energy) are agreed that this is more cost-effective than any previous scheme we have considered. It would probably tip the balance for Columba and, if so, we would expect it to result in a worthwhile net gain for the Exchequer. However, negotiations on royalty refunds for Columba broke down and there can be no guarantee that this relief would be effective where royalty refund failed. So there is some risk of embarrassment if you introduce the relief but Columba still does not go ahead.

5. The Inland Revenue recommend against introducing this relief. They are concerned that it would add an extra layer of complexity to an already complex regime. They are conscious that Ministers are anxious to keep down the length of Finance Bills and question whether this relief - targeted as it is on one project and with no guarantee that it will even be effective in securing that project - can be a priority for Finance Bill space.

6. There is clearly force in these arguments. But I and others in the Treasury (like Department of Energy) feel that these difficulties are outweighed by the benefits of making the change. The Revenue's best estimate is that the Exchequer would gain some

£60 million (net present value at 1988 prices discounted at 10 per cent real) by introducing the change. In view of this, and of the Chancellor's 1986 statement, I am in favour of going ahead with the relief.

7. If you were minded to take action there would be some advantage in doing so in the 1989 Finance Bill notwithstanding the pressures on space; the sooner the operators get this relief the more likely they are to use it, given that Columba would use the Ninian collection facilities, and that with the passage of time the economics deteriorate.

8. I have made some suggestions, in my minute of today's date on abandonment, how you might handle this report, both immediately and in relation to the Budget.

MCS

M C SCHOLAR

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FROM M C SCHOLAR
DATE 22 DECEMBER 1988

ECONOMIC SECRETARY

cc Chancellor
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Byatt
Mr Monck
Mr Culpin
Mr D J L Moore
Mr S Matthews
Mr M L Williams
Miss H Goodman
Miss Hay
Mrs Chaplin

Mr Beighton - IR
Mr M A Johns - IR
Mr Prescott - IR
PS/IR

[See also sep note on incrementals behind]

NORTH SEA FISCAL REGIME: REVIEW OF ABANDONMENT

I attach this review, and a covering note by myself following a discussion in the Steering Group. These, I hope, speak for themselves.

2. The Steering Group discussion closed the gap to a degree between the Department of Energy and us. But Energy remain in favour of alienated Funds and the Revenue are against them. I share the Revenue's view, although you will see from the Working Group's report that others in the Treasury do not.

3. When you have digested this and the parallel report I am putting to you today on incrementals you may want a discussion with us and the Revenue. I suggest that the next step after that would be a letter from you to Mr Morrison recording your conclusions, and thereafter a letter to the industry.

4. That presupposes that you will not want to hold back any of this for the Budget. You and the Chancellor will want to think about that, but my own view is that abandonment would not fit in the Budget but that the change on incrementals, if you decided to make it, should be held back for the Budget (although not for the Speech).

MCS

M C SCHOLAR

CONFIDENTIAL

REVIEW OF ABANDONMENT

Note by the Chairman of the North Sea Fiscal Regime Steering Group

I attach a report by the North Sea Fiscal Regime Working Party on abandonment. Chapter 1 of the Report contains a comprehensive summary of the issues which arise. This note, which follows a discussion by the interdepartmental Steering Group, suggests two possible courses of action for the government.

2. The immediate question for decision is whether tax relief should be conceded, as UKOOA propose, for payments into alienated abandonment Funds. The Steering Group concluded that, while there were attractions in this course, there were also considerable difficulties. Alienated Funds would enable the industry to provide for abandonment as part of the ongoing cost of field development rather than at the end of field life when production has ceased. Without tax relief it is unlikely that many of these Funds would be established, and without these Funds there would be a risk of default by the smaller companies, and thus risks for the larger companies. There would thus be much pressure over many years from the industry at large for a tax regime which they saw as fair and ensured (as the present regime does not) that abandonment costs could in all cases - not just in the majority of cases - be fully offset against taxable income.

3. Against this, the government has undertaken no obligation to change the tax rules, in the companies' favour, at this stage in the development of the North Sea. Most abandonment expenditure will get full and effective tax relief anyway under the existing regime, and we would not expect, by granting tax relief to the Funds, to affect the timing of abandonment, to any significant extent. The Revenue would need to devise very complex rules to ensure that these Funds were used only for their proper purpose, and cannot be confident that they would succeed in this.

Unless the rules allowed the Funds to be set up on terms which the companies found broadly acceptable they would be likely to continue to press for relaxations to these rules. There would also be pressure from other industries and from banks and insurance companies for a similar concession for them.

4. The Steering Group also considered other possible tax changes suggested by UKOOA:

(i) On Corporation Tax the industry have asked for immediate, 100 per cent deductibility for abandonment expenditure and for indefinite carry-back of any resulting losses against income of earlier periods. We think there are good arguments of principle for the first of these proposals; but there are difficulties. We think that if full, immediate allowances were conceded this would have to be extended to the cost in all industries of dismantling plant and machinery. And, because unlimited carry-back would impracticably require reopening corporation tax assessments in some cases for many years past, we suggest that no more than a three-year carry-back be conceded (the furthest allowed in other circumstances) - though this might in practice be of little help to the companies most concerned.

(ii) On PRT the industry are seeking a "conservation" formula which would provide effective PRT relief at not less than the average rate of PRT paid over the field life. Although we are doubtful about the rationale of this proposal it would be inexpensive, limited in scope, and would guarantee that all abandonment expenditure got effective PRT relief.

5. Although UKOOA insist that these proposals are not alternatives to Funds they may, clearly, to a degree, be so regarded. But there is a further complication. The Steering Group are agreed that action must be taken to limit or to abolish

interest on PRT repayments. This will be very unpopular with the industry, since it is likely to be very costly for them, but there can be no justification for PRT repayments which exceed the abandonment costs which generated them.

6. The Steering Group identified two alternative courses of action:

(i) to rule out tax relief for Funds, but return to the industry with more detailed discussions on an alternative package. This might comprise immediate 100 per cent relief on Corporation Tax, carry-back of losses for a three year period, action on Corporation Tax clawback (paragraph 32 of Section I) which will benefit the industry and further consideration of the industry's suggested PRT conservation formula.

(ii) if Funds are not to be ruled out we would need to say to the industry that only genuinely alienated Funds are on offer; that the income and gains of the Funds themselves had to be taxable; and that, where money taken out of the Fund was not spent on abandonment, there would be a tax charge at least equal to the relief already granted. (Since the Report was finalised, UKOOA have written to say that these conditions would be acceptable.) On this course the case for the other tax changes in paragraph 4 above is less clear.

7. On either course PRT interest relief will need to be limited, or abolished; and in neither case would there be legislation in the 1989 Finance Bill. The next step would be to return to the industry with broad guidelines which would be worked up into more detailed proposals for 1990.

8. Ministers are invited

(i) to agree that the public expenditure route canvassed in the Report should not be pursued;

(ii) to decide whether tax relief on payments into alienated Funds should be conceded or not;

(iii) if tax relief is to be conceded, to consider whether this should be done on the basis in paragraph 6(ii) above;

(iv) if not, to consider whether the alternative package in 6(i) above should be discussed with to the industry;

(v) to agree that action should be taken on PRT interest payments.

HM TREASURY
22 December 1988

CONFIDENTIAL

NORTH SEA FISCAL REGIME WORKING PARTY

REVIEW OF ABANDONMENT 1988

REVIEW OF ABANDONMENT

SECTION I: INTRODUCTION AND SUMMARY OF CONCLUSIONS

1. North Sea oil fields are unusual, though not unique, in involving very heavy expenditure at the end of their life from the removal of giant structures. The overall cost is likely to be about £4.2bn, in 1988 prices*, spread over a period of 20 years or so. Though alternative non-tax approaches would be possible, there are already rules in place - for PRT, CT (and Royalties) - which give relief via the tax system for most or all of the costs concerned. But, when these rules were written the problems of abandonment either did not exist (in the case of CT) or little was known of them (in the case of PRT). In particular, the industry are concerned because they do not believe they will always be able to get full effective relief even though the costs are generally allowable. They regard this as inequitable and risking encouragement of premature abandonment. They also seek fiscal encouragement for security arrangements against the possibility of individual companies defaulting on their obligations.

2. There are also potential distortions the other way, particularly concerning interest on repayments of tax, which could reduce companies' incentives to control costs on abandonment and/or to curtail uneconomic activity.

3. The Working Party looked at all this in 1981 but recommended at that stage that it was premature to make changes when so little was known about the size and nature of the abandonment obligations. Ministers did, however, authorise us to write to UKOOA saying that there would be a full review but the time was not right and that in their view there were some aspects Government would need to review from its side.

4. Abandonment is still a long way off for most fields - the bulk of abandonment expenditure is likely to occur in the period 1995-2015 - but we need to look again now because

(a) With the passing of the Petroleum Act 1987 and with the development of "Guidelines and Standards" by the IMO, both the regulatory framework governing companies abandonment obligations and the removal standards to be met, are becoming clearer.

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* All costs, yields, etc in this Report are in 1988 Prices unless otherwise stated.

(b) Companies are having to plan ahead, particularly on security arrangements.

(c) UKOOA have come up with a common industry line, and specific proposals. This report takes account of detailed consultations which - with the approval of Ministers - we had with them, and presentations by UKOOA about how companies are likely to approach the abandonment decision in practice.

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

General

5. An important general conclusion from our review is that the size and importance of any problems arising as a result of there being less than fully effective relief for abandonment expenditure is in practice likely to be much less than might at first appear. There are three main reasons for this.

6. First, most abandonment expenditure will in fact get effective relief. In the case of PRT, for example, we estimate that nearly half of all fields will not pay PRT at all during their life even before abandonment costs are allowed for, and that of the 40 or so that will more than half (24) will get relief for their abandonment expenditure at the full PRT rate. On our assumptions, only five PRT payers will get relief for abandonment expenditure at a significantly lower rate than the average rate of PRT on profits over the life of the field. (And all this ignores the interest companies would receive on PRT repayments in respect of the carryback of losses resulting from the abandonment expenditure.) Nevertheless, the licensees in the fields concerned (twenty companies) would no doubt feel a sense of grievance.

7. In the case of CT, we estimate that at least 90% of total abandonment expenditure will in practice probably get full CT relief as soon as that relief becomes available though this will depend upon all the circumstances of each particular company at the time. Much of the CT relief is, however, deferred until sometime after the expenditure is incurred and there is no very good case in economics or tax principle for that.

8. Second, analysis by UKOOA themselves suggests that the impact of the tax system on the timing of abandonment via its effect on relief for abandonment expenditure is likely to be small in the generality of cases, though in certain circumstances the impact could be more significant. In theory the cost of abandonment (and tax relief) influences the decision when to abandon because companies should be maximising remaining net present value (NPV) of the field. But UKOOA's analysis shows

that timing of abandonment under this criterion is likely to be much more sensitive to other economic variables such as the oil price and field reserves than it is to the effective rate of tax relief for abandonment expenditure. And in practice companies may be using other decision rules that are not sensitive to the cost of abandonment itself or, therefore, to the effective level of relief.

9. Third, tax is in any event only one of a large number of commercial, economic, technical and other considerations that may impact on the decision whether, when and how to abandon a particular field. Moreover, abandonment is still in most cases a long way ahead, and there are a great many uncertainties and imponderables all of which could significantly affect the method, timing and cost of abandonment in particular cases.

10. Nevertheless, within this general context, there are some arguments in favour of changes, though not necessarily as extensive as those UKOOA propose. Tax changes might do something

- to decrease the risk of companies defaulting on their obligations
- to give earlier CT relief, and more effective relief in the minority of cases where it is not at present effective, and thereby increase the companies perception that the UK tax regime is fair (which in turn could have a marginal effect on their desire to invest in the UK)
- to reduce risks of premature abandonment (usually by only short periods but large costs to the economy could be affected in those short periods)
- to increase cost consciousness in work on abandonment in the minority of cases where interest on repayments may distort decisions.

11. UKOOA have put forward four main proposals:

- CT and PRT (and Royalty) relief for contributions to abandonment funds set up in advance of abandonment to provide partners with security that eventual obligations will be met
- immediate CT relief for the expenditure when incurred (rather than, as at present, 25% writing down allowances)
- indefinite carryback of losses for CT
- a new "PRT relief conservation formula" which would provide a minimum level of PRT relief for

abandonment expenditure equal to the average rate of PRT paid over field life.

12. In addition they and UKOITC have raised a large number of more technical issues. And on the Government's side there is a need to consider reduction in the amount of interest which can be received where PRT is repaid because of abandonment losses.

TIMING OF ACTION

13. This is a long list of proposals to consider with complex interactions and ramifications for other sectors. The only proposal which would have any immediate impact is abandonment funds since these now need to be set up for some fields if they are to be fully effective. As UKOOA understand the difficulties in simply accepting their list of proposals as it stands but would like time to consider any amendments, they have proposed that immediate decisions should be limited to abandonment funds and that we should go on talking to them at Official level on the other proposals. With three important qualifications we think this is sensible. The provisos are:

- Action on abandonment funds would be a major step in the industry's direction. If Ministers decided to take it they ought to consider whether they want to make the main change adverse to the industry (interest on PRT repayments) at the same time. We could not guarantee that a second, later package could include as positive a balancing item as Funds for this negative item.

- It is not sensible to take a decision on Funds without at least some thought about where we wanted to end up on the other issues. For example, if Ministers actually decided that all the options on tax relief for abandonment expenditure were unattractive and wanted to go back to the drawing board and adopt a grant route, then tax relief on funds would not be a sensible first step to take.

- It might be helpful to focus any further work on areas which are likely to prove productive by telling UKOOA which proposals might prove attractive if they were worked up and solutions were found to particular problems with them and which proposals it is already clear are unattractive. UKOOA agree with this and would welcome some sort of Ministerial guidance or statement of intent on any proposals not included in the 1989 Finance Bill.

14. UKOOA have indicated that they would be very concerned if Ministers acted now on interest and some companies have indicated that they would rather defer action on Funds than have Funds accompanied by removal of interest. They believe that if they have more time on interest they might be able to come up with a compromise acceptable to both sides. We shall not know if UKOOA as a whole support this line until after their next Council meeting on 15 December.

15. In paragraphs 16-39 below we summarise our conclusions on the individual proposals, taking each one separately. In paragraphs 41-54, we consider the proposals as a whole and identify the decisions to be taken now against this background as regards timing.

Specific proposals

16. There is a particular problem faced by North Sea oil companies arising from the fact that each participator in a field is jointly and severally liable for the cost of abandonment and the resulting need for each participator to secure himself against the default of one or more of his co-venturers. To deal with this problem UKOOA have proposed an alienated funds scheme under which, in the context of security agreements, participators who could not provide other acceptable security to their co-venturers (eg by means of a parent company guarantee) would be able to provide for the cost of eventually abandoning fields by setting money aside in advance for this purpose in a special, independently administered trust fund. UKOOA propose that contributions to such a fund should be made 100% deductible for PRT, CT and Royalty purposes, and also that any income or gains earned by such Funds should be free of PRT, CT and Capital Gains Tax. This proposal is examined in depth in Section V.

17. There are a number of significant advantages in having such a scheme. It would make sense in economic terms since the payments against future liabilities are properly a part of the economic cost of providing current output. The more companies set up such schemes, the greater assurance the Government has that obligations will be met without having to use its regulatory powers. Relief would be spread more smoothly over time (reducing some very uneven and large costs to the Exchequer around the turn of the century). And by providing an effective means of getting relief in advance of abandonment the pressure to make changes to give full relief at the time of abandonment would be lessened. Such a scheme would also make it easier for smaller companies to meet the pressures which they face from their larger partners to provide security for abandonment in advance. Without such a scheme there may be real difficulty for some companies in meeting these pressures.

18. But the proposal raises a number of very real difficulties in practice. These would not necessarily be insuperable, but the scheme would have to be very complex and restrictive. Some companies would almost certainly not be prepared to accept all of the restrictions that we consider would be essential, and it seems probable therefore that Ministers would be under real and continuous pressure from the outset to relax it.

19. In particular if companies were not to be able to use the Funds as a convenient tax shelter for spare cash it would be necessary to ensure that there was a tax charge on withdrawals for any purpose other than abandonment at least equal to the rate of relief on contributions. Some UKOOA members are already indicating that they would find the sort of measures this would require pretty unacceptable. We also think that income and gains of the Funds themselves would have to be taxable but we believe that UKOOA would be prepared to accept this if the alternative was no tax deductible Funds at all.

20. There is also the question of possible repercussions elsewhere. There are obvious direct parallels with the nuclear industry and other heavy capital intensive industries and there could well be pressure to concede tax relievable alienated Funds for those industries as well. That would not necessarily be undesirable, given the general economic case for such relief, but we have not addressed in detail the other considerations involved in these cases.

21. There might also be pressure, particularly from eg banking and insurance to concede relief for 'provisions' more generally. However, we believe that Ministers should be able to resist this, provided that they were prepared to take - and maintain - a tough stance on Funds, particularly as regards alienation and the charge on non-qualifying withdrawals.

22. There is also the question of probable take-up and, linked to this, cost. The extent to which companies would make use of Funds is extremely uncertain. UKOOA's initial view was that relatively few companies would do so, because most of them would prefer to retain funds for their own use rather than to alienate them. But in a straw poll if 30 of their members, one third said they definitely would participate and another one third said they probably would. It is suggested that some companies might use the facility not just on security grounds, but as a way of hedging against the risk of the government subsequently changing the tax rules.

23. The main effect as regards cost, however, would be one of timing - bringing relief forward, with a substantial revenue loss up to about the year 2000 off-set by much larger yields thereafter. But there

would also be a real net cost to the Government in NPV terms of up to about £100M to the extent that Funds also enabled some companies to get more effective relief for their abandonment expenditure than they would otherwise. On the other hand, this is the maximum cost on the simplifying assumption that all companies participated in Funds; if they did, however, that would reduce the need for, and cost of, the other proposals and also the cost under the current regime of interest on PRT repayments.

24. Overall, we think that the judgement for Ministers is this: even if all of the conditions could be got right so as to avoid over-provisioning etc and were actually acceptable to the industry, would a major and complex new development of this kind really be justified, bearing in mind especially the relatively small scale nature of the problem and that in the absence of tax-deductibility for Funds companies could still adopt this or other mechanisms (albeit without the tax efficiency) to deal with the security problem?

25. One alternative mechanism would be third-party guarantees, particularly from a bank. Under present tax rules, however, the fee paid for such guarantees would not be deductible for either PRT or CT. UKOOA have asked for deductibility, though very much as an afterthought to their main proposal on Funds. We recommend against action on this proposal, certainly at this stage, not least because of the possible repercussions elsewhere of going down this route. Ministers could, however, review the position if UKOOA pressed the point and came forward with further and more specific proposals than hitherto.

26. The two main proposals from UKOOA on Corporation Tax are for full immediate allowances for abandonment expenditure, and for unlimited carryback against early income of any resulting losses. (Section VI)

27. We believe that there is a good case at least in principle for full, immediate CT allowances, but that would be true for dismantling costs of all assets, not just oil abandonment. We believe, therefore, that this is not a measure that could be restricted to oil - it would have to be extended to dismantling plant and machinery in all sectors. (For most other assets immediate full relief is already available.) The cost (assuming companies concerned were in a position to use up a full 100% allowance in the year it was given) would be up to about £40m in the early years (mainly in respect of non-oil companies), rising to a maximum about £80m in the early 2000's when abandonment begins to peak. However, much of this would represent a timing cost - ie giving relief earlier than would otherwise be available on the 25% Writing Down Allowance basis.

28. The Revenue would recommend strongly against indefinite carryback on operational grounds, and there is a strong case on these and other grounds for making any extension to the carryback period as short as possible.

29. On the other hand, a carryback of 3 years would give companies little beyond what is available already; and even doubling this, to 6 years, would not be enough to help all of the particular companies concerned.

30. A further possibility, to help minimise the operational difficulties, would be to confine any extension of carryback to oil abandonment losses only. This might be justified on the grounds that the regime for oil taxation is tougher than elsewhere. But it might sit oddly with extension of full immediate allowances to all industries; and, it would undoubtedly set a precedent for other companies seeking "me too" treatment.

31. These two proposals are clearly linked, though it would in theory be possible to act on one or the other and not both. Again, as regards either of them Ministers will want to consider whether the problem is big enough to justify action, and the wider repercussions involved, bearing in mind particularly our estimate that some 90% of companies' abandonment expenditure could get full CT relief anyway as soon as it becomes available.

32. We are also recommending a change in the rules concerning CT clawback of PRT repayments arising from the carryback of losses, including abandonment losses. The effect of this change would be to relieve companies of interest on the CT clawback which would otherwise become payable under the new "Pay and File" rules, and to create more CT assessable income in the period in which the abandonment expenditure was incurred and so provide more income against which that expenditure could get effective relief. UKOOA's preliminary response is to welcome this proposal, though they think there could be possible US tax problems for some companies and this aspect would need to be considered further.

33. As noted, many fields do not pay PRT and at least half of those that do will get full PRT relief for their abandonment expenditure. But a few PRT payers will get relief at a level significantly lower than the average rate of PRT paid on their profits over the life of the field. UKOOA regard this an inequitable and constituting a potential source of distortion, and they have therefore proposed introduction of a mechanism - a PRT relief conservation formula - that would provide where necessary for the effective rate of relief for abandonment expenditure to be increased so that it was at least equal to the average rate of PRT paid on profits over the field life. (Section VII)

34. We do not see a strong case for UKOOA's proposal. As noted, only a minority of companies will be seriously affected by the problem that it is designed to address. Moreover, the case in principle for such a mechanism is not strong anyway (UKOOA themselves describe it as a pragmatic solution) and it is open to a number of objections, particularly its asymmetry - ie giving more relief when this is less than the rate of tax on profits, but not reducing relief when it would otherwise exceed the rate of tax on profits. There would also be a number of technical and operational difficulties. On the other hand, the proposal would not cost a lot, and there would not be a problem as with the other proposals about repercussions elsewhere.

35. Interest on PRT repayments (Section VIII). Under present rules, where there is a repayment of PRT - eg resulting from carryback of losses - interest is also payable. This has not been a serious problem hitherto, mainly because the amount of losses being carried back is small. Once abandonment starts, however, there are likely to be very large losses being carried back over long periods. The cost to the Exchequer could become very large; and in some cases, the amount of tax relief plus interest might actually exceed the expenditure in question. The present regime could, therefore, lead to significant distortions in company behaviour concerning both cost control and the timing of abandonment, and involve a very large cost to the Exchequer.

36. We believe that Ministers will want to tackle this issue, though we recognise that this will not be easy. The only solution that would get to the heart of the problem would be to abolish interest on PRT repayments arising from loss carryback altogether. UKOOA have made clear, however, that companies would fiercely resist this. The alternative, which might be presentationally more attractive and deal with the worst aspects of the problem, would be some kind of capping arrangement so that the total amount of PRT relief plus interest could not exceed some specified proportion of the total expenditure. But this would not be ideal - total relief on expenditure at the margin could still exceed 100% - and it could in certain circumstances even have a perverse effect.

37. In theory, these problems could arise with CT as well, particularly with the introduction from 1993 of 'Pay and File'. We would recommend, however, confining action to PRT unless UKOOA's proposal for indefinite carryback of CT losses were accepted.

38. Finally, there are a great many technical issues and anomalies in the existing rules arising in connection with abandonment. (Section IX) Most of these need to be addressed regardless of what is decided about UKOOA's three main proposals. Some have been raised by UKOOA,

others by the Revenue. Most would involve changing the existing rules to ensure that they catered effectively for abandonment and the circumstances surrounding it, and to that extent would be regarded as helpful by companies. Two areas which UKOOA themselves consider particularly important are ensuring a sufficiently comprehensive definition of allowable abandonment costs for both PRT and CT, and changes to ensure that where one participator in a field does default on his abandonment obligations and that the other participators end up meeting those costs, they are actually allowed a deduction for them.

39. The Revenue will be pursuing all of these matters separately with Treasury Ministers in due course. We do not see a case for immediate action on any of them, even if Ministers did decide to act on Funds in 1989.

/COSTS

COSTS

40. The table below sets out our best estimates of the costs/yields for each proposal - on an annual basis, overall, and in NPV terms. These are extremely uncertain and most do not arise for quite a long time. The only immediate costs would be an annual cost of up to £100m (but almost certainly much less) for Funds, and a cost of up to £40m if immediate CT relief were given to non oil costs of removing plant and machinery as well as abandonment. An important general point to note is that some of the proposals would be alternatives from the company's point of view and the costs/yields would therefore not necessarily be additive. This is relevant particularly to Funds where, for simplicity, we have had to assume that all companies would provide for the whole of their abandonment expenditure via a Fund. But if they did so that would, of course, reduce the cost of the other proposals to nil.

	RANGE OF ANNUAL COSTS(-)/YIELDS(+)	OVERALL UNDISCOUNTED	OVERALL NPV(10%) FROM 1988 (£m, 1988 Prices)
FUNDS	-100 to +500	+2000	-20
CT			
(i) Immediate relief			
- oil only	-80 to +30	-40	-100
- non oil	-40 to +20	0	NA
(ii) Carryback extended to 6 years	NA (*)	-60	NA (*)
(iii) CT clawback of PRT repayments	NA (*)	-240	-40
PRT RELIEF CONSERVATION	-15 to 0	-25	-10
PRT INTEREST			
(i) Complete abolition	0 to +150	+670	+110
(ii) Restricted to 2 years	0 to +130	+500	+80
(iii) Capping to 85%	0 to +140	+500	+80

* Not available because dependent on unpredictable year to year level of non-ring fence profits in individual companies.

DECISIONS TO BE TAKEN

41. The first and most important immediate decision needed is whether to introduce tax relief for alienated Funds and if so, when. The basic question is whether the advantages of extra security, smoothing of Exchequer cost and giving companies a certain way to get effective relief are worth the complexities and immediate costs of the scheme.

42. But there is an interaction with other proposals. If Ministers felt that the present CT and PRT rules on abandonment expenditure were unsatisfactory then they might feel

- that changes on the lines UKOOA proposes would be acceptable and that these reduce the case for action on Funds (though UKOOA themselves argue they are not alternatives);

- that changes on the lines UKOOA proposes would not be acceptable and that a totally different approach would be needed through grants. In that case giving tax relief for Funds would be less appropriate since Ministers would then have a problem in taking account of tax relief on Funds given to some companies but not others when setting up the grants;

or Ministers could decide;

- that neither grants nor the sort of changes UKOOA proposes are acceptable in which case the arguments for Funds (as a way of guaranteeing relief) increase.

43. If Ministers do decide to act on Funds, there is the linked question of when to do so. UKOOA would obviously prefer action as soon as possible, but time is getting short and quick decisions would be needed if anything is to be done in 1989. The alternative - again assuming Ministers did want to act on Funds - would be to announce their intention now of doing so but to postpone the actual legislation until 1990. This would give more time to get the details of the legislation right and to consult the industry about them, but it would mean that a few fields needing to set up security arrangements now would have to start on a basis of no tax relief and later switch. If on the other hand the decision was not to act at all, this too would need to be announced at some stage - see paragraph 52 - below.

44. The Department of Energy would favour the introduction of Funds now. They believe that a significant minority of smaller companies could otherwise face serious problems in meeting their security obligations. Whatever anomalies may remain in the tax system, the introduction of Funds would provide at least

one way in which the industry could secure full deductions for abandonment costs by prudently setting aside funds in advance. In the Department's view this should do much to de-fuse the abandonment tax issue. The need for action on this proposal (unlike the others) is urgent because some fields are already approaching the point where the after-tax value of future oil revenues will be less than the abandonment cost.

45. The Treasury would be in favour of taking action now. Even if there were only partial take up, the Funds would enable those companies to secure more effective relief which would otherwise be denied them, despite the economic justification for it. Although the administrative arrangements would not be without difficulty, the Treasury feels that an acceptable scheme could be devised, which would probably have as one element an arrangement for monitoring withdrawals against prospective liabilities. Such an arrangement, which would probably be administered by D/Energy, would make more acceptable to the Government any swings or roundabouts in the tax rules, particularly when it would often be the timing of tax relief rather than its amount at issue. (The Department of Energy's view, which is reflected in paragraph 30 of Section V, is that an attempt to control withdrawals in this way would probably not be very meaningful).

46. The Inland Revenue recognise that Funds would have some real attractions but they have serious doubts whether the legislative complexity and administrative burdens are justified for a measure which UKOOA themselves see as only a partial solution of what does not anyway seem an enormous problem. The rules would need to be tough to ensure tax neutrality but it is already clear that not all companies would find that acceptable. This could reduce the number of firms using the scheme. It would also lead to continual pressure for relaxations. At the same time other sectors could use this radical new departure in the tax system as a basis for seeking similar reliefs elsewhere.

47. The <u>second</u> decision is whether to act on interest on PRT repayments and, if so and Ministers do decide to act on Funds, whether to do so at the same time.

48. As mentioned earlier, we believe that the case in principle for action of some sort is very strong indeed. However, the arguments as regards timing are more finely balanced. We do not have a perfect solution yet and this points to delay and inclusion in a later package. On the other hand, since Funds would be a major change and very welcome to the industry, and especially if there were not likely to be any significant concessions to the industry on their other proposals in later rounds, the announcement of Funds might be the best time, psychologically, to deliver bad news to the industry on interest. However,the industry would no doubt regard it

as artificial to couple just these two items together bearing in mind that Funds would not cost the Government very much money (whereas action on interest could be very costly to the industry), and that there is no more reason for urgency in dealing with interest than there is in dealing with the other outstanding issues which the industry has raised.

49. On balance we think action could be deferred but that Ministers should announce a firm intention to address the question of interest together with those of the industry's other proposals they were sympathetic to. If, however, Ministers wanted to act now, it would be possible to introduce capping now, knowing that it did not solve all the distortions but would be hard for the industry to oppose, and consider a more radical solution later if Ministers were willing to give the industry what they wanted on the remaining proposals.

50. If on the other hand Ministers decide not to agree to Funds, we would recommend deferment of action on interest until the remainder of UKOOA's proposals are addressed.

51. The <u>third</u> decision is probably whether Ministers see so many problems in a tax route that they would like to consider the grants alternative in greater detail than we have been able to do so far. This would be more predictable and be easier to avoid distortions; on the other hand the industry would regard it as less reliable and it would add substantial amounts to public expenditure around the turn of the century. It is doubtful whether the problems with the tax route are sufficiently great to necessitate a change of direction of this magnitude.

52. The <u>final</u> decision would be whether to issue some sort of "statement of intent" to UKOOA on the directions Ministers wanted to go on other changes and, if so, what it should say and, what its timing would be and whether it would be public or not. We think there would be many advantages in saying something in order to focus work in productive areas. There seems no great merit in making a public statement at this stage. But if a decision was eventually taken to introduce full, immediate CT allowances for dismantling plant and machinery, not confined to oil, then it would at a later stage be desirable to consult more widely (possibly on the basis of draft clauses) on that particular proposal. If the statement of intent is not public and takes the form of a letter to UKOOA it would seem sensible to issue it at the time of the Budget if Ministers were acting on Funds, but at some earlier date if not.

53. As for its contents it might say something on the lines:

- Recording Ministers decision on Funds (and on interest if a firm decision is taken).

- Stating whether Ministers see an attraction in principle in immediate full CT relief. If the cost (including non oil costs) are acceptable we think this is right in principle and might have some small effect on confidence but is not likely to affect distortions of timing or the risk of default significantly. At this stage, therefore, we would suggest a cautious indication that more work would be appropriate and a recognition that it would be difficult to limit change to oil.

- Explaining that indefinite carryback of losses for CT is impracticable, but suggesting that work should continue to examine lesser measures, including an alteration of the timing of clawback of CT on PRT repayments.

- Saying that the PRT relief conservation formula does not look attractive while not completely ruling out action on PRT.

- Promising a thorough review of the technical representations.

54. UKOOA would be disappointed by any decision not to proceed with Funds or by a decision to proceed with Funds but also act on interest this year. We do not think they would be surprised by that or by a "statement of intent" on the lines in paragraph 53 but they have warned - it is difficult to judge how seriously - that if the Government does not accept all their tax proposals they may wish to review their support for a tax route and reconsider whether they want to advocate a grants route.

SECTION II: FRAMEWORK FOR THE REVIEW

The basic problem

1. By and large, PRT and Royalty give a full allowance for qualifying expenditure (which would include most abandonment expenditure (abex)), but not until the expenditure is actually incurred. With CT also relief is not given until the expenditure is actually incurred, though in that case it is then given on a 'slow train' basis in accordance with the relevant capital allowances code, rather than in full immediately. By definition, this means that for a lot of abex there will almost certainly be insufficient current taxable income against which to relieve the expenditure. Carryback of resulting losses against profits of earlier periods is possible under PRT (and can be made so by administrative action for Royalty) and so effective relief may still be obtained in particular cases. But in other cases there will not be effective relief. And, in the case of CT, only limited carryback is permitted anyway.

Relevant criteria

2. We think that a number of criteria are relevant when considering whether or not there is a problem, and in appraising possible solutions, as follows

(a) Economic efficiency: is the absence of effective relief for abex in a significant number of cases likely seriously to distort decisions on the timing of abandonment and/or the methods adopted, including incentives to minimise costs? Would any schemes put up to provide effective relief introduce distortions of their own?

(b) 'Fairness'. This is not an easy or precise concept, but it is one which the industry itself is likely to stress. A system which resulted in the Government paying a substantially different share of abandonment costs than the share of profits from the fields it had taken by way of tax, or where the proportion of relief received by different companies varied significantly, might be difficult for Ministers to defend. Companies considering investing in the UK know that once they have spent the initial money they are exposed to changes in tax eroding the return they had expected when they invested. Ideally what they would no doubt like is a completely stable tax regime though that is clearly not possible. What they do need, therefore, is

confidence that the regime will at least remain broadly "fair" in their perception; without this perception investment could be diverted elsewhere.

(c) Equity and precedents for other industries - ie the extent to which particular changes to deal with problems of oil abandonment would have ramification elsewhere, and/or would put oil companies in a privileged position compared to other taxpayers with comparable problems.

(d) Financial security against default. Though the risk of the Government having to meet the costs of abandonment have been minimised, because of the statutory obligation of 'joint and several liability' placed on companies themselves, the Government does still have a wider interest in ensuring that there are no defaults and/or that there are adequate arrangements in place between companies to deal with any defaults which do arise.

(e) Macro economic considerations - in particular, the impact of abandonment on the amounts and timing of tax flows from the companies to the Exchequer.

(f) Practicability and the need so far as possible to avoid adding new complexities to an already very complex regime.

3. A major factor in the analysis of this issue is uncertainty. We are looking a very long way ahead, and there are a great many variables and imponderables all of which may significantly affect the method, timing and cost of abandonment in particular cases. It follows that this report is not a blue-print for the future, merely our best guess at this stage about what is likely to happen. There are bound to be further significant changes which we cannot at present foresee with any accuracy, and that in turn will mean that new problems and possible solutions for dealing with them will need to be considered from time to time. In short, this Report does not represent the end of the matter - there will be a continuing need to review abandonment issues in the years ahead.

Abandonment costs and the present tax structure.

4. Corporation tax is a tax on profits and the starting point is the accountancy measure of profits. However, this has to be departed from in a number of respects, for example where as with deductions for depreciation it

would give too much leeway for taxpayers to choose their own liability by selecting an accounting treatment to suit. Basic to the concept of a tax on profits is a distinction between revenue expenditure (ie the costs of earning current profits), and capital expenditure (ie the costs of earning a stream of future profits where it is appropriate to spread costs over the periods in which the resulting profits are earned). This results in a "tax wedge" - ie so that post tax returns are below pre tax returns. But this is unavoidable with a tax on income like CT and what matters here is not the existence of a wedge generally, but that any differences in the wedge between projects should be minimised so as to minimise misallocation of resources. Because companies could otherwise have excessive flexibility and in order to simplify administration, tax law does not accept depreciation in the accounts but sets standard percentage capital allowances designed to reflect commercial depreciation very broadly.

5. Expenditure on abandonment does not fit into this pattern because when it is incurred it represents neither a cost of earning the then current profits, nor of earning future profits: rather, it represents costs which are properly attributable to past profits. The proper accountancy principle is to make provisions over the life of the profits which create the obligation to incur those costs. However, to accept accountancy reserves would raise the same problems as accepting commercial depreciation. Nor can the problem be solved by imposing arbitrary percentages since the total expenditure is not and cannot be known for certain.

6. What CT law says is that relief for provisions for future revenue expenditure may only be given if there is a definite obligation, and if the amount can be predicted with sufficient accuracy for the purpose in hand. These conditions can rarely be satisfied in practice. Qualifying capital expenditure can only be claimed against income after it is incurred. One question this Report raises is whether a system allowing relief as the profits arise can be made workable by having the funds alienated and the cancellation of any tax advantages of over-provisioning and whether, in addition or instead, relief should at least be given in full when the expenditure is incurred rather than being spread forward.

7. There is no general presumption in CT that where losses arise there should be immediate relief. For reasons of cost and economical administration, losses are generally allowed sideways or forwards but only one year back. However, exceptions have been made (eg 3 year carryback for terminal losses and when there were 100% First Year allowances) where effective relief was highly

likely to be unavailable. Where the balance is struck is a matter of pragmatism coloured by the need to preserve consistency between taxpayers. This Report examines whether there are special features in abandonment justifying special treatment.

8. PRT has a different structure. Once payback is reached, it follows cash flow but also allows certain reliefs on top of expenditure relief. A cash flow tax is a type of expenditure tax involving a zero tax wedge. In practice the special reliefs mean that PRT can create a wedge (either on its own or in its interactions with CT) and the important thing is that marginal investment should as little as possible be put at risk. The way the special reliefs (especially oil allowance) are taken into account can mean that relief for marginal expenditure is not effective but just displaces the special reliefs. Looking at the regime as a whole it would be very expensive to give effective relief in all cases plus the special reliefs and Ministers have never accepted this as an aim of PRT. The issue in this Report is rather, whether the present rules are likely to have perverse economic effects or be unacceptably arbitrary in their incidence.

<u>The non-tax approach</u>

9. UKOOA's proposals for CT and PRT tax relief on abandonment are designed to give full effective relief. But without a system of tax credits it is difficult to avoid the problems of the erratic effectiveness of tax relief and the other possible alternative would be to give a grant. The Norwegians have introduced a grant system, but we are not convinced that their model solves the difficulties which we have identified. Two possible types of grant are considered at Annex B; a tax related grant and a grant which is a proportion of the total costs.

10. Grants of either kind share the advantages that they would help deal with the main cash flow problem directly and effectively. Straightforward proportionate grants have the added advantage of improving security to the companies and minimising and controlling the costs to the Government. Except for the need to approve expenditure as reasonable, they would be straightforward to administer. Both would influence the timing of abandonment, though in the case of tax-related grants in more unpredictable ways, as with tax relief on abandonment itself. The introduction of tax-related grant might open up unforeseen policy problems, but grants could have advantages over tax relief at the time of abandonment in terms of distortion of the timing and amount of abandonment and security. Tax relief on

contributions to alienated Trust Funds (see Section V) however would deal better than either solution with the security problem and would be less likely to distort decisions on timing. Because both systems of grants would run counter to Government policies on public expenditure our review concentrated on the tax system. Similarly, the industry in forming their proposals have assumed that Ministers would prefer to proceed by grafting any changes on to the existing systems. The industry may also have concerns, perhaps born out of their suspicions about Norwegian intentions, that the requirement for grant to be voted annually by Parliament would increase uncertainty of whether they would actually in fact receive it compared with tax relief.

SECTION III: COST AND TIMING OF RELIEF FOR ABANDONMENT

Introduction

1. Tables 1 and 2 of Annex A attached give detailed estimates of the overall cost and timing of abandonment, excluding onshore terminal and pipeline costs, E&A expenditure effects, cross field reliefs and downstream CT relief. As explained there, in our Base Case we assume a gently rising real oil price, but we also looked at this under an alternative, constant real price scenario.

2. On the Base Case scenario, the total cost of abandonment is likely to be about £4.2bn (1988 prices). This expenditure starts to build up from about 1995 onwards, with more than two thirds arising after the year 2005.

3. Annex A also gives details - in Tables 3 and 4 - of the relief available to individual fields under the Base Price scenario, and on certain other simplifying assumptions. (There are particular difficulties here in estimating the effects on abandonment of CT because the amount of effective relief will be determined by each company's CT position at the appropriate time and this will in turn depend on their interests in other fields and on whether they, or other companies in the same group, can make use of the relief outside the ring-fence.)

4. This field by field analysis suggests that only a few of the 40 or so fields expected to pay PRT at some point in their life will get little or no effective PRT relief. Over half will get full PRT relief on their abandonment expenditure. In only 5 cases would the effective rate of relief for abex be significantly lower than the average rate of PRT on profits over the life of the fields. Nevertheless, the 20 or so companies who are licensees in these fields will no feel strongly that the existing arrangements are unfair.

5. As regards CT, much will depend (as indicated above) on the extent to which companies are in practice able to get effective relief for their abandonment costs. In practice, many companies involved are likely to be able to make effective use of all the CT relief arising from their abandonment expenditure against profits from outside the ring fence. We therefore believe that it is possible that at least 90% of these costs would in practice get full CT relief once it becomes available. In that event, only about £m400 of total abandonment expenditure, spread over something like 30 years, would not get effective CT relief.

6. Table 5 of the annex shows the Government's share in the estimated cost of abandonment and how that is split between Royalty, PRT and CT relief. As will be seen, the Government's share is about 70%, taking into account expected availability of CT relief outside the ring fence. This figure also takes account of interest on PRT repayments and of interest on the resulting CT clawback that will become payable following introduction of Pay and File.

Cost of abandonment

7. Though there are many variables and uncertainties, the two factors which will have the major impact in determining the actual gross cost and timing of abandonment in practice are the regulatory framework governing companyies' abandonment obligations, including the technical standards set for abandonment, and future technological and other developments.

8. The Petroleum Act 1987 establishes the legislative framework for controlling the abandonment of off-shore installations and pipelines. It provides for these facilities to be abandoned in accordance with a plan approved by the Secretary of State; specifies the persons on whom the abandonment obligation may be imposed; and enables regulations to be made governing such matters as removal standards, safety standards and avoidance of pollution.

9. No decisions have yet been taken on the content or timing of the Regulations on removal standards. But the Maritime Safety Committee of the IMO has agreed draft guidelines and standards which are expected to be adopted by the IMO in 1989 and which, in the interim, member states are invited to take into account when making decisions about abandonment. Broadly, the main standards are

(a) Complete removal for platforms weighting less than 4,000 tonnes and situated in shallow water (75/100 metres).

(b) For heavy (4,000 tonnes plus) deep water platforms, left to the discretion of the coastal state subject to there being a clearance of at least 55 metres between any submerged mains and the sea surface.

The IMO guidelines and standards do not cover the related question of the disposal of material from abandoned platforms, including dumping of debris and toppled platforms on the seabed. Clearly, decisions about this

could have a significant impact on overall costs of abandonment.

10. Technological developments could also have a significant impact on the eventual method and therefore cost of abandoning particular facilities. For instance, there have already been big increases in the physical capacity of heavy lift vessels and further developments in this area could significantly reduce the time and cost involved in dismantling particular facilities.

<u>Timing of abandonment: the abandonment decision</u>

11. The exact timing of abandonment in particular cases will also depend on

(a) The economic criteria adopted by companies as a basis for their decision about whether and when to abandon.

(b) Other, non-economic factors that may be relevant in particular cases.

12. In their papers and presentation UKOOA identified three economic criteria for determining when a field should be abandoned that have been postulated in the literature on this subject and that the industry itself recognises as valid. These are

(a) The <u>zero net revenue</u> criterion. This postulates that fields will be abandoned when net revenue (gross revenue less operating costs and royalty) first becomes zero.

(b) <u>Minimum profit margin</u> criterion. Abandonment here would occur when the post-tax margin on operating costs first falls below some predetermined percentage. It was suggested by UKOOA that for abandonment, this ought be 5%.

(c) The <u>NPV</u> criterion. Here, a field will be abandoned at the point in time which maximises the remaining NPV of the field at a chosen discount rate. (We were told by one company that in their view the appropriate discount rate is likely to be relatively low because abandonment will occur at a late stage in the life of the project and so will involve relatively low risks.)

13. The first two criteria are relatively simple but may be of limited use in practice. The 'zero net revenue' criterion will be difficult to apply in practice because, with, for example, oil prices moving up and down even in

the short-term, it would be difficult to know - until after the event - whether zero net revenue point had been reached. Similarly, the minimum margin criterion might be impracticable as a decision rule because a margin of the order of at least 5% would be needed anyway just to allow for all the normal uncertainties. Neither of these criteria ensures maximisation of profits as the NPV criterion does.

14. There are also numerous engineering, technical and other non-economic factors that are likely to be relevant in influencing the decision whether and when to abandon, and in particular cases these may be the dominating factors. We were also told that managements generally would be reluctant to abandon in the sense that there was likely to be a psychological barrier to taking an irrevocable decision actually to close down a field for all time.

SECTION IV: IMPACT OF TAX SYSTEM ON ABANDONMENT

1. It will be clear from the preceding analysis that tax is just one of a range of factors that may impact on the decision whether, when and how to abandon. Two of the possible economic criteria for abandonment (zero net revenue and minimum profit margin) do not depend on the cost of field abandonment itself or, therefore, on the tax relief that is available for abandonment expenditure. Moreover, even under the NPV criterion, tax will only affect the timing of abandonment if at the margin the effective rates of relief for abandonment expenditure and for other expenditure (ie which would be incurred if abandonment was deferred) were not the same.

2. Another consideration is the impact of the system in providing an incentive or disincentive to control costs. For an initial investment it is important to ensure that tax neither over - nor under - encourages expenditure. On terminal expenditure like abandonment, there is some asymmetry. If tax relief is very high in relation to the expenditure, especially at the margin, there will be no incentive to control costs. If the relief actually exceeds the cost of the expenditure, there would be a positive incentive to wasteful expenditure. If tax relief is low, there will be an incentive to cut corners but such an incentive exists if there was relief at the full marginal rate of tax. (In either case, of course, companies would be better off if they spent less and so regulation is still needed to ensure that they do not skimp.) With an initial investment, if the tax system is neutral then the future after-tax stream of income should provide the right incentive to spend the right amount of money; this does not exist with abandonment.

3. UKOOA themselves undertook some detailed analysis of the possible impact of the tax system on the timing of abandonment via its effect on relief for abandonment expenditure. The key points to emerge from this analysis are

(a) In general, any distortions on the timing of abandonment caused by the tax system are likely to be small. As noted, two of the possible economic criteria for abandonment do not depend on the cost of field abandonment or, therefore, on the availability of relief for abandonment expenditure. And, any differences in timing from the use of different economic criteria for abandonment are not more than one year for the majority of fields. Moreover, premature abandonment on this scale would involve not

much loss of production, profits or tax revenue in relation to the project as a whole, since at the end of field life operating costs and revenues (including the interest benefit of deferring abandonment) are very close in size. Nevertheless, these are large projects and even with relatively small shifts in the timing of abandonment the absolute amounts involved and the opportunity cost to the economy as a whole could still be quite large especially if a number of fields were affected. For example, the total cost of lost production if all fields were abandoned one year early would be about £600m (1988 prices).

(b) The other major economic factors, apart from tax, likely to affect abandonment timing are oil and gas prices, production profiles, on-going costs of production and incremental investments to increase recovery of oil, and the existence of any satellite or third-party field using the host field's facilities. Some of these are interrelated, and timing is likely to be particularly sensitive to reserve recovery and production profile. But the impact of any of these in predicting the timing of abandonment is in any event likely to be swamped by the margin of error in seeking to forecast variables of this kind by more than just a few years ahead, especially since the decision to abandon may have to be made well in advance.

(c) Though the overall impact of tax on the timing of abandonment may be small, it may - assuming abandonment decisions are based on the NPV criterion - have rather more effect in shifting the optimal timing of abandonment in certain cases. These cases are in particular likely to occur where

- facilities are used for satellite field production

- companies with no other interests have insufficient profits against which to relieve abandonment costs.

- PRT loss carryback/oil allowance overlap becomes critical (see Section VII below).

Even here, however, the UKOOA analysis suggested that the optimal timing of abandonment would in most cases be shifted by three years or less.

4. As regards the effect of the system in providing an incentive or disincentive to control costs, there is one particular feature of the present system that is potentially a source of significant distortion and that will, therefore, need to be considered. At present, repayments of PRT also attract interest (which is itself not taxable) running, generally, from two months after the end of the chargeable period to which the repayment relates. Where PRT relief for expenditure on abandonment was given by way of carryback of any resulting losses - which is likely to apply in most cases - these interest payments could become very large, especially in cases where losses were carried back many years. In some cases, depending particularly on the length of carryback, the total amount of relief plus interest could actually exceed the cost of the abandonment expenditure - thus providing a positive incentive to postpone abandonment. As Table 3 at Annex A shows, in only one case would total relief exceed 100% if CT was calculated purely on a field basis. In practice, many companies will have other interests (inside and outside the ring fence) and so will be able to get full CT relief. Allowing for this, the number of cases in which relief plus interest exceeds the actual cost of abandonment would be very much greater. (Column 11 of Table 3.)

5. PRT interest paid for a number of years could also push the marginal rate of relief on extra abandonment over 100%. This would give an incentive to wasteful abandonment expenditure ("gold plating"). In practice, instances where the marginal rate of relief exceed 100% are likely to be more prevalent than those where the average rate exceeds 100%.

6. The gross aggregate cost of these interest payments is likely to be about £700M (1988 prices), representing, some 22% of the total cost of relief for abandonment.

SECTION V: THE SECURITY PROBLEM

INTRODUCTION

1. Each of the participators in a field is jointly and severally liable for the cost of abandonment. Each participator therefore needs to secure himself not only against his own share of the eventual cost of abandonment, but also his partners' shares in the event of a default by one or other of those partners. Generally speaking, there will not be a problem for so long as the value of the remaining field reserves exceeds the estimated cost of abandonment - if a partner does default, the value to the other partners (assuming he forfeits his interest in the field) of his share of the remaining reserves will more than cover his share of the abandonment cost. Once that point is reached, however, (and several fields are now close to this point) a default by one participator will mean a net increase in the exposure of the remaining participators to the cost of abandonment. (Matters are aggravated because, under present PRT and CT rules, relief would not be available to the remaining participators for the defaulter's share of the costs in cases where there had not been a transfer of interest.)

2. Though there is no statutory obligation (eg under the Petroleum Act 1987) to do so, a number of companies are therefore entering into security agreements, the object of which is for each participator to be able to demonstrate to the others adequate cover for his share of the eventual abandonment costs. This might be done in a number of ways - eg bank guarantees, group company guarantees, etc - but not all of these will necessarily be available and/or acceptable to all the other participators in a particular case.

UKOOA PROPOSAL - ALIENATED FUNDS

3. UKOOA have, therefore, proposed an alienated funds scheme under which, in the context of security agreements, participators would be able if they wished to provide for the cost of eventually abandoning fields by setting money aside in advance for this purpose. There are in theory a number of possible vehicles for such alienation of funds (eg tailor-made abandonment bonds issued by the Government), but UKOOA have suggested an arrangement involving a special, independently administered Trust Fund to which participators would contribute and out of which the costs of eventual abandonment would be met. But, say UKOOA, this would be most unattractive to companies under present tax rules and they are therefore proposing that any such contributions should be 100% deductible for PRT, CT and

Royalty purposes. They also want income earned in such funds to be free of PRT, CT and Capital Gains Tax.

4. UKOOA accept that such funds would need to be subject to various quite rigid rules and restrictions. To allow for the fact that relief would be given earlier under this approach than under normal rules, and that money held in the fund would itself be earning interest until released for abandonment, contributions would be calculated by discounting remaining reserves and abandonment costs at an appropriate discount rate.

5. Abandonment expenditure financed from the Fund would not, of course, be eligible for expenditure relief. If there was a shortfall between the amount accumulated in the Fund and the actual cost of abandonment, the balance would be met by the companies concerned and a deduction for the excess would be claimed by them against PRT, CT and Royalty in the normal way. If, on the other hand, there was a surplus in the fund, or money was withdrawn for a non-qualifying purpose the amount involved would be chargeable to tax (and Royalty) at an 'appropriate' rate.

6. There would also be strict rules to ensure that both the trustees and the Trusts remained at arms length from the participators concerned.

7. The basic mechanism would - under the security agreement - be a link between the value of the remaining reserves, the value of the Trust Fund and the estimated cost of abandonment. A shortfall between the estimated cost of abandonment and the combined value of a set proportion of remaining reserves plus what is already in the Fund would be the trigger for a contribution, equal to the size of the shortfall. The first trigger point - by which time companies would obviously need to have the Fund in place - would be reached when a specified proportion of the reserves first fails to cover expected abandonment costs. Two fields have already reached the point where 100% of remaining reserves do not cover these costs, another six will reach it (on our assumptions) by end 1990 and a further 18 by end 1995.

ANALYSIS OF FUNDS PROPOSAL

8. UKOOA believe that the alienated funds approach would represent an additional and useful mechanism at the disposal of companies for dealing with the abandonment security problem. Depending on the circumstances in each case, it might also help ensure that the companies concerned got more effective relief for their abandonment expenditure. To the extent that this did happen, the proposal would - for companies using a Fund - be a

substitute for UKOOA's two other main proposals concerning CT relief and PRT relief respectively.

9. There could also be some benefits for the Government in that Funds, to the extent that they were taken up, would help spread out more smoothly and predictably over time what is in effect the Government's contribution to the cost of abandonment. Moreover, the Government has an interest in promoting a tax regime that does not unnecessarily encourage company default, and that provides companies with the confidence to continue investment in the UKCS, and tax deductible alienated funds would help promote that objective as well. Specifically, in the absence of a tax deductible fund, the need to satisfy major partners on the question of security for abandonment could well put some of the smaller participators in the North Sea in real difficulty. In terms of the flow of revenue over time at least from the oil industry there may also be some wider advantage in reducing somewhat the inflow to the Exchequer in the years immediately ahead against the higher inflow or lower outflow in years of abandonment.

10. But this would be a major new departure, and the proposal gives rise to a number of very real difficulties and concerns. Acceptable and workable solutions to all of these would be needed if the proposal was to be adopted.

(A) OVERFUNDING/TAX CHARGE ON SURPLUS ETC

11. There is, first, a linked set of problems concerning uncertainty, possible over-funding, and the rate at which any such over-funding or other non-qualifying withdrawals from the Fund should be taxed.

12. In practice it will be very difficult for companies to estimate the timing and amount of future abandonment expenditure with any degree of accuracy. Abandonment itself may still be many years ahead, and much may happen before then. The facility to be abandoned (and therefore the cost of abandoning it) may be quite different then from what it is now as the field matures and the nature of the task being performed by the facility changes. Or, new techniques for dismantling facilities etc might develop and so again change significantly the way in which abandonment is achieved; and, therefore, the cost. Two practical consequences flow from this. First, it would be impossible for us or anybody else to determine the 'right' level of (discounted) contributions to an abandonment trust at any one time. Second, these Funds are therefore liable to be under- or over-provided, although an annual process of reappraisal and review should held counteract this tendency.

13. The risk of under-funding would obviously reduce the usefulness of Funds to companies in dealing with the security problem. That is not in itself an argument against them. Clearly, companies' exposure to default by other participators would still be less than with no fund at all. Certainly UKOOA themselves do not see this as a major weakness.

14. The alternative scenario is over-funding - either inadvertent, or due to a deliberate attempt by companies to get the cashflow benefit of earlier tax relief than otherwise. A proposition accepted as fundamental by Treasury Ministers in a number of contexts (eg Lloyds reinsurance to close) is that taxpayers should not effectively be able to write their own tax bills without any protection against over-deductions. It is not possible for government to second guess the companies' computation of contributions to abandonment funds. There would, however, be no advantage gained by companies from over funding provided that the following conditions applied

(a) The money in the Fund was genuinely alienated.

(b) Income and gains of the Fund were taxed at the same rate as the company's other income and gains.

(c) The company's discount rate was equal to or greater than the net rate of interest being earned on sums held in the Fund, and

(d) any excess or withdrawal of money from the Fund for other than qualifying abandonment expenditure was taxed at the same rate at which contributions to the fund had been relieved.

UKOOA themselves accept the need for (a). Companies discount rates - in a risky business - are likely to be substantially above the returns which can be earned on investment in the funds (condition (c)). And, while UKOOA want these Funds to be tax free (condition (b)), we judge that they probably would settle for taxability if the alternative was no Funds at all.

Charge on surpluses/withdrawals

15. That leaves the question of the rate at which amounts over-funded or withdrawn for non-qualifying purposes should be taxed (condition (d) above). There are a number of conceptual and practical difficulties here.

16. When a company made its contribution to a Fund it might be paying no tax, PRT only, CT only, or PRT and CT. (Where it was not paying tax, that in turn might mean either that it would never pay, or that it would pay eventually but defer for a longer or shorter time.) When it incurred the abandonment expenditure, it might again be in any of these positions, but not necessarily the same one.

17. It follows from this that there is no single 'correct' rate that could be applied universally in relieving contributions to, and charging relevant withdrawals from, these Funds by all and any companies using them. Nor is there a single 'correct' rate that could be applied to any one company, for example so as to equate the average rate of relief for its contributions with the average rate at which it would otherwise get relief for the abandonment expenditure. Though such a rate could be determined after the event (ie once the abandonment expenditure had actually been incurred), this would be of no use in determining the rate at which its contributions should be relieved which, by definition, would need to be known in advance of actual abandonment. The single rate of charge applied to Pension Fund surpluses does, however, provide something of a precedent for this kind of approach.

18. One solution involving a single, universal rate would simply be to charge all relevant withdrawals and over provisions at the top rate of tax - PRT and CT, with no off-sets. This might be justified on the grounds that companies should not be withdrawing money from the Fund except for abandonment anyway. It would also ensure that no one gained from over-funding (except, possibly, where the rate of tax itself was reduced).

19. But this would be tough on those companies that did not get full PRT relief and/or CT relief on their contributions. Moreover, where the over-funding was genuinely inadvertent (and in practice it might be difficult to prove that it was not), this would in effect mean that companies were penalised solely because of their inability to forecast eventual abandonment expenditure accurately - something which neither they nor we nor anyone else could reasonably be expected to be capable of doing.

20. A second option, to overcome these difficulties, might be to have a separate Trust Fund for each participator. In that way, the rate at which that particular participator's contributions had been relieved could be monitored and - with suitable ordering or weighting rules - the appropriate rate at which any

non-qualifying withdrawals should be charged could also be determined.

21. But this still might not work for CT, which is not field based.

22. There would also be some tricky questions concerning the treatment that should apply where there was a transfer of a licence interest and the surrendering participator had an abandonment Trust Fund. For example, if A sold his interest to B, would B be obligated to acquire the Fund as well, or would it become repayable to A? UKOOA propose the former, but that would raise very difficult questions about the rate at which any surplus (or non-qualifying withdrawals) of the Fund while in the hands of B should be charged - bearing in mind that it was A, not B, who got relief on the contributions. There could also be a problem of taxpayer confidentiality, although UKOOA accept that this would need to be overridden in these particular circumstances. If the Trust Fund simply became repayable to A - with an appropriate tax charge on the effective withdrawal - these particular difficulties would be avoided, but it would be necessary to guard against exploitation of the deduction rules for tax avoidance purposes.

23. A further difficulty in this area is that while companies might not over-fund in total, they might still attempt to over-provide in years where their tax rates were high and to under-provide in other years. One answer here might be to say that this would not matter because this would simply be a way of enabling the company to get effective PRT and CT relief for the expenditure which otherwise it would not. The objection, however, is that this would in effect guarantee relief to the company at the top marginal rates, rather than at, say, the average rate at which tax was charged on its income.

24. A third option would be to tax withdrawals and over-provisions like any other receipt or income, so that the actual charge would be that determined by the company's PRT and CT position at the time that the withdrawal was made or the surplus in the Fund was deemed to exist. (In the case of PRT, the withdrawal/over-provision might be treated as a "disposal receipt", in which case it could be eliminated by the cross field allowances, or reduced by oil allowance where that has not been used up and the field is still producing).

25. This approach - which was recommended by UKOOA - might be justified on the grounds of "swings and roundabouts". That is to say, in some cases, the result

would be tough on the company - eg an "exempt gas" field which got no effective PRT relief for its contribution to a Fund but would be charged to PRT on withdrawals. But in others, the resulting charge might be less than on strict economic neutrality grounds it ought to be - eg where the contribution had been relieved in full but where eg because of cross field or other allowances or reliefs the withdrawal/surplus was taxed at less than the full PRT/CT rates.

26. There are two main difficulties with this approach. First, precisely because it would be penal in some cases, some companies would be likely to object. Indeed, though UKOOA themselves first put forward the proposal, it was clear from our discussions that not all of their members would in fact find it acceptable. Second, there would probably be some scope for manipulation, over the timing of contributions/withdrawals so as to get the benefit of earlier relief.

Administrative Checks

27. A further possibility would be to buttress the deterrent effect of the tax charge on surpluses/non-qualifying withdrawals with administrative rules (and penalties for non-compliance) designed to ensure that any money contributed stayed in the fund until abandonment. This might also help psychologically in underlining that these Funds were intended to involve genuine alienation.

28. One option would be a very strict rule to the effect that no money could be withdrawn at all until the commencement of an approved abandonment programme. UKOOA suggested, however, that there might need to be some exceptions - for example, where there had been a sea change in abandonment technology or other major developments such that the amount accumulated in a Fund could be seen to be significantly more than would now be needed.

29. But this raises two further questions: defining and monitoring the exception, and the nature of the penalties (ie on the top of the tax charge) for non-compliance.

30. D/Energy could no doubt set up some kind of arrangement for monitoring withdrawals, including a procedure under which Funds required the Department's approval before releasing contributions. D/Energy are, however, not confident that this would be a particularly meaningful exercise. At the end of the day, companies and Funds would always be far better placed than anyone else to say whether, for example, there had been a significant change in abandonment technology and it would

be very difficult for the Department to try to second guess the industry on this. Concepts such as 'significant change' are also, of course, extremely vague and it would be very difficult to give them any kind of statutory precision and, therefore, meaning.

31. There would also need to be sanctions for non-compliance (on top of the tax charge that would apply), regardless whether the withdrawal was a 'qualifying' one or not. These would, presumably, have to be sanctions under the criminal law.

(B) POSSIBLE REPERCUSSIONS

32. There are a large number of situations in other industries where taxpayers face future liabilities and they are denied current CT relief either because the liabilities are capital in nature or because they are too unpredictable. What the taxpayers normally seek in such cases is relief for provisions in their accounts without any alienation of funds. While UKOOA would also like relief for provisions they accept that this is an unrealistic demand. The number of cases where taxpayers would be prepared to alienate funds so that they could only draw on them in the case of specific future eventualities is limited. We have considered what parallels might be drawn. The main focus is on CT: UKOOA also want contributions to be allowable for PRT but there are no other industries subject to an analogous tax.

33. The obvious direct parallels are decommissioning costs in the the nuclear industry (the US allows relief for contributions here) and, to a lesser extent, restoration costs incurred on the exhaustion of mines and quarries. Despite the disadvantages of alienation, it is just possible that heavy industries like chemicals might seek similar or equivalent relief for the eventual costs of closing down and removing structures for environmental reasons. It might also be suggested by some people that there were parallels with 'provisions' of a more general kind in certain other industries, and that those should therefore get deductibility as well. Examples here would include future provisions for bad debts by eg banks; insurance company 'equalisation reserves' (ie sums set aside out of current profits to meet possible future losses which are both uncertain and unquantifiable); and in certain other areas of insurance where, because reinsurance is not possible, a deduction for provisions in respect of remaining liabilities is at present permitted but subject to very strict rules.

34. One factor that clearly distinguishes abandonment from almost all other cases is the need for the participators in the case of oil to secure themselves not

only against their own share of the eventual cost of abandonment, but also their partners' shares in the event of default by one or other of the partners. This follows from the fact that each participator's liability for abandonment is joint and several. By contrast, in virtually all of the other cases the size of the obligation is limited to the size of that particular company's own involvement.

35. We doubt, however, whether this would be seen as sufficient justification for restricting tax deductible funds to abandonment alone, and not conceding similar treatment at least for nuclear decommissioning where there are clearly very close parallels. (In practice, Funds as such might not be of much use in the nuclear case - a main concern there, in the context of the CEGB privatisation, is with the cashflow implications of new nuclear investment and decommissioning of existing facilities and the alienation of funds clearly would not help in that regard.) We think, therefore, if the nuclear industry sought a similar arrangement, it would have to be conceded to both oil and nuclear or neither.

36. It is less clear that relief for abandonment funds would weaken the government's position in the financial sector. For example, subject to certain conditions banks are already able to get relief for their estimates of specific bad debts, without any alienation.

37. The position for insurance is rather closer. Relief is denied where claims history is not sufficient for a reasonable prediction of future claims to be made. And while relief is given for reinsurance where money is only returned to the original insurer in the event of a claim, it would not be available if the insurer could get his money back regardless of what claims were made. Whether or not insurers would be interested in arrangements where there were safeguards as tight as those proposed for abandonment funds (in particular a tax charge on recovery at the same rate as payments were relieved) is not clear. Moreover there are two important distinctions which can be drawn between the insurance and the abandonment situations: the former involves revenue expenditure and the latter capital; and the former does not involve joint and several liability with other partners like the latter and so has less call for specific security arrangements.

38. While there is a direct read across from funds for oil abandonment to those for capital closedown costs in areas like nuclear, this is much less so in the case of provisions of various kind in the financial sector - though the link with insurance is rather closer. Our judgement, therefore, is that it should be possible to

hold the line at alienated funds for abandonment (possibly extended to nuclear decommissioning if that is what they want), without thereby being forced to concede ground by allowing relief for provisions more generally in other areas. Clearly, however, there could nevertheless be pressure from other industries for comparable treatment, tailored to meet their particular circumstances. An important factor here would be the rules attaching to abandonment funds - the more relaxed the rules, the more others might press for similar treatment.

(C) FUND INVESTMENTS

39. Companies and the Government would have a common objective in preventing mismanagement of Funds. If a Fund was badly managed, companies' security objective would not be fully satisfied and they would have to make up the (after tax) cost of any shortfall. Similarly, there would be an additional revenue cost to the Government.

40. One possibility would be to restrict investment by these Funds to some form of 'abandonment gilt', specially issued for the purpose. However, the Treasury see a number of difficulties with this. Abandonment gilts designed to be similar to conventional gilts would, for example, not necessarily provide full security - ie where they had to be realised before reaching full maturity; while the issue of special non-marketable gilts would create a new specially privileged class of investor, which others would no doubt seek to follow. The issue of special abandonment gilts would also cut across the Government's funding policy.

41. We also considered whether the Trustee Investments Act 1961 (TIA) provided a suitable framework for these trusts but came to the conclusion that it was not appropriate for sophisticated investors such as the oil companies. In any case, it is likely to get increasingly outmoded, and there is already some doubt over its compatibility with the EC directive on Capital Movements.

42. We conclude, therefore, that there probably would need to be some kind of tailor-made arrangement. This would probably involve defining qualifying funds in legislation, who could control them, and with more detailed rules (possibly in Regulations) covering privileges and penalties, rules about the management of the fund (designed to avoid misuse and excessive risk taking) and (possibly) even about the detailed composition of the investment portfolio. One important aspect would be to ensure that no Fund resources could be invested in or lent back to the companies concerned.

(D) MONITORING/AUDIT

43. Arrangements would be needed to monitor Funds year by year, both to ensure that the rules concerning permitted investments were being followed and to determine whether or not expenditure from the funds was for a qualifying purpose. This would be largely a matter for the Oil Taxation Office, though perhaps with additional support by the way of inspection and certification by external auditors as regards monitoring of Fund investments.

(E) COST

44. The cost is highly uncertain because it is far from clear how many companies would use this kind of facility. UKOOA's initial view was "not many", because most companies will prefer to retain funds within their own control for investment rather than alienate them to a Fund. Only small companies may lack access to preferable forms of security. However, it is now suggested that some companies might use the facility not just on security grounds, but as a way of insuring against the risk of the Government subsequently changing the tax rules. If they wait until abandonment before they get any relief they run the risk that a future government will change the rules. If they invest in tax relieved Funds then they can be sure of getting tax relief under their belt now.

45. The main effect of Funds would be simply to advance the timing of relief so that in discounted terms there was no net gain to companies and no net cost to Government (assuming discount rates were the same). Assuming for simplicity that all companies participated, we estimate that there would in undiscounted terms be an overall yield to the Government of about £2bn (1988 prices). There would be losses in each year up the year 2000, and then much larger yields thereafter. The maximum annual cost as a result of this shift in timing would be about £100M in 1994. In practice, the figures are likely to be much lower than these.

46. In some cases, there would in addition be a permanent cost - ie where a a result of participating in a Fund the company concerned got a higher rate of relief on its contributions than it would otherwise have got on the abandonment expenditure. We estimate that the NPV cost of this would be in the range £20-100M (1988 prices), depending on how many companies participate and on which reliefs, including interest, would otherwise be available to the company concerned.

OTHER MECHANISMS: GUARANTEES

47. There are various other mechanisms that might be used in security arrangements, either together with or instead of alienated funds. UKOOA have in particular mentioned third-party guarantees.

48. Under this mechanism the company concerned would assure the other participators of its ability to meet its share of the abandonment cost by means of a guarantee from a third-party, in particular a bank. However, the fee charged by the guarantor would almost certainly not under present rules be allowable as a deduction for the company paying it. As regards CT it would be inadmissible on the grounds that the fee in effect related to future capital not income expenditure. Nor, in the Revenues view, would such payments fall within the various heads of expenditure qualifying for relief for PRT.

49. UKOOA therefore suggest that such fees should be made deductible to CT and PRT.

50. However, UKOOA have not put forward a specific proposal and they seem to regard the point as being of secondary importance to Funds, bearing in mind also that the absence of relief is unlikely to constitute a major deterrent to any company wanting to go down this route. Moreover, there are various possible objections

- In practice it would be difficult to confine any such concession to oil companies and abandonment.

- Under the Funds route there would be genuine alienation. This would not happen under guarantees where at most the company would have to accept a charge against its assets by the bank as security for the guarantee.

- It would be necessary to confine any concession to third-party - ie genuinely unrelated - guarantees, in particular excluding guarantees provided from elsewhere within the company's group or by an associated company. This might in practice be difficult to police (eg affiliates might provide hidden benefits to the guarantor).

- With contributions to a Fund the Government would in theory - if all the necessary conditions were satisfied - be giving the same relief in total (discounted) but giving it earlier. With guarantees the relief for the

guarantee fee would for PRT represent an additional cost - ie on top of the cost of relief for the abex itself.

51. For all these reasons, therefore, we would recommend against action on this proposal, certainly at this stage. Ministers could however review the position if UKOOA pressed the point and came forward with firm and specific proposals.

CONCLUSION ON FUNDS

52. Tax deductible Funds have some very real advantages. They would tend to smooth out the flow of tax revenues to the Exchequer, they would be good for the industry's confidence in the fairness of the tax regime, and they would go a long way towards solving the acute problems that smaller UKCS companies may otherwise have in providing adequate security for their partners. Because some fields are nearing the point where future after tax revenues no longer exceed abandonment costs the question of deductible funds needs to be addressed now.

53. But this proposal also raises a number of very real difficulties in practice. Not all of these are necessarily insuperable, but the scheme would have to be very complex and restrictive. It is far from certain that companies would in practice accept all of the conditions that we consider would be essential to prevent overfunding etc, and there could therefore be continuing pressure from the very outset to introduce relaxations.

54. If the nuclear or other heavy capital intensive industries sought and were prepared to accept Funds with the same onerous conditions, then this would have to be considered. There is some risk of knock on beyond that but we would judge it to be small. Another option might be to confine relief for contributions to PRT and Royalty. This might help contain possible repercussions elsewhere and ease some at least of the practical difficulties. But Funds would then be of little use to those companies which only pay CT, and many of the smaller companies most likely to take up a Funds route are in this position.

55. More generally, the question arises whether, even if all of the conditions could be got right, a major and complex new development of this kind would really be justified, or whether the difficulties it gives rise to and the possible repercussions would be out of proportion to the scale of the problem it is designed to deal with.

SECTION VI: CORPORATION TAX

Introduction

1. For CT, most abandonment expenditure - being of a capital nature - will qualify for relief in accordance with the relevant capital allowances (CA) code. Most of the infrastructure of oil fields is plant and machinery for CA purposes, including platforms, pipelines, etc. The cost of removing them will, therefore, be relievable under the code for plant and machinery - ie 25% Writing Down Allowances, on a reducing balance basis.

2. However, the level of effective relief that is then actually obtained, and the timing of it, will depend on the circumstances of the company concerned.

3. A key factor will be whether the company continues its UK oil extraction activities after production from the field in question ceases. Where it does so, it will get 'slow train' relief for the costs on the above basis in the ensuing years. If it ceases its UK 'ring-fence' trade, however, the whole of the abandonment costs incurred in the final accounting period (and any unallowed costs brought forward from previous accounting periods) will be included in the computation of the loss for the final period by way of a balancing allowance. This 'terminal loss' may then be carried back for set-off against ring-fence trade income in the three years preceding the year of final loss. Any balance of the loss which could not be relieved in this way (or by set off sideways) would be wasted.

4. An additional factor concerns the interaction with PRT where the field in question pays PRT and there is a PRT repayment resulting from the carryback of losses generated by abandonment. This will add to CT profits in the earlier periods (there is no time limit on the carryback of losses for PRT), but the company will not normally be able to carryback all of any corresponding CT losses to those periods.

UKOOA proposal

5. UKOOA see the potential lack of full effective and predictable relief for abandonment expenditure in some cases as a major cause of concern, and they have therefore proposed that for CT there should be

(a) immediate, 100% allowances for qualifying abandonment expenditure. (UKOOA suggest that this might be done by introducing a special 'abandonment cost allowance', rather than by

way of amendment to the Industrial Buildings and Plant and Machinery Codes); and

(b) that there should be unlimited carryback of any losses generated by such expenditure.

6. UKOOA argue that the present system - including the interaction with PRT - represents a distortion, the removal of which would help ensure that existing fields were not abandoned prematurely for tax reasons. And, without effective and predictable relief for abandonment, future investment in the North Sea might well also be lower than otherwise. Moreover, the financial strain of having to meet abandonment costs in full, but getting immediate relief on only 25% - or possibly less - could be intolerable to some companies and, by easing that burden, an additional potential for default would have been mitigated.

7. Some of these arguments obviously relate more to the level of effective relief (proposal (a)), and some more to its timing (proposal (b)). But they, and the proposals themselves, are obviously closely interrelated. Thus for example a full immediate allowance for abandonment expenditure (which may be available already in a terminal loss situation via balancing allowances for any unrelieved expenditure) would not necessarily itself ensure effective relief if the company did not have sufficient current profits, group relief opportunities, etc to enable it to make full immediate use of the allowance; hence the need - as UKOOA see it - for unlimited carryback as well.

8. Because a company's position will normally depend on a number of factors, not just the abandonment of one field, it is very difficult to gauge how severe this problem is likely to be in practice. As indicated in Section III, however, it seems probable that at least 90% of abandonment expenditure will in practice get full CT relief as soon as that relief becomes available.

APPRAISAL

9. Though these two proposals are linked, we think that they need to be considered separately.

(A): FULL, IMMEDIATE ALLOWANCES

10. As noted in Section II, abandonment costs do not fit into the present structure of CT, because they are neither costs of earning current profits nor of earning future profits - they are costs which are properly attributable to past profits. In fact, there is no real economic or fiscal logic for treating expenditure on

abandonment as though it was the same thing as capital expenditure on new assets. Capital allowances are a proxy for commercial depreciation and serve to provide a pattern of relief for the cost of capital assets that will, broadly, mirror the contribution which of those assets will make to the earning of future profits over their economic life. Abandonment expenditure is quite different. It is in reality part of the cost of the asset whose useful life has now ended. The whole of that original cost will have been allowed by the time of abandonment and so too on this view, therefore, should there be an immediate full allowance for the abandonment expenditure itself.

11. We have also noted that to a large extent the present treatment simply reflects the concept of the pooling system, introduced in 1971 essentially as an arrangement for simplifying things administratively, which is that a single allowance should be calculated on a pool of expenditure instead of separate allowances related to individual items. Under the old code, demolition costs were added to any unallowed expenditure on the individual asset and so allowed immediately as a balancing allowance; and that remains the case for industrial buildings that are not more than 25 (or in some cases 50) years old.

12. There are two other more practical reasons why Ministers might want to consider this proposal favourably.

13. First, these are costs of the business like any other but because of their particular nature, scale and timing a large part of them might not in practice get effective relief under existing rules. To that extent, the present regime could be said in effect to discriminate against abandonment in the oil industry (and similar large scale terminal costs in other industries) in the sense that, relative to businesses generally, a disproportionate share of oil companies' overall costs will not get effective relief. This is another dimension to the general 'fairness' or 'equity' argument.

14. Second, the CT ring-fence for North Sea oil operates one way only and companies are free to relieve current losses sideways against non-ring-fence income in the same period, or via group relief. If companies foresaw large unrelievable losses arising as a result of abandonment, they might tend to seek other, possibly unwelcome, options - eg mergers with profitable companies - that were motivated mainly by tax considerations rather than by economic and commercial logic. Alternatively, if these abandonment-related losses could not be relieved immediately (in which case, with the exception of the terminal loss situation, they could only be relieved by

carry forward against future income from the same trade), they could build up and come to represent a sizeable overhang in relation to any subsequent ring-fence income. That, too, might be thought undesirable.

TARGETING AND POSSIBLE REPERCUSSIONS

(a) Which costs?

15. The aim would be to confine the allowance to costs incurred in dismantling, demolishing and removing plant and machinery. Almost all oil abandonment expenditure will relate to plant and machinery, and as noted for industrial - but not commercial - buildings an immediate 100% allowance for the cost of demolition etc would generally be available already under existing rules.

(b) Which industries?

16. The aim might also be to confine the change to the companies with abandonment expenditure in the UKCS on the grounds that profits from North Sea oil are subject to a much tougher regime than profits in other industries and that it is, therefore, fair and reasonable that there should be special measures to ensure effective relief for these costs which are themselves exceptional. However, the arguments at paragraphs 10 and 11 above apply generally, not just to oil abandonment, and we think that in practice it would be very difficult for Ministers to hold the line at that. In short, we think that it probably would be necessary in practice to generalise this and allow full immediate allowances for the cost of dismantling plant and machinery in all industries, not just oil abandonment. The sorts of industry that might benefit would be nuclear decommissioning, demolition of chemical plants and indeed any other case involving dismantling of large scale plant and machinery.

(c) Which assets?

17. It is also for consideration whether the proposed allowance could be restricted to cases where the asset in question was not replaced, on the grounds that in a replacement situation dismantling costs could be regarded as part and parcel of the decision to invest in the new asset and that the tax relief should, therefore, be spread forward in the normal way. We do not, however, believe that this would be feasible. As noted, the argument in principle for giving immediate relief is that dismantling costs relate to the earning of past profits, and that argument is valid whether or not the asset is replaced. There would also be serious definitional and practical problems in determining whether or not an asset has been "replaced".

18. There would still be one other definitional point, albeit of a different kind. Assuming action was confined to costs incurred in dismantling plant and machinery, the distinction - in a replacement situation - between expenditure on the new asset and that on removing the old one would become very important - bearing in mind that while the former would continue to get relief on a 25% WDA basis, the latter would, if these changes were introduced, get an immediate 100% allowance. This distinction would inevitably create problems at the margin but there are precedents and the Revenue believes the problems should be manageable.

(d) Mechanics

19. Concern about possible repercussions is also relevant to the question of how exactly such an allowance might be expressed and presented. Though there would in reality be no inconsistency between full immediate allowances for abandonment expenditure and the Chancellor's 1984 Business Tax Reforms in which 100% First Year Allowances were abolished (the object being to remove the incentive element in those allowances over and above commercial depreciation), there could obviously be presentational difficulties in explaining the distinctions involved. A tailor made 'abandonment cost allowance' as suggested UKOOA might stand the most chance of limiting repercussions, but of course this route would not be open if the proposed change was to be applied generally and not just to oil abandonment. In that case, the plant and machinery CA code itself would need amending.

(e) Cost

20. Allowing for the fact that many oil companies would be able to get full effective relief for their abex anyway, we estimate that the cost of this measure for oil production would be about £40m (1988 prices) over the period as a whole. This is relatively small and reflects the fact that the main effect of this change would be to alter the timing of relief rather than the absolute amount. The annual revenue effect, including the effect of timing, would vary (1988 prices) from a cost of £80m to a yield of £30m - there would be little or no cost in the next few years.

21. The impact of changes of this kind on revenue from onshore companies is extremely difficult to assess. Figures for expenditure on demolition of plant and machinery cannot be obtained easily and in the one area where some estimates have been provided - the electricity industry - the Revenue is still discussing with the industry the application of the existing allowance

rules. We can only tentatively suggest that the cost in the early years would be in the range of £10 to 40M pa diminishing thereafter, giving yields (of up to £20m) in later years. The actual position within the range depends largely upon the outcome of discussions with the electricity industry.

(B): CARRYBACK

Indefinite carryback

22. An important consideration for any tax system is the need for finality, and a move to unlimited carryback for certain losses would obviously run directly counter to this. It would also have major administrative and operational implications, both for ourselves and, possibly, for companies as well, because of the need to reopen earlier years' assessments. These difficulties would be aggravated in those cases and industries (assuming any change was not restricted to the oil industry) where abandonment is not 'one-off' or undertaken in a single year. In these case there would not necessarily be a once and for all revision for all of the earlier years - rather, there could be a continuing succession of such revisions.

23. There would be another difficulty with indefinite (or even, possibly, extended) carryback, concerning repayment supplement. Without specific rules to prevent it, longer carryback could theoretically result in repayments which together with the interest exceeded the actual expenditure incurred by the company. This is the problem we have already with interest on PRT repayments - see Section VII - and would be a major new potential distortion in company behaviour. (Under 'pay and file', there would be some off-set in that companies would also be paying interest on CT clawbacks arising from the PRT repayments. However, this would not apply if the change described in paragraph 31-33 below was introduced.)

24. For all the above reasons, the Revenue would feel bound to recommend strongly against conceding carryback without limit.

Extended, but not indefinite carryback

25. An alternative would be to allow some extension of carryback, but still limited. The limit itself would be a matter of judgement.

26. One possibility might be 3 years, on the grounds that this is what applies already for terminal losses and is what applied under the pre-1984 system for losses arising from First Year Allowances.

27. But this would probably be of little or no help to the companies that needed it. As explained earlier, and in Annex A, it is likely that at least 90% of the estimated abex of £4.2bn will get full relief as soon as it becomes available because the companies concerned (or the group of which they are a part) will have sufficient other continuing ring-fence income, or non-ring-fence income, or terminal loss relief to achieve this.

28. The remaining 10% (£400m), however, is abex for which no relief would be available under existing rules, even after terminal loss relief. Most of it relates to companies which at the time the field in question is abandoned are likely to have no other ring-fence interest and insufficient (if any) non-ring-fence income. By definition, extending the carryback to 3 years would give these companies little or no extra help beyond what they get already from terminal loss relief.

29. A further possibility, therefore, might be to extend the carryback period to, say, 6 years. Again, we are concerned only with companies that are likely to have insufficient non-ring fence income against which to relieve these losses. We estimate that just over half of the otherwise unrelievable losses of companies in this group would be relieved if the carryback period was extended to 6 years. The total cost (undiscounted) would be about £60m (1988 prices), spread over 15-20 years. This might, however, reduce as companies will no doubt try to acquire other sources of income as abandonment approaches.

30. UKOOA have indicated that if unlimited carryback - their preferred solution - is not acceptable, they would still like an extension of carryback and for as long a period as possible, say 10 years. They also suggest that if carryback was still restricted, matters would be helped - in cases where abandonment expenditure was incurred over a number of years - by providing for the start of the carryback period for all of the resulting abandonment losses to be the beginning of the abandonment programme. There are precedents for this kind of approach and it would help ensure that losses were carried back into periods when there were still profits against which they could be relieved.

<u>Other limitations on carryback</u>

31. The following further possibilities could also be considered

(a) Even though full immediate allowances were applied generally (assuming that is what

Ministers did decide), relaxation of the carryback rules might still be restricted to abandonment losses - on the grounds that the regime for oil taxation is tougher than elsewhere.

(b) Various other restrictions of a more practical kind could be considered to cut-down the potential amount of work involved in revising earlier assessments. For example, the rule might be that relief could be available for carryback only to the extent that it created or augmented a loss for the year of claim; that relief had to be allowed against the latest profit first, and so back successively; that relief could only be given after all other reliefs available had been allowed; and that there could be no revision to release relief already claimed, particularly group relief.

(c) To deal with the problem mentioned at paragraph 23 above, interest on CT repayments could be withdrawn in cases involving carryback of the losses in question.

PRT INTEREST AND CT CLAWBACK

32. There is a potential problem in this area already because of the facility companies have for unlimited carryback of losses under PRT and the consequential need, if there is a repayment of PRT, to reassess their CT liabilities for the years in question. This is not much of a problem in practice at present, but clearly could become so in the years ahead when large losses as a result of abandonment begin to arise and those losses are carried back under PRT for lengthy periods. We think, therefore, that this problem needs to be tackled anyway and we have suggested that the way forward would be to change the rules by taxing the whole of the PRT refund in the accounting period in which the loss generating the refund arises, thus obviating the need to reopen earlier assessments.

33. This would have two main advantages for companies. First, they would avoid having to pay the interest on CT clawback that would otherwise become payable with the introduction of "pay and file". The cost (1988 prices undiscounted) to the Government - and therefore gain to companies - of this would be about £200m. Second, it would have the further advantage that it would help achieve more effective relief for the abex - ie because it would increase the assessable income at the time of the abex against which that expenditure could be relieved. Roughly one-third of the 10% of total abex

that would not otherwise get effective CT relief would do so as a result of this change. The overall cost to the Exchequer (undiscounted) would be about £40m.

34. UKOOA have indicated their support for this proposal. It might however create double taxation problems for US companies and this aspect would need to be considered further.

CONCLUSION ON CT

35. There is no immediate need for action since expenditure does not arise for several years. When it does, 90% will get CT relief but relief will be spread forward over many years.

36. There is a good case in principle for full, immediate allowances, but that is true for dismantling costs of all assets, not just oil abandonment. It would therefore be necessary to extend this to all plant and machinery. This would immediately cost £10-40m a year not related to the abandonment problem. The Revenue believe that indefinite carryback has to be ruled out on operational grounds, and there is a strong case for making any extension to the carryback period as short as possible. Other limitations might be possible, including restricting the extension to abandonment losses only.

37. Again, Ministers will want to consider whether the problem is big enough to justify such an upheaval and large scale repercussions.

38. The case for action would be reduced further if there was action on alienated funds. The proposal concerning CT clawback should also help.

SECTION VII: PRT

Introduction

1. Relief is available under PRT for expenditure incurred for the purpose of 'closing down of the field or any part of it, but only if and to the extent that the expenditure is incurred for the purposes of safety or the prevention of pollution'. This is likely to cover the vast bulk of expenditure incurred at the time of abandonment - as mentioned in Section IX there are one or two grey areas. As this expenditure will normally be incurred after cessation of production from the field, this will lead to the generation of field losses. These losses may be carried back and off-set against profits of the field in previous periods, starting with the most recent.

2. However, the nature of the special PRT reliefs - particularly oil allowance - is that such losses carried back are allowed against PRT profits before deduction of the allowance where available. Losses generated by abandonment and carried back may, therefore, simply displace oil allowance. (In theory, similar problems could arise in cases where losses were carried back into a period sheltered by safeguard, but the incidence of this is likely to be minimal in practice.) As a result, the effective rate of relief for abandonment expenditure could be very low - with no effective relief at all in extreme cases - even though the average rate at which profits from the field had borne PRT may be high.

UKOOA proposal: 'conservation formula'

3. UKOOA regard this as both inequitable and as constituting a potential source of distortion. They have, therefore, proposed the introduction of a mechanism that would provide, where necessary, for the effective rate of relief for abandonment expenditure to be increased so that it was at least equal to the average rate of PRT that had been paid on the profits (excluding the cost of abandonment) over the life of the field.

4. UKOOA say that the advantages of the proposal are that it would improve the predictability of relief, and remove a disincentive to maintaining production because the companies would be reassured that they would not incur a financial loss if they prolonged production to extract the maximum possible reserves from fields. They say that it would also benefit those whose need was greatest, and that only a small minority of fields would be affected - so the cost to the Exchequer would be small. UKOOA acknowledge that the formula is fairly crude, but say that their aim has been to develop a

fairly simple and pragmatic solution to the problem, as they perceive it, of inadequacy of relief in certain circumstances.

Impact and companies affected

5. Our analysis confirms UKOOA's own view that any problem here would affect only a few fields as mentioned in Section IV. We estimate that nearly half of all fields will pay no PRT at all during their life even before losses on abandonment, and we estimate that of the 40 fields expected to pay PRT at some point in their life 24 will get full PRT on their abandonment expenditure. Three more would get only partial relief but at a higher rate than their overall PRT rate, and eight would get no PRT relief but would have paid very little PRT (and perhaps none) over their life.

6. On this analysis there are just five cases at present where the field would have paid significant levels of PRT over its life, but would get relief for its abandonment expenditure at levels significantly below (more than a 5% gap) that level. Arguably, it is only this group where there might be said to be a problem. The main kind of field affected would be an old field which paid a significant amount of PRT early in its life, but is largely sheltered by oil allowance in its later years.

7. The question then is whether, even if there was insufficient effective PRT relief for abandonment expenditure (defined as above), this would have a significant distortionary effect on the timing of abandonment.

8. As mentioned in Section IV, UKOOA themselves did some analysis of this - taking for their base case a typical mature North Sea oil field and using the NPV criterion, and certain simplifying assumptions so as to be able to consider the impact of PRT on the timing of abandonment in isolation from Royalty, CT and interest on tax charges and repayments. The optimal timing of abandonment to the nearest six month chargeable period was calculated on a pre-tax basis - ie before PRT - and any difference in timing was then attributed to the impact of PRT. If the marginal PRT relief on abandonment is the same in terms of rate and timing in relation to the cost as the marginal PRT levied on the additional net revenue (all PRT relief on the additional net loss), then PRT will have no impact on optimal timing of abandonment. However, where losses carried back displace oil allowance, that will alter the post-tax economic balance between the benefit of deferring abandonment and

the additional net revenue loss incurred through prolonging production.

9. UKOOA's own analysis shows that, in their base case, the effect is in fact quite small - advancing the otherwise optimal timing of abandonment by just one six monthly chargeable period.

10. They also did some sensitivity analysis by reference to variations in main field parameters like abandonment cost, reserve depreciation rate and oil price inflation but again the optimal timing of abandonment was in most cases not significantly different between the pre and post PRT positions.

11. The impact was, however, more significant where the joint effect of two or more parameters were considered, the two most important in this respect being the size of the abandonment cost and the reserve depreciation rate. On this analysis, if the field depreciation rate was 5% higher, and abandonment costs 50% higher, the impact of PRT would be to advance the optimal timing of abandonment of the particular model field examined by 11 chargeable periods - ie 5½ years.

ANALYSIS

12. UKOOA themselves acknowledged that the proposed formula does have some rough edges and we have identified a number of ways in which it is rather unsatisfactory.

13. First, it is a general feature of PRT that relief for expenditure is given in priority to other reliefs, in particular oil allowance, so that on occasions extra expenditure will not be effectively relieved because it results in displacement of oil allowance. This is and always has been a feature of the system and it does not necessarily follow, therefore, that any shortfall in effective relief as a result of displacement of oil allowance should be compensated for.

14. Second, while 'economic neutrality' of the system is an important consideration, particularly if departure from it produces significant distortions, UKOOA's proposed approach does not necessarily achieve the right result. As their own analysis shows, what matters is the marginal rate of PRT relief on abandonment expenditure compared with the marginal rate on net operating costs (charge on the net profits) if production is prolonged. Their formula, however, seeks to equate the rate of relief with the average rate charged on profits over the life of the field. That is, of course, something entirely different.

15. Third, the UKOOA's formula is asymmetrical - it would operate to increase the level of relief on expenditure where it was lower than the rate at which profits had been taxed, but would not operate in the reverse direction. On a strict application of the economic neutrality principle, it should apply symmetrically. But as UKOOA themselves acknowledge, there are many incidences where the effective rate of relief will be higher than the effective rate charged on profits over the life of the field, and symmetry would, therefore, involve a lot of losers compared to the present system.

16. There are also various more detailed objections to the formula. For example, it would strictly speaking be necessary to put all of the amounts used in the formula onto a comparable, present value basis. It is quite likely, for example, that there will have been tax deferral in the past - ie with profits having been earned before tax started to be paid. If so, a present value basis for the calculations would - correctly - reduce the measure of the average rate of tax paid accordingly.

17. UKOOA acknowledge the validity of some of these points, but do not consider the objections overall to be compelling. They argue that while the numbers involved may be small, the present system could undoubtedly in certain circumstances produce quite significant distortions in the timing of abandonment and that of itself is a good reason for seeking solutions. They also draw attention to two more general considerations.

18. First, equity and fairness. The argument here is that abandonment is part of the cost of winning oil and it would simply not be right or fair to relieve the expenditure involved at an effective rate significantly below the rate at which the profits have been taxed. This is also a matter of ensuring that the reliefs which the rules appear to provide in theory are effective in practice, and that they operate equitably as between different companies and fields.

19. Second, more general reasons for ensuring that effective relief is given at a reasonable level are that there may otherwise be a risk of default in some cases (though the alienated funds proposal is designed to deal with this); and that failure to give relief at a reasonable rate might defer investment in new fields, partly because of an adverse cashflow effect if the investment phase coincided with abandonment of the oil field, and partly because the expected NPV on new fields would be low as a result of less generous relief for their eventual abandonment.

Technical and operational

20. There are also a lot of technical and operational aspects that would need to be considered. The main ones are

(a) the formula would need to work on the cumulative amount of PRT finally payable and paid for all periods up to and including the period in which formula relief was being calculated, and not just the amount actually paid up to that time. This in turn means that there would need to be scope for dealing with claims on a provisional basis and making any necessary adjustments thereafter.

(b) under the formula it would be necessary to recompute liabilities, excluding abandonment expenditure, for all chargeable periods to which the formula applied. But not all abandonment costs would arise post-production. Some would arise prior to actual abandonment and that would add considerably to the work involved in these recomputations.

(c) it would be for consideration whether and if so how account should be taken of any PRT paid by a previous participator, ie in cases where there had been a transfer of field interest.

21. It would also be necessary to decide how the additional PRT relief under such a formula should be treated for CT purposes. One possibility would be to charge the additional PRT repayment produced by the formula to CT in the year in which it was received. But this would give rise to difficulties if the trade had ceased beforehand. The relating of the payment back to the final accounting period in a cessation case could produce no liability at all if there were otherwise substantial losses arising from the abandonment costs. An alternative approach would be to pro-rate the repayment to the chargeable periods over which PRT remained paid (after relief allowed under existing rules). Taking into account past changes in CT rates, interest on the additional CT and, in the opposite direction (possibly), interest on the additional PRT refund, the Exchequer effect could be significant.

22. The proposed formula works on computational components of the existing scheme and would, therefore, in principle be achievable in statutory terms, though the necessary legislative changes would be intricate. But it would be operationally quite burdensome for the OTO. Computer support would be needed and the necessary additional resources for this would have to be provided.

Cost

23. We estimate that the overall undiscounted cost of the proposal would be about £35m (1988 prices) reducing to about £25m after allowing for CT clawback. This would be spread over the period 1996-2008. Thirteen fields would benefit, but in 11 cases the extra PRT relief would amount to £5m or less. If the proposed formula applied symmetrically, there would be a large net yield to the Exchequer.

CONCLUSION ON CONSERVATION FORMULA

24. The problem of less than full PRT relief is relatively small scale one, affecting only a few fields - though it is nevertheless significant for the licensees concerned. The case for action on economic neutrality grounds is not all that strong, though UKOOA believe there is also a more general "fairness" consideration. However, the proposed formula itself is open to a number of objections, particularly its asymmetry. There would also be a number of technical and operational difficulties

25. But it would not cost a lot and there would not be a problem over repercussions elsewhere.

26. Again, however, there is no need for immediate action except as part of an overall package.

SECTION VIII: INTEREST ON PRT REPAYMENTS

1. Where PRT relief for expenditure on abandonment is given by way of carryback of any resulting losses - which is likely to apply in most cases - any tax repaid would under present rules also attract interest, payable from the due date (or date of payment if later) relating to those earlier periods. These interest payments could become very substantial - especially in cases where losses were carried back many years - even though the abandonment expenditure giving rise to the loss would actually have been incurred only shortly before relief was given. In some cases, the amount of the tax relief and interest together might actually exceed the expenditure in question. Moreover, these interest payments are not chargeable to CT (unlike the PRT repayment itself) and there is limited compensation by way of interest on underpaid CT arising from the PRT repayment.

2. This has not been a serious problem hitherto, mainly because the amount of losses being carried back is small. Once abandonment starts, however, there are likely to be very large losses being carried back and over long periods. The problem could also apply to CT as well if UKOOA's proposal for extended carryback of CT losses resulting from abandonment was accepted. The cost to the Exchequer could become very large - for interest on PRT repayments we estimate that it could be some £700m (1988 prices) over a period of 20 years or so from the early 1990s. And the present regime could also lead to significant distortions in company behaviour, with regard both to cost control and to the timing of abandonment.

Arguments for and against present treatment

3. The main argument that might be advanced in support of the present rule is that interest on repayments is merely compensation for being stood out of the amount paid in tax for the carryback period. The tax system allows losses of a later period to be set against profits of an earlier period and, arguably, it is therefore only logical to give interest as well on the money which the company would have had the use of over the period concerned if the tax relief had actually been given in the earlier period.

4. But there are two main counter arguments, which we believe are compelling

(a) companies will not have been denied use of the money involved prior to the time when they actually incur the expenditure which gives rise to the loss. Payment of interest clearly is right in cases where the tax liability of a

particular period, assessed in accordance with the relevant rules, is found subsequently on the basis of the facts relating to relevant events in that period to be lower than the tax actually paid for that period. The taxpayer has actually been out of pocket for the difference, and interest makes commercial restitution. The situation is quite different where the tax paid for the period in question was, and remains, the correct amount and only requires to be adjusted because of losses arising in a different period. More fundamentally, if interest is given on repayments of tax then, because of "time preference", the losses being carried back should be reduced (ie discounted) by an equivalent interest factor. The same result is achieved by not discounting and not paying interest.

(b) Payment of interest means that relief together with interest can exceed 100% on additional abex which could positively encourage wasteful expenditure. Indeed, even at levels of relief which are less than 100% but nevertheless high relative to the marginal rate of tax on profits there is a disincentive to control costs. Payment of interest also means that abandonment will effectively be relieved at a rate substantially higher than the rate at which the participator has been charged to tax. This could encourage continued activity which would otherwise be uneconomic.

5. The extent to which such distortions might arise in practice would, of course, depend on the facts in each particular case. But the proportion of cases and the amounts involved could be quite high. "Pay and file" will help the problem a little - because of payments of interest on CT clawback arising from the PRT repayments. On the other hand, if the industry's proposals on CT for full immediate relief and unlimited carryback were accepted, and we switched to charging CT clawback of PRT repayment in the year of the repayment (see paragraph 31-33 of Section VI), the problem would be considerably exacerbated. It is perhaps also worth noting that for almost all major fields, abandonment will involve PRT losses being carried back at least five years (ie ten chargeable periods) and in some cases much farther.

Options

6. The problem appears significant enough, both in terms of cost to the Exchequer and in its potential distortionary influence on company behaviour and abandonment timing, to warrant serious consideration of the options. The present position is indefensible and the case for action - ideally in the context of a package of measures to deal with the fiscal problems of abandonment - appears very strong.

7. One possibility would be to reduce the rate of interest significantly on such repayments, thereby also reducing significantly the amount paid out. This would, of course, be restricted to repayments arising in loss-carryback cases. The main difficulty with this approach, however, would be to decide the level of rate appropriate to render the carryback of such losses 'unprofitable'. Where a very short carryback period was involved, only a small reduction in the rate might be needed to avoid significant distortions from arising in practice. With a very long carryback, however, it is doubtful whether anything short of a nil rate - ie effectively abolition - would be sufficient.

8. A second option might be to restrict the interest carryback period. This, too, would be a crude way of helping to contain costs and minimise the worst excesses; for example, the total of £700m for interest on PRT repayments mentioned earlier would be reduced by about a half if interest was limited to six chargeable periods. If the interest carryback period were sufficiently limited this could also serve to ensure that marginal rates of relief never exceeded 100%. But the cut off point would need to be chosen to ensure that this result was robust to changes in interest rates, and PRT, CT and royalty tax rates.

9. A third possibility would be to cap total interest plus relief. This might be done in a number of ways, but perhaps the most obvious would be a rule limiting the total amount of interest plus relief as a proportion of the loss (or the expenditure giving rise to the loss) being carried back. This might be a simple and fairly effective way of at least ensuring that, overall, tax relief plus interest on repayments did not exceed 100% of the abandonment expenditure.

10. It would also be for consideration whether the cap should be set at some level below 100%, bearing in mind that this would relate to the average rate whereas, strictly, what matters for the avoidance of distortions is the effective rate of relief on marginalabandonment

expenditure. This might also be justified on the grounds that the cap applied to PRT only and so did not take account of the CT relief which was also being given for the expenditure in question.

11. However, an important drawback to capping stems from the very fact that it would - as a matter of practicability - have to operate in relation to the average rather than the marginal rate of relief. This means that in certain circumstances, a cap of, say, 85% would still leave the marginal rate of relief in excess of 100%. And in a few, special cases capping would have a perverse effect - actually increasing the marginal rate of relief.

12. The final possibility would be to abolish interest on repayments altogether in cases involving repayment of tax arising from the carryback of losses. (Here, too, interest would continue as at present in other repayment cases.) This is the only option which fully satisfies the points of principle mentioned in paragraph 4(a) above. For administrative reasons (of concern, to companies as well as the Revenue), however, and to retain some incentive for companies not to delay in submitting their claims for expenditure, the suggestion would be to abolish interest except for the first say, 2 years, of carryback. This option would then be the same as a very restricted version of the second option, and with the same attribute of still serving effectively to restrict the marginal relief rate of relief.

13. In our discussions with them on this subject, UKOOA accepted that problems and possible distortions could arise in certain cases, particularly if the marginal rate of relief for abex exceeded 100%. But they are strongly opposed to going as far as abolition. They have accepted that in theory and subject to certain conditions there is an economic argument for not paying interest. However they argue that since the government deprives them of tax then they must raise more funds at a high cost of capital to save for abandonment in low yielding risk-free investments. They suggest that PRT interest is a fair compensation for this cost. We do not accept that their saving need be in risk-free investment for anything but the immediate run up to abandonment and even if we did it is not clear that it is a function of Government to compensate for this.

14. There are three other more general considerations

(a) If interest for PRT repayments was abolished or restricted and the arrangements for CT clawback on PRT repayments remained unchanged, it would

be for consideration whether it would be regarded as unacceptably unfair that we should also charge interest on the CT clawback - which will be required under Pay and File. Also, the economic argument for not paying interest on PRT applies with equal force to CT.

(b) Application to CT. Logically, the arguments for restricting or abolishing interest on repayments of PRT apply with equal force to repayments of CT. On the other hand, the CT aspect of the problem is relatively less important because of the very limited opportunities for carryback of losses under the existing CT rules. (The change to "Pay and File" will widen the availability of interest somewhat, but again probably not to an extent where the amounts and possible distortions involved were substantial.) Moreover, the Pay and File proposals, including retention of interest on repayments of CT, is part of a carefully balanced package in response to the recommendations of the Keith Committee, and Treasury Ministers would be most reluctant to disturb one part of that package - interest on repayments - at this stage without strong reasons for doing so. Clearly, however, the position here would change if UKOOA's proposal for unlimited carryback of abandonment losses were accepted.

(c) Ambit. As noted, the aim would be to abolish or restrict interest in respect of loss carryback, but not in respect of other events which can result in a repayment of tax. But it would also be for consideration whether action should be further restricted so as to apply only to carried back losses that arose as a result of abandonment, or whether it should apply to all carryback losses. We believe that the arguments of principle and the practical considerations both point firmly in the direction of applying any change to all losses carried back, not just to those arising from abandonment. As noted in Section VI, however, there are a number of options on the CT front that Ministers might wish to consider, one of which would be to agree to immediate 100% allowances for dismantling costs of plant and machinery (and for all industries, not just oil), but to restrict any extension of the carryback rules to abandonment losses only. In that event, the practical difficulties and additional complexities of having to

distinguish between losses arising from abandonment and those arising for other reasons would just have to be faced.

15. There are various other more detailed consequentials that will have to be considered if one or other of the above options were adopted.

Cost

16. We estimate that the overall (undiscounted) yield from abolition would be about £450m (1988 prices), and that abolition except for the first two years would yield about £500m. With capping, and assuming a cap of 85%, the yield would also be about £500m. All of these figures are gross in the sense that they take no account of the fact that, as a quid pro quo to action on PRT interest, it might be considered necessary not to charge interest on CT clawback (paragraph 14(a) above). If interest on CT clawback was abolished, the cost (undiscounted, 1988 prices) would be about £200m.

CONCLUSION ON INTEREST

17. There are strong economic neutrality arguments (avoidance of distortions, particularly wasteful expenditure) for abolishing or restricting interest; the present regime would also become very costly to the Exchequer. But this is a very contentious issue and will need handling carefully. In theory these problems apply to CT as well, but action would probably be confined to PRT unless extended or unlimited carryback for CT losses was conceded.

18. The two main options are abolition and capping. Abolition is the right course in principle and gets to the root of the problem, but there may be presentational advantages and equity considerations in favour of capping. However, capping fails to prevent marginal rates of relief from exceeding 100% in a small but significant number of cases.

Confidential

SECTION IX: TECHNICAL ISSUES

1. There are a great many technical issues and anomalies which arise in connection with oil field abandonment. Some have been raised by UKOOA/UKOITC. Others are points that we ourselves have identified as ones which need to be addressed in the abandonment context. Some arise directly or indirectly as a consequence of abandoning a field; others as result of the cessation of field production before the field is abandoned entirely - ie cases where the production facilities continue to be tariffed out to another field even though production in the host field has ceased.

2. Most of these points would require legislation, though some are more urgent than others. Some of them concern PRT only, some CT only, and some both.

3. Most of these points need to be addressed regardless of what is decided about UKOOA's three main proposals. In one or two cases, however, the way in which the point is dealt with may depend on the way in which we proceed on the main proposals.

4. UKOOA themselves have singled out two main areas as being of particular importance, though there are others.

5. The first concerns relief for defaulters' costs. As noted earlier, because of joint and several liability if one participator defaults the others would (in the absence of security arrangements) have to cover his share of the abandonment cost as well as their own. Under current rules, however, neither PRT nor CT relief would generally be available in such cases. For PRT, expenditure has to be divided between participators in accordance with their respective interests in the field and, in the Revenue's view, the present rules would not allow scope for disproportionate cost sharing of the kind that would be involved here. For CT, relief would not be available because the person actually incurring the expenditure in such cases would not be able to satisfy the normal requirement that the plant etc being demolished was in use for the purpose of his trade.

6. The industry propose that the rules should be changed so as to give relief in these cases to the participator who actually meets the costs. The rules would also need to cover situations where a parent company, affiliate or a third-party picks up the abandonment costs of a participator, either under a security agreement or as a result of action by the Secretary of State under the Petroleum Act.

7. Second, there are a number of grey areas and possible anomalies in the existing rule which need to be looked at to ensure that there is a sufficiently comprehensive definition of allowable costs. Most of the points here concern PRT. The present rule allows relief for expenditure incurred in 'closing down of the field or any part of it, but only if and to the extent that the expenditure is incurred for the purpose of safety or the prevention of pollution'. Arguably, the latter part of this definition is to restrictive and it is also doubtful whether certain other costs eg to do with onshore installations, would technically be covered by the definition. There are also technical problems with cases involving costs where a field is temporarily closed down, but perhaps for quite a long period, and where costs are incurred in maintaining partly removed structures.

8. The other main areas and the problems arising are, briefly, as follows

(a) Cost apportionment and disposal receipts.This concerns PRT. The present rules do not adequately determine how expenditure on abandoning assets used in more than one field in which a participator has an interest should be apportioned between those fields. There are also certain anomalies concerning disposal receipts, and the industry think there may be a further problem of apportionment in cases involving 'exempt' gas fields.

(b) Buying out abandonment obligations. Under certain unit agreements and most pipeline agreements it is possible for field participators to withdraw after a specified date. On disposing of his interest, however, a participator may be required to pay a sum to the other parties to the agreement in respect of his share of the estimated abandonment cost. At present, there would be neither PRT nor CT relief to the participator making the payments. When the abandonment expenditure was eventually incurred, there would similarly be no relief under PRT to the other participators for that expenditure - because it would have been funded out of the payment from the withdrawing participator. But no such restriction applies in the case of CT. UKOOA have proposed that for both PRT and CT relief should be available to the person making the withdrawal payment at the time of payment, with a corresponding restriction on relief

subsequently available to the recipients when the abandonment expenditure is incurred.

(c) Loss reliefs. There is a clutch of technical issues here concerning availability of relief, mostly under PRT, in cases where production has either ceased permanently, or where it has ceased but where tariffing continues. There are also certain technical problems concerning carry forward and back of CT losses where the particular CT ring-fence activity ceases, but where other non-ring-fence activities are continued.

(d) Transfers of interests in oil fields. These are all PRT points, concerned the treatment of losses carried back where interests in the oil field have changed hands prior to the loss itself crystallising. Some of these problems could arise already, but in practice they are more likely to arise on field abandonment.

(e) Clawback of CT on repayment of PRT. PRT paid is allowed as a CT deduction in the accounting period in which the relevant PRT chargeable period ends. Where the carryback of a PRT loss on field abandonment results in a PRT repayment, there is a corresponding restriction of the PRT deduction previously allowed in the CT computation, and additional CT will be due for that earlier period. The method by which the clawback of CT is achieved is likely to cause a number of administrative difficulties in the context of oil field abandonment. However, the solution here will depend in part on what is decided about interest on repayments of tax. On a separate point, UKOOA have also asked for an extension of the relevant CT time limits of claims in this area.

9. The Inland Revenue will be reporting separately to Ministers on these issues.

ANNEX A

ABANDONMENT: STATISTICAL ANALYSIS

1. This annex sets outs in more detail our estimates of the overall cost and timing of abandonment, and various other information referred to in the main report.

OVERALL COST AND TIMING OF ABANDONMENT

2. Tables 1 and 2 give detailed estimates of the overall cost and timing of abandonment, excluding onshore terminal and pipeline costs, E&A expenditure effects, and downstream CT relief. Tables 3 and 4 give field based results and certain other information, and Table 5 shows the Government share in the overall cost of abandonment.

3. In our analysis we adopted two main cases. In the Base Case (Table 1) we assume a real oil price that rises gently from $15 a barrel in 1988 to $25 in 2000 and $30 in 2010. We also looked at abandonment under an alternative constant oil price scenario (Table 2) where we assume that oil prices remain constant in real terms at a level of £12.50/barrel (1988 prices). Inflation is assumed to be 3% per annum throughout; the dollar/sterling exchange rate to £1.70; and interest rate for PRT repayments to be 8% per annum.

4. For simplicity, the assumption for both cases is that each field is abandoned as soon as it stops making trading profits. (See Section III of the Report concerning abandonment criteria). No account is taken of the possibility that some fields might continue for longer, or only be partially abandoned then, because some of the facilities are still being used by other fields.

5. Fields covered by Series 2 mode licences are eligible for Royalty relief on the costs of abandoning assets used for conveying and treating purposes. Our analysis assumes that 70% of total costs for all fields, except "old" PRT exempt gas fields (Series 1 Mode), are eligible and that there will be a Royalty repayment based on the total amount of unrelieved qualifying expenditure at the end of field life. This repayment is taken into account when calculating PRT and CT liabilities.

Corporation Tax

6. There are considerable problems in estimating the effects on abandonment of CT because the level of effective relief will be determined by each company's CT position at the appropriate time. This will in turn depend on the company's interests in other fields and on

whether it, or other companies in the same group, can make use of relief outside the ring-fence. All this is extremely difficult to model.

7. For purposes of the overall analysis (Tables 1 and 2), therefore, account has been taken of each company's interests within the ring-fence as a whole but no account has been taken of any non-ring-fence interests. (But these could be very important - see paragraphs 12-14 below.) For the field based analysis (Tables 3 and 4), it was necessary - in the interests of simplicity - to assume that each participator has no other ring-fence interests, so that CT losses could only be set against CT profits arising from that particular field.

Other data and modelling problems

8. Because of uncertainties and our inability correctly to model certain aspects, other simplifications were necessary as follows

(a) No account was taken of receipts from tariffing, though this could affect the amount of PRT relief available in particular fields and increase costs. Data on existing tariffing arrangements is not of good quality, and it is difficult to predict what future arrangements might be established.

(b) No account is taken of the cost of abandoning onshore terminals, or pipelines. In the case of onshore terminals, there would be difficulty in allocating these costs to particular fields, though the overall cost would be about £700M (1988 prices). In the case of pipelines, it is difficult at this stage even to say what the overall cost might be because there is as yet no clear picture as to what exactly abandonment might involve. (However, complete removal of all existing pipelines from the seabed could cost as much again as the aggregate cost of abandoning all offshore rigs etc.)

(c) We have similarly taken no account of future exploration and appraisal (E&A) expenditure and have also ignored the effect of the cross-field allowance in respect of 10% of development expenditure on certain new fields.

(d) Brent exempt gas. To the extent that abandonment expenditure for Brent relates to gas production which is exempt from PRT it needs to be excluded from these estimates. We

have assumed that only 80% of abandonment costs here would be eligible for PRT relief.

OVERALL RESULTS

9. On the Base Case scenario, the total estimated cost of abandonment on the above assumptions is likely to be about £4.2bn (1988 prices), with a government share of about 70% (see Table 5). The introduction of Pay and File will give rise to changes in the interest treatment of CT repayments and late payments. The main effect on abandonment costs under the existing regime is that CT clawback of PRT repayments will be subject to interest, and this could reduce the Governments share of costs by about £200.

10. Base prices are higher than the constant £12.50/barrel price from 1995 onwards. Under the Base Case, the negative net profit criterion used therefore leads to later abandonment for most fields than under the alternative, constant price scenario. But the difference is only one or two years for most fields, and the price difference has no effect on the abandonment date for a number of fields.

11. Because abandonment is later under the base price scenario, money of the day costs are also higher than under the constant price case. The increase in respect of government share is also proportionally greater. This is mainly attributable to CT, as the higher prices themselves and the consequent delays in abandonment mean that companies with interest in more than one field will be more likely to get effective CT relief on abandonment expenditure on all but their last field.

12. As noted in paragraph 7 above, this analysis takes no account of non-ring-fence CT interests and therefore probably significantly understates the true amount of CT relief that will be available for abandonment expenditure.

13. There are 59 different groups of companies with equity interests in the fields covered by this analysis. These groups vary considerably, both in terms of their size and in the extent of their non-ring-fence interests. The top 20% account for over 80% of the abandonment expenditure, and the three largest together account for more than 50%.

14. It seems very likely that the three largest groups in particular, but also certain other groups with substantial non-ring-fence interests would be able to make use of any CT losses not relievable within the ring-fence against profits arising from their considerable downstream activity in the UK or elsewhere

outside the ring-fence. Overall, it seems likely that downstream relief could add about £450M (1988 prices) to the government's share of abandonment costs (see Table 5). This would leave only some £400M worth of expenditure for which even after terminal loss relief there was no CT relief. This amount, equivalent to tax of less than £150M in 1988 prices, would be spread over something like 30 years.

FIELD BASED RESULTS

15. Tables 3 and 4 summarise the results, on the same assumptions, described earlier, for individual fields under the Base Price scenario. Table 3 covers fields likely to pay PRT at some point during their life, and Table 4 non-PRT payers. In addition to abandonment cost and timing details, the tables show what proportion of the abandonment expenditure would be covered by relief, including interest on PRT repayments (Column 10). They also show the position assuming that full CT relief was available (Column 11), and - for purposes of comparison - total tax as a percentage of pre-tax cashflow over the life of the field in question as a whole (Column 13).

16. The 40 fields (Table 3) expected to pay PRT at some point in their life, ignoring all cross-field effects, can be split into four categories as follows

(a) The 24 fields which get full PRT relief on their abandonment expenditure.

(b) Three which only get partial relief, but at a higher rate than their overall PRT rate.

(c) Eight which get no PRT relief but which will have paid very little PRT over their life. In practice, some may not pay any PRT at all because of cross-field allowances.

(d) Five where relief for abandonment expenditure will be significantly lower than the average rate of PRT on profits over the life of the field.

TABLE 1

Overall costs of abandonment

Excluding onshore terminal and pipeline costs, PRT cross field relief effects and downstream CT relief

Existing regime, excluding "pay and file" changes

BASE price

£ million

	MOD		1988 prices	
	Expenditure	Government share	Expenditure	Government share
1990	10	0	10	0
1991	10	2	10	2
1992	20	0	20	0
1993	10	10	10	4
1994	60	3	50	2
1995	100	10	80	10
1996	280	20	220	20
1997	220	90	170	70
1998	70	70	50	60
1999	270	50	200	30
2000	400	170	280	120
2001	230	200	150	140
2002	40	90	30	60
2003	240	50	150	30
2004	30	70	20	40
2005	350	50	210	30
2006	630	170	370	100
2007	880	680	500	390
2008	600	610	330	340
2009	510	660	280	350
2010	290	300	150	160
2011	190	160	100	80
2012	190	200	90	100
2013	480	170	230	80
2014	370	160	170	70
2015 and later	900	860	350	340
Total	7390	4850	4240	2630

TABLE 2

Overall costs of abandonment

Excluding onshore terminal and pipeline costs, PRT cross field relief effects and downstream CT relief

Existing regime, excluding "pay and file" changes

CONSTANT real £12.50 / barrel (1988 prices)

£ million

	MOD		1988 prices	
	Expenditure	Government share	Expenditure	Government share
1990	10	0	10	0
1991	10	2	10	2
1992	5	1	4	1
1993	40	0	30	0
1994	50	10	40	10
1995	100	5	80	4
1996	340	20	270	20
1997	180	130	140	100
1998	120	70	90	60
1999	380	90	280	60
2000	310	240	220	170
2001	180	160	120	110
2002	100	60	60	40
2003	330	50	210	30
2004	490	220	310	130
2005	970	340	590	210
2006	440	960	260	560
2007	290	430	160	250
2008	540	150	300	80
2009	430	230	230	130
2010	180	260	90	140
2011	510	120	260	60
2012	430	190	210	100
2013	90	210	40	100
2014	80	90	40	40
2015 and later	530	380	190	140
Total	7130	4430	4240	2530

TABLE 3

ndonment costs on field basis - PRT paying fields

:E price

;ld	Abandon-ment cost (£m 1988)	Final year of prod-uction	Percentage relief for abandonment costs (based on MOD figures): Royalty	PRT: royalty clawback	PRT: relief	CT (field basis): clawback	CT (field basis): relief	Total tax relief before interest	Interest on PRT repay-ments	Total tax relief including interest	Total if full CT relief available	Full life excluding abandonment: PRT as % of pre-PRT income	Full life excluding abandonment: Tax as % of pre-tax cash flow
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Full relief													
:THYST E	25	2011	0%	0%	75%	-26%	35%	84%	13%	97%	97%	55%	70%
:THYST W	7	2011	0%	0%	75%	-26%	35%	84%	9%	93%	92%	28%	53%
DREY	14	2010	0%	0%	75%	-26%	13%	61%	27%	89%	111%	58%	73%
RQUE	18	2011	0%	0%	75%	-26%	12%	61%	13%	73%	96%	11%	42%
RYL	100	2011	9%	-7%	75%	-27%	7%	57%	25%	82%	110%	62%	83%
ENT	397	2006	8%	-6%	60%	-22%	3%	43%	57%	100%	132%	30%	69%
AYMORE	57	1996	9%	-7%	75%	-27%	8%	58%	17%	76%	102%	49%	80%
IPPER	26	2010	0%	0%	75%	-26%	12%	60%	15%	75%	98%	18%	47%
RMORANT N	120	2015	9%	-7%	75%	-27%	8%	58%	36%	94%	121%	34%	69%
NLIN	109	1999	9%	-7%	75%	-27%	5%	55%	35%	90%	120%	47%	79%
RTIES	392	2005	9%	-7%	75%	-27%	5%	55%	33%	88%	117%	60%	85%
LMAR	81	1998	9%	-7%	75%	-27%	5%	55%	25%	80%	110%	51%	79%
GNUS	157	2005	9%	-7%	75%	-27%	8%	58%	24%	82%	109%	51%	76%
RCHISON	68	1998	9%	-7%	75%	-27%	5%	55%	20%	76%	105%	41%	77%
NIAN	214	2006	9%	-7%	75%	-27%	5%	56%	35%	91%	120%	45%	80%
VALIANT	18	2008	0%	0%	75%	-26%	11%	60%	21%	81%	105%	34%	57%
AN N	23	2012	0%	0%	75%	-26%	12%	61%	5%	66%	89%	37%	59%
AN S	23	2012	0%	0%	75%	-26%	12%	61%	6%	67%	90%	36%	58%
ATFJORD	75	2008	9%	-7%	75%	-27%	14%	63%	18%	81%	102%	59%	80%
MORECAMBE	142	2025	9%	-7%	75%	-27%	35%	85%	1%	85%	85%	57%	76%
NGUARD	5	2009	0%	0%	75%	-26%	35%	84%	9%	93%	93%	14%	44%
CTOR	7	2009	0%	0%	75%	-26%	12%	61%	13%	73%	97%	64%	78%
LCAN	15	2010	0%	0%	75%	-26%	12%	60%	8%	69%	92%	43%	63%
TCHFARM	8	2011	9%	-7%	75%	-27%	12%	62%	5%	66%	90%	60%	78%
PRT relief higher than full life PRT													
AE	145	2010	9%	-7%	18%	-7%	35%	48%	2%	50%	50%	1%	47%
AUREEN	64	1994	9%	-7%	24%	-9%	14%	31%	5%	36%	56%	14%	57%
LLER	129	2007	0%	0%	66%	-23%	13%	56%	17%	73%	95%	32%	56%
. No PRT relief but full life PRT rate under 5%													
MERALD	6	1997	0%	0%	0%	0%	0%	0%	0%	0%	35%	2%	37%
ORDON	9	1996	0%	0%	0%	0%	11%	11%	0%	11%	35%	1%	38%
IGHLANDER	6	1993	0%	0%	0%	0%	0%	0%	0%	0%	35%	4%	38%
VANHOE	6	1997	0%	0%	0%	0%	0%	0%	0%	0%	35%	1%	36%
ITTIWAKE	21	2002	0%	0%	0%	0%	28%	28%	0%	28%	35%	2%	36%
N HUTTON	68	2002	9%	0%	0%	-3%	23%	29%	0%	29%	41%	0%	48%
CAPA	20	1996	0%	0%	0%	0%	0%	0%	0%	0%	35%	1%	36%
ERN	73	2008	0%	0%	0%	0%	13%	13%	0%	13%	35%	1%	36%
. Others													
SMOND	23	1996	0%	0%	0%	0%	11%	11%	0%	11%	35%	13%	47%
ONTROSE	18	2002	9%	0%	0%	-3%	30%	36%	0%	36%	41%	7%	58%
ALWYN	146	1999	0%	0%	16%	-5%	15%	25%	3%	28%	49%	30%	55%
HAMES	16	1994	0%	0%	2%	-1%	3%	4%	1%	4%	37%	31%	57%
HISTLE	94	1995	9%	-7%	39%	-14%	19%	45%	5%	50%	67%	40%	76%

TABLE 4

Abandonment costs on field basis - fields not paying PRT

BASE price

Field	Abandonment cost (£m 1988)	Last year of production	Percentage relief for abandonment costs (based on MOD): Royalty	CT (field basis): royalty clawback	CT (field basis): relief	Total tax relief including interest	Total if full CT relief available	Tax as % of pre-tax cash flow over full life excluding abandonment
	(1)	(2)	(3)	(6)	(7)	(10)	(11)	(13)
ARBROATH	13	2012	0%	0%	35%	35%	35%	35%
ARGYLL	9	1990	9%	-3%	6%	12%	41%	58%
AUK	32	1994	9%	-3%	5%	10%	41%	57%
BALMORAL	6	1996	0%	0%	0%	0%	35%	‡
BEATRICE	63	1995	9%	-3%	4%	10%	41%	51%
BUCHAN	15	1991	9%	-3%	25%	31%	41%	58%
BURE	4	1994	0%	0%	0%	0%	35%	37%
CLEETON	19	2002	0%	0%	3%	3%	35%	35%
CLYDE	70	2000	0%	0%	5%	5%	35%	35%
CORMORANT S	93	2004	9%	-3%	5%	11%	41%	47%
CYRUS	-13	1993	0%	0%	1%	1%	35%	‡
DELLA	1	1998	0%	0%	11%	11%	35%	35%
DEVERON	1	1995	0%	0%	8%	8%	35%	35%
DON	4	2001	0%	0%	0%	0%	35%	‡
DUNCAN	3	1990	0%	0%	0%	0%	35%	40%
EIDER	57	2006	0%	0%	4%	4%	35%	35%
FORBES	9	1996	0%	0%	10%	10%	35%	39%
FRIGG ‡‡	174	1990	0%	0%	4%	4%	35%	50%
GLAMIS	4	1996	0%	0%	35%	35%	35%	35%
HEATHER	44	1992	9%	-3%	3%	8%	41%	55%
HEWETT	66	1999	0%	0%	11%	11%	35%	52%
HUTTON	26	1999	9%	-3%	11%	17%	41%	47%
INDEFATIGABL	108	2006	0%	0%	1%	1%	35%	48%
INNES	1	1989	0%	0%	36%	36%	35%	35%
KATRINE	2	1994	0%	0%	38%	38%	35%	35%
LEMAN	251	2012	0%	0%	3%	3%	35%	47%
NESS	6	1993	0%	0%	34%	34%	35%	35%
NEVIS	3	1998	0%	0%	0%	0%	35%	35%
OSPREY	21	2000	0%	0%	9%	9%	35%	35%
PETRONELLA	3	1992	0%	0%	0%	0%	35%	35%
RAVENSPURN	89	2021	0%	0%	18%	18%	35%	35%
ROB ROY	8	1997	0%	0%	0%	0%	35%	35%
TARTAN	41	2001	9%	-3%	10%	16%	41%	47%
S.VALIANT	7	2008	0%	0%	35%	35%	35%	35%
VIKING	35	2004	1%	-0%	0%	1%	36%	51%
WEST SOLE	26	2009	0%	0%	16%	16%	35%	47%
YARE	3	1994	0%	0%	3%	3%	35%	69%

‡ Negative pre-tax profits

‡‡ Frigg is finally abandonned in 2001

TABLE 5

Government share of abandonment costs

Excluding onshore terminal and pipeline costs, and PRT cross field relief effects

BASE price

£ million

	MOD	1988 prices
Royalty	410	230
PRT	2830	1510
PRT interest	1220	670
CT	390	220
Total - ring fence only before Pay & File (as in Tables 1 and 2)	4850	2630
Estimated interest on CT and CT clawback of PRT repayments under Pay & File	-350	-190
Estimated effect of downstream CT relief	800	450
Total Government share	5300	2890
Total Government share as percentage of abandonment costs	72%	68%
Total Government share of pre-tax cash flow over field life excluding abandonment	70%	72%

ANNEX B

ABANDONMENT: ADVANTAGES AND DISADVANTAGES OF GRANTS SYSTEM

(Note by the Treasury)

Objectives

1. There are a number of criteria against which the tax and public expenditure solutions might be judged. It is unlikely that any solution will meet all of them and, in any case, they are not all of equal standing.

2. The oil companies are concerned to overcome their cash flow problem; secure that each member of a partnership bears its share of the costs; and that there should be full and effective relief. The Government's objectives are that any action is non-distortionary; that precedents are not set which other industries will seek to follow; that any solution is practical and will not entail a huge administrative effort; that the costs to Government are controllable and minimised; that the effect on Government finances is to smooth flows; and that it does not cut across other policy objectives.

Public Expenditure Solution

3. Any public expenditure solution would mean spending at the time of abandonment as costs were incurred. This could be either as a fixed proportion of the cost of abandonment or a proportion of costs related to the tax paid in the field by the company.

4. Both routes would help with the cash flow problem. For the same amount of money it is probable that a tax-related grant (like a tax credit or relief) would relate better to the actual financial position of the company, but either would be effective. A grant would improve the security of partners, but since it might not cover the total abandonment cost and companies would probably be inclined to think tax relief was less likely to change it would not be possible to give absolute security. Tax related grants would affect partners differentially, so increasing existing tensions. So a grant system would probably satisfy the companies except on the security point.

5. Grants of either kind would not affect the pattern of flows from the fields, so, if the companies were taking decisions to abandon according to whether marginal costs exceeded marginal revenues (on either the zero or 5% margin basis), the timing of abandonment should not be affected by a proportionate grant unless abandonment costs were expected to change. If the grant was tax related a change in the tax status would influence timing. If the companies were seeking

to maximise NPV, both types of grant would distort behaviour pulling abandonment forward. Overall the effects of a tax based grant would have the same effect as tax reliefs, while a straightforward percentage grant would influence behaviour differently.

6. Grants of either kind could probably be satisfactorily ring-fenced, but the innovation of tax-related grants could be seen to undermine the tax-system and would undoubtedly raise unforeseen and sophisticated claims from other quarters.

7. A grant system would require certification of the abandonment costs on either model, as distinct from submission of claims and scrutiny of them by the Revenue under system of tax relief. Tax related grants would also require continuing measurement of the tax paid on the filed, as would some forms of tax relief.

8. Under the grant system, there would need to be some measure of the abandonment costs. If the grant was simply a proportion of total abandonment costs, the public expenditure implications would be finite, if difficult to forecast; but if the grant was tax-based, it would be even more difficult to forecast. A tax related grant might also encourage companies to manipulate their tax to maximise the grant. We have not considered a third option of the Government accepting all costs above a certain threshold, on the grounds that such a system would give no incentive to the companies to minimise costs. This incentive would be strongest with the proportionate grant and vary according to individual companies' circumstances on the tax-related basis. Whether or not proportionate grants minimise costs to Government depends finally on the rate at which they are set which is controllable. To the extent that grants bring forward abandonment beyond the economically efficient point in time, there will be further tax revenue losses to the Government.

9. Other things being equal it would be preferable for Government flows to be smoothed, so that the loss of tax revenue at abandonment was not compounded by having to pay a share the costs of the abandonment. Neither grants nor tax relief given at the time of abandonment would do this.

10. Finally, there are three wider issues which would affect the choice. First, it would be unacceptable if, when Government imposed a regulatory requirement on an industry, it was seen to accept part of the moral and financial burden of the requirement. This argues against the proportionate grant and strengthens tax-relief or a tax-related grant even though that might be more difficult to ring-fence. Second, the Government sets objectives for public expenditure which would be harder to meet if we used grants. This would be so, regardless of whether the effect on the PSBR were the same under grants as under tax relief. Any grant would be classified as public expenditure, but a tax relief would only be included in the planning total to the extent that it

exceeded tax paid previously. In addition there would be the need to get authority from Parliament each year for expenditure, which makes it more difficult to make long-term commitments.

chex.ps/jmt/2 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 3 January 1989

PS/ECONOMIC SECRETARY

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Byatt
Mr Monck
Mr Scholar
Mr Culpin
Mr D J L Moore
Mr S Matthews
Mr M L Williams
Ms Goodman
Miss Hay
Mrs Chaplin

Mr Beighton - IR
Mr Johns - IR
Mr Prescott - IR
PS/IR

NORTH SEA FISCAL REGIME

The Chancellor has seen Mr Scholar's two notes of 22 December, covering reports by the Working Party on the North Sea Fiscal Regime. He has commented that the suggested PRT Incremental Investment Allowance is clearly a starter for 1989.

J M G TAYLOR

est.ld/james/no8.jr

CONFIDENTIAL

FROM: S M A JAMES
DATE: 6 January 1989

MR SCHOLAR

cc PS/Chancellor
PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Byatt
Mr Monck
Mr Culpin
Mr D J L Moore
Mr S Matthews
Mr M L Williams
Miss H Goodman
Miss Hay
Mrs Chaplin

PS/IR
Mr Beighton - IR
Mr M A Johns - IR
Mr Prescott - IR

NORTH SEA FISCAL REGIME - REVIEW OF ABANDONMENT AND INCREMENTALS

The Economic Secretary was grateful for your minute of 22 December attaching the two reports by the working party on the North Sea Fiscal Regime. He has also seen Mr Taylor's minute of 3 January.

2. The Economic Secretary wishes to discuss the reports with officials and this office will be in touch to arrange a meeting next week. The Economic Secretary is inclined to do nothing on abandonment in 1989 (just incrementals). Although he would prefer to keep incrementals as a sweetener for any action on PRT interest in 1990, it looks as if the arguments for immediate action this year are stronger.

3. The Economic Secretary's inclination for 1990 is

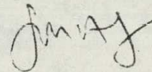
(i) to examine facilitating bank guarantees rather than alienated funds;

(ii) to look very closely at positive rationales for keeping PRT interest on abandonment expenditure losses before abolishing them - which will be fiercely opposed;

(iii) to favour immediate CT relief, backdatable at least 3 years, preferably from the start of abandonment;

(iv) to be wary of a complex formula for PRT relief.

But this jigsaw could be assembled in several different ways.



S M A JAMES
Private Secretary

fst.jf/docs/002.jr

CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 6 January 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Gilhooly
Mr de Berker
Miss Hay
Mr Knight
Mr Ramsden
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Lewis)
Mr Fraser) IR
Mr Wilcox)
PS/IR

Agree FST/PMG?

Agreed

STARTER 110: TAX TREATMENT OF LUMP SUM TERMINATION PAYMENTS TO EMPLOYEES

I have discussed Mr Wilcox' minute of 16 December with the Paymaster General and officials. You will recall that we decided to look at this area as it was clear that some people were receiving large redundancy payments which in reality they could reasonably have expected to receive (and which should therefore have been taxable as income under the normal Schedule E rules) but where the first £30,000 was tax-free under the redundancy payments rules.

Of the six options for change canvassed in the minute, I think we can rule out 2, 4 and 5 as (respectively) unduly harsh, operationally difficult and politically unacceptable. Both the Paymaster General and I believe that Option 1 (restricting relief to genuine redundancies and job losses) is theoretically the most attractive as the one most likely to meet our objective. But we are persuaded that it would be neither practical nor desirable to

have the Revenue become involved in the detailed probing of each individual case in order to check its merits. Reluctantly, therefore, this too must go.

That leaves options 6 (do nothing and let the £30,000 limit wither on the vine) and 3 (tax payments above £30,000 on a stamp duty "slab" basis). Both the Paymaster General and I prefer on balance Option 3. It is too much of a blunt instrument to deal with the specific problem directly; but it does subsume it. People receiving payments over £30,000 (estimated to be some 15,000 a year) would be taxed on either part or the whole of them, so there would be a yield to the Exchequer of around £50m a year. But this is not unreasonable - even for better-paid people in genuine redundancy situations - given the large reductions in the top rates of tax.

One problem with this option is the familiar one of the cliff-edge. There would obviously have to be some tapering of relief above £30,000 similar to that for the age allowance. Mr Wilcox identified one possibility in his minute; but the Revenue will be providing advice on other possible choices (which would affect the eventual yield). We also have to decide on the appropriate start date; Budget Day or 6 April. Again, the Revenue will be submitting advice.

The tax treatment of the proposed severance payments to Commons Ministers would not be affected by the choice between these two options because the payments will be below £30,000 in any one year. The only wrinkle here is the possible aggregation of payments when a Minister loses both his post and his seat as an MP. Officials believe that these would be treated as separate employments, but are checking this with the lawyers.

That leaves the timing point on when to introduce the legislation. Clearly nothing should happen until the Parliamentary Pensions Act is amended in the next Session so that the existing Lords scheme is extended to the Commons. The tax measure could then either be

taken at that time (officials are checking this is alright) or in the 1990 Finance Bill. The Paymaster General's and my preference would be to take it with the other pension changes; this would avoid a (possibly difficult) debate during the passage of the Finance Bill.

R.C.M.S.

pp NORMAN LAMONT

chex.rm/jmt/5 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 9 January 1989

PS/FINANCIAL SECRETARY

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Gilhooly
Mr de Berker
Miss Hay
Mr Knight
Mr Ramsden
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Lewis - IR
Mr Fraser - IR
Mr Wilcox - IR
PS/IR

STARTER 110: TAX TREATMENT OF LUMP SUM TERMINATION PAYMENTS TO EMPLOYEES

The Chancellor has seen the Financial Secretary's note of 6 January.

2. He agrees with the Financial Secretary and the Paymaster General that Option 3 (tax payments above £30,000 on a stamp duty "slab" basis) should be pursued. He also agrees that there will need to be some tapering of relief above £30,000; that we shall need to consider further the appropriate start date (Budget day or 6 April); and that the legislation should be introduced alongside the Parliamentary Pensions Act changes.

J M G TAYLOR

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS
EXT: 6371
DATE: 13 JANUARY 1989

CHANCELLOR

CAR SCALES: STARTER NO 104

1. At Dorneywood you asked for a note on the distributional consequences of a 20% increase in the car scales, and the yield.

2. This note looks at such an increase assuming bare indexation of allowances. We can, of course, look at any other combination of scale increases and personal tax changes which you would like to consider.

3. The note is set out as follows

- Tables A and B give the amounts of the increase in the scale and the additional weekly tax payable by a basic rate or higher rate taxpayer.

- Table C looks at the number of the losers and amount of losses from the combined income tax package and car scale increase.

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cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Wicks
Mr Scholar
Mr Monck
Mr Culpin
Mr Riley
Mr A C S Allan
Mr Gilhooly
Mr Matthews
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Unwin (Customs and Excise)

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Lewis
Mr Mace
Mr Hodgson
Mr Massingale
Mr Eason
Mr Evershed
Mr I Stewart

- Table D adds in the effect of NIC changes already announced (the raising of the UEL).

- The final sections takes account of wider changes - a 7.5% increase in earnings for 1989/90 and the broad impact of recent mortgage interest increases.

4. In looking at NICs, increased earnings, and mortgage interest relief, we have tried to carry the analysis rather further than last year. But all the estimates are still in cash terms. So far as tax alone is concerned all company car users would of course be losers in real terms from a 20% increase in the car scales.

20% increase in scale charges

5. Table A sets out by how much each of the three scales would change for each of the 5 categories of car. It also shows the distribution of cars between these 8 categories. As the figures show, the typical company car is in the 1400 to 2000 cc engine range, and is taxed on the main scale ie it does between 2,500 and 18,000 miles per annum on business journeys.

Table A: 20% increase in the scale charges

	Approx Proportion of cars in each engine size band	Main Scale	"Perk Car"	Over 18,000 business miles
Up to 1400cc	17%	210	315	105
1400-2000cc	62%	280	420	140
Over 2000cc	18%	440	660	220
Original cost £19,250-£29,000	2%	580	870	290
Original cost Over £29,000	less than 1%	920	1380	460
Proportion of all cars on each scale		75%	7%	18%

6. Table B shows the extra weekly tax payable by a basic rate and a higher rate taxpayer in respect of the increases to the car scales shown in Table A.

Table B: Extra weekly income tax payable on a 20% increase in scale charges

	Main Scale		"Perk Car"		Over 18,000 business miles	
	£ (weekly)		£ (weekly)		£ (weekly)	
	BR	HR	BR	HR	BR	HR
Up to 1400cc	1.01	(1.62)	1.51	(2.42)	0.50	(0.81)
1400-2000cc	1.35	(2.16)	2.02	(3.23)	0.67	(1.08)
Over 2000cc	2.12	(3.39)	3.17	(5.08)	1.06	(1.69)
Original cost £19,250-£29,000	2.79	(4.46)	4.18	(6.69)	1.39	(2.23)
Original cost Over £29,000	4.42	(7.08)	6.63	(10.62)	2.21	(3.54)

Losers - income tax only

7. The section of the Dorneywood paper on cars assumed an indexation figure of 6.25% for allowances. It suggested that 25% of company car users would be losers with a 20% scale increase.

8. The assumed indexation figure is now 6.7% (latest forecast). This gives an increase of £280 on the married man's allowance (exactly equal to the main scale increase for the typical 1400-2000cc car) and £180 on the single person's allowance. This small increase in allowances eliminates a large number of small losers, and puts them in a no gain/no loss position. Of the 1.4m liable company car drivers, 1.07m would be gainers, 0.15m would be in a no gain/no loss position, and only 0.17m (12%) would be losers. In addition, about 10,000 employees would start paying tax for the first time on their car because the scale charge

increase would take them over the P11D threshold. Because we have little information about them, these cases are not included in the analysis of losers in Table C.

Table C: Analysis of losers and annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	-	1	-	1
£100-£199	1	1	-	2
£50-£99	19	2	-	21
£1-£49	129	20	-	149
Totals	149	24	-	173
Average annual loss	£25	£43	-	£27

9. Almost all of the 173,000 losers are basic rate taxpayers. Higher rate taxpayers will benefit from the indexation of both personal allowances and the higher rate threshold and most higher rate taxpayers with cars are net gainers.

Losers - income tax and NIC

10. The UEL has been increased from £305 to £325 per week for 1989/90. If this change is also taken into account, we estimate that the number of company car losers would increase from 170,000 to about 365,000 (26%). Table D analyses those losers.

Table D: Analysis of losers and annual amount of losses, income tax and NIC

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	-	1	-	1
£100-£199	15	5	-	20
£50-£99	112	8	19	139
£1-£49	136	25	43	204
Totals	263	39	62	364
Average annual loss	£48	£58	£42	£48

11. Of the 365,000 losers, 126,000 are basic rate taxpayers below the UEL who are not affected by the NIC change; 205,000 are basic rate taxpayers above the UEL, an increase of 164,000 compared to the number of losers on tax alone in this category and the remaining 41,000 losers are higher rate taxpayers, an increase of 35,000.

12. There would, of course, also be losers outside the company car sector from bare indexation because of the UEL increase. We estimate the total for employees at 1.35m - 875,000 contracted out with an average loss of £12, and 475,000 contracted in with an average loss of £29.

Income tax, NIC and increased earnings in 1989/90

13. If the analysis is extended to include the effect of the increase in earnings in 1989/90, all but a very small group of

the losers are eliminated. We have used a 7.5% increase - the illustrative increase in the Autumn Statement, which will also be used in the Budget Press Notice on income tax.

14. The biggest losers would be some of the 10,000 people who start paying tax on the whole of the car benefit in 1989/90 because they come over the £8,500 benefits threshold, but were previously not liable in respect of their company car. We have little information about them, but it is possible that some would still be losers even after increased earnings are taken into account.

Tax, NIC, increased earnings and mortgage interest

15. The outcome is less favourable when the impact of mortgage interest increases is introduced.

16. We do not have information about the mortgages of company car drivers so a number of assumptions about their mortgage interest payments have had to be made, and the estimates are therefore tentative. Two bases of comparison have been used. First, we have compared an average interest rate of 11.8% in 1988/89 with an assumed average of 13.5% for 1989/90 (a similar basis was used in a recent PQ). Second, we have compared a 10.25% rate for 1988/89 with 13.5% for 1989/90. This represents the likely increase for an "annual budget" mortgage of the kind operated by some lenders eg the Halifax.

17. If the first basis applied to all company car drivers with mortgages, some 75,000 (5.%) would become losers. If the second basis applied to all drivers with mortgages about 200,000 (14%) would be losers. The average losses would be about £250 and £600 respectively. We do not have any information at present about the number of company car drivers with mortgages of these two types. But clearly the actual number of losers, and the average loss, will lie somewhere between these two sets of figures.

18. With very few exceptions, these losses are so large that the employees concerned would have been significant losers even with no increase in the car scales. For example, for a basic rate taxpayer with the typical car, the extra annual tax is only £70.

Revenue Yield

19. The estimated yield from a 20% increase in car scales is

1989/90	1990/91
£90m	£110m

20. Most of the tax comes in during 1989/90 because we would adjust code numbers during the Budget recoding to reflect the increased car scales. But in some cases we will not know of the liability until the following year - for example, people going over the P11D threshold for the first time - and in others we cannot collect all the tax due by a coding adjustment if the scale charge exceeds the personal allowances due.

Summary

21. Looking at income tax alone, only 12% of company car drivers would be cash losers, and the average loss would be only £27. (These figures could be lower if the final indexation percentage is higher).

22. Taking NIC into account, these figures increase to 26% and £48.

23. When increased earnings are taken into account, there could be a very small number of cash losers - a relatively small proportion of those 10,000 company car drivers brought over the P11D threshold for the first time by the increased scale charges.

24. When increased mortgage interest payments are also taken into account, perhaps some 10% or so of company car drivers would be losers, and their average losses might be of the order of £250 or £600 depending on the type of mortgage. Only a small part of those losses relate to car scale increases.

Questions for Decision

25. On the basis of this analysis, should the working assumption remain a 20% increase in car scales if the personal tax package is bare indexation?

26. Would you like us to update the analysis when the final indexation percentage is known? (With more time it should also be possible to refine it in some respects eg an analysis of losers by income.) Are there any other factors you would like to see reflected (if possible) in the analysis?

27. Are there any other combinations of scale charges and personal tax package you would like us to analyse at this stage?

Lisa Webbe

for P LEWIS

BUDGET CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: L E JAUNDOO

DATE: 9 JANUARY 1989

1. MR PITTS

2. FINANCIAL SECRETARY

Mr Jaundoo's minute below discusses some special cases of, and circumstances similar to, Instruments of Variation. If you agree to make no general exception for charities, heritage etc (2-8), you may want to give especial attention to his proposals to retain the present IHT effect for certain variations of trusts in favour of heritage maintenance funds (8b): and in any case that for disclaimers (17-21). Can defensible lines be drawn there? We are at your service if you would like to discuss.

[initials] 9/1

At para 23, while I see strength [illegible] so that [illegible], does it need to be as much as 4½ months (implied by Royal Assent)?

1989 FINANCE BILL STARTER 261

INHERITANCE TAX : INSTRUMENTS OF VARIATION

1. This note considers some second order questions arising from your decision to restrict the facility whereby beneficiaries of a death estate can rearrange its devolution within two years of a death so as to secure a tax advantage. The questions are concerned mainly with the implications of the proposed change for certain exempt bodies, particularly the national heritage, discretionary trusts created by Will, testators' non-binding requests and certain (mainly Scottish) rights of succession. In addition there is a general issue of whether the new rules should apply from Budget Day or from a later date.

---

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mrs Chaplin
Mr Tyrie
Mr Jenkins
(Office of the Parliamentary Counsel)

Mr Isaac
Mr Painter
Mr Pitts
Mr Bush
Mr Thompson
Mr McKean
Mr Kent
Mr Draper
Mr Jaundoo
Mr Ashcroft
PS/IR

The national heritage and other exempt bodies

2. The present unfettered facility available to beneficiaries for rearranging the devolution of the death estate with retrospective effect means that potentially they are able to do so not only for the benefit of relatives and friends but also for any of the exempt bodies - charities, political parties, employee trusts, certain national institutions, heritage conservation bodies and heritage maintenance funds. In practice, the facility is normally used to benefit individuals, and to a lesser extent charities.

3. The restriction of the general variation facility to those rearrangements making financial provision for dependants which are or could be ordered by the Court would mean that the foregoing exempt bodies would no longer be potential beneficiaries under the new rules. It would also mean that a legatee who was not willing to meet the preservation and public access requirements for heritage exemption from the death charge could not secure that exemption by passing the property on to someone who was willing to meet those requirements. The heritage representative bodies may be expected to lobby hard to resist the loss of this potential benefit to the heritage property itself and heritage maintenance funds.

4. There is another, related consideration. If the property is in trust and the trusts are varied in favour of a maintenance fund following the death of a life tenant, exemption from inheritance tax (IHT) is given under a special provision introduced in 1987 which corresponds to the general provision but is unique to maintenance funds.

5. The heritage interests will doubtless want to keep all the rearrangement provisions intact for post-death variations involving the heritage. Indeed, they have been pressing for a raft of further tax reliefs for maintenance funds including (of particular relevance) an extension of the two year time limit for execution of instruments of variation where property is redirected to a maintenance fund. The likely arguments are:

- the heritage is a special case meriting special reliefs;

- the older generation is often reluctant to make in advance the maintenance fund arrangements the heirs think appropriate;

- the needs of the fund are best assessed after the heritage property itself has come into hand;

- the heirs should be allowed to match the tax-free transfer of heritage property with tax-free transfer of an appropriate endowment for it;

- clawback provisions give sufficient safeguards against abuse for avoidance purposes.

6. These arguments are far from conclusive. The needs of the maintenance fund can be assessed at any time. The heritage property itself may have been passed on in lifetime. The heritage owner is as well placed as anyone else to plan in advance, and his heirs merit no more opportunities to improve on his tax planning (or lack of it) than anyone else's heirs. The withdrawal of the facility would encourage heritage owners to act in their own lifetimes, a course that accords with the heritage lobby's aim to secure the creation of more maintenance funds during the heritage owner's lifetime.

7. However it is also true that when we introduced the special provision for divesting interest in possession trust property to maintenance funds in 1987 (paragraph 4) we tacitly recognised the argument that it is often especially difficult in practice, expensive and sometimes impracticable for families to act while the life tenant is alive. In other words, the 1987 provision is distinguishable on these grounds from the general variation facility. It deals with a special set of circumstances and was deliberately enacted - after a lengthy lobby campaign - as a free-standing provision and not as an extension of the general

variation facility. Its withdrawal so soon after introduction would be strongly resented.

8. So we recommend that -

a) no exceptions in favour of the heritage or any of the other exempt bodies (in paragraph 2) should be made to the proposed new general variation facility rules (paragraph 3); but

b) the free standing 1987 provision in favour of heritage maintenance funds (paragraph 4) should be retained.

<u>Discretionary trusts created by Will</u>

9. Where a deceased leaves the whole or part of his estate on discretionary trusts, a parallel provision - section 144 IHTA - allows the beneficiaries to enjoy similar tax advantages to those available to them under the present general variation facility. In broad terms section 144 applies where property comprised in a person's estate immediately before death, is settled by his Will and within two years of his death and before there has been an interest in possession in the property, an event occurs which would have given rise to a charge under the discretionary trust regime. In those circumstances section 144 ensures that :

- no IHT is charged on the event in question, and

- for IHT purposes, the devolution of the deceased's estate is treated as if his Will had provided that on his death, his estate should devolve as it does after the event.

10. Section 144 can apply only if the deceased has made an appropriate provision in his Will, whereas the general variation facility can apply irrespective of the terms of his Will. It may be argued therefore that the general variation facility enables the executors/beneficiaries to ignore the deceased's Will but that Section 144 operates with the terms of his Will. However in

the latter case, this seeming compliance with the deceased's wishes is more apparent than real since the deceased has, in effect, left a blank Will to enable the trustees/beneficiaries to fill in the dispositions.

11. So Section 144 allows the deceased to delegate his testamentary capacity to enable a "wait and see" approach to be adopted and his estate to be distributed in the most efficient manner without tax penalty. For example -

A died on 11 March 1986 leaving a net estate of £2.5 million to trustees :

- to accumulate the income for the period of two years less one month after the death;

- to hold the residue and accumulation for A's two children equally absolutely;

- but with an overriding power to appoint by deed within the period of two years less one month for the benefit of all or such of A's wife, two children and remoter issue as they, the trustees, think fit.

IHT liability - around £1.5 million on the estate above the threshold at the rates then in force.

By Deed dated 5 February 1988, the trustees gave the widow a short-term income interest in the whole estate limited to end on 1 or 10 June 1988 some four months only after the Deed, and subject thereto the property goes to the two children equally absolutely.

Revised IHT - NIL on A's death since the estate is now covered by the spouse exemption. If the widow survives for seven years after her short-term income ceases, the PET to the children would become an exempt transfer.

12. So, as in the case of the general variation facility, the section 144 provision is used just as easily to transfer property to children or grandchildren via the surviving spouse to obtain the spouse exemption on death and, provided the spouse survives seven years, without incurring a tax charge. If therefore nothing were done about section 144, the policy intention behind the proposed restriction of the general variation facility would be undermined.

13. We recommend that where a deceased leaves his estate on discretionary trusts the present favourable treatment of distributions made within two years of his death should, as in the case of the general variation facility, be restricted to those making financial provision for dependants which are or could be ordered by the Court.

Testators' non-binding requests

14. Testators occasionally bequeath property (for example a personal item of jewellery or other memento) to a person expressing a wish that that person should transfer the property to someone else. The person to whom the property is bequeathed nevertheless owns the property beneficially and is under no legal obligation to comply with the testator's wishes. If he were to do so, he would be making a transfer of value, most probably a PET. However provisions in the IHT code ensure that where a person complies with a testator's non-binding requests within two years of the testator's death

- the transfer is not a transfer of value; and

- the property is treated for IHT purposes as if it had been bequeathed by the testator's Will to the transferee.

15. This favourable treatment is an extension of the present general variation facility. Although at present it is rarely, if ever, used, its scope is very wide. Its retention after the proposed restriction to the general variation facility, might

encourage beneficiaries to use it to circumvent the new arrangements. Moreover, if it were repealed, the small gifts (less than £250) exemption should prevent a lifetime claim on most transfers of this kind of sentimental items.

16. We recommend that the special provisions for testators' non-binding bequests should be abolished.

Certain (mainly Scottish) rights of succession

17. Under Scottish common law the surviving spouse and issue are entitled to a share of the moveable estate of the deceased spouse or parent. These legal rights arise whether the deceased died testate or intestate, although in the latter case the surviving spouse is also entitled to certain additional rights - prior rights - which take precedence over the legal rights. Moreover these legal rights vest automatically by survivance.

18. So where there is a surviving spouse or issue the devolution of a Scottish estate depends on decisions taken by such survivors about their legal rights. Where such a claimant has been left a bequest under the Will, he or she has to elect between taking the legal right ie claiming against the Will, or taking the bequest under the Will.

19. If the claimant elects for his or her legal rights, the estate devolves accordingly by operation of general Scottish law. If, however, the claimant disclaims legal rights, then he or she would be making a PET. In fact, this outcome is prevented because the present general variation facility applies both to instruments of variation and to disclaimers of benefits under Wills or intestacies. Its rationale rests on the argument that it would be unfair if a beneficiary who refuses an unwanted legacy under a Will were by so doing to be treated as making a transfer of value to the person benefiting from the refusal. However the benefit of the disclaimer provision is limited to disclaimer in its strict sense. So, it does not apply to a person who accepts a legacy and then passes it to someone else.

Nor does it apply if the person disclaiming receives any compensation in money or money's worth for doing so.

20. Although the provision applies to disclaimers throughout the United Kingdom, the situation in which a claimant may have to elect to disclaim Scottish legal rights arises quite frequently in practice (paragraph 18). So the withdrawal or curtailment of the provision is likely to have more adverse effects for the disclaimer of Scottish legal rights rather than for the disclaimer of rights under Wills or intestacies in the rest of the United Kingdom. Moreover, the special characteristics of Scottish legal rights is reflected in the present IHT rules which allow for the fact that minors entitled to claim legal rights (legitim) cannot effectively disclaim them until they have attained the age of 18.

21. We recommend that the present treatment of disclaimers of benefits under Wills or intestacies, including, in Scotland, legal rights vested by survivance, and the special provision for minors entitled to claim legitim be preserved.

Commencement date

22. The usual practice is to apply proposed new rules to transfers on or after Budget Day. This has the effect of preventing forestalling (where the new rules impose charges or restrict reliefs) while allowing relieving measures to take effect immediately. However, in the present circumstances some Wills would have been drawn on the basis of the existing rules, and the testators' untimely death may have prevented them from being revised to take account of the new regime. There will almost certainly be representations asking for some breathing space to adjust to the new rules.

23. So we recommend that we anticipate such representations by providing for the changes to apply to transfers where the death occurs on or after Royal Assent.

Conclusion

24. We would be grateful to know if Ministers agree that

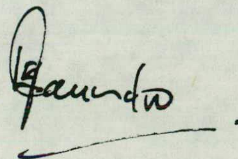
- no special exceptions should be made in favour of the heritage or any of the exempt bodies, but that the free-standing 1987 provision in favour of heritage maintenance funds should be retained (paragraph 8);

- discretionary trusts created by Will should be subject to the proposed new restrictions for the general variation facility (paragraph 13);

- the favourable treatment of testators' non-binding requests should be abolished (paragraph 16), and

- the present treatment of disclaimers of benefits under Wills or intestacies including, in Scotland, legal rights vested by survivance, and the special provision for minors entitled to claim legitim should be maintained (paragraph 21).

25. We would also be grateful to know if Ministers agree that the new rules should apply to transfers where the death occurs on or after Royal Assent (paragraph 23).



L E JAUNDOO

chex.ps/jmt/22 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 13 January 1989

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Isaac - IR
Mr Pitts - IR
Mr Jaundoo - IR
PS/IR

1989 FINANCE BILL STARTER 262
INHERITANCE TAX: INSTRUMENTS OF VARIATION

The Chancellor has seen Mr Jaundoo's note of 9 January.

2. He notes Mr Jaundoo's recommendation (paragraph 23) that we should provide for the changes to apply to transfers where the death occurs on or after Royal Assent. He recognises that some interval is clearly required, but he wonders whether it needs to be as much as 4½ months (which this implies).

J M G TAYLOR

fst.js/Robert/03.18.1.89

BUDGET CONFIDENTIAL

FROM: R C M SATCHWELL
DATE: 18 January 1988

MR JAUNDOO - IR

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Matthews
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Pitts) IR
Mr Thompson)

PS/IR

STARTER 261: IHT - INSTRUMENTS OF VARIATION

The Financial Secretary was grateful for your minute of 9 January, which he discussed with you and others.

The Financial Secretary agrees with the recommendations in para 24 of your minute. On the point raised by the Chancellor about the commencement date (your para 25), he believes that the new rules should apply to transfers where the death occurs on or after Royal Assent. This would allow a reasonable time for existing (and possibly complicated) wills to be revised. And although it opens up the possibility of forestalling during the 4½ months between Budget Day and Royal Assent, he notes that a taxpayer would have to die in order to take advantage of it; which would be an unattractive option in the vast majority of cases.

Finally, the Financial Secretary confirms that he would like this Starter to go ahead. But he recognises that if pressures on the Finance Bill became so great that some Starters had to be dropped, then this would have to be a candidate, given its relatively low priority when compared with other Starters.

R.C.M.S.

R C M SATCHWELL
Private Secretary

cst.rj/docs/19.1.1

BUDGET CONFIDENTIAL

FROM: A G TYRIE
DATE: 19 January 1989

CHANCELLOR

cc: Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Matthews
Mrs Chaplin
Mr Call

Mr Pitts - IR
Mr Jaundoo - IR
Mr Thompson - IR

STARTER 261: IHT/INSTRUMENTS OF VARIATION

I have seen Robert Satchwell's note of 18th January to Mr Jaundoo. When I first heard about these I was gung ho for doing something about them. But, having taken a closer look, my enthusiasm has cooled somewhat. On balance I favour not doing anything this year for several reasons:

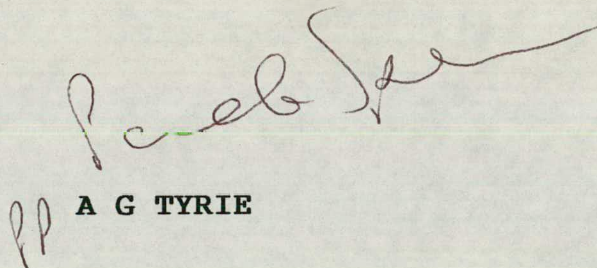
First, this measure does not, in fact, tighten IHT much. For the most part it would catch the beneficiaries of ill informed testators. In other words, if you plan ahead and get good legal advice you can almost always avoid the consequences of this proposed change. [Of course, this to some extent could depend on exactly how an individual wanted to distribute his estate.]

Furthermore, as Mr Jaundoo points out in his minute of 9th January (paragraph 26) most of those caught are likely to have "relatively modest tax paying estates". So the net effect is likely to be a string of articles in the financial pages of the newspapers advising testators of 'medium sized' wills to get some pukka legal and accountancy advice. There would be no simplification, merely a few more jobs for the legal and accountancy boys.

Secondly, on reflection, I can't see that there is so much wrong with permitting beneficiaries to rearrange things that may have been messed up by their gaga parents, where there is mutual consent. I'm not sure we should tax senility but I accept that's a moot point!

Thirdly, there is virtually no yield. Without behavioural effects Mr Jaundoo's top-end estimate is £25 million. As people inform themselves and get decent advice I expect that would wither to virtually nothing. There's not much tax reform in it either: IHT remains something of a dog's breakfast, either way. So is the (albeit relatively minor) political hassle worth the candle?

Fourthly, whether or not one is swayed by the above arguments, we already have a long and messy Finance Bill and on purely administrative grounds I'd put this one high on my list for dropping.



pp **A G TYRIE**