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1989 BUDGET
STARTER

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REGISTRY SYSTEM

SECRET

Inland Revenue

Personal Tax Division
Somerset House

FROM: B A MACE

DATE: 20 JANUARY 1989

CHANCELLOR OF THE EXCHEQUER

STARTER 100: INCOME TAX:
ALLOWANCES, BASIC RATE LIMIT AND INCOME TAX RATES

Indexation

1. I attach a table setting out the firm indexation figures for the income tax allowances and thresholds in 1989-90 on the basis of the 6.8 per cent increase in the RPI to December 1988 published today. Compared with the unindexed base the latest estimate of the direct revenue cost of indexation for income tax is £1,455 million in 1989-90.

2. The cost against the unindexed base in 1988-89 is only £5 million higher than in the Scorecard of 19 January. This is

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cc Principal Private Secretary
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Sedgwick
Miss Simpson
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Unwin (C and E)
Mr Jefferson Smith (C and E)
Mr Jenkins (OPC)
Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Lewis
Mr Calder
Mr Mace
Mr Cayley
Mr Hodgson
Mr Eason
Mr Boyce
Mr McNicol
Miss Dyall
Mr Wardle
Miss White
Mr Ko
PS/IR

because the operation of the statutory rounding rules means that - of the indexed allowances and thresholds - only the married age allowances and the basic rate limit differ from the levels corresponding to the 6.7 per cent indexation assumed for the Scorecard.

3. The indexed values of the threshold for inheritance tax (£118,000) and annual exempt amount for capital gains tax (£5,400) are unchanged from the those assumed for the Scorecard.

<u>Budget Scorecard: leading income tax option</u>

4. For income tax the leading option is:

- bare indexation (6.8 per cent on 1988-89 levels) of the main personal allowances and basic rate limit;

- an increase of 10 per cent (on 1988-89 levels) in the age allowance for those aged 80 and over;

- a reduction in the age allowance withdrawal rate from £2 of allowances for each £3 of income above the income limit (£11,400 for 1989-90) to £1 for £2.

5. Although the firm indexation figure is a little more than 1/2 percentage point higher than the Autumn Statement forecast of 6 1/4 per cent on which my submission of 30 November last year was based, the broad picture of the effects of indexation which I described in that note has not significantly changed. Very briefly the main implications of the leading option, taking account of the latest estimates are:

a. a cost of about £15 million in 1989-90 on top of indexation , (£10 million for the increase in the over 80s age allowance, £5 million for the change to the age allowance withdrawal rate). The corresponding figures for 1990-91 are the same;

b. basic rate taxpayers of working age gain 87p per week (single), £1.35 per week (married) in cash terms from the increase in allowances;

c. approaching $1^{1}/2$ million basic rate taxpayers with earnings above the UEL/UPL are cash losers from the combined effect of tax and NIC changes in 1989-90;

d. average rates of tax in 1989-90 rise slightly for everyone compared with 1988-89 (on the basis of the $7^{1}/2$ per cent increase in average earnings to 1989-90 assumed by the Government Actuary in his review of the National Insurance Fund and published in the Autumn Statement). This is the usual basis for illustrating the effect of Budget income tax changes. The rise in average rates will show up in the traditional Budget Day press release. A forecast for the increase in average earings is not published but the current forecast is about 1 percentage point higher. On this basis average rates of tax would show a larger increase than on the GAD assumption.

e. the increase in average rates between 1988-89 and 1989-90 for couples with children, taking account of child benefit, will be larger than for those without children, reflecting the freezing of the benefit in 1989-90;

f. for most people real take-home pay will rise by around 1-2 percentage points in 1989-90 compared with 1988-90;

g. basic allowances fall substantially below 1978-79 levels as a percentage of male average earnings. In 1978-79 the married man's allowance was 31.8 per cent of average earnings; in 1989-90 it will be 30.8 per cent.

h. there will be about 120,000 more taxpayers (counting husband and wife as one) overall in 1989-90 compared with 1988-89;

i. the number of higher rate taxpayers in 1989-90 (at just short of 1.4 million) will be close to the historical peak of 1976-77;

j. there will be an overall staff cost in the Revenue of around 20 units in a full year;

k. the increase of 10% in the allowance for those aged 80 and over means:

   i. single allowance up £340 on 1988-89 to £3,650 (up £110 compared with indexation);

   ii. married allowance up £530 on 1988-89 to £5,735 (up £170 compared with indexation);

l. compared with indexation the real increase in the age allowance for those aged 80 and over is worth around 53p per week (single), 82p per week (married); and it reduces the number of single people and married couples aged 80 and over liable to tax by some 5,000.

Car Scales (Starter 104)

6. As requested in Mr Taylor's note of 16 January, now that the firm indexation figure is available we shall update the analysis in Mr Lewis' note of 13 January (where necessary) before the Overview on 30 January.

B A Mace

B A MACE

INCOME TAX: ALLOWANCES, THRESHOLDS AND RATES

	1988-89	1989-90ϕ	(Indexation)
Allowances	£	£	
Single person	2,605	2,785	(180)
Married Man	4,095	4,375	(280)
Additional Personal/ Widow's Bereavement	1,490	1,590	(100)
Age - Single person (Age 65-79)	3,180	3,400	(220)
Age - Married (Age 65-79)	5,035	5,385	(350)
Age - Single person (Age 80 and over)*	3,310	3,540	(230)
Age - Married (Age 80 and over)*	5,205	5,565	(360)
Age - Income Limit	10,600	11,400	(800)
Tax rate bands			
25%	0 - 19,300	0 - 20,700	(1,400)
40%	Over 19,300	Over 20,700	

ϕ On the basis of the RPI for December 1988 which at 110.3 (January 87 = 100) is 6.8 per cent above the level of December 1987 (103.3).

* If the age allowances for those aged 80 and over were raised by 10 per cent on 1988-89 levels they would go up to £3,650 (single) and £5,735 (married). These are increases of £340 and £530 respectively on 1988-89 levels.

CONFIDENTIAL

Inland Revenue

Oil and Financial Division
Somerset House

FROM: M PRESCOTT
DATE: 23 JANUARY 1989

1. MR JOHNS
2. ECONOMIC SECRETARY

PRT: INCREMENTALS (BS 353)

1. You decided at your recent meeting to recommend proceeding with this proposal, and you authorised us to instruct Parliamentary Counsel accordingly. This is in hand. You also asked for a short note listing the main more detailed parameters that are proposed for the new allowance, with a brief word of explanation. This is set out below. There are also one or two second order policy issues for you to decide.

GENERAL

2. This new "Incremental Investment Allowance" (IIA) will be a narrowly targetted PRT relief designed to encourage worthwhile incremental projects that are outside the existing development area of certain mature North Sea oil fields, where those projects might otherwise be inhibited by the present tax regime. It will be in the form of a 15% enhancement to the relevant expenditure that is allowable as a deduction for purposes of determining PRT profits.

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cc		
	PS/Chancellor	Mr Beighton
	PS/Financial Secretary	Mr Bush
	Mr Scholar	Mr Johns
	Mr D J L Moore	Mr Elliss
	Mr Culpin	Mr Prescott
	Mr M L Williams	Mr R Haigh
	Ms Goodman	Mr Alderman
	Ms Hay	Mr J Evans
	Mrs Chaplin	Mr Parker
	Mr Jenkins (OPC)	Mr Sharma
		PS/IR

3. The allowance will, therefore, be for qualifying expenditure in respect of a qualifying area. It is to be modelled largely on the relief for "uplift", but will be more narrowly targetted. The figure itself - 15% - is essentially a matter of judgement. There is no guarantee that an IIA will cause Columba (ie the particular project most likely to benefit) to go ahead, but in the Working Party's view it would almost certainly not go ahead with an IIA of less than 15%. On the other hand, if it was higher than 15% the result could be a post-tax return which exceeded the pre-tax return.

QUALIFYING AREA

4. The target is undeveloped reserves consisting of discrete accumulations in certain (geologically determined) PRT fields, where those reserves are outside the existing development area (ie as approved by D/Energy) for the field in question. In more detail, this target area is defined by the following parameters:

(a) Oil fields determined and given development consent before 1 April 1982.

5. 1 April 1982 is a convenient and natural break point for a number of reasons. Later fields have a different, more generous tax and royalty regime - they do not pay royalties, and they also get the benefit of the new higher oil allowance introduced for fields determined after that date. On both counts, therefore, there is less of a disincentive to development. Moreover, since 1982 the boundaries of the development and the PRT areas as agreed or determined by D/Energy are likely to be coincidental, whereas in the older fields (reflecting caution on the part of both Energy and the companies in respect of development plans) the development area is often significantly smaller than the PRT area. Confining the relief to pre-1982 fields therefore achieves the targeting required, and for what is in effect a "closed" population.

(b) Fields which are wholly offshore

6. Generally speaking, fields wholly or partly onshore are more profitable than those offshore and some of their costs - eg drilling - are lower. Moreover most onshore fields are small, and will not pay PRT because of their entitlement to oil allowance. On either count, therefore, the post-tax economics of onshore fields are likely to be better than those for offshore fields, and so the need for any new allowances is correspondingly less. They are also less likely to be constrained in the same way as are higher-cost offshore incrementals, which often rely on ageing infrastructure in the main field.

(c) Fields wholly outside Southern Basin

7. This is largely a practical matter. All fields in the Southern Basin are gas fields, and many of those approved before April 1982 supply gas to British Gas on pre-1975 contracts and, as such, are effectively exempt from PRT anyway.

(d) Projects outside the existing development area (ie as at Budget Day 1989) of the field in question

8. The target for the relief is new projects, not those that are part of existing development plans and that might go ahead anyway. It is possible, of course, that projects outside the existing development area might still go ahead without an IIA or, conversely, that some projects within an existing development area might not actually go ahead unless there was some extra relief. Nevertheless, restricting the relief to projects outside the existing development area will increase the chances of it being given only for "new" projects, so reducing any deadweight costs.

9. The development area of a field may be extended or limited from time to time by D/Energy. By restricting the relief to projects outside the development area as at Budget Day 1989,

therefore, we further help narrow down the target area to "new" projects. This also ensures that companies could not simply adjust their behaviour in order to get the benefit of the new allowance - ie by seeking to reduce the area for which development consent had already been given prior to Budget Day (only to re-extend it later).

QUALIFYING EXPENDITURE

10. To qualify for IIA, the expenditure will have to be allowable under the general scheme of PRT. In addition, however, it will have to be for one or more of the following purposes

- bringing about the commencement of the winning of oil from a qualifying area or the commencement of the transporting of such oil to the UK;

- ascertaining the extent or characteristics of any oil bearing area wholly in a qualifying area, or what the reserves of oil of any such oil bearing area are;

- carrying out works for, or acquiring an asset or interest in an asset to be used for the purpose of, substantially improving the rate at which oil can be won or transported to the UK from a qualifying area.

11. These are similar (but not identical) to the conditions applying for normal uplift and, broadly, target the relief on capital expenditure. There is no tax disincentive to incremental operating expenditure.

TIME LIMIT

12. The trigger for availability of the relief will be consent from D/Energy to develop any part of the "qualifying area" - ie the area outside the existing development area, but within the

area of the field. The definition of the "field" will remain the same as for PRT generally.

13. The Working Party in its Report suggested there should perhaps then be a time limit on the availability of IIA for a particular field, in the same way that "uplift" is only available up to "payback". To an extent, the tests mentioned at paragraph 10 above contain their own inherent time limit (eg the "bringing about of the commencement of"), but we agree that it would indeed be desirable to have a more explicit limit as well. In the case of projects like Columba the aim of the allowance is, after all, to encourage new development quickly so that existing collection facilities etc can be used effectively. Without some kind of time limit for each field, the allowance might simply encourage staged development over a longer period than is otherwise necessary on the basis of the existing economics of the field. Similarly, a time limit might encourage comprehensive development plans for the whole of the qualifying to be created at the outset.

14. We could not use a concept like "payback" with IIA, because we would not in practice be able to separate out the incremental project's production and profits from those of the field generally. We think, therefore, that there should be a simple time limit, running from the date on which consent to develop any part of the qualifying area is given. It needs to be long enough to ensure that platforms, transport facilities etc can be built in time and benefit from the relief, but short enough to encourage speedy development of the resource. We believe that a period of 5 years should be sufficient and more than enough for Columba. (We can check this once D/Energy have been told that you intend to go ahead on IIA) We recommend a 5 year limit accordingly.

SHARED ASSETS

15. IIA is intended for expenditure on new incremental projects outside the existing development area, and not for additional spending on production etc from within that area. In some cases, however, the expenditure might be partly for one purpose and partly for the other. For a number of reasons it would in practice be very difficult for us to distinguish one from the other and so apportionment of such expenditure for IIA purposes is not possible. The Working Party therefore recommended that none of any such "shared" expenditure should qualify for IIA.

16. But there is a second possible situation involving shared assets, not considered by the Working Party. This is the case of expenditure in relation to an asset which is used partly for winning oil etc from a qualifying area within a field and partly in connection with a different, satellite field - for example on transporting oil from each field. There are then two main possibilities.

17. First, the asset in question might be acquired by persons who were participators in both the qualifying and the satellite field. Under present rules in that case, the allowable expenditure incurred by such a person would be allocated for relief to each field - ie apportioned - on a "just and reasonable" basis. The part thus allocated to a field may then qualify for supplement.

18. Alternatively, there might be no common ownership but the asset might in part be tariffed out by the owners of the main field to the satellite field. Apportionment of the expenditure is not required in this case under existing rules - all the tariff receipts are taxable in the main field and so too, therefore, is all the expenditure relievable there. In such circumstances all of the expenditure may again then qualify for

supplement in the main field - apportionment for supplement purposes not being practicable anyway.

19. In practice, of course, things might get even more complicated - eg where there was some common ownership and also some tariffing. The legislation provides more detailed rules to cater for this.

20. The question for decision is whether in these situations we should deny IIA altogether, as is proposed with the other kind of "sharing" described at paragraph 15 above, or whether we should follow the precedents which exist and allow IIA in part (shared asset, common ownership), or in full (shared asset, tariffing).

21. There are arguments both ways. The main argument for not allowing IIA at all in such cases is that this is meant to be a narrowly targetted relief designed to encourage recovery of remaining reserves and accumulations from within an existing field. Giving the relief for assets that were partly - or perhaps in a particular case primarily - for sharing with/tariffing to another field would seem to be inconsistent with that objective. This would also be the simplest option administratively and legislatively. On the other hand, it could happen that the economics of a particular incremental project were dependent in part on shared use/tariffing as well, and as noted there is also the "uplift" precedent. It may also be the case that denial of IIA in the instance of "tariff sharing" would lead to a decision not to tariff and the incurring of further expenditure on alternative systems in the other field with consequentially larger PRT expenditure claims overall.

22. On balance, we recommend that IIA should not be available in these two "shared-use" situations either. However, this is perhaps a point you could be ready to reconsider if there was any real pressure on it. (Again this is something we can also check with D/Energy, once they have been notified of your decision on

IIA.) In that case, we would recommend following the existing precedents for shared/common ownership and shared/tariffed assets respectively.

POINTS FOR DECISION

23. The only new points for decision are as follows

(a) Are you content, please, with what is proposed concerning the time limit and in particular that this should be a period of 5 years running from the date when consent to develop the qualifying area for the field in question was given?

(b) As regards "shared assets" are you content with the recommendation at paragraph 22 above - ie that IIA should be available in all cases only where the expenditure is wholly and exclusively for the qualifying area?

M. Prescott

M PRESCOTT

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM HM TREASURY AT 2.30PM ON MONDAY 23 JANUARY 1989

Present: Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gieve
Mr Gilhooly
Mr Michie
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Jefferson Smith C&E
Mr Tracey C&E
Mr Cross-Rudkin C&E

....

ECJ JUDGEMENT ON VAT ON NON-DOMESTIC CONSTRUCTION

Papers: Mr Culpin's note of 19 January; Mr Wilmott's minute of 18 January (ECJ progress report); Mr Wilmott's note of 17 January (VAT: Charities and the handicapped); Economic Secretary's note of 17 January (exposure of draft legislation).

The Chancellor, opening the discussion, said he was most grateful to the Economic Secretary and Treasury and Customs officials for the work they had undertaken. In a brief preliminary exchange, it was noted that (i) the liability of oil and coal products would be determined by the size and quantity of delivery, and occasionally by the status of the end-user; (ii) that the supply of water and sewerage would be taxed not only to manufacturing industry, but to

the construction and extractive industries. Those industries would, however, be able to reclaim the VAT from Customs. The Economic Secretary noted that this sort of definition was both consistent with the wording of the ECJ judgment for these goods and services and in practice the only way in which hospitals and schools could be kept out of charge.

The Chancellor invited the meeting to consider the questions set out in the annotated agenda (Annex B of Mr Culpin's note of 19 January).

Presentation

(i) It was agreed that draft clauses should be issued under cover of a Customs' News Release, with copies being placed in the House Library.

(ii) The Chancellor invited Customs to submit drafts of the new material. He would prefer that the material contained no deadline, though it should be made clear that it was issued in relation to the forthcoming Budget. Mr Jefferson Smith should, however, alert interested bodies to make their representations before the end of February. It should be emphasised that technical representations only were sought. It was agreed that an explanatory commentary should be provided in addition to the text of the draft clauses.

(iii) It was agreed that publication should take place on 2 January.

(iv) It was agreed that all clauses should be published at this stage, though it should be made clear that implementation would be staggered.

(v) It was agreed that there should be a Government statement at the same time as publication of the clauses. There was some discussion of whether this should be an oral statement to the House by the Economic Secretary. Such a statement would have the advantage that the Government would be seen to take the initiative, and would be able to scotch any ill-informed criticism. On the other hand, an oral statement might run the risk of whipping up interest in the issue. Moreover, the Economic Secretary had already made a statement to Parliament on the principle of the matter; and a statement at this stage, in relation to the Budget, might set an unwelcome precedent. It was agreed, therefore, that the announcement should be by written answer.

(vi) It was agreed that: the Economic Secretary should write to Sir Leon Brittan (on a private and personal basis); that Commission officials should be approached via UKREP; and that briefing should be provided to MEPs (identical to that which will be prepared for backbenchers).

Charities

(i) It was agreed that there was a reasonable story to tell in relation to charities.

(ii) It was agreed not to point up the improvement in the position of charities arising from the changes to the local authority rating system at the time the draft clauses were published. This point could be deployed at a later stage (perhaps the Budget Speech).

(iii) It was agreed that (i) exemption for charity and certain other fund-raising events; and (ii) extension of existing zero rates to include both sterilising equipment and classified advertising should be provided. The Chancellor invited Customs to consider whether the overall turnover limit for exemptions for charities could be removed. It was noted that removal would cost little in terms of revenue foregone, because of the current "voluntary donations" loophole.

(iv) It was agreed to resist zero rating for building alterations for social welfare charities, general purpose equipment for medical activities, wireless sets for the bedridden, charities' purchases of lifeboats, and remote controlled devices to open doors.

(v) It was agreed that we should continue to resist exemption for gravestones.

(vi) It was confirmed that there were no other reliefs which could be targeted at smaller charities. The Chancellor noted that smaller charities would be the hardest hit; Ministers should look sympathetically at suggestions made during debate.

(vii) It was agreed that VAT lollipops should be announced as part of the Budget package.

(viii) The Economic Secretary was invited to consider further whether a concession on the construction of shops, offices and warehouses should be ready for use if necessary. An alternative possibility would be to include any relaxations in the draft clauses. The Chancellor was inclined to follow this latter course. Since the legislation was being

presented as being forced on the UK, it would be reasonable to go as far as possible at the outset to mitigate its effects. Making concessions later would imply that the Government had tried to go further than the ECJ judgment required.

Overall consistency and defensibility

The Chancellor said he was satisfied that the overall package was equitable. He would like to be able to say that the Government had gone as far as it could, consistent with the law, to meet the wishes of those affected by the judgment. (This sort of argument could, incidentally, be used against eg Mr Bradman.) It was agreed that the package was reasonably EC-proof; that the compliance burden was reduced to something manageable; and that adequate safeguards were built in against abuse.

The Chancellor noted that the problem in relation to the penalty for incorrect customer declarations had now been resolved. It was also agreed to extend relief to holiday accommodation.

The Chancellor invited Mr Jefferson Smith to submit drafts of the statements and related material to Ministers by the end of the week.

J M G TAYLOR

24/1

Copies to:

Those present
PS/Financial Secretary
Mr Anson
Mr Wilmott - C&E
Mr P R H Allen - C&E

PEP STARTER 152

CONFIDENTIAL

for overview

Inland Revenue

Savings and Investment Division
Somerset House

This is for Monday's Overview meeting. It has been seen and agreed in draft by Mr Isaac and Mr Corlett, and reflects comments from FIM

From: A J WALKER

Date: 25 January 1989

1. MR KUCZYS
2. FINANCIAL SECRETARY

25/1

STARTER 152: PERSONAL EQUITY PLANS

1. At the last Overview you asked for a note on the idea of setting a limit on the total amount of any person's accumulated PEPs, instead of an annual investment limit. This note meets that request. (FIM have prepared a separate note on the other outstanding PEPs issue: how to enable new issue shares - in particular from privatisation-to be brought within PEPs.)

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c.c Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Matthews
Mr Gilhooly
Mr Ilett
Mr Riley
Mr MacPherson
Miss J Simpson
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Unwin) C & E
Mr Jefferson Smith) C & E
Mr P R H Allen) C & E

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Kuczys
Mr Davenport
Miss Dougharty
PS/IR
Mr Walker

AJW3 AJW56

CAR SCALES
STARTER 104

[...]DENTIAL

Inland Revenue

Personal Tax Division
Somerset House

Put on overview folder
(+ my note of 16/1).

LEWIS → CHEX 26/1

FROM: P LEWIS
EXT: 6371
DATE: 26 JANUARY 1989

CHANCELLOR

CAR SCALES: STARTER NO 104

1. Mr Taylor's note of 16 January recorded that you would like to discuss at the next Overview Meeting my note of 13 January on the distributional consequences of a 20% increase in the car scales, and that you would like the figures updated when the final indexation percentage was known.

2. The note attached is a revised version of my note of 13 January. The new, or changed, sections are sidelined.

3. The figures take account of the final indextion figure of 6.8%. But since the figures in the previous note were based on 6.7%, that makes very little difference indeed.

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cc Principal Private Secretary
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Monck
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr Gilhooly
Mr Matthews
Mr Macpherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Unwin (C&E)
Mr Jefferson Smith (C&E)
Mr P R H Allen (C&E)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Lewis
Mr Mace
Mr Hodgson
Mr Massingale
Mr Eason
Mr Evershed
Mr I Stewart
PS/IR

Outline of approach

2. The only feasible way of setting a cumulative limit would be to put an overall limit on PEP investment (ie inputs). To put a limit on holdings would be very difficult (because plan managers would have to keep track daily on the value of every PEP holding to check that it never exceeded the overall limit; and there would have to be - probably complex - rules for clawback of relief or compulsory disinvestment if a holding exceeded the limit even for a short period).

3. An overall limit on investment bears some similarities to the Capital PEP which was considered as an option before Christmas (my note of 30 November sets out the main features). Both would allow relatively large sums to be invested, in excess of the present annual limit.

4. The broad outline of a possible approach might be:-

- replace current annual limit with a lifetime limit of, say, £25,000 or £50,000;

- only one plan allowed per individual, but could be transferred from one plan manager to another;

- tax-free build-up and exit as now;

- most simplifications still possible but, given large sums involved, would need to ensure that cash holding rules not abused: higher rate charge on interest would be needed;

- cost

    a. £25,000 limit: assuming up to 500,000 initial take-up, £20 million in first full year, rising to £75 million after 5 years.

    b. £50,000 limit: assuming up to 550,000 initial take-up, £25 million in first full year, rising to £100 million after 5 years.

Advantages

5. The main attractions would be:-

- it would allow investors to establish a viable portfolio inside their PEP from the outset;

- it would provide a facility for those who receive large sums (inheritance, redundancy etc) who are not catered for by the present PEP arrangements - and who, if they once put their money into building societies etc, may remain there through mere inertia;

- at the same time, by setting an overall limit on the use of PEPs by those who can afford to make the maximum annual investment year after year, it would help one aspect of the political presentation;

- it would allow managers to collect substantial sums quickly (from the better off) which would help to keep down average administrative costs and boost PEPs' profitability.

Disadvantages

6. The main disadvantages would be:-

- the freedom to invest large sums in a single year could be seen as catering for the wealthy (despite the overall limit). Small or first-time investors are unlikely to be particularly constrained by a reasonable annual limit;

- there would be a danger that plan managers would aim at the top end of the market by setting a high minimum investment level (eg £5,000 or £10,000);

- there would be a substantial Exchequer cost up front: roughly twice that for the most generous proposals for annual limits. Virtually all of the additional take-up would be deadweight;

- there would be some additional compliance work to ensure that multiple plans were not taken out;

- it would no longer allow the flexibility to hold annual plans with different plan managers.

Conclusion

7. On balance, both we and the Treasury (FIM and FP) think that the disadvantages outweigh the advantages: the change would be seen as mainly for existing, better-off investors.

Other options

8. Following the Overview, two other options have been suggested to us:-

i. modify the current approach to allow carry forward of any unused excess of the annual limit;

ii. have both an annual limit and a ceiling (eg £30,000) on total investment allowed.

9. On i., the idea would certainly be attractive in allowing flexibility to invest an amount larger than the annual limit in a year when they had more money to save. But there would be an administrative cost for plan managers who would have to satisfy themselves that an individual really did have some surplus to carry forward. There are various possible ways of achieving this approach (eg certificates provided by previous plan managers) but in practice the additional work would be unwelcome (and appear bureaucratic), and would tend to act against the general theme of a significant package of simplifications to PEPs. On balance, we and the Treasury do not recommend it.

10. The advantage of ii. - keeping an annual investment limit, but imposing in addition an overall investment ceiling of, say,

£30,000 - is that it would restrict the scope for the wealthy to build up very big holdings, and could be presented as a necessary safeguard in the light of the increase in the annual limit. There would be a greater administrative cost for plan managers: in this case they would have to ensure not only that an individual did not invest more than the ceiling in their PEP, but also that he did not have investments in other plans which would take him over the ceiling. But the main question is how concerned Ministers are about the allegations that this is a scheme designed to give maximum benefit to the rich.

11. Both options would entail an increase in the compliance work carried out by the Revenue.

Summary

12. We and FIM recommend against replacing the annual limit with an overall (lifetime) limit.

13. You will need to decide whether you want an overall limit in addition to an annual one. If so, should that overall limit be (say) 10 times the annual limit (and increase accordingly whenever the annual limit increases - which would be a further complication)?

14. On balance, FIM and we would recommend staying with the present structure and proposals - ie:-

- the significant package of simplifications already agreed;

- measures to make it easier to use PEPs for new issues (in particular privatisations);

- raising the investment limits. The main illustrative options here are:-

	Unit/investment trust limit	Overall limit
i.	£2,400	£3,600
ii.	£2,400	£4,800
iii.	£3,000	£4,500
iv.	£3,000	£6,000

15. Other options for raising the limits are possible, but it will be easier for administration if the unit trust limit produces a round number when divided by 12 (to aid the marketing of monthly investment schemes), and if the unit trust limit is set at a simple proportion (eg one-half or two-thirds) of the overall limit (this will help keep the Regulations straightfoward).

16. Two questions for consideration in choosing what the new limits should be are:-

- how high does the unit trust limit need to be raised (above the present maximum of £750) to generate significant further investment? and

- how far above the unit trust limit does the overall limit need to be set to give the message that the Government still wishes to encourage direct investment in equities?

A J WALKER

fim2.cr/Neilson/m.019

BUDGET CONFIDENTIAL

FROM: M J NEILSON
DATE: 26 JANUARY 1989

1. MR ILETT
2. FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr MacPherson
Mrs Chaplin
Mr Tyrie

Mr Isaac IR
Mr Corlett IR
Mr Kuczys IR
Mr A J Walker IR
PS/IR

The substance of this is for the minority of own choice, equity PEPs. But it has presentational attractions for the others, and is well worth doing.

The proposal is in paragraph 6: transfer of new issues into the PEP within (30 days) and within the going PEP ceiling, shares to be valued at issue price for ceiling purposes.

M. 26/1

NEILSON TO FST PEPS + NEW ISSUES 26 JAN

PEPS AND NEW ISSUES

At the Chancellor's meeting on 13 December it was agreed that the PEP rules should be changed to allow new issues to be put straight into a PEP. This minute advises on how this can be achieved. It has been agreed with the Inland Revenue.

2. Three types of PEP need to be considered:

- Own choice PEP (currently about 10% of all PEPs)

- Managed PEPs (currently around 80% of all PEPs)

- unit trust (or investment trust) only PEPs.

3. It is likely that many of the managed PEPs, which are already being run in a way very similar to unit trusts, will be replaced by unit trust PEPs once the Budget changes have been introduced. The importance of the managed PEP may therefore become rather less, and the importance of encouraging those who offer unit trust only PEPs to make it possible for their investors to "top up" with

equity, more important. The different categories are considered in turn.

a. **Own-choice PEPs**

4. At present an investor can simply instruct his plan manager to subscribe in the normal way. But he cannot apply for more than the maximum annual subscription, and may well be scaled down. He cannot apply separately outside his PEP, so is left* with the choice of a relatively small application within his PEP or a larger application which he cannot subsequently transfer into a PEP. (There are usually, also, rules limiting applications to a particular numbers of shares, which may not fit neatly the "headroom" available in a PEP).

* because of multiple application rules M.

5. If PEP holders were able to make their application outside the PEP, and subsequently transfer the shares into the PEP, this awkward restriction would be removed.

6. We would suggest the transfer into the PEP should be subject to rules along the following lines:

- Shares would be valued at the offer price (rather than the market price)

- The value of shares transferred would count against the investment limit, in the same way as cash subscriptions. (otherwise the scheme could be brought into disrepute by large transfer of new issues which were immediately sold to finance other, tax-free, investment)

- Transfers into the PEP could be made for a period of up to (30) days after the allocation was announced.

7. The Inland Revenue have identified one potential opportunity for exploitation by stags. If shares went to a premium they could be transferred into a PEP and sold, sheltering any gains from tax. If the price fell, the stags could establish a loss <u>outside</u> a PEP to set against other gains. The question is whether this

should simply be allowed to happen, or whether the opportunities for abuse should be removed by treating the transfer into the PEP as a disposal for CGT purposes.

8. Our view is that no action is needed. Most people are not likely to be caught by CGT, and, for those who are, the amount at risk, given the PEP limit, is rather low. More important, it is relatively rare for new issues to go to an immediate discount (BP and the market crash apart), since issuers intentionally offer shares at a discount to their real value in order to attract investors. So the occasion when a loss is generated are likely to be relatively rare. The alternative approach, of treating the transfer into the PEP as a disposal for CGT purposes is exactly the sort of complication we have been trying to remove from the PEP scheme rules.

9. There is a more general presentational problem about 'stags'. These proposals may be criticised as offering sophisticated stags an extra way to shelter their capital gains. This is a difficult criticism to rebut. But, in practice, the scope for abuse is limited; only a small proportion of stags pay CGT now, and for those that do the tax savings from using the shelter of a PEP are pretty small (only about £100 a year assuming they transfer the maximum amount of shares in, and the average after-market premium is 10%). It is therefore possible to argue that this very limited scope for abuse is completely overshadowed by the broader benefits.

b: Managed PEPs

10. A similar scheme could be extended to managed PEPs. But this might well be unpopular with the mass market plan managers. They have set up their schemes so that each investor has a similar portfolio, and they aggregate portfolios for dealing purposes. For each plan holder to be able randomly to inject shares into his plan would render this approach impossible. Each plan would have to be managed separately, which is simply not cost effective for small amounts. It might also seem odd to investors envisaging a

long term investment in the issue if the plan manager promptly re-sold the shares.

11. Against this background, we think the best approach is to give plan managers the option to allow new issue shares into managed PEPs, and leave competitive forces to determine whether this option is offered in practice.

12. But we have to recognise that this will not solve mass market plan managers' problems with new issues. They are unlikely to take up this option, and they are usually unable to apply for new issue shares within a PEP because they need a guaranteed allocation in advance, otherwise their systems cannot cope. We had a solution for BP, which was based on the priority registration system. Whether this is available in future privatisation cases will depend on broader questions of offer structure and marketing. If it is not, we run up against the Stock Exchange's strict rule that we may not "discriminate" in favour of PEP holders over other potential investors, even if we try to compensate by eg depriving such PEP holders of the possibility of applying for shares above the minimum limit. This remains an intractable problem.

c: Unit trust only PEPs

13. When the unit and investment trust limit is raised to £2,400 (or some larger amount) the proportion of PEPs taken out in this form is likely to increase substantially. It would be useful if managers offering unit trust PEPs could be persuaded to provide a means by which holders could also invest directly in equities up to the overall limit of £3,600 (or a higher figure).

14. It is possible that taking new issues into PEPs may provide a solution. To be cost effective it would be necessary to ensure that the plan manager had as few additional costs as possible. One option would be; to allow unit trust only plan managers to accept new shares into PEPs, (on the basis outlined in paragraph 6 above) up to the overall investment limit; we could then make clear that the plan manager could, if he wished, impose the condition that if the plan holder wished to sell those shares he

would not be able to reinvest through his PEP; he would simply receive the cash proceeds of the sale. (This would be a contractual matter between manager and investor, and would not require changes to the PEP rules). In other words, the plan manager would act as a custodian for the share holdings, allowing the plan holder to benefit from PEP tax reliefs. The plan manager would have to deal with dividends etc. but would not have to get involved in dealing in shares, which is where the main costs would arise.

15. It is very difficult to know if unit trust plan managers would take this up, (as with managed PEPs it would have to be an option rather than a condition) but it would be a way of balancing the presentation of the Budget package back towards equities. In post-Budget briefing we would draw plan managers' attention to this new marketing opportunity.

Partly-paid shares

16. One major difficulty faced by plan managers wishing to apply for new issues will be largely removed by your decision to simplify the PEP rules. Plan managers have particular difficulty with new issues in partly paid form, especially when the subsequent calls fall in future PEP years. Your decision to remove the holding period and distinction between plan years deals with this difficulty.

Conclusion

17. It would be fairly straightforward to make it possible for plan holders to take new issues into their PEPs. There may however be criticisms that this is a stags' charter. But whether the opportunity is in practice taken up will depend largely on the type of plan. There should be no problem with own choice PEPs, where each is, by definition, run separately. But mass market plan managers may not have the systems to cope with absorbing new issues into managed PEPs. And it is very difficult to know what

reaction unit trust plan managers (who are likely to be of increasing importance after the Budget changes) will have to the opportunity to offer a custodian service. But our view is that, on balance, it is worth making these changes so that the Budget PEP package has something in it for direct equity holding as well as unit trusts.

Nicholas Barker
for M J NEILSON

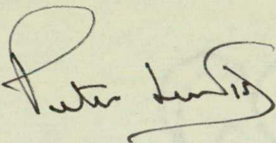
4. We have, however, been able to improve the analysis in two main respects.

5. First, there is now an analysis, by income range, of the losers after taking account of NIC as well as tax - Table D2.

6. Second, we have been able to get a slightly better feel for the position after increased mortgage interest payments and earnings are taken into account, as well as tax and NIC. Table E gives an analysis in broad categories of taxpayer.

7. So, the picture is a little more focused; but it is essentially the same picture as before.

8. Following the earlier note, your provisional view was that the working assumption should remain a 20% increase in car scales if the personal tax package is bare indexation. Should that continue to be the case?



P LEWIS

CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS
EXT: 6371
DATE: 13 JANUARY 1989
(revised 26 January)

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.

- Tables D and D2 add in the effect of NIC changes already announced (the raising of the UEL).

- The final sections take 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 actual indexation figure is 6.8%. 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. (In a practical sense these people will not lose in 1989/90; we will rarely become aware of the liability, and be able to take steps to collect it, until the following year.)

Table C: Income Tax: 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
£50-£99	19	2	-	21
£1-£49	129	20	-	149
Totals	148	24	-	172
Average annual loss	£25	£41	-	£27

9. Almost all of the 172,000 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 about 170,000 (12%) to about 370,000 (26%). Table D analyses those losers by the annual amount of the loss; and Table D2 shows average losses by income range.

Table D: Tax and NIC: analysis of losers by 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	19	5	-	24
£50-£99	104	9	25	138
£1-£49	146	26	35	207
Totals	269	41	60	370
Average annual loss	£49	£56	£45	£49

Table D2: Tax and NIC: analysis of losers by income range

A = Average loss

B = Number of losers (thousands)

Income range (total income of tax unit)	Main Scale A	Main Scale B	"Perk car" A	"Perk car" B	Over 18,000 business miles A	Over 18,000 business miles B	All Scales A	All Scales B
under £15,000	£26	47	£31	12	-	-	£27	59
£15-£20,000	£42	106	£30	4	£43	12	£42	122
£20-£25,000	£70	70	£74	8	£45	40	£62	118
£25-£30,000	£50	31	£55	2	£48	6	£50	39
over £30,000	£63	15	£73	15	£42	2	£66	32
All income ranges	£49	269	£56	41	£45	60	£49	370

11. Of the 370,000 losers, 144,000 are basic rate taxpayers below the UEL who are not affected by the NIC change; 196,000 are basic rate taxpayers above the UEL, an increase of 155,000 compared to the number of losers on tax alone in this category and the remaining 30,000 losers are higher rate taxpayers, an increase of 24,000.

12. There would, of course, also be losers outside the company car sector from bare indexation because of the UEL/UPL increase. We estimate the total at about 1.5 million, the contracted out with an average loss of £12, and 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, but we estimate that even then rather less than 10% of company car drivers would be losers.

16. We do not have detailed 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. We estimate that the total of losers will be about 130,000 with an average loss of about £450. Some 90,000 will have annual review mortgages with an average loss of about £550; the average loss of the other 40,000 will be about £250.

18. Table E gives an analysis of these losers by broad income range (more detailed information is not available).

Table E: Tax, NIC, increased earnings and mortgage interest: analysis of losers

A = Average loss
B = Number of losers (thousands)

Taxpayer category	Number of losers (thousands)	Average loss
Basic rate taxpayers below UEL (1)	67	£300
Basic rate taxpayers above UEL (1)	38	£610
Higher rate taxpayers (2)	25	£620
All income ranges	130	£450

(1) UEL for 1989/90 = £16,900
(2) HR threshold with bare indexation = £20,700

19. With 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

20. The estimated yield from a 20% increase in car scales is

1989/90	1990/91
£90m	£110m

21. 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.

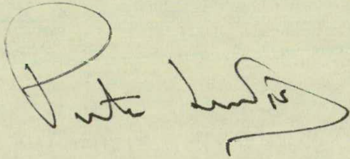
Summary

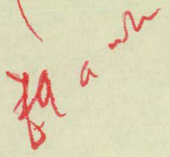
22. Looking at income tax alone, only 12% of company car drivers would be cash losers - half the number estimated in the Dorneywood paper. The average loss would be only £27.

23. Taking NIC into account, these figures increase to 26% and £49.

24. When increased earnings are taken into account, as well as tax and NIC, there would 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.

25. When increased mortgage interest payments are also taken into account, about 10% of company car drivers would be losers, and their average losses might be of the order of £450. Only a small part of those losses relate to car scale increases.





P LEWIS

CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: C E GORDON
EXT: 6739
DATE: 26 JANUARY 1989

1. MR PITTS
2. FINANCIAL SECRETARY

RURAL HOUSING ASSOCIATIONS: STARTER 263

1. You will recall that when you met the Country Landowners' Association (CLA) on 8 November last year they raised a point in connection with the taxation treatment of landowners transferring land at less than market value to Rural Housing Associations. Others too have raised the same point - including Mr Ridley. You asked us to discuss the issues with the CLA in order to explore the extent of any difficulties in practice and to see whether there was scope for easing any such difficulties within the existing tax regime.

2. This meeting has now taken place. As well as meeting the CLA we took the opportunity to bring in other parties who had expressed an interest in this issue: the National Federation of Housing Associations, the National Agricultural Centre Rural Trust and officials from the Department of the Environment; in view of the numbers it proved difficult arranging a date convenient to all those wishing to attend which is why the discussions have not taken place sooner.

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c Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Anson
Mr Monck
Mr Gilhooly
Mr S Wood
Mr Tyrie
Mrs Chaplin
Mr Jenkins(PC)
Mr Painter
Mr Pitts
Mr Cayley
Mr Hamilton
Mr Keith
Mr Reed
Mr Jaundoo
Mr C Gordon
Mrs Evans
Mr Ashcroft
PS/IR

3. This note reports the outcome of our discussions and seeks your guidance on how you would like to see matters taken forward.

Background

4. Where a landowner donates or sells land cheaply to a Housing Association he is deliberately conferring a benefit on the recipient and in the normal way for IHT and CGT purposes the market value of the land is taken into account to determine the extent of any tax charge. This means that the person transferring the land may face a tax liability based on hypothetical disposal proceeds greater than any actual sale proceeds he receives.

5. Whether and to what extent the land changes hands at below market value may involve tricky questions of valuation. It is suggested that uncertainty as to what our valuation people are likely to decide to be the market value of a piece of land transferred in this way discourages transfers which would otherwise take place - because landowners are not prepared to risk a higher market value being placed on the land than what they are selling it for, and hence to face a tax bill on money they have not received.

6. There may also be a separate question about the valuation process itself. This is relevant because in many cases the Housing Association does in fact pay the full market value. But it was not clear from our discussions to what extent the valuation question causes problems. It was agreed that the most appropriate way forward would be for valuation experts on both sides to discuss that question and in due course a further meeting will be arranged. We think that in the light of this the valuation question can be left on one side. We doubt there will be any need to consider legislation on this.

7. The remaining issues focus on the taxation treatment in probably a minority of cases where there is in fact a transfer (including a gift) of land to a Housing Association at less than market value.

Capital Gains Tax

8. Where the Housing Association receiving the land has charitable status - and we were told that probably between two thirds and three quarters of Housing Associations were charitable - CGT is not a problem. This is because there are already special rules dealing with transfers to charities which ensure that the transferor does not pay tax on money he has not received. However, the point was made that under those rules the landowner cannot realise a loss: this is because if he sells his land for less than he paid for it the disposal is treated as taking place for no gain or loss. To allow a loss in these circumstances would actually be giving a fiscal subsidy to those transferring land to Housing Associations - a subsidy not available to those transferring assets cheaply to other charities. It was generally agreed that this was probably not a problem in practice and it was recognised that it would be difficult to confer even more beneficial treatment on those transferring assets to charitable Housing Associations without doing the same for those transferring assets to other charities.

9. On the other hand where the Housing Association does not have charitable status the normal CGT rules apply. But again in many cases the landowner would not face an immediate tax charge because this land would be a business asset and to the extent that there was any element of gift in the transfer he could claim (jointly with the Association) a form of gift hold-over relief (and this will still be the case after the Budget).

10. Although the availability of this holdover relief would solve the CGT problem in some cases there would still be others where uncertainty as to the boundaries of the relief deterred landowners who might otherwise be willing to transfer land. And the relief is not normally available where the land transferred is non-agricultural. So although under present (and post-Budget) rules many people could arrange things so as to avoid any problem with CGT there would be some who could not.

Inheritance Tax

11. Again where the Housing Association receiving the land has charitable status there will often be no problem: gifts to charities are normally exempt from IHT. However there are special rules for IHT designed to prevent avoidance in cases where something less than an outright interest in the asset is transferred, for example where the freehold interest is owned but is not transferred - only a lease of land is granted. The IHT charities exemption is not available unless the entire interest is transferred.

12. In many cases involving charitable Housing Associations the land would be transferred outright so the problem does not arise. And as with CGT, this is a rule which applies to all transfers of assets to charities so it would be difficult to change the rule for transfers of assets to charitable Housing Associations without doing the same for transfers to other charities.

13. Where the Housing Association is not charitable there is however relatively limited scope for relief. In particular, the transfer does not qualify as a potentially exempt transfer (P.E.T.) because it is not made to an individual. It is therefore immediately chargeable. Agricultural relief - a 30 or 50% reduction in the value transferred - may be available on part (in some cases a small part) of the gift but subject thereto the gift would be charged in full to IHT in the normal way.

Summary

14. In what seems likely to be by far the majority of cases no question of a tax charge based on an amount which the landowner has not received should arise. This is because in most cases - and the discussions to be held with our valuation people should help to clarify this - what the Housing Association pays will be the market value.

15. In those remaining cases where either there is an outright gift of land or a transfer at under value, so far as

capital gains tax is concerned, where the Housing Association is charitable special rules already ensure that there will be no problem. Where the Housing Association is non-charitable there will often be no immediate tax charge because of the availability (and this will still be the case after the Budget) of a form of gift hold-over relief.

16. With Inheritance Tax, if the Housing Association is charitable there will be no problem in most cases: problems will only arise where the landowner does not divest himself of his entire interest in the land being transferred and we see no case for dealing with that. However where the Housing Association is non-charitable there will often be an IHT charge.

Conclusion

17. The main question therefore is whether you want to do something about the possibility of an IHT charge based on the market value where land is transferred at below that value to a non-charitable Housing Association. If the answer to that is yes then we would recommend at the same time providing more certainty in the CGT area by ensuring that no immediate CGT charge could arise on anything greater than disposal proceeds on such a transfer to a non-charitable Housing Association. One way of achieving this would be to extend the special CGT rules described above for transfers to charitable housing associations, to transfers to non-charitable ones.

18. The Department of the Environment would like to see something done this year because any tax changes would then coincide with initiatives they are making through the Housing Association movement to facilitate the provision of lower cost housing in rural areas.However you may feel that as a tax problem is likely to arise in only a minority of cases this issue cannot be considered of sufficient urgency to merit legislation this year - particularly given competing pressures both on Finance Bill space and on those involved in Finance Bill work. In that case if you do decide that something should nevertheless be done

this year an alternative way forward would be to proceed by way of Extra-Statutory Concession.

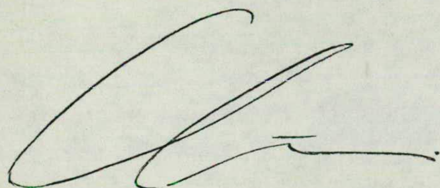
19. Although the point has only been raised in the context of rural Housing Associations we think that any changes would have to apply to transfers to Housing Associations generally. There is almost certainly no sensible means of defining a "rural" association but more importantly, we suggest it would be difficult to justify singling out Housing Associations providing houses in rural areas for beneficial treatment. On this basis we would envisage legislation running to not more than 1 page

20. If there is to be legislation this year we will need an urgent decision so that we can get the drafting sorted out in time. We would be grateful to know therefore whether you think that any changes are called for this year

(a) to remove the possibility of an IHT charge based on market value where land is transferred at below that value to a non-charitable Housing Association and

(b) to ensure that on such a transfer no immediate CGT charge can arise on an amount over and above actual disposal proceeds.

If you do think that action this year is called for, do you want to include provisions in this year's Finance Bill or would you prefer us to proceed by Concession? If the latter we will in the normal way prepare a Concession and covering Press Release for your approval.



This is not intrinsically very suitable for an ESC, but it could be done. [initials] 26/1

C E GORDON

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

Ch/ This still seems a sensible resolution of a knotty problem — tho' on precedent grounds I don't much like the idea of sticking draft clauses etc. to the Trust

30/1

FROM: C STEWART
EXT: 7414
DATE: 27 JANUARY 1989

1. MR CORLETT 27/1
2. MR ISAAC 27/1
3. FINANCIAL SECRETARY

CHARITIES - COVENANTED MEMBERSHIP SUBSCRIPTIONS (STARTER 151)

1. You authorised us to have further discussions with the National Trust about their proposal for legislation to permit tax relief for their covenanted membership subscriptions to continue (my note of 4 November and Miss Feest's minute of your meeting on 11 November).

2. We have now had a further discussion with the Trust (and the National Trust for Scotland) and their Counsel (Andrew Park QC). The purpose of this minute is to report back to you and seek your decision on whether to go ahead with legislation in the Finance Bill.

3. Briefly, the basis of the legislation would be that for certain charities, the benefit of free or cheap entry to view the charity's property would be ignored in deciding whether members' covenanted subscription payments qualified for tax relief.

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

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

Definition of qualifying charities

4. The Trusts were content with the way we suggested defining qualifying charities - ie those whose sole or main purpose is the preservation of property or conservation of wildlife for the public benefit. That would cover heritage and conservation bodies, including museums, and also supporters' organisations such as Friends of Museums.

Benefits to be ignored

5. We suggested that the benefit which should be disregarded - so that it should not disqualify covenant payments - should be the member's right of free or cheap admission to view the charity's property. The present law would continue to apply to other benefits, so that they would disqualify the covenant payment unless they were small - ie (broadly speaking) worth less than about 25% of the subscription. We suggested that the relief should be limited to entry to view the property, as distinct from entry for some other purpose such as attending a concert or opera performance or engaging in a sporting activity. In the case of heritage and conservation charities, the main purpose of entry is to see the property or wildlife being preserved, and there is no obvious reason why (for example) free entry for members to concerts or other activities should get tax relief if paid for by covenant.

6. The Trusts felt that that could be over-restrictive. They accepted that the main purpose of admitting members and the public was for viewing the property (or inspection or study). They said their general policy was not to give members special discounts on the charges for concerts or other special events which took place on Trust property. They did however have some property where people went to walk or sail rather than "view" the property; there would be no charge for admission to the land itself, but there might well be a charge for car parking, which members would not have to pay. They were concerned that if only entry to "view" was disregarded, the benefits of (eg) free parking at these sites would disqualify the covenant payments. They suggested that entry for recreation and enjoyment should be disregarded, as well as entry for viewing.

7. Letting in entry for recreation or enjoyment seems to us to go rather wide and to give scope for abuse. For example, it would bring in free entry to concerts or other performances. Thus National Trust members getting free entry to concerts etc on Trust property could, in effect, have tax relief for that benefit through their covenant; but people getting free or cheap entry to concerts in ordinary concert halls through a membership scheme would not (since in that case the charity's main purpose would not be the preservation of the hall). Similarly, it would be possible to get relief for some sporting activities. For example, some golf courses are owned by trusts which qualify as charities on the grounds that their purpose is to maintain the land for public recreation. It would obviously be unsatisfactory if the trust could set up a membership scheme under which members could make covenanted subscriptions in return for free entry to play golf, and so in effect get tax relief for their golf subscription.

8. We find it difficult to see any very satisfactory dividing line once we go wider than disregarding entry to "view" the property. In the National Trusts' case, we think that the number of properties where entry is not primarily to view the property is so small that we could ignore it as de minimis, along with the other small benefits (the occasional magazine and annual handbook) which the Trusts give to members. If the legislation was framed in that way, we think we could give the Trusts an assurance that their covenanted subscriptions would qualify for relief, unless their charging policy changed significantly in the future. We hope it would be possible to persuade the Trusts to be content with that.

9. On a point of detail, the Trusts - and possibly some other membership charities - also offer a family subscription under which free entry is extended to the member's spouse and children under 18. We think the relief should extend to these rights (but not to rights which the member can transfer to anyone else).

Other conditions

10. We also discussed with the Trust the possible other conditions set out in paragraph 16 and Annex 2 of my note of 4 November. These were that -

a. the covenanted payment is in return for annual membership of the charity. The Trust saw no objection to that, but - like us - they were inclined to think it was unnecessary;

b. membership of the charity should be open to the general public. Again the Trust saw no problem with this. The question is whether adding in this condition is necessary. To be a charity, a body needs to have a clear "public benefit" element anyway. If it operates "exclusive" membership arrangements which prevent members of the public from joining if they wish, that casts doubt on whether the body is really charitable. On balance we think this condition is unnecessary. But there would be no difficulty about including it if you would prefer to do so;

This is perhaps arguable - eg public school charities
C.T.C.?

c. the property is open to the general public as well as to members. Here the Trust made the point that some of their properties are open by appointment only (but to non-members as well as members), and that in some cases the property can be viewed from the outside but there is no public access to the inside (eg small houses let as ordinary homes). Parliamentary Counsel's first draft of a Clause goes as far as we think is necessary to meet this condition, by providing for relief where the right the member gets is to be admitted without paying the charges normally payable for admission by members of the public. The clear implication is that if the property is open to members, it should be open to the general public as well; and that if properties are open to members only, that particular benefit may disqualify the covenant payment unless it comes within the ordinary de minimis rule;

d. fees charged to members of the public for viewing the property should be small in relation to the membership subscription. This is a test originally suggested by the Trust themselves. We think it may cause some problems, partly because it is a matter of judgement what is "small", and partly because there may be different subscription rates for individuals and families. In the case of a large family, for example, the cost of a single entry might well not be "small" in relation to the subscription.

Next steps

11. The question now is whether you wish to legislate in the Finance Bill for the relief for covenants to be extended on the lines set out above. Doing so would deal with the problem of the National Trust and other similar heritage and conservation charities which operate membership schemes; and you will recall that in the Standing Committee debate last year, there was support for the National Trust's case on both sides of the Committee, though the Opposition were concerned that any relief should not be abused for more "private" purposes such as paying school fees by covenant.

12. There may well however be debate about the scope of the relief. The most likely pressure points are -

a. for other types of charity to be included as well - for example, arts bodies may press for free or cheap concert, theatre or opera tickets given to covenanting members to be allowed to qualify, so that members can, in effect, get tax relief for some sort of season ticket. The counter-argument would be that these are different from charities like the National Trust. There would be nothing to prevent members selling their cheap tickets (unless perhaps they were non-transferable). And the activity is commercial in the sense that people going to the concert are, broadly speaking, meeting the costs of putting on that particular concert, rather than helping to preserve a building or land on a more permanent basis;

b. for other types of benefit to be disregarded as well - eg books or literature going beyond the kind of occasional magazine or annual handbook produced by charities like the National Trust. But again, books of that kind are likely to have some resale value, and it is difficult to distinguish them from payments for goods or services more generally.

13. It is difficult to estimate the cost of introducing relief on the lines set out above, but we think it should be small - perhaps about £m 10 . The cost will depend on how many charities make use of the legislation to start - or restart - covenant schemes for members, and how many members decide to covenant.

14. If you decide to introduce legislation, a starting-date will have to be fixed. The most obvious course would be to apply the new rules to covenant payments due on or after either Budget Day or 6 April. We would recommend taking Budget Day, but if you prefer to take 6 April there is no particular difficulty about doing so.

15. We assume that the announcement of any legislation would be made on Budget Day, with the usual Press Release. The National Trusts are anxious to know as soon as possible whether Ministers decide to legislate. We have already assured them that, whatever happens, we will not withdraw their relief for the current tax year. But if there were to be no relief from 1989-90 onwards, that will have a significant effect on their financial plans. They would also of course want to start lobbying elsewhere (eg other Ministers) if the answer is going to be unfavourable to them.

16. So far, they have been content that Treasury Ministers are considering the problem. If your decision is to legislate, it might be useful to give the two Trusts some advance indication - on a strictly confidential basis.

17. At our last discussion they also asked if they could see any proposed legislation in draft. We did not give any commitment on this, and it is not essential to give the Trusts a preview of legislation which will affect other charities as well as themselves. On the other hand, there may be some advantage in letting them see a draft Clause - again on a strictly confidential basis - so that any problems can be ironed out before publication.

I agree CHL

18. Once Parliamentary Counsel has produced a revised draft Clause, we could let the Trusts see it in confidence, either

a. on the basis that you are prepared in principle to introduce legislation, or

b. on the basis that you would like to see their reaction to the draft before deciding whether to introduce legislation.

British Museum

19. One other small point has cropped up in the course of drafting, which we think need to be tidied up. The British Museum and Natural History Museum have a special provision in the Taxes Act giving them exemption from tax on certain types of income. This is separate from the charity exemption. The special provision goes back to at least the early 19th century, and it appears that the reason for it is that the two museums are not exclusively charitable - for example if they were wound up, their assets would not necessarily be devoted to charitable purposes.

20. The special exemption does not cover covenant income. This does not seem to have caused problems in the past, but it is likely to do so in future. In particular it would mean that the two museums could not benefit from the proposals discussed in this note. This would not be very easy to justify. The problem could easily be cleared up by a small amendment to bring the two museums into another special provision which already gives

charity exemption to the National Heritage Memorial Fund and the Historic Buildings and Monuments Commission for England; and abolishing the present separate exemption for the museums. We recommend that that should be done if you decide to go ahead with the legislation discussed earlier in this note.

Questions for decision

21. The questions for decision are -

a. Do you wish to introduce legislation in the Finance Bill on the lines set out in paragraphs 3-10 above?

b. Should the starting date be Budget Day or 6 April (paragraph 11)?

c. Should we give the two National Trusts an advance indication of your intentions and/or a draft Clause in confidence (paragraphs 16-18)?

d. Should the legislation also tidy up the position of the British Museum and Natural History Museum (paragraphs 19-20)?

Cs

C STEWART

FROM: J M G TAYLOR
DATE: 27 January 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Anson
Mr Monck
Mr Gilhooly
Mr S Wood
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Painter - IR
Mr Pitts - IR
Mr Gordon - IR

RURAL HOUSING ASSOCIATIONS: STARTER 263

The Chancellor has seen Mr Gordon's note of 26 January.

2. He has commented that he finds this worrying. One of the problems with Rural Housing Associations appears to arise because the abolition of tax on lifetime gifts, which he had intended to be complete, appears not to apply when the gift is not made to an individual (see paragraph 13 of Mr Gordon's note). In other words, CTT lives. This was not his intention in 1986, and he would be grateful for an explanation.

J M G TAYLOR

est.ld/james/30 Jan/Prescott

BUDGET CONFIDENTIAL

FROM: S M A JAMES

DATE: 30 January 1989

MR PRESCOTT - IR

cc: PS/Chancellor
PS/Financial Secretary
Mr Scholar
Mr D J L Moore
Mr Culpin
Mr M L Williams
Ms Goodman
Mr Jenkins
- Parly Counsel

PS/IR
Mr Beighton IR
Mr Johns IR

PRT INCREMENTALS (STARTER 353)

The Economic Secretary was grateful for your minute of 23 January.

2. He is content with:

(i) your proposals concerning the time limit (paragraphs 12-14 of your minute), particular that this should be a period of 5 years running from the date when consent to develop the qualifying area for the field in question was given;

(ii) the recommendation in your paragraph 22, that IIA should be available in all cases only where the expenditure is wholly and exclusively for the qualifying area. But as you say this should be a concession to be held up his sleeve for Committee.

S M A JAMES
PRIVATE SECRETARY

BUDGET CONFIDENTIAL

Inland Revenue

Compliance and
Collection Division
Somerset House

Ch, Content to drop the starter, + for IR to issue a discussion document this summer?

OK subject to FST's views

FROM: J H ROBERTS
DATE: 30 JANUARY 1989

1. MR BEIGHTON

2. FINANCIAL SECRETARY

Further and wider consultation with a view to legislation in the 1990 seems the appropriate course here. JUB 30/1

BUDGET STARTER 454: ELECTRONIC PAYMENT OF DIVIDENDS

1. The attached note by Mr Sullivan details the revised APACS proposals for electronic payment of dividends. There are three key points:

- We are well short of agreement even in outline of a scheme satisfactory to all parties. The attitude of company registrars to the latest options is crucial to their acceptability and the extent of enabling legislation needed.

- The scheme the APACS Director of Operations has in mind will cost around 70 Revenue staff in the first year, and perhaps 20 thereafter even if APACS do not get the whole shift to a voucherless regime they intend.

- The present state of the Finance Bill argues against legislative gestures of this sort.

2. We recommend dropping this Starter for 1989, and getting the APACS proposals into wider circulation.

JHR

J H ROBERTS

c.c PS/Chancellor of the Exchequer
PS/Chief Secretary
PS/Economic Secretary
PS/Paymaster General
Mr Ilett
Mr Neilson
Mrs Chaplin
Mr Tyrie
Miss Hay
Mr Jenkins (OPC)

Mr Beighton
Mr Roberts
Mr Campbell
Mr Hall
Mr Templeman
Mr Davenport
Mr Cannavan
Mr Oakley
Mr Curnow
Mr Burrell
Mr Hinson
Mr Boyce
Mr Wilson
Mr Sullivan
Mr Eccleshall
PS/IR

[illegible]

CONFIDENTIAL

Inland Revenue

Compliance and
Collection Division
Somerset House

From: C D SULLIVAN

Date: 30 January 1989

1. MR ROBERTS
2. MR BEIGHTON
3. FINANCIAL SECRETARY

ELECTRONIC PAYMENT OF DIVIDENDS - BUDGET STARTER 454

1. You will recall that the Association for Payment Clearing Services (APACS) have suggested replacing a piece of tax legislation by enabling powers, to assist with the introduction of electronic payment of dividends into a shareholder's bank account. (Mr Eccleshall's submissions of 27 October and 16 November; mine of 2 December; Mr Ilett's of the same date).

Present system

2. At present, a shareholder may choose to mandate his dividend to his bank or building society account. Then the registrar sends a composite payment plus a batch of vouchers to the bank: the vouchers are sorted to branches: the amount credited to the customer's account and the vouchers sent to the shareholder, often with the next statement. If he does

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c.c PS/Chancellor of the Exchequer
PS/Chief Secretary
PS/Economic Secretary
PS/Paymaster General
Mr Ilett
Mr Neilson
Mrs Chaplin
Mr Tyrie
Miss Hay
Mr Jenkins (OPC)

Mr Beighton
Mr Roberts
Mr Campbell
Mr Hall
Mr Templeman
Mr Davenport
Mr Cannavan
Mr Oakley
Mr Curnow
Mr Burrell
Mr Hinson
Mr Boyce
Mr Wilson
Mr Sullivan
Mr Eccleshall
PS/IR

RAE3 RAE85

not choose to mandate his dividends, he will be sent a dividend cheque, plus a voucher advising of the net payment and tax credit, by the Registrar of the company. The vouchers are in the same format in either case.

3. Both regimes involve a substantial amount of paperwork and clerical intervention through the payments clearing system. So it is obviously right to look for ways of reducing the costs of these procedures, both on national resource grounds and (for wider share ownership reasons) to reduce the costs such as bank fees of running a share register. The question is how to do this without damaging the interests of other interested parties, including shareholders and company registrars.

APACS proposals

4. Section 234, ICTA 1988 (as the provision now is) requires dividend cheques to be accompanied by a voucher carrying specified information. Dividend vouchers act as proof of deduction of tax for repayment claims: and help taxpayers complete their returns and understand tax assessments. APACS would like the requirement to attach vouchers to be replaced by a regulation-making power, to be used as and when a scheme satisfactory to all parties is agreed, to set out the new Revenue requirements. We have advised you that you ought to have a better idea that such a scheme exists, and of its outline, before legislating. You have authorised us to resume past discussions with APACS. You wanted (5 December) to defer a decision on the fate of this Starter until a meeting had been held.

5. The APACS Director of Operations agreed to a meeting on 22 December. At his request, this was a small meeting, with no other APACS representatives and no proposals on paper. The APACS Director wanted to explore proposals with us before attempting to obtain the agreement of the wider APACS membership. He felt that past discussions with wider APACS

representation had shown unproductive splits of opinion on the APACS side. Our operational and staff costings people have been thinking about what he said.

6. Previously, we had been discussing with APACS the idea of replacing vouchers for mandating shareholders by a special bank statement or certificate listing and totalling dividends paid. This had looked quite promising to us. But APACS have abandoned this line. It would be expensive to introduce, and offered no financial advantage over the present regime for them. Further, some banks wanted to reserve such a facility for added-value services, rather than provide it free.

7. What APACS would ideally like is for the burden of sending payment advice to be put back to company registrars just as employers provide payment advice for electronic payment of salary. So vouchers would be sent from the registrar direct to the shareholder: and payment would be made electronically to shareholders' accounts.

8. We think shareholders would find that service fully satisfactory. Indeed, it is probably an improvement on the present options. Subject to amending Section 234, it would have no adverse effect on us. Shareholders would have the same evidence for repayment or completing their tax returns as they do now. However, company registrars would face increased postage costs: so the regime probably would not, as APACS accept, attract them.

9. APACS thought registrars would want to retain the present mandating system, which probably provided transport of payment advice for less than the proper cost. However, an increase in the fees banks charged for the present system could be used to influence registrars' preferences.

10. Nevertheless, the APACS Director of Operations suggested a system of 3 options for shareholders rather than the present 2:-

1. to be sent a cheque plus voucher direct by the registrar

2. to receive an electronic payment to the mandating account, and to be sent a voucher direct by the registrar

3. to receive an electronic payment, but no advice of payment other than a brief entry in the next statement for the account.

Option 1 is the same as the present non-mandating system. Option 2 is the same as the APACS ideal in paragraph 7 above. APACS intend Option 3 to become the norm for shareholders with no pressing need for a voucher e.g. because they are not due a tax repayment.

11. At present, APACS say only around a third of dividends are mandated. This percentage has fallen from the 1983 estimate of 45%. Inertia will doubtless be a factor in many cases, but the figures might also suggest that many of the new small investors feel more comfortable receiving payment plus payment advice direct.

12. Nevertheless, APACS hope to organise or co-ordinate a campaign to encourage shareholders to shift to electronic mandating. The hope would be to shift the balance to two thirds or more mandated. We pressed APACS on the likelihood of achieving this. Without inertia selling (ruled out by the Chancellor in 1985) or without financial inducements, there seems little reason why a shareholder should willingly accept less information of a sort many will find useful to check their tax.

13. Anyone anticipating they may need a voucher will elect for option 1 or 2: or re-elect for this if their circumstances change (e.g. a married woman leaving work to start a family). APACS had not anticipated the very substantial increase in the number of repayment cases likely to arise from independent

taxation: and were taken aback when we warned of this. (Our current estimate is that Independent Taxation will put around 1.5 married women in a position to make claims for tax repayment. Accordingly, this may set up a significant trend away from new-style mandating.) These figures, and those in paragraph 11 above, take no account of big flotations to come, such as Abbey National.

Costs

14. If APACS are right that they can achieve a big reversal of the trend away from mandating and in favour of Option (3), that would substantially reduce the costs both for APACS and for registrars. However, it does shift problems to us and shareholders. Particularly at the outset, we anticipate significant numbers of repayment claimants who had accepted Option 3 having to be told by us to obtain - and how to obtain - vouchers before they could have a repayment. This will, of course, involve some cost to shareholders. Those completing a tax return will have to work through their bank statements to extract the dividends they must (under penalty) return. If they omit something, we will lose any higher rate tax on the omissions unless exceptionally they come to light. Since the bank statement will show only net income, there will be some new clerical work on explaining grossing up to those taxpayers not familiar with it.

15. Our preliminary thoughts are that, assuming just 50 per cent of shareholders are persuaded to shift to Option (3) rather than the 2/3 sought by APACS, an initial clerical cost of around 70 and ongoing cost of around 20 might be involved. This could arise during the PES period, and is unfunded by PES.

16. If APACS achieve little shift towards mandating, registrars would be in no worse position than now for shareholders remaining under Option 1. But, depending on the fees APACS levied, they could face additional costs particularly for mandating shareholders choosing Option 2.

Against that, Option 3 would require registrars to run a 3-tier rather than a 2-tier system: and face clerical intervention every time a shareholder decides to change category. If there were likely to be a high shareholder take up of Option 2 rather than Option 3, it might be that registrars would be content to let Option 3 fall - which would be much preferable for everybody else involved at present.

17. A new factor on the horizon, however, is the Stock Exchange's "Taurus" computerisation project. Although details of this have not been finalised, any regime for payment of dividends will have to be compatible. If Taurus is to be largely a nominee-based system, the new nominee organisations will be as keen to keep their costs down as all the other parties.

Form of legislative change

18. The precursor to Section 234 was drafted long before electronic transfer was envisaged. It is arguable (although APACS have not so argued) that the requirements of Section 234 do not apply to electronic transfers. Whatever the outcome of the current discussions, all parties need a clear legislative framework. We think the Section needs to make it clear that bulk electronic transfers, as well as individual payments, are covered.

19. If only Options 1 and 2 were involved, we would need to allow the voucher to be despatched to the taxpayer within a given time of payment (say 14 days), as an alternative to being annexed to the payment. Registrars might well be attracted by the option to spread the work of bulk issue of vouchers in electronic payment cases. Subject to a decision on the appropriate time there would be no saving in legislative space in taking an enabling power rather than making the substantive change in primary legislation.

20. If Option 3 were also involved, it would additionally be necessary to allow information to be supplied in bank or

building society statements: and, because of the limitations of many computer systems, to allow those statements not to show the tax credit, where dividends were paid directly by a company or its registrar. If we wanted to stipulate any minimum requirement for the form of the bank statement entry, that would need legislative cover. The more information on the bank statement, the more likely taxpayers will identify dividends they should disclose: but the computer systems of some financial institutions would only be able to offer a very limited entry. The APACS Director thought such institutions might have to be debarred from offering a mandating service. Further, tax legislation on the format of personal bank statement entries is not an ideal prospect.

21. Dividends received in a year must be disclosed on the tax return for the year. So individual taxpayers under Option 3 might want a bank statement at the end of the tax year. Alternatively, they might want bank statements sufficiently frequently that they could identify dividend payments in, say, late March in time to return them promptly. Even monthly statements might give little time to meet the 30 day deadline that in principle applies, eg monthly statement date 20th, dividend received 21 March, not shown until statement issued 20 April. Also, since the dividends would be one of the very few credits without independent advice, some customers might want to increase the frequency of their statements in any event. Because of the 14 day deadline for quarterly ACT returns, companies receiving dividends would need frequent statements: or else would not accept Option 3. We imagine that any significant increase in the number of statements requested by customers would mean an unacceptable increase in costs for banks and building societies.

22. Rather than leave taxpayer and bank to determine (usually in unequal relationships) what frequency of statement the bank is prepared to give, we think it would be desirable to provide for a minimum frequency or at least an end-year statement, as a condition of the account being available for electronic payment of dividends.

23. Then, registrars would have to be clear that they were paying into an appropriate account. Otherwise they face a modest penalty under Section 234. So, as part of the setting-up process, they might need assurance either from the banks or the shareholders that the receiving account met these conditions: and that registrars would be warned if the mandate was moved to a non-qualifying account. Registrars acting on such an assurance could then be written out of this penalty.

24. Arguably, banks breaching any statement frequency requirements (say by pressing customers to accept less frequent statements than they had requested for a mandate-receiving account) should face the same modest penalty as registrars who fail to send vouchers to Option 1 and 2 shareholders. Otherwise, banks may undermine Option 3 by cutting down on statements to reduce their own costs.

25. While much of this material could indeed be consigned to regulations, we have suggested (subject to Counsel's advice) up to a page of legislation for the enabling powers and other material, mostly to support Option 3.

Entry into force

26. With substantial setting up work and costs especially for registrars, we cannot see a start date before April 1991 as plausible. So there is no need, except as a gesture in favour of electronic transfer, for primary legislation this year.

Conclusion

27. We accept that legislative change to Section 234 is inevitable and desirable: and necessary to achieve a reduction in the paper burden of handling dividend payments through the payments clearing system. The question has been how best to achieve this, in the interests not just of APACS but of others at least as important from the wider share ownership standpoint.

28. The current APACS proposal involves a number of extra complications and disadvantages for shareholders and registrars. Registrars only clearly gain if shareholders voluntarily accept a worse service. If they do, it may have a noticeable staff cost for us and an unquantifiable revenue cost. If they do not, the extra complications and setting up costs will be unnecessary.

29. We doubt if the APACS Director's proposals will have universal appeal even within his membership, let alone with registrars and other interested parties. The views of registrars on the costs of share registers under different options are of paramount importance: in particular, whether the staff and other costs of a 3-tier system means it is preferable to an 'all voucher' system with the availability of electronic payment.

30. Accordingly, we recommend:-

i. that we revert to the APACS Director of Operations with a view to drawing up an agreed paper for a wider audience (in the first instance, the APACS membership) on the legislative and administrative aspects of his proposal and in particular the desirability of Option (3)

ii. that you authorise us to tell APACS

- that you remain very attracted to the principle of developing electronic rather than paper transfer of dividends

- that you would give very favourable consideration to legislating as soon as it is clear that a satisfactory proposal exists which is seen to command wide-spread support.

- and that you would like the Inland Revenue to issue a discussion document this summer on ways

of reducing the constraints of Section 234 on electronic payment, so as to tap the views not just of APACS and registrars, but of other interested parties.

iii. that you drop this item from the 1989 Bill but make it a 1990 Starter.

31. We would be grateful to know if you are content, in particular with the suggestion of a discussion document to reach a wider audience.

32. The draft of this submission was seen by Treasury FIM2.

C D SULLIVAN

Inland Revenue

CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: MRS A C MAJER
DATE: 31 January 1989

1. MR FARMER

2. FINANCIAL SECRETARY

ELECTRICITY PRIVATISATION : EMPLOYEE SHARE OFFERS (STARTER No 455)

1. You may remember authorising the Inland Revenue Press Release of 11 October which announced the Government's intention to propose technical improvements, in this year's Finance Bill, to the employee priority legislation introduced by Finance Act 1988. This was the legislation which provided income tax relief, in defined circumstances, for the benefit enjoyed by employees by virtue of priority in allocations of shares in public offers. The improvements announced were operative immediately on an extra-statutory basis. The Press Release also announced the Government's intention to publish draft legislation "as soon as it is available".

2. We were unable to start immediately on this drafting, however, because within a matter of days after the Press Release was issued the Department of Energy came forward with a variety of urgent and difficult proposals relating to employee participation in the forthcoming electricity

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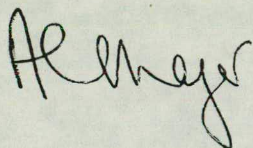
c Chancellor
Mr Moore
Mrs Lomax
Mr Culpin
Mrs Brown
Mr Gilhooly
Mr M L Williams
Ms Hay
Mr Holgate
Mr Jenkins (OPC)

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

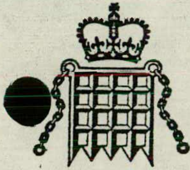
privatisation. It was evident that these would bear on the 'priority' amendments. It was not until shortly before Christmas that we were able to secure a clear enough idea of their intention, provide you with advice and, with your agreement (Mr Satchwell's note of 21 December), give our reactions to Energy. Subsequently at a meeting held on 9 January they indicated that they were rethinking their whole approach and would write again. They did so only last week, and we are now considering the matter afresh.

3. In these circumstances we are still unable to finalise the Finance Bill clause which is to amend last year's 'priority' legislation. As a matter of good management we have now obtained from Counsel draft provisions to effect the changes announced in October, but we cannot advise yet that they be published lest further substantial change is found to be necessary when a view can be taken, and agreed, on the electricity privatisation aspect.

4. You will wish to be aware of this, in case the failure to publish draft provisions attracts comment (though this may be unlikely - the October announcement attracted little interest). We will, of course, advise further once the electricity privatisation aspect is clearer.



MRS A C MAJER



Board Room
H M Customs and Excise
15th Floor Alexander House
21 Victoria Avenue
Southend-on-Sea
SS99 1AA
0702348944

FROM: C C FINLINSON

DATE: 31 JANUARY 1989

BUDGET CONFIDENTIAL

pmp

ECONOMIC SECRETARY

STARTER NO 34: REVALORISATION OF THE UK VAT REGISTRATION AND DEREGISTRATION THRESHOLDS

1. This submission details our proposals for increases in the thresholds at the time of the 1989 Budget. The necessary changes to the registration threshold will be included in the Finance Bill Clause, which amends Schedule 1 to the VAT Act 1983 to reflect the simplified registration requirements approved under Starter No 35 (paragraph 5 below). The changes to the deregistration threshold can be made by way of Treasury Order under paragraph 12 of Schedule 1 to the VAT Act 1983.

Registration threshold

2. We recommend continuing with our established practice of revalorising in line with inflation. The 6.8 per cent year on year movement in the RPI to December 1988 (published on 20 January 1989) justifies an increase in the threshold from £22,100 to £23,600, rounded down as is customary. The increased threshold would be effective from 15 March.

Circulation:

Chancellor	CPS
Chief Secretary	Mr Jefferson Smith
Financial Secretary	Solicitor
Paymaster General	Mr Wilmott
Mr Culpin	Mr Nissen
Mr Gilhooly	Mr Allen
Mr Call	Mr Holloway
Mr Jenkins Parliamentary Counsel	Dr McFarlane
	Mr Garratt

E.R.

Draft Directive on SMEs

3. There has been little progress in Brussels during the past year on the draft Directive which proposes an optional higher registration threshold of 35,000 ECUs. In the early stages of negotiation this figure was equal to about £24,500 and would have been a welcome increase to most trade interests. However, its current value is only about £22,950, and therefore below the increase proposed for this year. We shall, continue with our pressure in future negotiations to provide for an even higher optional threshold.

4. Small businesses and the VAT registration threshold (Starter No 35)

This year we have proposed a further simplification of the registration procedures to which you have already given your approval. The simplification, which will be of particular benefit to small businesses, involves the replacement of the present rules, including the quarterly threshold, with a single "backward look" rule . This rule, subject to limited exceptions for protection of the revenue, will only require persons to be registered at the end of any month if the value of taxable supplies in the past 12 months has exceeded £23,600. These proposals require Finance Bill legislation and the necessary Clause has been drafted. The revalorised registration threshold needs to be stated in the Finance Bill Clause and it will not, therefore, be necessary for it to be included in the Treasury Order this year.

Deregistration threshold

5. At present a registered person may seek cancellation of his registration if he can satisfy us that his taxable turnover in the coming twelve months will not exceed the current deregistration limit of £21,100. Assuming that the registration threshold is increased to £23,600, we recommend that the deregistration threshold, which traditionally takes effect from 1 June, be increased by the same amount to £22,600.

Effect on revenue and staffing

6. In accord with the convention adopted in the last two years, and because the threshold is increased from an indexed base, the revenue effect of the proposed revalorisation in the FSBR budget year (1989-90) will be negligible. The staffing effect would be to obviate the need for about ten extra staff (over and above those allowed for in PES), who would otherwise be required to handle the increased registered trader population.

Conclusion

7. We should be grateful to have your authority to include the revised threshold in the Finance Bill Clause referred to in paragraph 4 above and to draft an Order to implement the change proposed in paragraph 5 above. The Finance Bill Clause would have effect from 15 March by way of a Resolution by the House under the Provisional Collection of Taxes Act 1968. The Order would be subject to Negative Resolution.

C C FINLINSON1

chex.rm/jmt/84 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 31 January 1989

PS/FINANCIAL SECRETARY

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

Sir A Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Beighton - IR
Mr Bush - IR
Mr McGivern - IR
Mr Elliott - IR

TAYLOR → PS/FST 31/1

TAX RELIEF FOR RESIDENTIAL LANDLORDS

This is to confirm the Starter which the Chancellor mentioned at yesterday's overview meeting:

- He wishes the possibility of tax relief for residential landlords to be looked at further as a matter of urgency;

- The scheme could be limited either to a certain number of rooms for a certain number of days, or to a given income per week or per month;

- An income limit per resident is, however, probably the more attractive option and would most effectively stop abuse. The level of such a limit should be based on real, market rates, and could be in the order of £90 to £100 per week.

2. I should be grateful if the Revenue could take this forward.

J M G TAYLOR

BUDGET CONFIDENTIAL

Inland Revenue

Compliance and
Collection Division
Somerset House

FROM: D L SHAW

DATE: 1 FEBRUARY 1989

JR 1/2

1. MR ROBERTS
2. FINANCIAL SECRETARY

STARTER 450 - KEITH

1. We met the representative bodies yesterday to discuss parts of the Keith package, including the penalty for very late personal tax returns. We are meeting you on Friday to discuss this further, but thought that you might like a note on the views of the representative bodies first.

2. Much of the meeting was taken up with explaining the detail of various proposals and answering their questions. Only two points came up on which the representative bodies were generally opposed to the proposal. These were the penalty for very late personal tax returns and the restriction of protection for advice by accountants to "duly appointed" tax agents. The representative bodies seem broadly content with the rest of the package.

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cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Miss Hay
Mr Finlinson (C&E)
Mr Jenkins (Parliamentary Counsel)

Mr Beighton
Mr Bush
Mr Cherry
Mr Roberts
Mr McGivern
Mr Page
Mr Hugo
Mr Duxbury
Mr Hinson
Mr Shaw
Mr Elliott
Mr E Jones
Mr Sutcliffe
Miss Barlow
PS/IR

3. We invited all of the representative bodies that have taken an active part in the Keith consultations to the meeting. Thirteen attended, and are listed in the Appendix to this paper. Between them they cover, reasonably comprehensively, the accountancy and legal profession and large and small businesses.

<u>Penalties for very late tax returns</u>

4. We wrote to the representative bodies before the meeting explaining that there are two options for the penalty for very late personal tax returns. First, to leave it unchanged as a fully-mitigable penalty of up to 100 per cent of the tax lost. Second, to bring it into line with the similar penalty for companies as an automatic, ie non-mitigable, penalty of 20 per cent of the tax lost. In practice, the fully-mitigable penalty is normally set at between 25 per cent and 30 per cent of the tax lost.

5. All of the representative bodies agreed with the principle that penalties should be charged for very late tax returns based on the tax lost. The Institute of Chartered Accountants for England and Wales accepted the principle that automatic penalties should be charged for regulatory offences, such as late returns, and fully-mitigable penalties for culpable offences, such as tax evasion. They accepted that it was correct to make the penalty for very late personal tax returns automatic and fair to bring it into line with the equivalent penalty for companies. The National Federation of Retail Newsagents agreed. The British Bankers' Association agreed where the return is for someone in business, but preferred fully-mitigable penalties otherwise. The Institute of Taxation found the arguments finely balanced, but came down marginally in favour of mitigation.

6. The other nine representative bodies said that they were opposed to automatic penalties in principle. They dislike the automatic penalties that the Government

introduced for VAT in the 1985 Keith legislation. They would prefer to see no further move towards automatic penalties in the direct tax field.

7. On the other hand, all of the representative bodies were content with the proposed level for the automatic penalty, and thought that it would work satisfactorily in the vast majority of cases. Their real concern was with a very small number of very marginal cases, where the taxpayer has reason for his delay which borders on innocent error but falls short of reasonable excuse. They accept that this would be very rare with the penalty for very late returns. The problem is more real with the fixed penalties for very short delays that can occur for VAT. They believe, however, that such cases might occur and that a fully-mitigable penalty would then be needed to cope fairly. Their fears are probably groundless, as the Revenue would give the benefit of the doubt to the taxpayer in such marginal cases and allow the reasonable excuse let-out, reducing the penalty to nil, even though the let-out might not strictly be due.

8. In summary, most, but by no means all, of the representative bodies are opposed to automatic penalties on principle but accept that the proposed penalty is pitched at about the right level. They claim that fully-mitigable penalties are needed to cope fairly with a very small proportion of marginal cases, although this is not necessarily the case. The largest of the bodies of accountants, on the other hand, thinks that the automatic penalty would be fair and proper. And the automatic penalty would be simpler and cheaper to administer, both for the Revenue and for taxpayers and their advisers.

Protection for tax accountants

9. This concerns the difficult problem of privilege. You will recall that you decided to make no change to the protection for legal professional privilege for tax purposes, neither to extend it nor to impose the override.

You decided also to give accountants protection for tax advice that was similar to the protection for lawyers, but distinct from legal professional privilege. These decisions were announced in the July consultative paper and further consultations with the professional bodies on the detailed drafting were promised.

10. We sent copies of the relevant draft Clauses to the representative bodies, on a confidential basis, in advance of the meeting. They said at the meeting that they were generally content, except with one particular point.

11. Keith recommended that the protection should be restricted to professional tax agents. By professional, Keith meant a person who had been admitted a member of an incorporated society of accountants or of the Institute of Taxation. By tax agent, Keith meant a person appointed by a taxpayer and notified as such to the Revenue to act on his behalf in all or any of his tax affairs.

12. In drafting the legislation, we dropped the professional requirement. There were two reasons for this. First, there is no such restriction in the present form of accountants' protection which this is replacing. We thought that introducing such a restriction could be seen to be a restrictive practice and against Government policy. Second, there would be considerable practical difficulties with this restriction, for instance in deciding whether protection should be given where the advice was given by an unqualified clerk, nominally under the supervision of a qualified superior. The professional bodies of accountants would, not surprisingly, be quite happy to see this restriction imposed.

13. We kept Keith's restriction to duly appointed tax agents, however. The attraction of this is that it would allow a taxpayer to appoint a known firm of avoidance specialists as his agents, and their advice would then be protected. But the Revenue would, at least, be alerted to their involvement.

14. The main professional accountancy bodies said, at the meeting, that they are strongly opposed to this restriction. They suggested that it was unnecessary, the well advised taxpayer would comply and duly appoint every agent that he used as a matter of course. And, as usual, they maintained that none of their clients use avoidance specialists, so the question of duly appointing such advisers would never arise. They argued that this would impose an unreasonable burden upon taxpayers and the Revenue, resulting in a deluge of notifications.

15. There is some force in what they say. On the other hand, we have suggested administrative rules which would cut out the need to notify the Revenue of their normal tax advisers. So the burden may not be so very great in practice. And there would be advantages to the Revenue, in some cases, if we knew that avoidance specialists were acting.

Starter 212

16. The draft Clause for Starter 212, reopening claims following a discovery assessment, was on the agenda for the meeting but there was insufficient time to discuss it. We have asked the representative bodies to let us have their comments, if any, as soon as possible in writing.

Conclusion

17. There are three issues to be decided:

- whether the penalty for very late personal tax returns should be automatic,

- whether the protection for advice by accountants should be restricted to professional accountants, and

- whether they should have to be duly appointed.

18. In each case, the arguments are finely balanced, and the final judgement falls very much to be taken on political grounds.

David Shaw

D L SHAW

APPENDIX 1

1. Institute of Chartered Accounts (England and Wales)

2. Institute of Taxation

3. Law Society

4. Public Companies Tax Discussion Group

5. British Bankers' Association

6. Confederation of British Industry

7. Law Society (Scotland)

8. Institute of Chartered Accountants (Scotland)

9. Chartered Association of Certified Accountants

10. National Federation of Retail Newsagents

11. National Federation of Self-Employed

12. British Retailers' Association

13. Association of British Insurers

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: C STEWART
EXT: 7414
DATE: 1 FEBRUARY 1989

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

TRUSTS (STARTER 118)

1. When you discussed Mr Corlett's and Mr Golding's notes of 25 November about the review of trust taxation with us on 15 December, it was agreed that any general reform of the trust regime was not for the 1989 Finance Bill, but that we would put up a separate submission about the question of legislating this year to deal with the consequences of Independent Taxation and the covenant reform (paragraphs 53-58 of Mr Golding's minute). (Mr Mace (Personal Tax Division) has contributed the section below on Independent Taxation.)

Ministerial commitment

2. In the statement you made in Committee last year (copy attached) about the trust review, you said that

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cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Culpin
Mr Gilhooly
Mr J Dixon
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)
Sir A Battishill
Mr Isaac
Mr Painter
Mr Lewis
Mr Corlett
Mr Calder
Mr Bush
Mr Davenport
Mr Mace
Mr Golding
Mr Ko
Mr Boyce
Mr Kuczys
Mr Stewart
PS/IR

a. under Independent Taxation, an outright gift of income-bearing assets between husband and wife should be made effective for income tax purposes. In other words once the asset had been transferred the income would be the recipient's income for tax purposes;

b. where the arrangements between the couple fell short of an outright transfer of the asset - for example where the husband seeks to transfer only income to his wife, while retaining control over the capital - there was no reason why the couple should obtain a tax advantage from that arrangement. In other words, in that example the income should remain the husband's income for tax purposes;

c. following the ending of tax relief for non-charitable covenants, the existing provisions dealing with arrangements designed to transfer income to others would be reviewed.

3. These points are all concerned with the "settlements legislation", which was designed to prevent the use of trusts and similar arrangements to shelter income from full personal tax rates, either -

a. by accumulating income in a trust and then extracting it in non-income form; or

b. by diverting income to someone liable to tax at a lower rate, but retaining an interest or control for the settlor or his spouse.

INDEPENDENT TAXATION: OUTRIGHT GIFTS AND OTHER TRANSFERS BETWEEN HUSBAND AND WIFE.

4. In the following paragraphs we look at the Independent Taxation aspects of the review of the settlements legislation.

5. The Government's general approach to the treatment of the income from outright gifts and other transfers between husband and wife under a system of independent taxation was initially set out in paragraphs 5.11 and 5.12 of the 1986 Green Paper on the Reform of Personal Taxation (see copy attached). Briefly the view taken is that

a. where there is an outright transfer of income-producing assets from husband to wife, the transfer should be effective for tax purposes so that the income from the assets is taxed as the wife's income.

But

b. where a husband or wife seeks to transfer income to their partner without also transferring the right to the underlying capital from which the income is derived, the arrangement should not be effective for tax purposes. In these circumstances the income should continue to be taxed as the income of the partner making the transfer (settlement).

Outright gifts

6. The difficulty at 5(a) is that one of the provisions in the settlements legislation would operate so that the income from an outright gift of property from husband to wife would, under Independent Taxation, continue to be treated as the husband's income for the purposes of higher rate tax, though it would be treated as the wife's income for basic rate tax purposes. This is not the result we want. We therefore need an amendment to take outright gifts of income-bearing assets between husbands and wives outside the scope of this provision. At the same time we have to ensure that other arrangements, for example where the husband seeks to transfer only the rights to the income from the property but not the underlying capital, are still caught.

7. As you may recall we were originally planning to include in last year's Finance Bill an amendment to take outright gifts

between husband and wife outside the scope of the settlements legislation. But, in deciding that we should begin the wider review of the effects of the settlements legislation which we now have in hand, you agreed that this isolated change should be deferred. We already have on file an amendment, drafted by Counsel last year, which we think should achieve the objective we want on outright gifts between husbands and wives. We shall however want to look carefully at the draft (which amounts to be about 1/4 page of legislation) and discuss it with Counsel again.

Other transfers of income between husband and wife

8. Under the present aggregation system the settlements legislation does not normally come into play in the taxation of income settled by a husband on his wife since the wife's income is in any case treated as the husband's for income tax purposes. Under Independent Taxation, however, the settlements legislation will be our main protection against couples who seek to obtain a tax advantage by transferring income between them without also transferring the underlying capital (paragraph 5(b) above). As they stand at present, however, the settlements provisions will not operate satisfactorily under Independent Taxation where a husband or wife seeks to transfer income from property (of any kind) to their partner without also transferring the underlying capital. Examples of this sort of arrangement might be where, say, a husband set up a trust giving his wife the income from the settled property for life with the remainder going to their children or a third party; or where, say, a husband himself retained an interest in a trust which he had set up but where the income from the trust was payable to the wife.

9. In these cases the income would still be treated as the husband's income for higher rate purposes. But the present legislation would not prevent the income being treated as the wife's income for basic rate purposes. She would then be able to set any unused part of her own personal allowance against the income and get a repayment (at 1989-90 indexed allowance levels) of £2,785 @ 25 per cent = £696.25, that is almost £700 per annum. There is little logic in such a result and the scope for married

couples to reduce their income tax liabilities by this means without the partner who initially owned the capital having to give up control over it would be very wide. There could be a substantial loss of tax through this form of income splitting.

10. The remedy would be to extend the relevant provisions of the settlements legislation so that, in the sort of circumstances described above, the income from the trust would continue to be treated as the income of the settlor for the purposes of the basic rate income tax charge, as well as for higher rate purposes. In general the provision should apply to all settlements made by a husband or wife in favour of their partner (including those already in existence.) (See also paragraph 29 below). No-one should be worse off as a result of this. Applying the provision to existing settlements will in most cases simply ensure that the present aggregation rule effectively continues to apply to the settlement income after 6 April 1990.

Scope of the legislation

11. It is not easy, at the margin, and particularly where complicated trust arrangements are involved, to draw the dividing line between outright gifts of income-producing property between husbands and wives - which we propose should fall outside the scope of the settlements legislation altogether under Independent Taxation - and arrangements falling short of an outright transfer - where we propose that the income from the property should continue to be treated as the income of the settler for both basic and higher rate purposes. We propose however that the definition of an "outright gift" should be quite tightly drawn so that it takes outside the scope of the settlements legislation only the very straightforward, everyday gifts of assets between husbands and wives. For these gifts - as the 1986 Green Paper explained - there would be severe practical difficulties in attempting to disentangle how much of, say, a married woman's savings come from her husband and how much from her own resources. Where more complex arrangements or trusts are involved - so that the problems of identifying the assets and income concerned will not normally arise - and where either

a transfer of assets does not carry with it the right to the whole of the corresponding income from those assets; <u>or</u>

a transfer of income does not also give unfettered control over the underlying capital

we think that the let-out for outright gifts should not apply and the income from the settlement should be treated as the income of the settlor for both basic and higher rate tax purposes. This would, we think, be wholly consistent with the approach you outlined in your statement to the Standing Committee on 23 June 1988 and with the Government's earlier statement of principle in paragraphs 5.11 and 5.12 of the 1986 Green Paper. Even with a tightly drawn definition of an "outright gift" the tax treatment of transfers of assets between husband and wife will still be very generous. Under Independent Taxation, provided a husband, say, gives his wife an absolute right to both the income and capital in any assets which he transfers to her, the income will be treated as hers for income tax purposes and the transfer itself will be treated on a no gain/no loss basis for capital gains tax purposes. And of course there is no potential charge to inheritance tax on transfers between husband and wife. In other cases, where a transfer of income between a husband and wife falls short of an outright gift the settlements provisions would not be a barrier if, for example, a husband, wished to create a settlement for purposes other than to reduce his income tax liability. He would simply be in the same tax position as he would have been without the trust.

<u>Law Society representations</u>

12. In their representations on the 1988 Finance Bill the Law Society asked us to consider excluding from the scope of the settlements legislation an arrangement where, for example, a husband establishes a trust under which his wife has a life interest in the income but the remainder goes to the couple's children or a third party. The Law Society did not explain in detail why they thought such an arrangement should be outside the settlements legislation but it was presumably on the basis that by

giving up control over the capital the husband was making an "outright gift" even though his wife did not receive the totality of what was given.

13. Against the background of the analysis in paragraph 11, however, we recommend that the kind of case the Law Society mention should not be excluded from the scope of the settlements legislation. As explained we think that the criterion for excluding an outright gift should be that the gift is a transfer of the whole of the income from an asset <u>and</u> the underlying capital <u>from</u> one partner in a marriage <u>to</u> the other. The Law Society's example does not satisfy that test. Allowing this further relaxation of the settlements legislation would be inconsistent with your statement on 23 June 1988 and with paragraphs 5.11 and 5.12 of the 1986 Green Paper. In any case the couple in the example in paragraph 12 can achieve the result the Law Society want if the husband makes an outright gift of the assets to his wife and she then settles them on the children or third party while retaining the life interest in the income.

<u>Allocation of pension</u>

14. There is one very limited special circumstance where we think a further amendment to the settlements legislation is needed under Independent Taxation.

15. Certain statutory pension schemes such as the Principal Civil Service Pension Scheme (PCSPS) and schemes which operate "by analogy" with the PCSPS (for example those of the Atomic Energy Authority, the Forestry Commission, the schemes for the House of Lords and House of Commons (which cover House officials) and schemes for about 80 other statutory boards) allow a pensioner limited opportunities to allocate part of their pension in favour of a dependant. Where the dependant is a wife or husband there are two possibilities. Either

a. the pensioner can give up part of their own pension to provide for a separate pension to come into payment to their husband or wife on the pensioner's death (in addition to any widow's or widower's pension that may be payable); or

b. the pension can come into payment to the dependent husband or wife immediately, during the lifetime of the pensioner.

In either case the amount of dependant's pension which can be provided by the pensioner's forgoing £1 of their own pension is determined on an actuarial basis taking account, inter alia, of the relative ages of the pensioner and the dependent husband or wife. Before an allocation of pension can be made the pensioner has to undergo a medical examination and satisfy certain other strict tests. Once a pension has been allocated the decision cannot be revoked even if there is a change in the circumstances of the couple (for example they divorce or separate). We do not have detailed information about the total number of individuals who have already allocated part of their pension or who are potentially able to do so. But such information as we have suggests that the number making allocations is very small. For example of the 2,600 individuals who retired from the Inland Revenue in the last two years only 15 made an allocation of part of their pension. This figure includes all allocations not just those in favour of wives or husbands who are living.

16. Under Independent Taxation an allocation of pension by, say, a husband in favour of his wife, to come into payment after his death gives rise to no difficulty. But where a husband , for example, allocates a pension to his wife for immediate payment during his lifetime the income would be caught by the settlements legislation as it now stands. Taking account of the proposed change described in paragraph 10 above the effect would be that the income would continue to be taxed as his income and not hers, even though in law she is absolutely entitled to the income and he has no control over it.

17. We do not think that the consequences of the settlements legislation in these circumstances can be justified. (They were, of course, never in mind when the legislation was drafted.) There is a very close analogy between these allocated pensions and the Category B national insurance retirement pension paid to a wife on the basis of her husband's contributions. As you know, at present the Category B pension is earned income of the wife for tax

purposes but there is a specific provision which prevents the wife's earned income allowance from being set against it. The effect is that the pension is all taxed at the husband's marginal rate. Under Independent Taxation the wife's earned income allowance is abolished and a wife gets a full personal allowance in her own right which she can set against any income of her own including a Category B pension. Similarly, a pension allocated to a wife by her husband while he is living is her earned income for tax purposes but the same provision as applies to the Category B pension also precludes the wife's earned income allowance from being set against the allocated pension at present. We can see no justification, under Independent Taxation, for treating allocated pensions differently from the Category B National Insurance retirement pension and we therefore recommend that such pensions should be taken outside the scope of the settlements legislation. The necessary legislation would be no more than a few lines, and the revenue cost would be negligible. At the margin the change in tax treatment might lead to rather more allocations being made than at present. But since the size of the allocated pension is determined actuarially as described in paragraph 15 above, there should be no overall effect on public expenditure. Under the proposals currently under consideration to allow unapproved occupational pensions schemes, there would be nothing to prevent such a scheme adopting a form of allocation which might not be irrevocable (see paragraph 15). We would propose to ensure that those allocations did not benefit from the proposal to take irrevocable allocations of pension under statutory pension schemes outside the scope of the settlements legislation.

Timing

18. We think it is essential to include provisions dealing with the Independent Taxation aspects of the settlements legislation in the 1989 Finance Bill. Although you gave an assurance in the Standing Committee debate on 23 June 1988 that it was not Ministers' intention that outright gifts of income bearing assets between husbands and wives should be caught by the settlements legislation we are still getting questions about this issue and it would be very helpful to make the position absolutely clear at the

earliest opportunity. More importantly taxpayers and practitioners need to be told very soon about how the settlements legislation will apply in circumstances where a transfer falls short of an outright gift between husband and wife. Press articles are already appearing offering advice about how married couples should organise their affairs under Independent Taxation and we must be able to make clear to taxpayers what the precise effect of their arrangements will be. It would be too late to leave the legislation until the 1990 Finance Bill. That might not be published until after 6 April 1990 when Independent Taxation begin and it would almost certainly not receive the Royal Assent until several months after Independent Taxation has started. We do not think this could be regarded as consistent with your statement in Standing Committee on 23 June that any necessary changes to the law would be brought forward "in time for the introduction of Independent Taxation".

19. None of the provisions which are necessary for Independent Taxation should prejudice our wider work in reviewing the trust provisions.

CONSEQUENCES OF THE COVENANT REFORM

20. The covenant reform was also concerned with arrangements designed to transfer income from one person to another (but irrespective of whether they were husband and wife).

21. Before the 1988 Budget, a person making a non-charitable covenant could get basic rate relief for the payments. The settlements legislation prevented him getting higher rate relief; it provided that the income remained his for higher rate purposes. (This is the same provision as is mentioned in paragraph 6 above.)

22. The 1988 Budget removed the basic rate tax relief from non-charitable covenants, by making the payments completely ineffective for tax purposes.

Scope for avoidance

23. It is however still possible for people with substantial capital to get much the same result as a covenant by using a trust. For example, someone may set up a trust under which the income is to go to his student son for 7 years (or the end of full-time education if sooner), and the capital is to revert to himself or his wife at the end of that period. The trust income is then the student's income for basic rate purposes (but remains the settlor's income for higher rate purposes). If (say) the trust capital is £20,000, and it is invested to yield 10% gross, the student will get £2,000 a year income which he can set against his personal allowance, in the same way as he could have done with covenant income before the 1988 Budget. So there is a tax saving of £500 (£2,000 at the basic rate).

24. Thus the settlor can transfer income temporarily, but without losing control of the capital. Clearly many people who in the past made covenants could not use trusts in that way, because they either do not have the capital or cannot afford to tie it up in that way for a period of years. But for the minority of people who do have the capital, it is easily arranged and could be attractive.

25. This has already aroused some comment in the Press; I attach an article from last Saturday's "Times" advising people to set up trusts for that purpose. There have also been complaints from people who feel that it is not fair that when the tax benefit of covenants has been taken away from the man in the street, people with capital can still get the same benefit by using trusts.

26. There is also a potential loss of revenue if the idea catches on among people with capital - in the same way as covenants in their time became popular. We do not as yet have hard evidence about how many people may be doing it, if only because we are unlikely to find out until trust beneficiaries make a claim for tax repayment on the trust income, some considerable time after the trust has been set up. But although

it is difficult to predict the potential loss of tax, the risk is there and the criticism of unfairness will be a difficult one to answer if nothing is done.

Remedy

27. The problem here is very similar to the one with transfers between husband and wife (paragraph 8 above); the settlor is trying to transfer income to someone else with a lower tax rate. As in the case of married couples, the remedy would be to extend the relevant provision of the settlements legislation, so that it provides for the trust income to remain the settlor's for basic rate as well as higher rate purposes.

28. These rules only apply, however, if the settlor has not divested himself and his spouse completely of the property - in other words, if he or his wife have retained any interest in the income or capital. Thus the proposal to make the legislation effective for basic as well as higher rate would only affect cases where they wished to transfer income to someone else, but were not giving the capital away outright.

Transitionals

29. We think there would also have to be transitional provisions. In general the new rule should apply only to ~~trusts~~ settlements ~~set up~~ made on or after Budget Day (~~just~~ broadly as pre-Budget covenants were allowed last year to continue to get relief under existing law until they expired). But where a wife or husband of the settlor benefited from part or all of the income from a trust, the new rule would apply to that income irrespective of when the trust had been set up.

CONCLUSIONS

30. As explained above (paragraph 18), we think the independent taxation points need to be dealt with this year. The proposal on the use of trusts to transfer income to other individuals is a logical extension of the proposal to deal with similar transfers between husband and wife:

a. both require a similar amendment to the same existing legislation, and it may be more complicated to do one without the other, and to have to draw distinctions between trusts which are caught by the new provisions and those which are not;

b. if the proposals above on husband and wife are in this year's Bill, and nothing is done about similar transfers to other individuals, people will naturally assume that the Government do not intend to take action;

c. the legislation would be short (probably no more than 1 page overall);

d. the change does not prejudice the wider question of whether the settlements legislation as a whole can be simplified. That study is in hand.

31. We would be grateful to know whether you agree that there should be legislation in the 1989 Finance Bill -

a. to stop outright gifts between husband and wife being caught by the settlements legislation (paragraphs 6-7 above);

b. to extend to basic rate the provisions which treat income as the husband's if he has given his wife an interest in the income without giving her the capital (paragraphs 8-10);

c. to stop allocated pensions being caught by the settlements legislation, in the limited circumstances described in paragraphs 14-17;

d. to extend to basic rate the provisions which treat income as the settlor's if he or his wife has retained any interest in the income or capital (paragraphs 27-28).

C STEWART

23 6 88

Question proposed, That the clause, as amended, stand part of the Bill.

Mr. Arbuthnot: The clause has one unfortunate effect, and my concern is shared by my hon. Friend the Member for Taunton (Mr. Nicholson). If all the income of a trust is subject to an interest in possession, the additional rate will not apply. If all the income is to be applied at the discretion of the trustees, the additional rate will apply, which is right and proper. The trouble is that if some of the income is discretionary, or if the income is discretionary for only a part of the year, under the clause the additional rate will apply to all of the income for all of the year, despite the fact that there is an interest in possession in the rest of the income. There may be an interest in possession in the majority of the income.

My fear is that that effect will cause people to set up a large number of different settlements. Such fragmentation would be a pity and would not be particularly sensible. I ask the Financial Secretary to look at the problem which has been raised by a number of different bodies to see whether an answer can be found.

Dr. Marek: One of the problems is that if there is to be a pro rata division in a trust depending upon whether it is discretionary, a lot more accountants may be employed and may make things very difficult by trying to enlarge one part of a trust at the expense of another. Although I see the sense of the argument I wonder whether it is practical.

Mr. Lamont: I do not think that I need dwell on the general purpose of the clause. My hon. Friend the Member for Wanstead and Woodford (Mr. Arbuthnot) has asked about mixed settlements. I believe that he is complaining not that the provisions are unfair but that they will create an incentive for the fragmentation of trusts, which he thinks will be an undesirable and expensive development.

We have also received a large number of representations about the way in which the additional rate is to apply to all the gains of mixed settlements.

Concern has also been expressed about mixed settlements for children in which older children may be non-discretionary beneficiaries and younger children discretionary beneficiaries. This is a very complicated subject, as my hon. Friend the Member for Wanstead and Woodford will know from his professional experience. I am afraid that it is not possible to make changes this year, but because we have received so many representations about the matter, we shall certainly look into it in the coming year.

We shall be looking at a number of aspects of the tax regime for trusts in the light of the Budget changes. On the capital gains anti-settlor provisions, we shall look at both the potential for avoiding the higher rate charge on gains of settlements set up for the settlor's children and, as a separate matter, gains of non-resident settlements which are outside the scope of the new clause and schedule. This will be as part of a considered wider review of trusts over the coming year which will include the capital gains treatment of mixed settlements with discretionary and non-discretionary beneficiaries.

Other representations have asked about the effect under independent taxation of existing legislation that applies to the income arising from trusts and other settlements in certain circumstances when the person making the settlement—the "settlor"—or the settlor's husband or wife retains an interest in the settlement. A particular question which we have been asked and which may interest the hon. Member for Wrexham is whether, under independent taxation, income from outright gifts of assets between husband and wife could be affected by these provisions. There is also a wider issue of how these "settlements provisions" now fit in with the changes that we have made this year to end tax relief on transfers of income between individuals, generally by means of covenants.

Looking at the special position of husband and wife, where one partner in a married couple makes an outright gift of assets to the other, our objective is that that should be recognised for tax purposes, and that the recipient and not the donor should be taxed on any income that arises from the assets after the transfer has occurred. But the position is different where arrangements fall short of an outright transfer of both income and capital from one partner to the other. Where, for example, a husband seeks to divide his income from the underlying capital and to transfer only income to his wife, while retaining control over the capital, we see no reason why couples should enjoy a tax advantage from arrangements of that kind.

As hon. Members may understand, the major changes that we have made this year, both in the taxation of husband and wife and in the ending of tax relief for covenants, have fundamental implications for the highly complex existing provisions which are designed to ensure that individuals cannot obtain a tax advantage by arrangements designed to transfer income to others. It may be that, as some have suggested, there are some aspects where the present law is now too wide, and others where it may be too narrow. We shall also therefore be looking at the law in this area to see whether it achieves our objectives. If any changes are found to be necessary, we shall bring them forward in time for the introduction of independent taxation. I hope that those affected will bear that possibility in mind when considering how the existing law applies.

We shall, therefore, be standing back and looking at a number of aspects of the income and capital gains tax regime for settlements. I think that I have answered a number of the points that the hon. Member for Wrexham raised earlier.

Question put and agreed to.

Clause 94, as amended, ordered to stand part of the Bill.

Clause 95

UNDERWRITERS

Question proposed, That the clause stand part of the Bill.

5.8 Overall the additional cost of allowing independent taxation of a wife's investment income compared with a transferable allowance system which retained aggregation of investment income would be about £100 million. This is the measure of the tax penalty the present aggregation rule imposes on marriage. The case for ending the present discrimination in the tax system against a married woman's investment income applies to incomes at all levels.

Rearrangement of investment income between husband and wife

5.9 If a married woman's income were taxed separately from her husband's, there would in some cases be an incentive for couples to rearrange the ownership of their income-producing assets between them. For example, if a husband with investment income was liable to tax at 60 per cent, whereas his wife was liable only at the basic rate, the couple's combined tax bill would be reduced if the husband transferred some of his investments to his wife. This process of rearrangement is sometimes known as income splitting.

5.10 It is very unlikely that all couples would seek to rearrange the ownership of their income-bearing assets in order to take maximum advantage of separate tax rate bands. Many would not be able, or would not want, to make the necessary transfers of assets. But if, for example, those affected were to transfer assets yielding half the relevant investment income there could be a revenue cost of around £100 million.

5.11 The Government do not consider that there would be a case for special measures to prevent rearrangement of investment income between husbands and wives where this resulted from an outright gift or other complete and irrevocable transfer of the right to the underlying capital. There would be great practical difficulties in enforcing such special provisions – for example, in trying to determine how far a married couple's joint bank deposit derived from the married woman's own savings, as distinct from money contributed by her husband. In any event, under a system of independent taxation, there is no reason in principle why couples where, say, the wife derives all or part of her capital from her husband should pay more income tax than a couple – in otherwise similar circumstances – where she derives her capital, say, from an inheritance. If one partner in a marriage made a genuine transfer of assets to the other, there would be no reason to impose a tax penalty on the income from those assets.

5.12 Different considerations would arise where a husband might seek to transfer income to his wife (or vice versa), in order to enjoy a reduction in their joint income tax liability, without genuinely transferring the right to the underlying capital. It would be necessary to consider whether steps would need to be taken to prevent tax avoidance by this means.

Mortgage interest relief

5.13 One of the aims of independent taxation with transferable allowances would be to remove the tax penalties that can arise on marriage.

THE TIMES
28.1.89

Students and widowed mothers can boost your take-home income

24

Still lots of scope for tax plans

It is a widespread fallacy that there is little scope for creative tax planning any more, although it is easy to see the reasons why this misapprehension has taken hold.

Mr Nigel Lawson's last Budget largely completed the process, begun in 1984, of broadening the tax base so that rates of tax could be reduced.

In the 1970s, the nominal rate of tax might have been 98 per cent, but only a very few extremely wealthy (or ill-advised) people paid at this rate, since there were so many "tax breaks." The current policy is to keep the system simple — keep deductions to the minimum, so that people actually pay tax at the nominal rate.

The courts have also played their part. A series of House of Lords decisions, starting with the 1981 Ramsay case, mean there is little point in relying on artificial tax schemes.

Despite these trends, there is often a great deal which can be achieved by sensible long-term planning.

The last Budget abolished relief for deeds of covenant effected after March 14 1988, (unless they were made in favour of charities). This brought to an end a very widely-used way in which parents took advantage of their children's tax allowances to cover part of the living costs while the children were at university or college. However, it is possible to obtain the same relief in a slightly more complicated way.

The key is to create a settlement under which your son or daughter is entitled to the income for a period which is capable of exceeding six years and to transfer investments to the trustees of that settlement. The formula which determines the period can be identical to that used in deeds of covenant:

> "There is little point in relying on artificial tax schemes"

Your daughter. . . .shall be entitled to all income arising to the trustees for a period of seven years or until she ceases to be in receipt of full-time education, whichever be the shorter period.

The income of the settlement for this period will belong to your son or daughter for basic rate tax purposes, although the trustees will be taxed in the first instance and your son or daughter will have to file a repayment claim. When the period has elapsed, the settlement will come to an end and the capital will revert to you.

You, as settler (ie, the person who created the settlement), will be assessable for higher rate purposes, in that the Inland Revenue will charge 15 per cent of the settlement income. However, there is no real change here, as payments under non-charitable deeds of covenant were not allowed for higher rate purposes: the net effect is precisely the same.

No stamp duty or capital gains tax need be payable on setting up such a settlement, or on transferring assets to the trustees. An election under section 78 of the Finance Act 1981 may be necessary for capital gains tax purposes. No inheritance tax will be payable on the creation of the settlement or when the settlement comes to an end.

How do you go about creating such a settlement? Unfortunately, there is no standard form, so you will need to consult a solicitor. However, a one-off charge of, say, £250 will be recouped many times over if you have, for example, three children who will be undergoing higher education, and they can recover income tax of nearly £600 per annum.

For example, if you presently have investments worth £20,000 which produce income of £2,000 per annum. As a 40 per cent taxpayer, you have net spendable income of £1,200.

If you set up a settlement of this nature, your son or daughter will receive net income of £1,500. However, they can recover £500 if they have no other taxable income. On the other hand, you may be assessed for tax purposes at 15 per cent on £2,000 ie, tax payable of £300. Nevertheless, your family will be at least £500 a year better off.

In the past, deeds of covenant have been used to transfer income to an elderly relative in order to make use of his or her tax allowance. This will be at least £3,180 if he or she is aged over 65 and has no income apart from the state retirement pension, and if no action is taken, more than £1,000 of this allowance will go to waste. As a family, you may be throwing away tax relief of between £250 and £400 a year!

> "A great deal can be achieved by sensible planning"

One approach is to set up a settlement, but another technique may be more appropriate here. Suppose you have a widowed mother and you anticipate having to contribute £25 per month to her upkeep. You earn more than £25,000, so you are subject to 40 per cent tax. This means that you have to earn £500 per annum in order to be able to pay your mother £25 per month. However, there is a way of providing your mother with this income *and* getting tax relief of £2,000.

The way to do this is to invest £5,000 in one of the syndicates which invest in enterprise zone properties. You can deduct the cost of this investment from your taxable income, so the true cost to you will be only £3,000. You then give the investment to your mother. This can be done without your forfeiting the tax relief that you have enjoyed.

She will receive a guaranteed rental income of about £300 per annum which will be tax-free as it is covered by her personal allowance. In due course, you will probably receive the investment back under your mother's will — meanwhile, it will have provided a 10 per cent return on your net outlay.

Do-it-yourself tax planning can be dangerous. You will need professional help in making the necessary elections and agreeing the position with the Inland Revenue. However, despite the widespread simplification there are no grounds for despondency (or complacency). There is plenty of scope for tax planning yet.

Tony Foreman

The author is a taxation partner with Pannell Kerr Forster, the accountant.

BUDGET CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS
EXT: 6371
DATE: 2 FEBRUARY 1989

FINANCIAL SECRETARY

TAXATION OF LUMP SUM TERMINATION PAYMENTS (STARTER 110)

1. Mr Fraser's note attached provides a fuller picture of what would be involved in Option 3, the option you and the Chancellor asked us to pursue.

2. I do not think you will have much difficulty with the choices Mr Fraser describes as to the starting date and the taper based on the outline scheme we discussed with you and the Paymaster.

3. But further consideration of the point the Paymaster raised - whether people would avoid the new provision by keeping their lump sums at £30,000 and taking the rest in income - does seem to put a real question mark over the viability of the original proposal. The choice may lie between going back - to do nothing - or going forward to a more complicated proposal, with all that entails in terms of extra compliance and administrative work. In short, when you have considered Mr Fraser's note, I think you will want to stand back and decide whether, against this rather changed background, the relatively "blunt instrument" we were

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Scholar
Mr Monck
Mr Gilhooly
Miss Hay
Mr Knight - IAE
Mr de Berker
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Chairman
Mr Painter
Mr Lewis
Mr Ridd
Mr Fraser
Mr Northend
Mr O'Brien
Mr Hodgson
Mr Boyce
Mr I Stewart
Mr Howland
Mr Wilcox
PS/IR

considering is still worthwhile, or whether the balance of advantage has now changed in favour of the other option you preferred, letting the present threshold "wither on the vine".

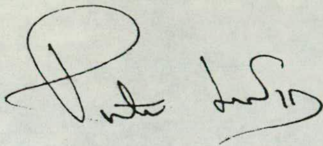
4. We have been able to identify very few restraints on a large termination payment being limited to £30,000, and the rest being taken as income. The only really certain and material factor is employers' NIC which will be payable on the income but not the termination payment. But a payment needs to be well over £200,000 before the increased employers' NIC would exceed the cost of compensating the employee for the loss of tax relief, at 40%, on £30,000. We would expect the well-advised soon to get on to that. And since the people who can determine or influence their own termination payments fall very much into that category, the outcome could be that the new provision made very little difference to such people and its main effect was to disadvantage some genuine long service/well paid redundancy cases. As we understand it, that would be exactly opposite to the result you hope to achieve.

5. The second half of Mr Fraser's note outlines a revised scheme which would seek to overcome this difficulty. It would look at the combined level of the lump sum and income from the employment in the last 12 months; and the gradual withdrawal of the £30,000 exemption would operate where the combined income and lump sum were above a specified level - perhaps £80,000. This scheme would, we think, very largely overcome the problem identified with the original simple scheme; and you may feel the distributional effects are in some respects an improvement on the original - it would bear less heavily on people with small incomes and large lump sum payments, and more heavily on those with large incomes and small lump sum payments.

6. But, as Mr Fraser explains, bringing income into the reckoning, for a specific period, means a much more elaborate provision. The number of taxpayers who would be affected would still be quite small - perhaps 10,000 to 15,000 each year would pay tax on more of the lump sum than they do now, though the position would, of course, need to be considered in many more

cases to see whether or not people were within the new provision. There is no doubt that it would be seen as unhelpful in the context of deregulation and compliance, and would be unfavourably contrasted both with other simplification measures you are considering for this year, and what was done to these rules last year. And a more elaborate provision inevitably entails extra staff costs - a first broad estimate is an on-going cost of perhaps 25-50 instead of 10. The legislation also, would need to be longer, perhaps about 2 pages instead of the quarter of a page that the straightforward option would have entailed.

7. If you see this as a priority for the Finance Bill, we can, of course, still go ahead if you would like to do so. We would, subject to Parliamentary Counsel's views, need a PCTA Resolution because we would need to start collecting the extra tax (through PAYE) before Royal Assent. Drafting would therefore have to be complete well before Budget Day. So an early decision on whether you wish to proceed would be helpful.



P LEWIS

BUDGET CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: I FRASER

DATE: 2 FEBRUARY 1989

Financial Secretary

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

1. Mr Wilcox's minute of 21 December outlined a wide range of options. The Chancellor agreed (Mr Taylor's minute of 9 January) with your recommendation that Option 3 (progressive withdrawal of exempt threshold for payments over £30,000) should be pursued. This minute looks at the distributional impact of Option 3 and raises a number of points on which decisions are needed. The topics discussed are:

- the commencement date
- the distribution of payments in excess of £30,000
- the choice of taper for payments in excess of £30,000
- the avoidance possibilities
- the employer compliance and Revenue staff implications
- the impact on Parliamentary payments to Ministers and MPs.

<u>Commencement date</u>

2. Under the lump sum rules, payments are chargeable as income received on the date on which the event (eg the date of redundancy) giving rise to the payment occurs. The date on which the <u>payment</u> is received is not relevant. The choice is therefore between applying the new rules to events which occur on or after either Budget Day or 6 April 1989. There are no technical considerations which favour one date over the other. And in either case, subject to Parliamentary Counsel's advice, we think a PCTA resolution would be necessary, because we need to start collecting the tax (through PAYE) before Royal Assent.

3. A Budget Day start would prevent employers from arranging that leavers with large payments keep the full benefit of the £30,000 threshold by bringing forward the termination date. It is difficult to predict the extent of forestalling. There would be some by those able to influence the timing of their departure - for example, directors and senior executives. But for most people who are made redundant, when they go is largely determined by events beyond their control. A Budget Day start might be interpreted as a measure of Ministers' determination to close an avoidance loophole. But, as Ministers have already acknowledged, the proposal is somewhat of a "blunt instrument" against abuse.

4. A 6 April start would appear less rushed, would give any employers about to announce redundancies a short period to consider the implications of the change and would be consistent with the commencement date of last year's changes (raising of threshold from £25,000 to £30,000 and withdrawal of "top-slicing" relief).

5. Unless Ministers are concerned about forestalling - possibly with publicity about big cases - we would recommend a 6 April 1989 commencement date.

Distribution of payment in excess of £30,000

6. The tables in Annex 1 set out our estimates of the distribution of lump sum termination payments over £30,000 by size of payment (Table 1) and by range of income (excluding the termination payment)(Table 2) in 1989/90. The most interesting figures are that 70% of all payments exceeding £30,000 are less than £40,000, and, of the payments in the range £30,000 to £40,000, 17% are made to people whose income is less than £15,000 and 95% are to people with other income of less than £40,000. Of all lump sum payments over £30,000 about 15% are paid to people with less than £15,000 other income and nearly 88% are to people with less than £40,000 other income.

7. These figures are based on projections of data collected in the 1986/87 Survey of Personal Incomes and reflect forecast

changes in the level of average earnings but not any behavioural effect which may have arisen from the withdrawal of the top slicing relief. The pattern of redundancy payments may have altered since the survey was done eg reflecting high salaries paid by financial institutions. Although we have information on recipients' income levels for tax purposes for the full year in which redundancy occurred we cannot identify whether the recipients are ordinary employees (perhaps with long service) receiving redundancy payments under employers' schemes, or senior executives or directors able to ensure that their "golden handshakes" are ex-gratia and "unexpected". And the figures referred to in paragraph 6 may underestimate income levels where the recipient was only employed for part of the year.

Rate of withdrawal of the tax exempt threshold

8. The object of the withdrawal arrangement is to prevent the "cliff edge" effect of total loss of the threshold once the payment exceeds £30,000. The illustration in Mr Wilcox's minute of 16 December involved a reduction of the threshold by £1 for every £1 by which a payment exceeded £30,000. This would result in total withdrawal by £60,000 with a maximum marginal rate in the taper of 80%.

9. It would be possible to adjust the rate of the taper, the point at which it started or both. The table below provides four possible variants, setting out for each our estimates for 1989/90, assuming no behavioural changes, of the tax yield, the number of individuals losing their whole entitlement to the exempt threshold and the maximum marginal rate of tax in the taper.

Variant Number	Starting point for withdrawal of threshold	Amount of payment over starting point leading to a £1 threshold reduction	Run out point for taper	Full year yield (£1m)	Number in taper	Number losing all allowance	Marginal rate in taper
a.1	£30,000	£1	£60,000	50	13,500	1,500	80%
a.2	£30,000	£2	£90,000	30	14,500	500	60%
b.1	£40,000	£1	£70,000	30	3,500	1,000	80%
b.2	£40,000	£2	£100,000	15	4,000	under 500	60%

10. Both a. variants assume the starting point for withdrawal of the threshold to be £30,000. Any more generous taper (eg £1 for each £3 excess) would result in very few people losing the threshold entirely (about 1%). Any steeper taper (eg £2 for every £1 excess) would involve a penal marginal rate of over 100%.

11. The b. variants would mean that recipients of sums of £40,000 or less (which might include a significant number of ordinary employees) would not have their threshold reduced. As explained above, 70% of payments exceeding £30,000 are of less than £40,000.

12. The question of which withdrawal arrangement is most appropriate is a matter of judgement. But on the face of it variant a.1 is the simplest and has more teeth since (ignoring behavioural effects) it would result in more people paying tax on the whole of their lump sum.

Avoidance possibilities

13. This measure will inevitably provoke some behavioural response intended to prevent any loss of the tax exempt threshold. In our minute of 16 December (paragraph 37), we indicated that one possible effect would be that, where employees or directors had sufficient influence, lump sum payments might in future tend to be restricted to £30,000.

14. Another possibility - which the Paymaster General raised - is that individuals would attempt to split up payments which exceed £30,000. The ex-gratia component would be limited to £30,000; and the remainder paid (eg as a bonus) and taxed in full as part of pay. This arrangement would effectively leave the employee in precisely the same position as under the current rules and protect up to £ 12,000 of tax relief which would otherwise be lost. There is nothing we can do to prevent lump sums being restricted to £30,000. This is what is done in many cases already. (In the past payments were often kept at or below £75,000 - the point at which top slicing relief ran out). And although there may be factors which would deter some employers from agreeing to split larger payments into £30,000 lump sum (exempt) and additional pay (taxed), we do not think we could do much to counter arrangements of this kind <u>unless</u> Ministers are prepared to consider anti-avoidance arrangements, which, as we explained at your meeting, would have to be fairly arbitrary.

15. Splitting payments could involve an extra cost which might deter some employers. Depending on the precise circumstances, employers might find that the extra salary or bonus means that they have to pay additional pension contributions. And there would also be an employers' NIC liability of 10.45% on the "bonus" or extra "pay" (ex-gratia and redundancy payments are not liable to NIC at present). These would certainly be factors to be taken into account if the employer was laying off several skilled long-service employees. But for companies making an ex-gratia payment to one executive or director, additional NIC would be less expensive than grossing up the potential loss of tax relief unless the intended ex-gratia payment was rather more than £200,000. (We believe that considerably less than 1% of all payments over £30,000 are more than £200,000).

16. For those few cases where very large "golden handshakes" are paid, the £12,000 maximum tax relief probably plays little or no part in the decision to make the payment, and the company would adjust the gross payment rather than split it. At the other end of the scale, we suspect there would be practical

difficulties in relation to redundancy payments where entitlement is precisely spelt out, according to age and length of service, under detailed (Revenue approved for tax purposes) redundancy schemes. In the short term, it seems likely that even sympathetic employers would find it difficult to change the nature of payments made under established redundancy schemes or to bear the additional NIC burden that might arise. We have no evidence, for instance, that employers have been prepared to adjust payments to employees since top slicing relief was withdrawn last year.

17. It would be tempting to assume that only those with very large payments and/or high salaries are likely to be able to arrange payment in a tax efficient way; this would mean that the numbers involved might be relatively small. But even among recipients with lower income and moderate payments, there could be a significant number (for example, close company directors) in a position to determine or influence how the payment of monies out of the company should be arranged.

18. It is therefore not possible to estimate with any confidence how many of the 15,000 or so individuals who each year receive termination payments in excess of £30,000 would be able switch partially from lump sum to pay or bonus. If half of the recipients were able to switch part of their lump sum to pay or bonus, the actual yield from this measure might be only half of the estimates given in paragraph 8. But those best placed to do so are likely to be those who currently are best able to ensure that payments are ex-gratia and qualify for the benefit of the £30,000 threshold ie those who you were most concerned to see taxed on a fairer basis. There is a risk of criticism that the new rules are likely - at least in the short term - to impact most on the ordinary employee who will be unable to split his lump sum.

What action could be taken to reduce avoidance?

19. We have considered what anti-avoidance measures might reduce the attractiveness of splitting payments and set out

below two different approaches. Both turn on looking at the combined amount of the lump sum and ordinary pay. They are not "bolt-on" anti-avoidance measures. They would entail structural changes to Option 3.

The "exceptional pay" approach

20. Under this arrangement the object would be to look at the employee's normal pay and identify "exceptional" pay and benefits received within a prescribed time of the date of termination. Any exceptional pay would be taxed in full in the usual way, but it would also be added to any lump sum received for the purposes of determining whether or not any part of the exempt threshold should be withdrawn. For example, if the lump sum was £35,000 and the exceptional payment £20,000, for the purposes of determining threshold withdrawal the overall amount would be £55,000. If the threshold was withdrawn by £1 for every £1 over £30,000, the £25,000 excess in this case would reduce the lump sum exemption from £30,000 to £5,000. The effect would be that £5,000 of the lump sum would be payable tax free; the £30,000 remainder would be taxed in full.

21. Simple as this may seem, we doubt if this arrangement is a practical starter. Apart from having to measure the pay and benefits for the prescribed period, there would be considerable difficulties in identifying, except entirely arbitrarily, what a person's ordinary pay is. In practice, we think there would be,in a large number of cases, considerable scope for dispute. That would create uncertainty for employers over the correct amount on which PAYE should be operated and a lot of extra work for tax offices. And in addition, some directors might be able to split the lump sum in such a way that a bonus was paid in part for the period immediately preceding termination and in part for the period to be used as a measure of normal pay.

Withdrawal of threshold once pay and lump sum exceed a prescribed threshold

22. Under this arrangement lump sum and normal pay (including benefits in kind) for the 12 month period before termination

would be added together. If the total exceeded a prescribed limit, then the excess would be counted towards the reduction of the exempt threshold available for the lump sum. The rate of withdrawal could again be £1 for £1 or whatever alternative Ministers wished. The individual's normal pay would of course continue to be taxed in full in the usual way.

Example

Lump sum £30,000, ordinary pay (including non-cash benefits) £60,000. Exempt threshold withdrawn by £1 for each £1 by which the total of lump sum and ordinary pay exceeds £80,000 (in this example the "prescribed limit")

	£
Total lump sum and pay	90,000
Excess over prescribed limit (£90,000-£80,000)	10,000
	======
Lump sum threshold	30,000
Reduced by excess	10,000
Exemption due	20,000

So employee is taxed in full on:-

Ordinary pay	60,000
Lump sum less exemption (£30,000-£20,000)	10,000
Total on which tax is paid	70,000
	======

23. Information is not available (for example, about lump sum payments below £30,000) to enable us to give an accurate analysis of various combinations of limits and tapers along the lines of paragraph 9 for this approach. But we tentatively estimate that a limit of £80,000 might produce a similar yield (about £50 million) to that suggested for variant a.1

(paragraph 9 above). By comparison with that variant, about 9,000 recipients would gain and about 9,000 would lose, and the number liable on their lump sum payments would still be about 15,000. This approach would tend to catch only those with big salaries or big lump sums or both.

Variant	Starting point for withdrawal of threshold (income plus lump sum)	Amount of payment over starting point leading to a £1 threshold reduction	Run out point for taper	Full year yield (£1m)	Approx number in taper or losing all allowance	Marginal rate in taper
x.1	£80000	£1	£110000	50	15000	80%

(We have concentrated on an £80000 limit because we estimate that it may produce a similar yield to variant a.1 (paragraph 9). We could provide equally tentative estimates for other limits but, in the interests of getting this note to you as soon as possible, have not pursued these at this stage).

24. Compared with the original proposal (progressive withdrawal of exempt threshold as lump sum payments exceed £30,000), this arrangement would be more generous to the lower paid because their lower incomes would allow them to have a greater lump sum tax free. But people on high salaries near the chosen limit would lose much of their threshold whatever the size of lump sum. (Annex 2 compares this approach, with an an £80,000 limit, with the present position and with the original approach using the taper a.1 in paragraph 9).

25. However, whatever limit is chosen, there are a number of practical difficulties with this approach.

- It would be necessary to determine the amount of pay (and value of benefits) of the recipient for a period which will not normally coincide with the tax year.

- To be equitable, non-cash benefits should be taken into account; employers do not normally have to calculate the taxable value of benefits in kind and we would probably have to arrive at such values by apportioning the taxable benefit calculated for the relevant tax years to the period concerned.

- If the employer makes expense payments (which will be taxable) he will not (nor will we at the time the lump sum is paid) know what expenses the employee will claim as a deduction.

- Earnings from associated employments would have to be taken into account otherwise bonuses etc will be channelled through these to avoid aggregation.

- Legislation would have to require employers to return all lump sum payments (even if less than £30,000) so that we can check whether the threshold needs to be reduced. (We might be able, administratively, to limit this requirement so that we did not insist on returns of payments where restriction of the threshold would clearly not be involved).

26. This arrangement would be easier to operate than the "exceptional pay" approach. It would focus on a much higher limit - say £80,000 - which you might see as having presentational advantages in relation to the genuine redundancy cases. But the limit chosen would be arbitrary; it would affect genuine redundancy cases as well as those who would otherwise attempt to abuse the new rules. And by comparison with the present rules it would undeniably be much more complicated.

Employer compliance and Revenue staff implications

27. If the amount of the tax threshold due is calculable by reference only to the size of the lump sum itself, employers would have only a very slightly more complicated calculation to

perform when deciding how much should be included for tax under PAYE. The staff cost for the Revenue of variant a.1 (paragraph 9 above) would be up to about 10 staff.

28. If however a measure of income is needed to establish the size of the lump sum threshold, this would place a heavier burden on employers in relation to payments in the middle range. We would seek to minimise this burden by offering to help employers who sought our advice to achieve a provisional PAYE deduction as near as possible to the final liability. Alternatively, except in cases where it was obvious that the full £30,000 threshold would be due, employers would have to tax the payment in full leaving the tax office to make any refunds later. Additional reporting requirements would add to employers' compliance costs. The Revenue staff cost would arise both from the need to advise employers and from the additional work involved in scrutinising returns by employers of lump sum payments made. More work needs to be done on the details of the procedures that would be required but our rough estimate is that the staff cost would rise to 25-50.

Ministers and MPs Parliamentary payments

29. We have concluded that the proposed severance payments for Ministers would not be aggregated with a resettlement grant received if the Minister lost his Parliamentary seat in the General Election. Our view is that each office is distinguishable and is not associated for aggregation purposes. Moreover, if you wish to proceed with the alternative approach outlined above, an MP's Parliamentary salary plus any other taxable benefits and his resettlement grant would not at present bring him near a limit of £80,000.

30. May we please have decisions on the following matter:

a) Do you agree that the change should apply only to events occurring after 6 April 1989?

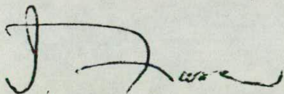
b) Do you still wish to proceed with the simple version (Option 3) discussed in the previous note?

c) If so, do you agree that the exempt threshold should be withdrawn by £1 for every £1 lump sum that exceeds £30,000? Or would you prefer some other taper?

d) On the other hand if you feel that something further needs to be done because of the avoidance possibilities, do you agree that the approach described in paragraph 22 - reducing the exempt threshold (£1 for £1) by the amount that the total of lump sum and ordinary pay in the last year exceeds a prescribed limit - is preferable?

e) If so should that limit be £80,000 (paragraph 23); or would you like us to illustrate, so far as we can, the effect of other combinations.

31. We will of course be glad to discuss the matters raised in this paper with you.



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ANNEX 1

Table 1

Termination payments	As percentage of payments exceeding £30,000	Numbers (approx)
£30000 - £40000	70%	10500
£40000 - £60000	20%	3000
£60000 - £90000	8%	1200
Over £90000	2%	300
	100%	15000

Table 2

Range of income* for tax purposes excluding termination payments

Termination payments	Less than £15000	£15000-£25000	£25000-£40000	Over £40000	Total
£30000-£40000	17%	27%	51%	5%	100%
£40000-£60000	8%	29%	41%	22%	100%
Over £60000	8%	16%	37%	39%	100%
Over £30000	15%	26%	47%	12%	100%

* The income referred to is the other income subject to tax of the recipient for the tax year in which the event giving rise to the termination occurs. It does not therefore necessarily equate to pay plus benefits for the last 12 months preceding that date.

ANNEX 2

Comparative impact of (A) present law
(B) variant a.1 (paragraph 9)
(C) variant x.1 (paragraph 23)

Termination payments	Amount taxable present (A)	Amount taxable variant a.1 (B)	Amount taxable under variant x.1: Pay for 12 months preceding termination: £10000 (C)	£20000	£30000	£40000	£50000	£60000	£70000	£80000
£25,000	Nil	Nil	Nil	Nil	Nil	Nil	Nil	£10000	£20000	£25000
£50,000	£20000	£40000	£20000	£20000	£20000	£40000	£50000	£50000	£50000	£50000
£75,000	£45000	£75000	£50000	£60000	£70000	£75000	£75000	£75000	£75000	£75000

chex.ps/jmt/79 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 2 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
Mr Ilett
Mr Neilson
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Beighton - IR
Mr Roberts - IR
PS/IR

BUDGET STARTER 454: ELECTRONIC PAYMENT OF DIVIDENDS

The Chancellor has seen Mr Roberts' note of 30 January.

2. Subject to the Financial Secretary's views, he is content to drop this starter for 1989, and for the Revenue to issue a discussion document in the summer.

J M G TAYLOR

Susan 04.03.2.89 **BUDGET CONFIDENTIAL**

FROM: MISS S J FEEST
DATE: 3 February 1989

MR D L SHAW - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Miss Hay
Mr. Finlinson (C&E)
Mr Jenkins (Parliamentary Counsel)
Mr Roberts
Mr Shaw
PS/IR

STARTER 450 - KEITH

The Financial Secretary held a meeting today to tidy up the outstanding points in this year's Keith package. This note confirms the decisions made.

PENALTIES FOR VERY LATE TAX RETURNS

In view of the opposition from the representative bodies at your meeting with them, the Financial Secretary has decided not to change to a system of automatic penalties for very late personal tax returns; but to retain the present fully-mitigable penaltie for up to 100% of the tax lost.

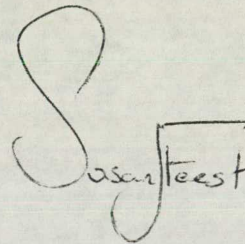
PROTECTION OF TAX ACCOUNTANTS

The Financial Secretary agrees that the legislation to restrict protection for advice by accountants to "professional" accountants, should not be imposed.

He decided that Keith's requirement for tax agents to be notified to the Revenue should be dropped.

It was also agreed that protection should also cover second tier appointments ie if a taxpayer's advisor asks for advice from a larger firm of accountants.

Parliamentary Counsel can now go ahead and finalise the drafting of the Finance Bill clauses.



SUSAN FEEST

BUDGET CONFIDENTIAL

FROM: R C M SATCHWELL

DATE: 6 February 1989

MRS MAJER - IR

cc PS/Chancellor
Mr Culpin
Mr Moore
Mr Odling-Smee
Mr Bent
Mr Gilhooly
Mr M L Williams
Miss Hay
Mr Holgate
Mr Jenkins - OPC

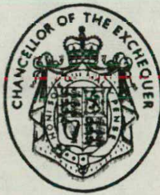
Mr Farmer - IR
PS/IR

STARTER 455: ELECTRICITY PRIVATISATION-EMPLOYEE SHARE OFFERS

The Financial Secretary was grateful for your minute of 31 January. He has commented that he hopes that the delay in sorting out the electricity privatisation employee share proposals does not rule out completely the publication of draft clauses on Starter 114 (the technical improvements to the FA88 employee priority legislation). It would be nice if the commitment in the 11 October Press Release could be met; though he recognises that with the Budget coming up shortly, the chances of doing so are slight.

R.C.M.S.

R C M SATCHWELL
Private Secretary



FROM: J M G TAYLOR
DATE: 6 February 1989

PS/FINANCIAL SECRETARY

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Monck
Mr Gilhooly
Miss Hay
Mr Knight
Mr de Berker
Mrs Chaplin
Mr Tyrie
Mr Jenkins

Sir A Battishill - IR
Mr Painter - IR
Mr Lewis - IR
Mr Fraser - IR
PS/IR

TAXATION OF LUMP SUM TERMINATION PAYMENTS (STARTER 110)

The Chancellor has seen Mr Lewis' note of 2 February, and Mr Fraser's enclosed paper.

2. He has commented that option 3 does not, on this basis, look at all promising.

J M G TAYLOR

1234/021

BUDGET CONFIDENTIAL

FROM: MISS S J FEEST

DATE: 6 FEBRUARY 1989

MR J H ROBERTS - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Mr Ilett
Mr Neilson
Miss Hay

Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Beighton - IR
Mr Sullivan - IR
PS/IR

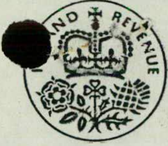
BUDGET STARTER 454: ELECTRONIC PAYMENT OF DIVIDENDS

The Financial Secretary was grateful for Mr Sullivan's submission of 30 January 1989 and your covering note. He has seen PS/Chancellor's note of 2 February 1989 and agrees that the starter should be dropped and a discussion document issued in the summer.

Susan Feest

SUSAN FEEST

CONFIDENTIAL



Inland Revenue

Savings and
Investment Division
Somerset House

From: A J WALKER

Date: 6 February 1989

1. MR KUCZYS
2. FINANCIAL SECRETARY

STARTER 152: PERSONAL EQUITY PLANS: LIMITING UNIT AND INVESTMENT TRUSTS TO UK EQUITIES

1. It was agreed at the Chancellor's meeting on PEPs on 13 December that eligible unit and investment trusts within PEPs should be confined to those investing largely in UK equities. This note - which takes into account comments from FIM - seeks your agreement to the details of the provision.

Present position

2. At present, those authorised unit trusts which invest to any significant extent in UK equities are obliged by regulations under the Financial Services Act to hold at least 80 per cent of their investments in "approved securities" (ie alpha and beta stocks); but they are allowed to hold a small proportion in cash for management purposes and for hedging. Investment trusts must have their income derived "wholly or

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c.c Chancellor
Chief Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Neilson
Mr MacPherson
Mrs Chaplin
Mr Tyrie
Mr Isaac
Mr Corlett
Mr Bush
Mr Cleave
Mr Davenport
Mr Kuczys
Miss Dougharty
Mr Tomlinson
PS/IR
Mr Walker

AJW3 AJW67

mainly" from shares or securities (including gilts): for tax purposes we usually take this to mean at least 70 per cent. There is, of course, no provision at present that the investment should be in UK companies.

Suggested approach

3. The approach we suggest is to introduce a straightforward provision in the PEP regulations that the value of UK shares in the unit or investment trust's portfolio must not fall below 70 per cent of the value of the whole portfolio of investments. This figure may seem on the low side; in earlier discussion Ministers - and we - have tended to assume an 80 per cent requirement. But our experience with investment trusts leads us to think that it is likely to cause fewer problems for unit and investment trusts (eg in a bear market) than a higher figure; and some allowance for liquidity is essential for hedging and general management purposes. It will probably mean unit and investment trusts will normally aim to be well over 80 per cent in UK equities for most of the time, so as to leave a contingency margin (for example, to deal with shares in a UK company being swapped for overseas shares in a take-over deal).

Alternative approach

4. An alternative approach which has been suggested would be to require the articles or trust deeds of all unit and investment trusts in which plan managers invest to state that the trust may invest only in UK equities (at least to the extent that it is obliged to invest in shares or securities at all). This approach might be slightly easier to present than the other approach; but it would also have some disadvantages:-

- it would allow investment trusts considerably less flexibility than they have at present;

- policing the application of the rules might prove difficult (see paragraph 13);

- all existing unit or investment trusts within PEPs would have to be reconstituted with new articles or trust deeds.

5. Our view is that the approach suggested in paragraph 3 is likely to prove the better option.

Transitional provisions

6. Whichever approach is adopted, it is likely that most unit and investment trust holdings within PEPs will not at present meet the new requirements. Most of the changes to PEPs will take effect from 5 April 1989, and we are very conscious that plan managers will have little time to digest and introduce the new provisions. For the most part, however, we think that they should be able to make the necessary changes by 6 April, but we have doubts about the practicality of imposing the UK holding rule by then.

7. We therefore propose that there should be a transitional provision. This could be either:-

i. allow existing holdings to continue under the old rule indefinitely, but require all new investment in unit and investment trusts to meet the new rule (in practice, we would have to allow some time - perhaps 6 months - for new trusts to be set up or existing ones to bring their investments into line with the new rules); or

ii. simply allow a period of grace of, say, 6 or 12 months, after which all unit and investment trust holdings must satisfy the 70 per cent test.

8. On balance, our preference is for option i. - although it is not quite so simple as option ii., it will allow 1987 and 1988 PEP holders to continue more-or-less unaffected if they and plan managers wish.

Policing the limit

9. I understand from Mr Allan that the Chancellor has expressed an interest in this issue.

10. Policing the PEP scheme itself is carried out with a very light touch, in order not to place undue burdens on plan managers. It is done by checking records and visits by Inland Revenue auditors (which has served as much to encourage good practice as to uncover misdemeanours). In addition, plan managers' accounts have to be audited annually by a qualified auditor.

11. If the 70 per cent rule is adopted, we think the best way to ensure that unit and investment trusts within PEPs keep within the limits is to require plan managers to obtain certificates from an independent qualified auditor that the value of UK shares did not fall below 70 per cent of the value of the trust's total investments. The reports would be required annually or for any shorter period of investment in the unit or investment trust by the plan manager.

12. For a plan manager investing - as many do - in a unit trust within his organisation, this would be very straightforward. There would, however, be some additional work where the plan manager was investing in a totally separate unit or investment trust; but we do not think that this should be an undue burden.

13. Policing a requirement that articles or trust deeds should state that the trust may invest only in UK equities poses problems. The policing role would fall naturally to DTI, but FIM have doubts about how effectively they would do the job (if they could be persuaded to do it at all). If the Revenue had to police the provisions, they would need not only additional powers but also additional manpower and expertise. This would be an unwelcome extra burden on our technical resources.

14. If a plan manager found he held units or shares in a trust which had ceased to satisfy the UK holding rule, he would be obliged to sell the units or shares immediately. The ultimate sanction for any plan manager who deliberately flouted the rules would be to withdraw his approval to act as a plan manager.

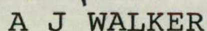
Conclusion

15. The issues for decision are:-

- do you agree that there should be a rule that 70 per cent of the value of a unit or investment trust's investments should be in UK equities, rather than a requirement that articles or trust deeds should state that the trust may invest only in UK equities?

- do you agree that plan managers should be given 12 months (ie until 5 April 1990) to meet this rule?

- do you agree that, to ensure compliance with the new rule, an annual certificate by a qualified independent auditor should be required?



A J WALKER

BUDGET CONFIDENTIAL

FROM: R C M SATCHWELL

DATE: 6 February 1989

MR STEWART - IR

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

Mr Isaac)
Mr Corlett) IR
PS/IR

STARTER 118: TRUSTS

The Financial Secretary was grateful for your minute of 1 February.

He agrees that there should be legislation in the 1989 Finance Bill to:-

- stop outright gifts between husband and wife being caught by the settlements legislation;
- extend to basic rate the provisions treating income as the husband's where he has given his wife an interest in the income but not given her the capital;
- stop allocated pensions being caught by the settlements legislation in some (limited) circumstances;
- extend to basic rate the provisions treating income as the settlor's if he or his wife have retained any interest in the income or capital.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Inland Revenue

Business Tax Division
Somerset House

FROM: E MCGIVERN
DATE: 8 FEBRUARY 1989

1. MR ISAAC
2. FINANCIAL SECRETARY

TAX RELIEF FOR RESIDENTIAL LANDLORDS: "RENT-A-ROOM"

1. Mr Elliott's paper responds to the Chancellor's request that consideration should be given to a new relief for residential landlords letting rooms in their own homes. Although most of the discussion is in terms of lettings by owner occupiers, we assume that the relief would also be available to lettings by tenants who themselves rented their homes, either from public or private sector landlords.

2. As Mr Elliott's paper brings out, there are some rather difficult issues to be decided about targeting and the scope of the relief but before turning to those, you will want to consider the strength of the case which DoE have made for another special tax relief for housing.

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cc		
	Chancellor	Chairman
	Chief Secretary	Mr Isaac
	Economic Secretary	Mr Beighton
	Paymaster General	Mr McGivern
	Sir P Middleton	Mr Bush
	Mr Byatt	Mr Cleave
	Mr Scholar	Mr Elliott
	Mr Culpin	Mr Pearson
	Mr Gilhooly	Mr Dearman
	Mrs Chaplin	Mr Streeter
	Mr Tyrie	PS/IR
	Mr Call	
	Mr Jenkins (OPC)	

3. The Secretary of State said in his letter to the Chancellor that he was not yet convinced that tax incentives were the right answer; and DoE officials have said they have no idea of likely take up but would see the relief as providing a basis for a campaign to encourage people to take in lodgers. But it must be very much open to doubt whether someone would really be put off from letting a spare room by the possibility of a tax liability which, in the majority of cases is likely to be very small - if there is anything at all to pay - after expenses and personal allowances.

4. Investment in residential property is of course already favoured by the tax system in comparison with other investment eg in equities. In addition to the mortgage interest and capital gains tax relief for owner occupiers, the new BES relief is expected to attract substantial investment this year into assured tenancy lettings. BES commentators are suggesting that total investment this year (1988/89) could be of the order of £300 to £500 million, the vast bulk of it in assured tenancies, although we think that the outturn is likely to be closer to the lower end of that range.

5. Against that background, as we see it the questions for Ministers are whether the, imperfections of the housing market can best be tackled by the introduction of a further tax relief - perhaps to "level up" the tax regime if levelling down is otherwise not acceptable; and whether the proposed relief - which risks being seen as a step back from the strategy underlying the Chancellor's tax reform policies - would have any significant impact on the supply of rented accommodation.

Targeting

6. There are some tricky questions to be faced here. We assume that Ministers would want to exclude the "professional landlord" from the new relief. These will

include the residential landlord who is running a boarding house; as well as those who live in large Victorian houses and let the greater part of the property as bedsitters or self-contained flats. We have not yet been able to find a definition of the idea of "rent-a-room" which would successfully ring-fence the relief in this way; and certainly the DoE's suggestion of a "sharing test" would not of itself be the answer. It would be the simplest of matters for any resident landlord to bring himself within that definition by ensuring that he and his family shared at least one of the rooms in his house with the tenants of his self-contained flats. Certainly the resident owner of a boarding house would have no trouble in satisfying the sharing test. In practice, therefore, that would mean that these landlords would effectively enjoy a tax exemption for the first slice of their rental income unless we can devise a suitable cut-off mechanism.

7. We would clearly need to have further discussions with DoE officials to see whether they have any better ideas for targeting the relief - if this is what Ministers intend - on the owner occupier or the tenant who lets out a spare room possibly as a bedsitter or provides the usual kind of "digs" for a lodger (we have not ourselves, been able to find any existing definition in housing legislation which looks promising). If we don't get this right, the whole nature and shape of the relief would be changed from a narrowly targetted (almost de minimus) scheme - essentially to remove any tax disincentive there may be for a householder to let out a spare room - to something closer to an exemption for a first slice of all rents from property in which the owner lives.

A possible scheme

8. When this idea was being looked at last year, the Chancellor was anxious that the new scheme of relief should be kept as simple as possible to encourage maximum take up. If DoE cannot help any further on the difficult issue of

targeting, then I think we would have to accept that there would inevitably be some rough edges in any new scheme of relief which might perhaps be on the following broad lines:

i. The relief would be restricted to rent received from letting rooms in the taxpayer's only or main residence (to exclude "holiday lettings" as defined in existing legislation).

ii. To keep the scheme simple and to help people see at a glance that they need not concern themselves about the tax consequences, the exemption could be in terms of the gross rent received rather than the profit from the letting.

iii. To exclude the professional landlord and self-contained flats, there might then be three further restrictions -

a. there would be a limit on the number of ("living") rooms, say two;

b. there would be automatic cut off (with no marginal relief) if the gross rent exceeded £X per week in respect of each of the rooms; and

c. a DoE type "sharing test" might be added to underline the special nature of the relief.

9. The automatic cut off rule b. may however be criticised as too harsh (ie £1 over the rental limit and the exemption is lost) but any kind of "marginal relief" would introduce a degree of complexity into the scheme which would, for both the Revenue and the taxpayer, be wholly disproportionate to this kind of operation.

10. It would have to be recognised that the "sharing test" would be mainly presentational as, for example, the resident owner of a boarding house (and indeed a residential owner of

a bed and breakfast hotel for homeless families) would have no real difficulty in bringing himself within it. But it might help to exclude the genuine self-contained (and often expensive) flats. The brutal cut off rule should be enough to exclude professional landlords.

Rental limit

11. Mr Elliott has given some illustrative figures but we would like to consult DoE on this before putting firm proposals to you.

Husband and wives and joint owners/sharers of residential property

12. As Mr Elliott explains, there is a tricky little point here which, if we are not careful, risks introducing the "sex and tax" issue.

13. If the relief were to be given only to the owner occupier or tenant of the house/flat, there would be difficulties where the wife (or partner) was receiving the rental income, doing the cooking, cleaning and laundry but was not co-owner or joint tenant of the property. And where they were joint owners/tenants, Ministers will need to consider whether there should be two sets of exemptions; or whether there should be a single exemption to be shared between all the joint owners/tenants. That would not of course solve the problem where the wife/partner was not a join owner/tenant but was effectively the person doing the letting and receiving the rent. We shall want to discuss with DoE and our lawyers the kind of formula which would tie the relief to rent paid to the occupier or householder of the house/flat in which the rooms are let, or some other form of words which would be wide enough to cover all joint owners, tenants and sharers without having to spell out all the details.

Pressure for a wider relief

14. There will be strong pressure on Ministers to extend the relief more widely than is intended, particularly by the owner occupier who lets a self-contained flat in his house and, more importantly, by non-resident landlords.

- Self-contained flats

15. The argument will be that if the objective is to free up accommodation to relieve homelessness then it makes no sense to exclude such flats. The point will be made that there is no justification for exempting in the hands of Mrs Smith, the £X per week which she receives from her two lodgers, while Mrs Jones next door has to pay tax on the same amount of money she receives from letting a self-contained two room flat to two single sharers or a young married couple.

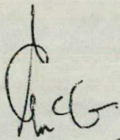
Non-resident landlords

16. We would expect considerable pressure for a wider relief from non-resident landlords such as the Leeds Residential Property Association who provide accommodation, including furnished bedsitters, in property which is not their own homes and much of it for young single people. They will argue, and with some justification, that their contribution to the private rented sector is just as socially important and beneficial as the provision of "digs" in private houses.

17. In both these cases, the justification for the narrower relief would have to be that it is not intended as a general relief to increase the supply of rented accommodation but is more narrowly targeted to encourage the owner occupier or private tenant to let out a spare room in their homes. Whether or not that is a line which could be defended is of course a matter for Ministers political judgement.

18. We shall need to come back to you on certain second order aspects of the scheme eg if the limit were, say, £60 per week per room, would rent of £120 per week be exempt if paid by one tenant for two rooms (one perhaps a sitting room); and would it matter if instead of a single tenant, a couple shared those two rooms?

19. In the meantime, we would welcome your authority to go back to DoE urgently to see whether they can help further on targeting but, before we do so, we should be grateful for guidance from Ministers on the shape and scope of the relief - see Mr Elliott's paragraph 31.



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You may want a very early discussion of the questions raised in these papers.

The major question, if you wish to proceed, is whether you have in mind

(a) something on the lines of the earlier proposals for a "Rent-a-room" relief; or

(b) something which looks more like a special exemption for the first £x thousand pa of income from letting furnished accommodation (including boarding houses and private hotels).

The approach at (a) points to some pretty arbitrary rules to target the relief, with marginal definitions open to challenges of the purchase tax/Nabarro kind (I can see why the thing reminded Peter Cropper of the 1940s). As the notes by Mr McGivern and Mr Elliott explain, however, approach (b) points to a scheme of relief which would raise questions which you may feel would be more difficult, not just in degree but in kind. And even if we can leave the cost aside, it would mean giving income from furnished accommodation a tax threshold perhaps three or more times higher than the tax threshold for the normal run of self-employed - and on the face of it more "entrepreneurial" - businesses, employment income and so forth.

A J G ISAAC

BUDGET CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

From: M J G ELLIOTT
Date: 8 February 1989

1. MR McGIVERN
2. MR ISAAC

Separate notes attached

3. FINANCIAL SECRETARY

ELLIOTT → FST 8/2

TAX RELIEF FOR RESIDENTIAL LANDLORDS

1. Mr Taylor's note of 31 January records the Chancellor's decision that the possibility of tax relief for residential landlords should be looked at further as a matter of urgency.

2. As you know, this was considered as a possibility for last year's Budget, and I believe you have recently looked again at the note we provided then. To make this note self-contained, I am afraid that some repetition will be unavoidable.

Purpose of the relief

3. The starting point presumably is Mr Ridley's Budget representations letter to the Chancellor, in which he said "You are aware of the problem we face with growing homelessness. The issues were discussed at E(LF) under the Prime Minister's chairmanship on 9 November. My officials are due to discuss with yours a suggestion made there that we should look at tax allowance for resident landlords who let out spare rooms. I am not yet myself convinced that tax incentives are the right answer here".

---

cc

4. Following the Chancellor's meeting with Mr Ridley at which this point was raised again, Miss Hay (FP) and I had a meeting with DoE officials - at their request - to find out what sort of relief they had in mind and what they saw as the objectives. They said that the main aim was the E(LF) objective of reducing homelessness by encouraging owner-occupiers with spare rooms to let them. They also saw a relief as a way of encouraging owner-occupiers who were overstretched with mortgage payments, or elderly owner-occupiers who were contemplating getting out of their houses altogether because they could no longer afford to keep them in reasonable repair, to stay in the owner-occupied sector.

5. We asked DoE whether they could give any estimates - or guesstimates - of likely take-up. They said they couldn't. There was simply some anecdotal evidence that people were deterred from taking in lodgers because of a reluctance to get "entangled with the Revenue".

6. Later in the meeting they suggested that the main purpose of any tax relief would be presentational; it would be a positive peg on which to hang a campaign to encourage people to take in lodgers. (They had some suggestions about the form of the relief as well - I will come on to those later).

7. So - as when we looked at this last year - the justification for the relief would be that there was a gap in the housing market which could be partly filled by rooms potentially available in private houses; that much of the prospective rent from these rooms wouldn't be taxable anyway (because covered by allowances); and that tax relief would be a low cost way of ensuring householders could take in lodgers without having to worry about tax.

Present tax treatment of rental income

8. If the landlord provides substantial services for the tenant, typically meals and laundry, the income may be taxed as trading income. In that case it will be treated as earned income, and - if a married woman is providing the services - wife's earned income allowance will be available to set against it. Any tax will be payable in two instalments, with CGT roll-over and retirement relief available where appropriate: and any expenses in excess of the rental income can be set off against other income. If the landlord doesn't provide any services, or not on a scale which amounts to trading, the rental income is treated as investment income, and expenses can only be set off against that income. Furnished holiday lettings, however, get special treatment: the income from this sort of letting (defined by reference to availability for short letting periods at particular times of the year) qualifies for all the reliefs associated with trading income, regardless of the level of services provided.

Types of letting by resident landlords

9. Before considering possible schemes of relief, it may be helpful to identify the types of letting which a resident landlord may undertake. These include

i. letting furnished rooms to lodgers and providing some services - eg meals, laundry - and shared facilities (bathroom and sitting room);

ii. letting furnished rooms as bed sitters and providing separate facilities (bathroom and kitchen) for the lodgers,

iii. converting some rooms into a self-contained flat or flats, divided from the rest of the house, perhaps with a separate entrance; the flat probably let furnished so as not (under earlier rent legislation) to give the tenants complete security of tenure.

10. Obviously the scale of any of these letting activities could vary enormously. Thus (i) could cover, at one extreme, a residential hotel (including bed and breakfast accommodation for homeless families), or boarding-house where the landlord lived on the premises; and at the other, an elderly couple with a spare room taking in a lodger, giving him breakfast and/or an evening meal, cleaning his room and doing some laundry.

Target type of letting

- General

11. We need to know, first of all, how wide a relief Ministers want. The choice seems to be between, on the one hand, a very limited, "rent-a-room" scheme, almost in the nature of a de minimis relief: or, on the other, a general "first slice" exemption applying to all income from furnished accommodation. With the rent-a-room approach, there will be some tricky distinctions to be made in devising conditions for relief; a general exemption, on the other hand, would be a very different proposition - in kind as well as degree.

12. The difference between these two approaches - and the difficulties of targeting a "rent-a-room" scheme in a defensible way - can be illustrated by considering some specific questions.

- Should boarding houses be included?

13. If the objective is "rent-a-room", boarding houses clearly ought in principle to be excluded: running a boarding house is an overtly commercial form of letting, and the Government's objective is simply to flush out unwanted spare rooms in family houses. But with a wider scheme it could equally be argued that, if the Government's objective is to reduce homelessness,

a room in a boarding house is just as much help as a room with (say) an elderly retired couple whose children have moved out in the world.

- Should flats be included?

14. The argument for cutting out "commercial" activities could equally be applied to flats. The letting of a flat seems to imply more of a business undertaking than the letting of a room, and the "rent-a-room" argument that people would be dissuaded from letting a separate flat by possible involvement with the Revenue seems far less plausible than in the case of spare rooms; but - even with a limited "rent-a-room" scheme - what would be the basis for drawing a distinction between two attic rooms let separately as bed sitters and two comparable rooms in the next door house which had been converted into a self-contained flat - possibly for two people?

- "Shared" accommodation?

15. When we met DoE officials, they suggested restricting any relief to lettings where the tenant shared accommodation with the landlord. There is a definition of "shared accommodation" in last year's Housing Act provisions which exclude "lodger type" tenancies from statutory protection against eviction. The legislation says that a tenancy is excluded if (very broadly) -

- the tenant shares any accommodation with the landlord or landlord's family, and the landlord (or his family) occupy the premises as their only or principal home.

(The DoE suggested that rent from "sharing tenants" who satisfied this definition could be exempt without limit).

16. There would obviously be attraction in attaching any relief to an existing statutory category of tenant. But to

rely on a sharing test to target the relief could produce some odd results. Why (for example) should a widow who wants to maintain her privacy and who can afford to instal an extra shower and basic kitchen to go with her spare room, let as a bedsitter, get no relief, while her neighbour who doesn't mind sharing one of his rooms gets relief?

17. Moreover, every boarding house could be brought within the definition by the owner (who lives on the premises) making one room available on a shared basis - sitting room/TV room/bathroom.

Possible restrictions on relief

18. Mr Taylor's note identifies three of these

- a limit by number of rooms;
- a limit to lettings of longer than a month;
- a monetary cap on the amount of rental income to be relieved.

Number of rooms

19. The suggestion that relief might only apply to income from letting (say) 2 or 3 rooms is similar to the Alliance "Rent-a-Room" proposal in their 1987 Election Manifesto. They suggested a limit of 2 rooms. As we see it, a "rooms" limit would be an important presentational feature of a "rent-a-room" type relief, even if there was also some monetary limit; it would be an, admittedly crude, way of signalling that the relief was aimed at spare rooms and not at, for example, single people who have large Victorian houses, live on the ground floor, and turn the rest into bedsitters.

20. If there were to be a rooms limit, we suggest that 2 rooms

would be the right number. To go for a higher number would be moving away from the spare room/de minimis concept. Moreover it could create the anomaly that the marginal rate of tax on those who chose to let a room over the limit, would be 100 per cent. Suppose that a person has 4 rooms in his house, potentially capable of being let as bedsitters, each at £50 a week. He is a basic rate taxpayer. If he lets 2 rooms, the rent of £100 is exempt. If he lets 3, (and 2 rooms is the limit) the rent of £150 is fully taxable - say, (ignoring expenses) £35 tax; so in effect he keeps £15 of the rent from his third room. But if he lets 4 (and the limit is 3 rooms), the rent of £200 is fully taxable, and the tax is £50; so he gains nothing and may be worse off taking in an additional lodger.

21. Assuming there were to be a monetary limit as well, it could be argued against a rooms limit that it would be unreasonable to refuse relief to someone who happened to be able to let out, say, 5 rooms for a total rent which was within the monetary limit. Why should he only get relief on the income from 3 out of the 5 rooms? And it would be virtually impossible in practice to police a rooms limit.

Length of letting

22. We suggested last year that there might be a restriction of relief to lettings for continuous periods of more than 30 days. The aim would be cut out holiday lettings by owner-occupiers (and indeed other very short term commercial lettings, eg for the Wimbledon fortnight, if there were no other convenient way of excluding them). The difficulty would be that potentially homeless single people, whom the relief would be designed to benefit, could be said to need maximum flexibility of tenure (eg if they were travelling round looking for work). But - certainly with a "rent-a-room" scheme - we would recommend cutting out holiday lettings.

Monetary ceiling

23. Mr Taylor's note suggests that the level of such a limit should be based on real, market rates, and could be in the order of £90 to £100 per week. (His note, incidentally, refers to "an income limit per resident", but I have agreed with him that this should be taken as a reference to the individual landlord rather than the individual tenant - an income limit of £90 to £100 per tenant would amount to total exemption).

a. Level of the limit

24. As we said last year, this would need careful consideration, and it is a matter on which we should want to consult the DoE before we put any firm proposal forward. But some preliminary comments may be helpful.

25. First, we have made some tentative (and confidential) enquiries through the Valuation Office about levels of rents for furnished rooms in the London area. These enquiries reveal that the average week rental varies from some £35 a week in Barking, though £60 to £75 a week in Camden, to £100 and over in Westminster and Kensington. This seems to suggest that on the basis of real market rates a figure of around £75 would be nearer the mark. But of course that takes no account of wider regional variations.

26. Second, we should need to bear in mind the position of husbands and wives after independent taxation, (and unmarried sharers). If a husband and wife owned a house jointly (as joint tenants or tenants in common) or shared a tenancy of a long leasehold property), both would presumably count as landlords in relation to any lettings in their house. If they - and unmarried sharers/owners - were each to have their own limit, that would be an argument for restricting it - but would that then be fair to single landlords?

27. Finally, should any limit apply to gross or net rents? If net, the limit could be set at a lower figure (though I am not sure how easy it would be to arrive at a figure for average expenses). There would be a clear presentational advantage in taking gross rents, because then potential landlords would be able to see how they were placed from the outset; but it might then be right to restrict relief for expenses, on a proportionate basis, where some rent was chargeable because it exceeded the limit.

Resident or non-resident landlords?

28. There are two final points on scope. Mr Ridley's letter referred to resident landlords, and I have written this note on the basis that Ministers are interested only in a relief for landlords who live in the same premises as those in which they are letting residential accommodation. But Mr Taylor's note refers to residential landlords, and if a relief were to extend beyond the simple "rent-a-room" concept there would clearly be an argument for extending it also to non-resident landlords who provide a variety of accommodation (including furnished bedsitters) in houses separate from their own homes. The Leeds Residential Property Association, for example, who have been complaining regularly that they did not benefit from the furnished holiday letting legislation, despite the fact that much of their accommodation is let to young single people, would no doubt complain if they were left out of any relief for residential landlords as well.

Furnished or unfurnished?

29. We would see no difficulty, with a rent-a-room type of relief, in confining relief to furnished letting.

Conclusions on scope of relief

30. The crucial preliminary question, as I have said, is how widely Ministers see this relief going - whether it is just "rent-a-room" or a much wider type of relief - and if, as we suspect, it is "rent-a-room", how easy they judge it to be to defend any the various sorts of limitation which would be needed. As we said last year, an exemption for any form of rental income is a novel departure and, as always, the complaints of those who find they will not benefit will be very much louder than the thanks of those who find they do. And if the declared policy objective is reducing homelessness, it is difficult to see any convincing reason for favouring one sort of letting over any other.

31. The initial question on which we should be grateful to know Minister's views is, therefore, whether we are thinking of, say -

Option A

- an exemption, up to a monetary ceiling, of income received by owner occupiers or tenants from letting up to 2 rooms in their homes, for periods of more than 30 days (perhaps including a "sharing" test as a further restriction), - or, say,

Option B

- a much wider and different exemption, up to a monetary ceiling, of income received by any landlord who lives on the property, from letting either rooms or flats?

Staff costs

32. These would be likely to be negligible.

Exchequer costs

33. These would obviously depend on the nature of the scheme. An exemption for the first £3,000 of income received by resident landlords might cost some £10-12 million in 1989-90. All of this would be deadweight. If the relief extended much wider, eg to hotels and non-residents landlords, the cost would rise considerably.

M J G ELLIOTT

Inland Revenue

BUDGET CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: J ANNYS
DATE: 9 February 1989

PAYMASTER GENERAL

PRP : HEADQUARTERS CONCESSION (STARTER No 116)

1. You have agreed that action should be taken to allow employers to set up "headquarters" schemes based on profits of the whole undertaking. In drawing up the instructions for Counsel on this it has been appreciated that where two or more such schemes are based on the same profit and loss account problems of mutual deductibility may arise similar to that caused by the effect of employer's NIC (which we are legislating for in the minor changes package agreed at your meeting on 18 July last year).

2. In this case the problem is that PRP paid under any headquarters scheme cannot easily be calculated until PRP from any other scheme based on the same profit and loss account is known.

3. You will wish to be aware that we are instructing Parliamentary Counsel to provide that, similar to the NIC solution, PRP and employer's NIC on that PRP may be calculated before any PRP payable under another headquarters scheme or schemes based on the same profit or loss account is taken into account.

---

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Mr Monck
Mr Burgner
Mr Burr
Mr Culpin
Mr Gilhooly
Ms Young
Mr Painter
Mr Lewis
Mr Farmer
Ms Fairfield
Mr Annys
PS/IR

4. We are not proposing to extend the same approach for 'conventional' schemes based on the same profit. This would, we think, lead to abuse by giving some employers the facility to cream off the profit into the headquarters scheme first and leave little or no PRP to be paid from the conventional scheme. PRPO experience suggests that this could be the aim of some employers who might set up headquarters schemes merely to get round the similar terms rule.

5. We should be grateful to know whether you are content with our proceeding in this way.

J. Annys.

J ANNYS

chex.pj/jc/9.2.1

BUDGET CONFIDENTIAL

For [illegible]

CHAPLIN → FST 9/2

FROM: MRS JUDITH CHAPLIN
9th February 1989

FINANCIAL SECRETARY

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

PS/IR
Mr Isaac)
Mr McGivern) IR
Mr Elliott)

TAX RELIEF FOR RESIDENTIAL LANDLORDS: "RENT-A-ROOM"

I have seen Mr McGivern's and Mr Elliott's minutes. One of the issues they raise is whether the relief should be for a "rent-a-room" scheme or for a wider type of relief. I hope the relief, if it is given, will be for a "rent-a-room" scheme in the landlord's own home. I do not think it would be difficult to defend this limitation, for the point of the scheme would be to encourage additional accommodation on to the housing market. Those owning boarding houses or flats, or the accommodation provided by the continuously prayed-in-aid Leeds Residential Property Association, are unlikely to leave it empty as they would almost certainly be incurring running costs and will have incurred capital costs previously. The need for a return would ensure that these properties are let and there is no need for a tax relief to encourage them, whereas to keep a room unused in one's own home does not incur additional expense and the relief would be to encourage the letting of such rooms.

2. It is not clear to me why there needs to be more than a simple monetary limit if it is kept relatively low. Those who earned more than the limit from letting rooms would be totally excluded from the scheme. I think it illogical to argue that this would encourage people to let up to the limit but not beyond. If the limit is, say, £75 a week of gross income (the equivalent of two rooms in much of the country but probably only one in London), a landlord would still get more by letting a third room and paying

tax on the whole of his letting income (even before expenses were deducted) than he would from sticking with the two rooms. If the number of rooms is specified there will be endless arguments about different room costs in different parts of the country, and there would have to be a variable monetary limit.

3. I would have thought that a low enough monetary limit would remove the need for details about whether the accommodation is shared or self-contained or other precise definitions. The owners of "large Victorian houses" and boarding houses would then be ruled out unless they were singularly unprofitable ones. However, there may be cunning methods of tax avoidance which in my innocence I have failed to spot, but I am sure the simpler the scheme the better.

4. I think it unlikely that such a relief will bring a flood of new rooms available for rent on to the housing market. For one thing many rooms are already let like this undeclared, but once it was legal without involvement with the Revenue I think there would be a worthwhile increase. Bodies such as the CAB and the university accommodation officers could give publicity for the scheme - indeed it could help with the problems that students are going to face once they lose housing benefit.

JC

JUDITH CHAPLIN

FROM: FINANCIAL SECRETARY
DATE: 8 February 1989

CHANCELLOR

cc 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 Jaundoo)
PS/IR

OK.

STARTER 261: IHT - INSTRUMENTS OF VARIATION

You will recall that you asked me, in the light of Andrew Tyrie's minute of 19 January, to decide whether we should go ahead with this starter. Having had further discussions with officials, I believe we should. Although not the most pressing issue in the world, I believe the original arguments set out in my minute of 28 November still stand, and I have instructed officials to proceed on this basis.

NORMAN LAMONT

FROM: FINANCIAL SECRETARY
DATE: 8 February 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Mr Anson
Mr Monck
Mr Gilhooly
Mr S Wood
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Pitts) IR
Mr Gordon)
PS/IR

Ch, Agree? Agreed –

[The answer to your question behind, is apparently that gifts not to individuals did not have their tax removed, because the "non individuals" would never die (+ ∴ IHT could not be levied on them.] NBW.

STARTER 263: RURAL HOUSING ASSOCIATIONS

I believe we should go ahead with this Starter. While we don't have evidence of a problem, DoE believe strongly that the rules are inhibiting below-market disposals of land to rural housing associations, and hence putting a block on efforts to improve the supply of low-cost housing. Nick Ridley mentioned it to you recently, and Malcolm Caithness has since written to me about it.

With charitable housing associations, there is usually no problem; transfers to them are generally exempt from IHT, and charged to CGT on no more than the disposal proceeds (rather than the usual market value). But for non-charitable housing associations there are immediate CGT and IHT charges; though they might well of course be mitigated in some cases by rollover relief and/or agricultural property relief.

I therefore propose to legislate to remove, for below-market transfers of land to non-charitable housing associations, the possibility of an IHT charge based on market value; and to ensure that any immediate CGT charge on such transfers arises on an amount no greater than the disposal proceeds. This will put charitable and non-charitable housing associations on the same footing. The

Original proposal was for this relief to be extended only to rural housing associations. But defining "rural" would not be easy; and it would be difficult to justify excluding urban ones. I therefore recommend it should apply to all non-charitable housing associations.

There will remain a possible CGT charge for non-charitable housing associations if they themselves dispose of the land. But I understand this is not a problem.

R.C.M.S.

pp **NORMAN LAMONT**

FROM: J M G TAYLOR
DATE: 9 February 1989

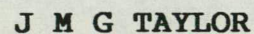
PS/FINANCIAL SECRETARY

cc 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 Jaundoo - IR
PS/IR

STARTER 261: IHT - INSTRUMENTS OF VARIATION

The Chancellor has seen the Financial Secretary's note of 8 February. He is content with the Financial Secretary's decision to proceed with this starter.



J M G TAYLOR

chex.ps/jmt/9 BUDGET CONFIDENTIAL

Can I see PPS PA
JM

FROM: J M G TAYLOR
DATE: 9 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Anson
Mr Monck
Mr Gilhooly
Mr S Wood
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Pitts - IR
Mr Gordon - IR
PS/IR

STARTER 263: RURAL HOUSING ASSOCIATIONS

The Chancellor has seen the Financial Secretary's note of 8 February. He agrees that we should go ahead with this starter along the lines proposed by the Financial Secretary.

J M G TAYLOR

FROM: FINANCIAL SECRETARY
DATE: 10 February 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

Ch/ Agree FST?
10/2

Agreed

STARTER 110: TAX TREATMENT OF LUMP SUM TERMINATION PAYMENTS TO EMPLOYEES

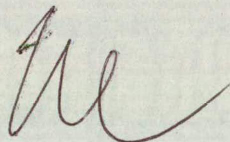
I have discussed Mr Lewis' note of 2 February with officials.

You will recall that both the Paymaster General and I originally favoured Option 3, taxing payments above £30,000 on a stamp duty "slab basis". But the point raised by the Paymaster General about whether people could avoid the charge by taking only £30,000 of the payment as a lump sum and the rest as income seems insurmountable. Reluctantly therefore, I believe we have to drop this option.

Of the two other possibilities canvassed by the Revenue, I do not favour the "exceptional pay" approach. But I am quite attracted to the idea of withdrawal of relief based on a threshold combining the lump sum and pay over the previous 12 months. It takes us back towards the old option 2 of taxing all lump sum payments as income; but without some of the harshness of that regime, since its effect would be that only those on higher incomes would pay tax on the lump sum.

However, it would require substantial further work in order to get this option into shape for this year's Finance Bill. Moreover, we would need a PCTA Resolution for this to go ahead; so everything would have to ready by Budget Day. Pressure for change in this area is not very great. I therefore recommend we defer legislation this year and work up this option as a proper starter for next year's Bill.

Such a course of action would of course alleviate a little the current pressures on drafting. But it would not affect the Parliamentary pensions issue; the combined pay and lump sum threshold would be some way above the meagre returns which Government office provides for us!



NORMAN LAMONT

Inland Revenue

CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: MRS A C MAJER
DATE: 10 February 1989

1. MR FARMER

2. FINANCIAL SECRETARY

ELECTRICITY PRIVATISATION : EMPLOYEE SHARE OFFERS (STARTER No 455)

1. My minute of 31 January explained that the final form and consequently the publication of draft clauses on Starter No 114 (the technical improvements to the Finance Act 1988 employee priority legislation which arose out of the British Steel flotation) had been delayed because the Department of Energy (DEn) are still considering various alternative methods of flotation and different approaches to employee participation in the electricity privatisation. I undertook to advise further once their intentions became clearer.

2. You have already agreed (Mr Satchwell's note of 21 December) the different legislative changes which you would accept to facilitate employee share offers under either of the first two alternative methods of flotation which DEn had by then put to us - separate simultaneous flotations of the 12 distribution companies or the offer of 'Distribution Shares' (DS) each representing one underlying share in each of the 12 distribution companies (and each being capable of subsequent 'conversion' or 'explosion' into shares of particular distribution companies).

---

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

3. At the end of January DEn informed us of a third option which Mr Parkinson has asked to be studied - a 'Combined method', which would embrace 12 separate sales of the distribution companies and the simultaneous sale of an "industry share" representing a package of shares in the 12. The IS would differ from the DS in that the 12 company shares would be floated at the same time and no conversion option would attach to it; but like DS it would have a limited life. We understand that the DS scheme itself will now be dropped. Mr Williams of Treasury is today minuting the Chancellor on these latest proposals.

4. Our concern here is the prospect now that a final decision on which flotation method is to be used is likely to be delayed at least until early March. This means that the shape of the likely employee share offers will not be decided for some time, and therefore it will be some weeks yet before it is possible to determine what precise legislative changes to facilitate these offers may be necessary and acceptable. This in turn could well mean that it would be too late to include such changes in the Electricity Bill or possibly in the Finance Bill as published. (We are advised that the former is scheduled to complete its Committee Stage in early March and its Report Stage in the last week before Easter.)

5. The employee share offer requirements at present appear likely to consist solely of changes to the provisions relating to tax exemptions for employee "priority". It is likely that any other tax-related changes would be confined to SD/SDRT. If the Electricity Bill is ruled out we shall try to include the changes in the Finance Bill as published if possible, but it looks as though Committee Stage amendments will be necessary.

i. What would be the effect of placing these tax changes in the Finance Bill only by amendment at Committee Stage?

Their belated appearance in this way, especially when the Bill as published already contained provisions touching on similar matters (as with employee priority) would throw them into prominence and could provoke debate.

ii. What does this mean for the commitment to publish draft clauses (on employee priority) in advance of the Finance Bill - Mr Satchwell's note of 6 February?

The choice here appears to be between

a. publication now - ie just as soon as we have the changes announced in October in final legislative form - which implies the subsequent appearance of further changes either (just conceivably) in the Finance Bill as published or in Committee Stage amendments; or

b. acceptance now that publication of draft clauses in advance of the Bill will not be possible.

Summary

6. Clearly from the standpoint of the orderly presentation and passage of the tax-related legislation necessary for electricity privatisation, the earlier decisions on the method of privatisation and the shape of employee offers can be taken, the better. That apart, we recommend publication of the draft clause by Press Release as soon as possible, since it is unlikely that the electricity component of the legislation will be ready for inclusion in the Finance Bill as published. This should be possible in the next 10 days or so, subject to final consideration of the draft clause by Parliamentary Counsel.

We should be grateful to know if you are content. If so, we shall submit a draft Press Release shortly for your approval.

A C Majer

MRS A C MAJER

FROM: FINANCIAL SECRETARY
DATE: 10 February 1989

CHANCELLOR

cc
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins - OPC

Mr Isaac)
Mr McGivern) IR
Mr Elliott)
PS/IR

See also FST's personal note, behind, + Andrew Tyrie's note behind.

STARTER 217: TAX RELIEF FOR RESIDENTIAL LANDLORDS - "RENT-A-ROOM

I have discussed the various papers on this starter with officials.

In order to go ahead with this, I believe we need to have as simple a scheme as possible. That suggests:-

1. no limit on the number of rooms;

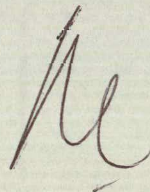
2. a simple monetary limit with no marginal relief above that;

3. excluding genuinely self-contained flats;

4. building on the existing DoE definition of "shared accommodation";

5. applying it to both owner-occupiers and tenants who sub-let.

That would give a rough-and-ready, if rather harsh, regime. It would not eliminate all of the "Nabarro" problems. But it would be relatively easy to understand; and it might be more easily defended against annual pressure from outsiders for a widening or deepening of the relief.



NORMAN LAMONT

Robert 02.10.2.89

BUDGET CONFIDENTIAL
PERSONAL

FROM: FINANCIAL SECRETARY
DATE: 10 February 1989

CHANCELLOR

STARTER 217: TAX RELIEF FOR RESIDENTIAL LANDLORDS - "RENT-A-ROOM"

I remain very sceptical about doing this, for four reasons;

- any cost would be mostly deadweight, Even Judith Chaplin, probably this idea's keenest supporter, does not expect much increase in the supply of rooms available for rent;

- the scheme, even my proposed "simple" version, will be messy, complicated and have politically difficult rough edges;

- do we want "yet another tax relief for housing"? I know we are none of us saints where tax reliefs are concerned. But we've just done BES for assured tenancies; and there is no "level-playing field" argument of the same weight as that in the savings area;

- is it worth doing something which will merely legalise part of the black economy?

Why don't we just have an undramatic Budget?

NL

NORMAN LAMONT

cst.rj/docs/10.2.1

BUDGET CONFIDENTIAL

FROM: **A G TYRIE**
DATE: **10 February 1989**

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Call

Mr Isaac
Mr McGivern

TAX RELIEF FOR RESIDENT LANDLORDS

Mr McGivern's note of 8 February and Judith's of 9 February make me wonder whether this concession is worth the candle.

2. The minor hassles set out move me from being neither for nor against the scheme to being unenthusiastic. The main reasons why I was not an ardent supporter (last year or this) are:

- I don't believe that this measure would result in a lot of additional accommodation. The taxation of rented income is not a big deterrent. The main deterrent to the growth of this market is people's fear that they couldn't get rid of their tenants. The latest Housing Act gives landlords all the protection they need: our main task must be to get that message across.

- There would be more merit in this scheme if it could be used as a means of giving a time-limited "kick start" to the change in attitudes required. BES fitted this bill and is time limited to 5 years. I think it would be extremely difficult to claw back the granting of relief in this area in a few years time. Rather the contrary, I think it is likely we would be pressed into making further concessions at the margin.

3. So, all in all, I am mildly in favour of dropping this starter.

A G TYRIE