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1988 BUDGET

3.2.89

BUDGET SECRET:TASK FORCE LIST

NEWS RELEASE

No [ ]/88 15 MARCH 1988

BUDGET 1988:HYDROCARBON OILS

UNLEADED PETROL:INCREASED DUTY DIFFERENTIAL

In his Budget Statement today, the Chancellor of the Exchequer announced that there would be no change in the excise duty on unleaded petrol, while the duty on leaded petrol would increase by 5.6p a gallon. This increases the duty differential in favour of unleaded petrol from 5p per gallon to ~~about 10.7p~~ nearly 11p per gallon, (~~2.3p~~ 2p per litre) including VAT. Garages stocking unleaded petrol should now be able to price it comfortably below their 2 star petrol.

Operative date: The increased differential applies from 18.00 hours today when deliveries from refineries and bonded warehouses of leaded petrol will be charged at the new rate.

Definition: "Unleaded petrol" is defined as petrol containing not more than 0.02 grams of lead per litre (0.013 grams per litre from 1 April 1990).

Budget Notice: Details of the changes are given in Budget Notice BN 3/88.

BACKGROUND NOTE

As a result of a United Kingdom initiative, European Community law (Directive 85/210/EEC) now requires unleaded petrol to be generally available throughout the Community by 1 October 1989. Member States are to take appropriate steps to ensure its balanced distribution and to encourage its use. In last year's Budget the Chancellor introduced a duty differential of 5p per gallon in favour of unleaded petrol, to encourage wider distribution and uptake by offsetting its higher production costs. This change in taxation was fully reflected in pump prices, and allowed garages stocking unleaded petrol to price it typically 0.5p per gallon below their 4 star petrol.

In the year following introduction of the differential, the number of garages in the UK stocking unleaded petrol has increased from about 200 to over 700, and information about unleaded petrol and the vehicles which can safely use it has become widely available. However, unleaded petrol still accounts for less than 0.1 percent of total petrol consumption. The increased duty differential should encourage a further increase in outlets, and stimulate sales. Garages stocking unleaded petrol should now be pricing it comfortably below their 2 star petrol and the number of cars using unleaded petrol should increase significantly. Most cars currently running on 2 star petrol can use unleaded petrol without adaptation, and the number of new cars specifically designed to run on unleaded petrol is increasing. Many cars currently running on 4 star petrol can also readily be adapted by motor dealers to run on unleaded petrol.

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BUDGET SECRET - TASK FORCE LIST

No. [ ]/88 15 MARCH 1988

Change in structure of duty for beer + coolers?

BUDGET 1988: ALCOHOLIC DRINKS

INCREASES IN DUTIES ON BEER, CIDER AND PERRY, WINE AND MADE WINE

In his Budget Statement today, the Chancellor of the Exchequer announced increases in the excise duties on certain alcoholic drinks. The duty increases (and consequential additional VAT) are equivalent to:

Beer:	[ ]	a pint of typical beer
Cider:	[ ]	a pint
Table wine and made-wine:	[ ]	a 75cl bottle
Sparklng wine and made-wine	[ ]	a 70cl bottle

There will be no change in the duties on spirits or fortified wines.

Operative date: The changes will apply to goods cleared from 6pm today.

Revenue effect: The estimated revenue yield from these changes is £[ ] million in 1988-89.

BUDGET SECRET - TASK FORCE LIST

Budget Notices: Full details of the duty changes are given in Customs and Excise Budget Notices BN [ ]/88 for beer, BN [ ]/88 for cider and perry and BN [ ]/88 for wine and made-wine.

BUDGET SECRET - TASK FORCE LIST

NOTE TO EDITORS

The ~~main~~ duty rates are as follows

		Old (£)	New (£)
Spirits	per litre of alcohol	15.77	[ ]
Beer	per hectolitre	25.80 plus 0.86 for every degree of original gravity above 1030°	[ ] plus [ ] for every degree of original gravity above 1030°
Wine and made-wine	per hectolitre		
Light		98.00	[ ]
Medium		169.00	[ ]
Heavy		194.90	[ ]
Sparkling		161.80	[ ]
Cider and perry	per hectolitre	15.80	[ ]

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BUDGET CONFIDENTIAL

HM CUSTOMS AND EXCISE

NEWS RELEASE

No [redacted]

which took account of many useful comments from trade and professional bodies.

March 1988

VAT: REVIEW OF CIVIL PENALTIES

The Chancellor of the Exchequer announced in his Budget today a package of proposed changes to most current VAT penalties, as well as a number of technical changes to clarify the law.

The proposals, which

The proposals~~, which~~ follow a review of the 1985 Finance Act VAT penalties by HM Customs and Excise, ~~will~~ mostly be to the advantage of traders, especially small businesses, are as follows:

VAT REVIEW OF CIVIL PENALTIES

Late registration penalty

The structure of the penalty imposed under s15 of the Act has been changed to a tiered, time related, provision and the rate of penalty on the net tax due (output tax less input tax) eased from the single rate of 30%. The revised rates are:

belatedness not exceeding nine months	-	10%
belatedness exceeding nine months but not exceeding eighteen months	-	20%
belatedness exceeding eighteen months	-	30%

The new penalty rates will be applied from 16 March. The old fixed rate of 30% will be payable on the net tax due up to and including the 15 March and the new appropriate rate to the net tax due after that date. The minimum penalty of £50 will be retained.

The provision, in s18(2) of the Act, which would have made it necessary to charge default interest on tax arrears already subject of the late registration penalty will be repealed.

Reasonable excuse

A Public Notice about the late registration penalty and giving guidance on what might be, and what is not, a reasonable excuse will be published in the Summer. Meanwhile the text of the notice will be available shortly from local VAT offices. Similar guidance will be given in the Spring in 1989 when the default surcharge system has been reviewed. In due course guidance will be available about the serious misdeclaration penalty.

Unauthorised issue of tax invoices

Under s15(1)(b) of the Act persons who were not registered for VAT but nevertheless issued tax invoices were liable to a penalty of 30% of the tax involved or £50 per invoice, whichever was the greater. The provision has been changed so that the penalty is now 30% of the tax involved subject to a minimum penalty of £50 regardless of the number of invoices involved. This change relates the penalty to the offence.

Regulatory penalties

The daily rates of penalty for regulatory offences imposed under s17(1) of the Act have been halved to £5, £10 and £15 a day. Additionally a maximum penalty of 100 days at the appropriate rate and a minimum penalty of £50 are introduced. It will be a statutory condition that a penalty can be imposed only if the registered person concerned has been given a written warning in the two years preceding the assessment. Previously the amount of penalty was unlimited; the changes consolidates the Commissioners previous practice of issuing a warning letter before imposing a penalty and introduces statutory minimum and maximum amounts.

Technical changes have been made to ensure that where registered persons are required to notify changes in their activities there is also a sanction for failure to so notify.

Serious misdeclaration penalty

The serious misdeclaration penalty will not be implemented until late 1989 but in anticipation the complicated third objective test contained in s14(2)(b) of the Act will be repealed. This test was to have been applied automatically. Apart from its complexity the test would have applied only to smaller businesses.

A new tax geared penalty is, however, proposed in clause 14 of the Finance Bill to deal with persons who, despite a previous written warning, persistently underdeclare or overclaim tax. The penalty will not be imposed automatically, and may only be assessed when there have been 2 previous failings within a period of two years and a written warning has been issued. The rate of penalty is 15% of the tax involved.

However, underdeclarations and overclaims which are either voluntary disclosures, or the amount involved is less than a specified amount will not count as previous errors.

Voluntary Disclosure

With the introduction in late 1989 of the serious misdeclaration penalty it will be necessary to introduce a new VAT Return form and a revised method for adjusting errors made on previous returns. This is because of the need to know the true tax liability in an accounting period. This will require notification to the local VAT office on each occasion an error is found. However, in order to facilitate voluntary disclosure of minor errors, registered persons will be permitted to declare amounts, not exceeding £500 in total, in their VAT Account. It is a contingent requirement of the concession that any adjustments made in the VAT Account shall be treated as tax due in the period in which it is declared. It is also intended that, when the Default Interest provisions are introduced in late 1989, the Commissioners will not assess for interest such sums which are correctly adjusted in the VAT Account. It is particularly relevant that there is no liability to the serious misdeclaration penalty or the proposed penalty for persistent misdeclaration if an error is 'voluntarily declared' to Customs and Excise before an official visit has been notified. The overriding objective of these provisions is to encourage candour between the taxpayer and the tax collector.

Repayment Supplement

The level of error on a repayment return above which eligibility to a repayment supplement ceases has been increased from £100 to £250 or 5% of the amount of the claim, whichever is the greater. It has also been decided that where an overclaim of tax is found after payment of the claim, Customs and Excise will in future recover any excess supplement paid if this is more than £30.

Local Authorities and similar bodies

It is proposed that Local Authorities and similar bodies who are **both** registered for VAT **and** who receive refunds of tax under s20 of the Value Added Tax Act 1983 should be eligible, subject to the usual conditions, to receive a repayment supplement on the full amount of their claim. Previously these bodies were only eligible for a supplement in respect of the tax repayable on their business activities. This change saves the bodies having to separately account for their business and non business activities and, for them, extends significantly the scope of the repayment supplement provisions. However, these same bodies will also be liable, as are all other registered persons, to the serious and persistent misdeclaration penalties on the full amount of the errors they make. These arrangements will not apply to small unregistered councils and the like who receive only refunds of tax under s20 of the VAT Act 1983.

Technical amendments

Technical amendments are proposed to the powers of Customs and Excise to assess tax and the manner in which debits and credits in a persons account are adjusted. The changes permit assessment of tax for the accounting period in which the error occurred or, where a credit has been erroneously taken under the voluntary disclosure arrangements. A separate change to the accounting arrangements permits the Commissioners to adopt the commercial practice of striking a balance between all types of debits and credits in a registered persons account and to arrive at a net balance either due or repayable.

BACKGROUND NOTES

The civil penalty system was introduced by the Finance Act 1985 and replaced criminal prosecution in the courts for all but the most serious fraud. This system was itself the result of recommendations made by the Keith Committee. The object of the civil penalty system, including the default surcharge, is to encourage persons to register at the proper time and when registered to furnish returns and pay any tax due promptly. The serious misdeclaration penalty and the default interest provisions are to be introduced in late 1989, and are intended to improve the accuracy of the returns. The package of measures is aimed at reducing the amount of tax remaining unpaid by at least £600 millions in the first five years of operation.

The white paper "Building Businesses .... Not Barriers" (May 1986) announced a review of the civil penalty system which Customs and Excise undertook in the autumn of 1987. The review, which took on board a considerable volume of comments and criticisms from trade and professional bodies, was considered by Ministers and changes agreed for implementation in the Budget. The review included the default surcharge but there has been insufficient experience of it to reach satisfactory conclusions. Therefore it has been decided to separately review the surcharge system before the 1989 Budget. The provisions for dealing with serious fraud (the civil evasion penalty in s13 of the Finance Act 1985) will be subject of a further review in 1990, and the serious misdeclaration penalty in 1992 when sufficient experience of the working of those provisions has been obtained.

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[BUDGET CONFIDENTIAL]

No /88 15 March 1988

BUDGET 1988 : VALUE ADDED TAX

CHANGES IN THE LIMITS FOR REGISTRATION AND CANCELLATION OF REGISTRATION

In his Budget Statement today, the Chancellor of the Exchequer announced changes in the turnover limits for VAT registration and cancellation of registration. The details are:

<u>Registration</u>

- From midnight tonight the annual registration limit is being increased from £21,300 to £22,000.

- From the same time, the single quarterly limit is also being increased from £7,250 to £7,500.

<u>Cancellation of registration</u>

- From 1 June 1988, the limit will be increased from £20,300 pa to £21,100 pa (excluding VAT) for persons considering cancellation of their registration on the basis of their expected future annual turnover.

- It is estimated that as a result of this change a further 16,000 persons will be eligible to request cancellation of their registration.

BUDGET NOTICE

Details of the changes in the registration and cancellation limits are in Budget Notice BN 1/88, copies of which are available from all local VAT offices.

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[BUDGET CONFIDENTIAL]

HM CUSTOMS AND EXCISE

NEWS RELEASE

No /88 15 March 1988

BUDGET 1988: VAT AND SELF-BILLING

It was announced in the Budget today that from Royal Assent, the customer will be responsible for the correct VAT liability of a supply if he issues a tax invoice to himself for supplies he receives under a self-billing arrangement.

If a self-billed invoice shows the wrong VAT liability, Customs and Excise will then be able to assess him for the tax.

Currently the supplier is responsible for the correct tax liability of a supply even if the customer is allowed to make out the invoice.

BACKGROUND NOTES

Self-billing is a procedure where the customer makes out the supplier's tax invoice and sends it to the supplier with payment. It is a long established commercial practice in, for example, the construction industry, scrap metal business and paying authors' royalties. It pre-dates VAT and was allowed to continue when VAT was introduced. The customers who are allowed to use the facility are formally approved by Customs and Excise and must comply with conditions.

Problems can occur where tax should have been charged on a supply and this tax is not reclaimable by the customer. An example would be in constructing new houses; they are zero-rated, but tax on items not normally installed, such as carpets, washing machines and refrigerators, cannot be reclaimed by the builder. If he were to self-bill these items at the zero-rate the only current course would be to assess the sub-contractors for underdeclared tax. The change announced today means that Customs and Excise will be able to assess the builder for the tax.

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2. The abolition of COBO will only directly affect the ability of overseas borrowers to issue deep discount sterling bonds in the UK, although in practice the Bank have also discouraged such issues overseas. However, tightening up the tax rules just for these issues will confer a significant, comparative tax advantage on bonds issued outside the UK and we might expect a flood of such issues - possibly in other currencies as well as sterling - specifically angled at UK investors. So this is also an opportunity to review the treatment of deep discount bonds generally, to see whether the present variety of taxing methods can and should be rationalised.

3. The background and the present tax rules applying to bonds with different features are summarised in Annexes A and B. For ease of reference, the existing tax arrangements and the proposals for reform are tabulated in Annex C.

4. Briefly, current tax rules would mean that any deep discount bond issues made possible by the abolition of COBO would receive a treatment which allows the conversion of income into capital for tax purposes. This arises because, unless such a bond is held to maturity, the discount element in the profit on its disposal is likely to be regarded as capital rather than income for tax purposes. Two main tax advantages flow from this. Firstly, although capital gains are now taxed at the same rate as income, a substantial advantage remains for the investor in the indexation provisions of the capital gains tax regime. Secondly, some bonds may be exempt from capital gains and so any profit will be tax free.

OPTIONS

5. There are two main approaches to revising the tax treatment of these foreign public sector bonds. They could be treated

a. in the manner of corporate deep discount bonds (ie the discount to be taxed as income and the residual treated as a capital gain or loss) - though this could only be applied to non-variable foreign deep discounts; or

b. on the basis that the whole profit on the disposal of all such bonds is taxed as income.

6. We examine each approach in turn.

Extending the 1984 corporate deep discount rules

7. The first approach involves amending, and widening out the scope of, the special 1984 regime for certain deep discount bonds issued by companies.

8. As explained in Annex B (paragraphs B7 and B8) this regime applies only to corporate issues which have no variable features. It was designed to encourage UK companies to borrow on favourable terms. In introducing the legislation Ministers emphasised that it was designed to give the corporate sector an avenue for raising finance which was denied to other issuers. Moreover the legislation was introduced after the issue of a consultation paper and discussions with representative bodies.

9. The essential advantage to the issuer lies in the allowance year by year against the company's taxable profits of the accruing discount. But the company does not have to account for that accruing discount to the investor until the bond matures. So, for example, on a ten year bond issued today, say at 50 and redeemable at 100, the company does not have to pay the premium of 50 until 1999. However, for the purposes of computing the company's profits chargeable to tax, the 50 is spread over the ten years. The appropriate portion calculated on a compounding basis is allowed as a deduction each year. Symmetry of tax

treatment is maintained by charging the accruing discount to income tax in the hands of the investor when he sells or redeems the bond. Any surplus or shortfall is treated as a capital gain or loss on which indexation relief is allowable - unless the bond is a qualifying corporate bond exempt from CGT.

10. In order to be able to calculate the accrued discount, it is essential that the yield on the bond be known in advance - which means there can be no variable features. The legislation requires that the yield and redemption details are stated on the bond certificate in advance by the bond's issuer. There has been difficulty in enforcing this requirement - especially since there are no penalties for non-compliance. However there is an incentive for UK companies to comply so as to ensure they do not put at risk the benefit of the generous relieving provisions.

11. For reasons largely of non-discrimination the 1984 rules apply also to non-variable deep discount bonds issued by <u>foreign</u> companies. As the taxation of a foreign company's profits is generally outside the net of UK tax, such a company has no incentive to comply with the certificate requirements. This puts the onus on the UK bondholder to provide details for the calculation of the accrued income. Errors and misunderstandings increase the Revenue's administrative costs.

12. However, applying the 1984 corporate rules to foreign <u>public sector</u> deep discount bonds would cover only non-variable issues. To go no further would achieve very little because foreign public sector borrowers would simply ensure that their bonds included a variable feature. The existing opportunities for investors to convert income into capital would continue.

13. A separate regime is therefore required for variable bonds.

CONFIDENTIAL

Taxing all profit as income

14. The alternative approach - b. in paragraph 5 above - is to see whether it is possible to design a new system for all deep discount bonds, except those which are at present within the 1984 regime for corporates, with a view to a regime which:

a. minimises the opportunities for avoiding tax by converting income into capital,

b. is clear and certain in its scope,

c. is cost-efficient for the Revenue to administer and for borrowers and lenders to comply with,

d. minimises further distortion of the workings of financial markets.

15. The clearest and simplest way of achieving these aims is by treating all the "profit" on the sale or redemption of a bond as income - ie. the whole difference between the price at which the bond is bought and the price at which it is resold or redeemed would be taxed as income. It would also imply that the bonds affected should be exempt from CGT (as we are separately suggesting for non-convertible sterling bonds generally - Mr Cayley's note on Starter 262).

16. The advantages of this approach are:

a. It avoids the problems involved in separating the accruing discount from the capital elements in the disposal profit.

b. It would ensure that, over the life of a bond, tax would be charged only on the difference between its issue price and its redemption value in exactly the same way as if it had been held to maturity.

c. By avoiding the distinction between income and capital, it minimises the costs to investors of attempting to circumvent it and to the Department of enforcing it.

d. It is simple and straightforward, and could be extended to cover other types of deep discount bonds.

17. The regime is a harsh one, and its effect would be to discourage such issues being made - unless they were angled only at overseas investors subject to a more generous tax regime. It would not be essential to restrict this "all profits as income" solution to variable bonds. It could also be applied to non-variables, leaving the 1984 legislation for corporate issues only, as originally intended.

Proposed approach

18. The choice is therefore either:-

a. to apply the 1984 regime to non-variable foreign public sector bonds and a new "all profits as income" regime to variables or

b. to leave the 1984 regime as it is, and to apply the "all profits as income" regime to all foreign public sector bonds whether variable or non-variable.

19. The advantages of a. are:

- It distinguishes income from capital in as many cases as is practically possible.

- Issuers who include non-variable terms will not be discriminated against compared with corporate issuers, or as compared with HMG (if the proposals for gilts below are adopted).

- It provides an option under which the harsh "all profits as income" regime can be avoided and some issues could be expected to take place.

- It provides equitable treatment between the corporate and non-corporate sectors.

20. The advantages of b. are:

- It treats all foreign public sector issues on the same basis.

- It avoids the need for detailed examination of the terms of issue and the possibility that a particular bond might fall into one or the other regimes on no more than a technicality.

- It preserves the 1984 regime for the corporate sector, and protects their competitive edge.

- It is likely in practice to deter overseas non-corporate non-variable as well as variable issues coming to the UK market.

21. Either approach is likely to be controversial and will open up a debate on the capital/income divide. Option b. would involve drawing a distinction between foreign corporate issues and foreign para-statal issues, some of which will have corporate form. Option a. is less draconian and, on balance, is the preferred solution to emerge from the discussions between the Treasury, the Bank and the Revenue. In effect, the 1984 regime would be open to non-corporate issuers who structure their issues appropriately. Otherwise, they will fall within the new "all profits as income" regime.

CONSEQUENTIALS

UK gilts

22. If the recommended option a. is accepted, the question arises whether the discount on UK zero-and low-coupon gilts could remain tax exempt. Ministers would be open to criticism for discriminating against similar foreign sovereign issues. The justification for the gilts exemption lies simply in their being a form of public borrowing.

23. The Bank and the Treasury believe the price advantage was, on average, sufficient to balance the cost of the generous tax regime. The net benefits of the gilts exemption to the Exchequer lay more in the opportunity it gave for tapping a specialised area of demand for gilts - no longer a material factor now that we are buying back gilts. The Treasury's view (which the Bank accepts) is that there should, in future, be no special treatment for gilts so that future issues of UK low-coupon gilts will be taxed in the same way as all other deep discount bonds (ie. the Government would be able if it wished to issue such bonds and to structure the issues so as to make its bonds subject to the 1984 tax regime).

Other variable bonds

24. Limiting the new regime to foreign public sector issues would still leave corporate bonds with variable features enjoying a comparative advantage. It would seem sensible, therefore, to consider closing this loophole also by bringing <u>all</u> variable deep discount bonds into the new "all profits as income" regime.

Foreign exchange gains and losses

25. There will also be an opportunity to tidy up the rather complicated rules by which transactions in foreign currency deep discount bonds are taxed. A UK investor wishing to hold, say, a dollar bond may first exchange into dollars; and, when he resells or redeems the bond, he may exchange out of dollars. The transactions of acquiring and disposing of foreign currency are a separate matter from the calculation of profit on the purchase and resale of the bond. And, however the dollar profit on the bond is taxed, any gain or loss on the associated foreign currency transaction is subject to capital gains rules.

26. The simplification would be to treat as income the difference between the sterling value of the bond at the exchange rate prevailing at the time of purchase and its sterling value when resold or redeemed (again at the exchange rate then in force). This would tax on the same terms all elements of the profit from holding those foreign currency deep discount bonds not covered by the 1984 legislation.

27. We do not envisage this simplification creating any difficulties for the wider review of foreign exchange gains and losses which is now in progress. The treatment of deep discount bonds is peripheral to the main issues in that review. So there would be no reason to delay its introduction until the review is complete.

Losses

28. Although, generally, a bond will appreciate in value over its life to reflect the accruing discount, there will be some occasions when it might be sold at a loss. An investor disposing of a bond within the 1984 regime will be taxed on the accrued discount. But the bond may be exempt from capital gains tax if

it is a qualifying corporate bond and so any capital loss will not be relievable. Similarly where an investor disposes of a bond covered by the new proposals, the profit will be taxed as income and the bond will be exempt from capital gains tax. There is no statutory basis for giving relief for any loss against income.

29. It is unlikely that investors will generally sell at a loss, and given the deterrent effect of the proposals we see no compelling reason to allow loses. There is a precedent in the offshore fund legislation for denying loss relief but charging the profit.

Capital gains tax

30. As mentioned in paragraph 15, taxing all the profit on a deep discount bond transaction as income would imply that the bonds involved should be exempt from CGT. If they were not exempt, they would give rise only to capital losses (attributable to CGT indexation) - never to capital gains - and there would be scope for exploiting this.

31. We are separately putting up a submission on the possibility of extending CGT exemption to all non-convertible sterling bonds - Starter 262. At present, the exemption applies only to qualifying corporate bonds - broadly, those issued in sterling either in the UK or by an issuer whose securities are dealt in on the Stock Exchange or unlisted securities market. If that extension went ahead, it would cover most of the <u>sterling</u> bonds in our proposal. We will need to ensure that all the remaining bonds within the proposal are exempt from capital gains tax.

INDEXED BONDS

32. One category of variable deep discount bonds which needs special consideration is indexed bonds. These are specifically excluded from the existing 1984 legislation (by a definition which is in very general terms). There is, of course, a considerable volume of indexed gilts in issue. There have been very few UK indexed issues apart from gilts, but there have been some foreign (at present all public sector) issues aimed particularly at the Lloyds market. While there would be a revenue gain from taxing indexed bonds like other variables and charging the indexed uplift to income tax, we do not imagine that Ministers would wish to charge the uplift on indexed gilts to income tax, given the general philosophy of capital gains indexation. Equally, we imagine that Ministers would want to provide similar treatment to securities issued by other borrowers which were on all fours with gilts. It would therefore be necessary to exclude indexed securities from the new treatment proposed for variable deep discount bonds and to leave them to be treated as capital gains (exempt in the case of sterling bonds, liable to CGT but eligible for indexation in the case of foreign currency bonds).

33. The question arises of how tightly you would want to define the let out for indexed bonds. The definition in the 1984 legislation is very general and would let through some bonds which do not particularly resemble indexed gilts - in particular some very short-term bonds. As you know, separately in the Lloyds context allegedly "indexed" bonds have been causing some problems. Some of these can be dealt with under the existing law, but it is probable that very short-term indexed bonds, having much the same effect, can be constructed so as to attract capital treatment. So it is for consideration whether you would want to define the exclusion for indexed bonds to cover only long-term bonds modelled closely on indexed gilts. This is

particularly relevant in the context of Lloyd's and Mr Johns discussed the possibilities in paragraphs 21 to 24 of his note of 15 December.

34. A number of conditions would have to be written into the legislation to define the features needed by an indexed bond before it would be exempted from the treatment proposed for other variable deep discount securities. The most important would be that there would be a minimum term to the first date where either the issuer or the investor could redeem the bond. Mr Johns suggested five years as the conventional dividing line between short and medium term gilts but, as he said, a shorter period would be sufficient to stop these bonds being an attractive tax saving device for Lloyd's. The Treasury and Bank of England would prefer any minimum term to be as short as possible in order to keep their options open for issuing fairly short term indexed gilts: the shortest indexed gilt to date had a six year term but they would prefer a minimum of no more than two years. Our own view is that three years would be the lowest which would be safe to prevent significant loss of tax.

35. As Mr Johns explained, the advantage of this approach is that it would prevent short term indexed bonds being used to convert income into capital for all taxpayers and would not be restricted to Lloyd's. However, Lloyd's are the main users. We would not suggest the risks of loss of tax through other taxpayers issuing such bonds were high enough to justify the extra complications of a tight definition of indexed bonds if you decided to adopt Starter 258 (Case 1 treatment for Lloyd's capital gains) which would end the loss of tax through Lloyd's use of indexed bonds.

YIELD

36. These proposals are essentially a preventive measure, designed to avoid the potentially large losses of tax which would result from the abolition of COBO, rather than to produce additional revenue.

37. Estimates of the potential losses if no action were taken would depend upon the precise assumptions which are made about how investors might switch their funds to take advantage of anomalies in the tax treatment of different types of deep discount bond - and about the responsiveness of borrowers in floating tax efficient issues. And they would also depend upon the nature of the measures adopted to deal with the indexed bond problem and Starter 258 (Case 1 treatment for Lloyd's capital gains). If you decide against taking action on Starter 258, the losses involved could then be of the same general magnitude as those estimated for indexed bonds - up to £50 million.

START DATE

38. The immediate need for new rules arises from the abolition of COBO. As the primary target is the bonds which could then be issued, the appropriate start date would be the date of the COBO announcement, on which the Treasury will be advising.

39. As regards bonds other than UK gilts, to distinguish between bonds issued before and after the start date would only encourage a market in the bonds of earlier vintage. The Revenue therefore recommend that the new provisions should apply to bonds disposed of after the start date. This coincides with the commencement rules being suggested for Starter 262 (CGT exemption of sterling bonds). But, as for that Starter, if that is felt to be too harsh, an alternative would be to give a year's grace and apply the charge for existing investors to disposals from a year after the start date. The Bank think that a year's grace should be given.

TRANSITIONAL ARRANGEMENTS

Existing issues

40. The question of transitional arrangements for investors in existing deep discount bonds arises in two cases only: low coupon gilts, and deep discount foreign currency bonds. There have been no deep discount sterling corporate issues other than under the 1984 regime, and overseas public sector deep discount issues have been blocked under COBO. Low coupon (ie deep discount) gilts pose the most difficult problems - partly legal, and partly of good faith.

UK gilts

41. There are about £2.5 billion of gilts originally issued as low coupon stock. These mature over the next 4 years - with the last one maturing in June 1992. When these gilts were issued they were bought in the expectation that the structure of the present tax regime would apply throughout their life (ie that only the coupon would be taxed as income), and this expectation was reflected in the price the Government was able to secure. (On average the Treasury and Bank believe the price advantage was sufficient to balance the cost of the generous tax regime.) To change the tax treatment during the life of an existing low coupon gilt would thus give the Government a double benefit, and would be regarded as a breach of good faith.

42. Moreover, we are advised that in this case the existing tax treatment is so fundamental to the nature of the stock that there is a significant risk that existing holders would be able to make a successful contractual claim against the Government, based on a breach of an implied term that the basic tax structure applicable to the stock when sold would remain substantially unaltered. This would be true even if some modest transitional arrangements

such as a 1 year grace period for existing stocks, or a grandfathering of existing holders, were introduced. The tax change would be likely to have a substantial impact on the market value of the stock. The argument here differs from that in 1985 when CGT was abolished on short-term capital gains on gilts - removing the possibility of establishing indexed capital losses to set against other CGT liabilities. In that case the change was expected to have only a very modest impact on the market value of stocks, and it was sufficient to provide for a 12 month grace period during which existing holders could if they wished realise CGT loses.

43. Our conclusion on gilts, therefore, is that the only safe course is to "grandfather" all existing low coupon gilts for the rest of their life, and to apply the new tax rules only to new issues.

Foreign currency bonds

44. Rather different considerations apply in the case of other existing deep discount bonds - ie deep discount foreign currency bonds. Here there is no possibility of a contractual claim against the Government, and no question of the Government's good faith being involved. If we wished to have some form of transitional arrangement, a 1 year grace period (or grandfathering existing holdings) should be sufficient. But as with Starter 262 - corporate bonds and CGT - there is a case for considering whether a grace period is really needed. The alternative would be the simple course of applying the change to all disposals on or after the start date. It would seem sensible for the decision here to be the same as for the commencement arrangements for Starter 262.

Subsequent issues of existing stocks

45. There is a difficult question of how to tax subsequent issues, made at a deep discount, of stocks that were originally issued at a shallow discount. This is likely to arise where there has been a sharp rise in interest rates since the original issue. Under the 1984 regime for corporate bonds, in theory a subsequent issue at a deep discount would be subject to the deep discount regime, even if the original issue had not been. But in practice, no such tranches have been issued.

46. While this has caused no real difficulties in the sterling corporate bond market, in constructing a regime for investments in foreign currency deep discount bonds we have to allow for the existence of subsequent issues of this kind. That is, we have to decide how we will tax UK investors in, say, US Government securities where the original issue was at a shallow discount but subsequent tranches had been issued at a deep discount. There are really only two practical options: to treat all investments in the stock as investments in a deep discount stock; or to treat them all as investments in the original parent, shallow discount, stock.

47. The former would be very hard on those who had bought the parent stock before the subsequent deep discount tranche had been issued. Moreover, there is no reason why either the taxpayer or the Revenue should necessarily be aware of the subsequent deep discount issues.

48. The latter could open the way to abuse: if interest rates rose, issuers might issue large extra tranches of existing shallow discount stocks specifically angled at UK taxpayers. We would, however, quickly come to know if this were happening, and we think the simplest approach is to provide that the tax treatment depends on the term of the original issue; but at the

same time to make it clear that we would monitor the situation closely, and that if there was evidence of abuse we would take steps to prevent it. Added protection would be given if we legislated that where the "tranchette" was bigger than the original issue deep discount treatment would be applied to both the original issue and the "tranche".

49. We think we should follow basically the same approach for gilts. That is the tax treatment of any new tranches would depend on the tax treatment of the parent stock. There is the additional argument here that if we did issue additional tranches at a deep discount the Government should get back in the price compensation for the subsequent tax foregone. In fact in current circumstances it seems most unlikely that the Government would want to issue tranchettes of this kind, and it would be possible to say, if Ministers wished, that we did not envisage doing so (other than in exceptional circumstances).

QUESTIONS FOR DECISION

50. The main points for decision are whether to:

a. widen the 1984 corporate deep discount legislation to include non-variable bonds issued by foreign public sector borrowers (paragraphs 7-12), and

b. put in place a new "all profit as income" regime for their variable issues (paragraphs 14-19);

c. extend the legislation to cover UK low coupon gilts (paragraphs 22-23); and

d. all other variable deep discount bonds (paragraph 24).

51. Subsidiary decisions are needed on:

e. foreign exchange gains and losses (paragraphs 25-27)

f. losses (paragraphs 28-29)

g. CGT exemption (paragraph 31)

h. indexed bonds (paragraphs 32-35)

i. start date (paragraphs 38-39); and

j. transitional arrangements (paragraphs 40-49).

B O'CONNOR

AMNEX A

ANNEX A

CONFIDENTIAL

DEFINITIONS

Deep Discount Bonds

A1. A bond is described as 'discounted' when the price at which it is issued is less than the amount received at maturity. It may be issued either at a 'deep' or a 'shallow' discount. There is no generally accepted distinction between the two. But the legislation affecting companies defines a discount as deep where:

a. it represents more than 15 per cent of the amount payable on redemption, or

b. it amounts to more than half a percentage point for each year of the bond's life.

A smaller discount is shallow. So, a bond issued in 1988 which will be redeemed on its tenth anniversary for £100 is a deep if issued for less than £95 and a shallow otherwise.

A2. Bonds issued at a deep discount will normally pay either a low rate of interest (as in the case of low-coupon gilts) or none at all (zeros). Thus a deep discount could be viewed as a substantial (or even a total) substitute for interest on a bond. In contrast, the discount on a shallow is mainly used to adjust the yield on a fixed interest rate bond to capital market conditions at the time of issue. The proposals in this paper cover only deep discount bonds as shallows do not offer significant special opportunities for tax avoidance.

A3. Deep discount bonds may be either 'non-variable' or 'variable'. Non-variable bonds are those whose coupon, redemption value and maturity date are all known at the time of issue. This allows the exact yield of such bonds to be calculated in advance. Bonds may be variable for a number of reasons. For example, the coupon may be variable; or the bond may incorporate options for early redemption with differing yields to each date; or the redemption value may be tailored to take account of intervening changes in interest rates, inflation rates or tax rates. Although the market will produce a price for a variable bond, reflecting current expectations about the eventual value of these variable elements, a unique yield to redemption cannot be calculated in advance. As a result devising tax rules for variable deep discount bonds is a much more difficult and complex task than for non-variables.

A4. Issues in London may be made, in any currency, by the UK government and by UK or foreign companies. Until COBO is relaxed, foreign governments and public sector organisations may not issue deep discounted bonds in sterling in London. UK local authorities are prevented from issuing deep discount securities under COBO and this embargo will continue.

A5. Deep discount bonds may be used as a form of finance in preference to more conventional bonds for a variety of reasons. They allow the borrower to delay much of the cost of servicing his debt - a useful facility where revenue from an investment is not expected for a number of years. They offer corporate borrowers who are UK taxpayers the benefit of generous relief provisions. And - the point which is important for present purposes - they can be a relatively cheap form of funding because of their attractions to investors - part or all of the discount may be treated as capital rather than income for tax purposes. Although income and capital gains are now taxed at the same marginal rate, indexation relief (and the exempt slice) mean that the effective rate on gains can be much lower than on income, easily half or less.

Foreign Currency Bonds

A6. Bonds denominated in or convertible to foreign currencies can be issued either in the UK or overseas by UK or foreign borrowers. Most UK investors are likely to hold sterling bonds but more sophisticated investors may well acquire foreign currency bonds. Unlike sterling bonds, the buying and selling of foreign currency bonds may involve an additional transaction, namely the conversion of funds into and out of the foreign currency. This has repercussions for the UK taxpayer because it complicates the measurement of income and gain. Regardless of the tax rules which apply to the profit on the purchase and resale of the bond in question, the foreign currency conversion is treated as a separate transaction and any gain or loss produced is subject to capital gains rules.

ANNEX B

ANNEX B

CONFIDENTIAL

TAX ISSUES

Taxation of Deep Discount Bonds

B1. The tax arrangements described here, as well as our proposals for reform, apply only to transactions by individuals and companies investing in bonds. (They do not apply to transactions made in the course of their business by financial traders - where the profit is chargeable to tax as trading income.)

B2. The present rules provide a variety of tax treatments for deep discount bonds according to whether they are issued by companies, by the UK government or by foreign governments; according to whether they are sterling or foreign currency bonds; and according to whether or not they incorporate variable features.

B3. In all cases any interest coupon is treated in the same way and taxed as income. No problem arises in that respect.

B4. It is the discount element where the complications arise. It may be treated entirely as income (for example, foreign government issues held to maturity); or entirely as capital (foreign government issues sold before maturity); or partly as income and partly as capital (company issues). And even where it is regarded as capital, the tax treatment may differ. In some cases, the gain is exempt from capital gains tax (UK gilts and "qualifying" corporate bonds - broadly bonds issued in sterling either in the UK or by an issuer whose securities are dealt in on the Stock Exchange). In other cases, it will be chargeable to capital gains tax, to the extent that indexation relief has not eliminated the gain; if the relief exceeds the gain it gives rise to losses (indexation losses).

B5. As a consequence, there are three broad categories of deep discount bonds - gilts, company issues and others - from the point of view of tax. We examine each in turn.

UK Gilts

B6. Under an exemption dating from 1973, the discount which arises when a UK gilt, except for Treasury Bills, is sold or redeemed is not taxed as income. In addition, all UK gilts have been wholly exempt from the charge on capital gains since 1986. This means that any gains are not charged. But it also means that any capital losses do not give rise to CGT loss relief.

Company Issues

B7. Legislation was introduced in 1984 with the specific intention of encouraging UK companies to borrow long-term funds from the public rather than from banks. It was designed to allow a company to claim relief each year for part of the total discount (on a deep discount bond issued by it) although it would pay the discount to the bondholder only when the bond was redeemed. The amount that can be claimed each year ("the accrued discount") is calculated according to a formula in the legislation. The formula relies on the bond having no variable features and its yield being known in advance. It can be denominated in any currency. Foreign companies may also issue deep discount bonds that fit these rules but, not being UK taxpayers, they do not benefit from the relief provisions - the main point of this legislation.

B8. The rules for taxing the investor ensure that the full amount of discount (for which the company receives relief) is taxed either at maturity or on prior disposal of the bond. If the bond is held from issue to maturity, the discount is taxed as income. If it is sold before maturity, then the discount element in the profit from the sale - which corresponds to the accrued discount for the time the investor has held the bond - is taxed as income. Any residual gain or loss is treated under CGT rules unless the bond is a qualifying corporate bond and thus exempt.

Other Bonds

B9. For all issues outside the scope of the 1984 legislation, the tax treatment is neither straightforward nor certain. This is partly because tax law is not sufficiently specific and partly because each bond issue can differ depending on, for example, the size of the discount, the amount of the coupon, the term of the bond and the credit worthiness of the issuer.

B10. In general, however, any discount realised on sale or maturity of a short-term security is likely to be taxable as income. The discount on the disposal of a longer-term bond, on the other hand, is more likely to be of a capital nature. Where the discount on maturity is regarded as income, the investor can minimise his tax liability by selling a longer term bond to an exempt taxpayer just before redemption, so that the profits on the sale can be treated as a capital gain - in which case they will be either exempt or covered by indexation relief. It is this last feature which makes the issue of these types of deep discount bonds so attractive to UK investors - and hence to the issuers who can reduce the cost of their borrowing. And also why the abolition of COBO may have a significant effect on tax revenues - and on the position of competing issuers - unless something is done about these tax advantages.

Post COBO Bonds

B11. It is of course perfectly open to foreign governments (and foreign companies) to issue non-sterling deep discount bonds at present outside the UK, and sell them to UK investors with the advantageous tax consequences described above. But most UK investors hesitate to invest abroad directly and so the problem has not so far been seen as serious. The lifting of the COBO restrictions, however, will alter that. The advantageous tax treatment will then - unless the law is changed - apply to sterling bonds issued in London by overseas governments and para-statal organisations. And the ability to issue sterling deep discount bonds in London will give overseas governments ready access to those investors who are unwilling to deal in foreign financial markets but are all too prepared to minimise their overall tax liability if they can do so by investing at home. Since there are no adverse UK tax consequences for foreign issuers - unlike UK issuers using this route - they can easily design bonds which are tax efficient for the UK investor by minimising the gains which are chargeable as income.

B12. The potential volume of issues once COBO is abolished is almost impossible to predict. But there is little doubt that many investors would be attracted by deep discount bonds with zero or low coupon and where any profit on sale would be subject to capital gains provisions. If they are qualifying corporate bonds they will be exempt and will not lead to indexation losses. (And in a separate paper we are suggesting bringing all <u>non-convertible</u> sterling bonds within the qualifying corporate bond definition.) In any event, the result would be a loss of tax to the Exchequer.

ANNEX C

DEEP DISCOUNT BONDS : TAX TREATMENT OF DISPOSAL/REDEMPTION PROCEEDS IN HANDS OF INVESTOR

Notes : (a) Coupon is taxed as income in all cases.
(b) "Residual" refers to any net gain or loss on a transaction over and above the discount element.
(c) A parallel proposal (Starter 262) would extend the definition of a qualifying corporate bond (QCB) to all sterling non-convertible bonds.
(d) Proposals to treat all disposal profit as income would imply also exempting from CGT those foreign currency bonds involved.

A : NON-VARIABLES	EXISTING REGIME	PROPOSED REGIME
1. FOREIGN GOVERNMENT/PARASTATALS		
a. Sterling (i) discount	income - unless sold before maturity when (i) and (ii) both taxed under CGT rules (unless exempt as QCB).	income
(ii) residual		CGT [except where exempt as per note (c) above].
b. Non-sterling (i) discount)	income unless sold before maturity	income
(ii) residual)	when both taxed under CGT rules	CGT
(iii) foreign exchange gains/losses	CGT	CGT
2. COMPANY BONDS WITHIN 1984 RULES		
a. Sterling (i) discount	income	unchanged
(ii) residual	CGT - unless exempt	unchanged except for note (c) above
b. Non-sterling (i) discount	income	unchanged
(ii) residual	CGT	unchanged
(iii) foreign exchange gains/losses	CGT	unchanged

	EXISTING REGIME	PROPOSED REGIME
3. UK GILTS		
a. Sterling (i) discount	exempt	income
(ii) residual	CGT (exempt)	unchanged
b. Non-sterling (i) discount	exempt	income
(ii) residual	CGT (exempt)	unchanged
(iii) foreign exchange gains/losses	CGT	unchanged
4. NON-COMPANY ISSUES MEETING AMENDED 1984 RULES (OTHER THAN THOSE IN 1.)		
a. Sterling (i) discount)	as per A.1.a.	income
(ii) residual)	above	CGT (except where exempt as per note c)
b. Non-sterling (i) discount)	as per A.1.b.	income
(ii) residual)	above	CGT
(iii) foreign exchange gains/losses	CGT	unchanged
5. OTHER NON-VARIABLE ISSUES NOT MEETING 1984 RULES		
a. Sterling (i) discount)	as per A.1.a.	income
(ii) residual)	above	income
b. Non-sterling (i) discount)	as per A.1.b.	income
(ii) residual)	above	income
(iii) foreign exchange gains/losses	CGT rules	income

B : VARIABLES	EXISTING REGIME	PROPOSED REGIME
1. ALL ISSUES OTHER THAN UK GILTS		
a. Sterling (i) discount	As per A.1.a.	income
(ii) residual		income
b. Non-sterling (i) discount	As per A.1.b.	income
(ii) residual		income
(iii) foreign exchange gains/losses	CGT	income
2. UK GILTS		
a. Sterling (i) discount	exempt	income
(ii) residual	CGT exempt	income
b. Non-sterling (i) discount	exempt	income
(ii) residual	CGT exempt	income
(iii) foreign exchange gains/loses	CGT	income

STARTER 453

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: C W CORLETT
EXTN. 6614
FAX. 6766
18 January 1989

Ch, We await advice from FST.

18/1

1. MR ~~ISAAC~~ I hope that you will find this a reasonable approach to a formidably (and notoriously) complex area. C.E.C. 18.1.

2. FINANCIAL SECRETARY

DEEP DISCOUNTED BONDS: ABOLITION OF COBO: BUDGET STARTER 453

1. The abolition of COBO will remove the present restriction on the issue in London of deep discount bonds in sterling by foreign public sector bodies. Since under current tax rules investment in such bonds offers a simple way to convert income into capital gains, with significant tax advantages to the investor (whether company or individual), this could lead to a flow of such issues resulting in loss of revenue to the Exchequer. In the attached paper Mr O'Connor discusses the options for preventing this, and for dealing at the same time with the tax treatment of investment in other deep discount bonds.

How big are these advantages? What do we think the scale of loss to the Exchequer? (Aside from the Lloyds issue)

2. The paper, and this cover note, are the outcome of discussion between the Revenue, the Treasury and the Bank.

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cc Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Paymaster General
Sir Peter Middleton
Mr Scholar
Mr Peretz
Mr Culpin
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Plenderleith - Bank of England
Mr Jenkins - Parliamentary Counsel

Sir Anthony Battishill
Mr Isaac
Mr Beighton
Mr Bush
Mr Johns
Mr Pitts
Mr Houghton
Mr Deacon
Mr McGivern
Mr Davenport
Mr O'Connor
Mr Cayley
Mr Templeman
Mr Orhnial
Mr Pardoe
PS/IR
Mr Corlett

CORLETT TO FST 18 JAN

The arguments are neither simple nor all one way, and the proposals represent something of a compromise.

Background

3. The tax rules for deep discount bonds have grown up over time on an ad hoc basis, and the result is something of a mess - with different regimes for gilts, corporates and the rest.

4. The special tax regime for deep discount issues of corporate bonds was devised in the 1984 Finance Act. This legislation defines a deep discount (see Annex A to the paper); and provides that in the hands of the investor the element of profit that corresponds to the original discount is taxed as income rather than capital (see Annex B to the paper).

5. This treatment is only feasible where bonds have features which cannot be varied: ie bearing either no interest or fixed interest, and a single maturity date. However, the regime was introduced specifically to help companies issue deep discounts - by giving them the advantage of being able to claim corresponding tax relief each year on the accruing discount. So corporate deep discount bonds issued by UK companies wishing to take advantage of the 1984 regime have in practice all been structured so as to meet the criteria.

6. As Mr O'Connor explains, investors in non-corporate bonds can arrange matters so that the whole discount is charged as capital gains rather than income. Since such bonds issued in London after COBO goes will under present rules benefit from the same attraction, something needs to be done if they are not to become a target for those (like Lloyds) looking to minimise the tax on new investments.

Issues

7. There are a couple of underlying issues running through the paper:

a. whether the 1984 regime should remain open only to corporates, as originally intended; or whether it can be thrown open to non-corporates whose issuers are prepared to meet the necessary conditions;

b. the extent to which the opportunity should be taken to formulate a more coherent regime for taxing bonds generally.

Proposed Approach

8. The approach proposed - on balance - in the paper would in principle give issuers a choice:

- They could on the one hand structure deep discount issues to make them of a non-variable kind, allowing them to fall within the 1984 tax regime - which would be amended so as to apply to income from investment in all deep discount bonds, not just corporate issues.

- Alternatively, if the issuer chose to structure a deep discount bond in a different form (eg variable interest rate, and/or variable redemption date) then all profit from investing in the bond, whether capital or coupon payment, would be taxed in the hands of the investor as if it were income. This might well make such bonds unattractive to UK investors, so that there would be few (if any) such issues in sterling, or in foreign currencies, specifically angled at UK investors. (See paragraphs 17-21 of the paper.) So we could expect most such issues in practice to be of a kind that brought them within the (expanded coverage) 1984 tax regime.

9. This approach has the advantage that it can also be extended to cover the tax treatment of profits from investment in overseas deep discount issues, as well as issues in the UK.

10. The paper further proposes, with the agreement of the Treasury and Bank of England, that it be extended to cover investments in future issues of low coupon (ie deep discount) gilts. (See paragraphs 22, 23 and 43 of the paper.)

11. Finally it raises as an option extending this approach to short term indexed stocks (those with a term of less than, say, 3 years). This would be an alternative way of dealing with the Lloyd's problem if you decide not to legislate directly to bring their capital gains within Case I.

12. These changes would mean that the tax treatment of profit from investment in deep discount bonds would no longer depend on the nature of the issuer (eg whether it was a UK company or not), or whether the bond were issued in the UK or abroad or in sterling or foreign currencies.

13. This has the advantage of simplicity and creating a more level playing field. It deals with many of the problems arising from the ability at present to convert income into capital. And, it also avoids continuing the difficulty inherent in the existing legislation (but which does not arise in practice because of COBO) of drawing a dividing line between foreign "corporate" and foreign "parastatal" issuers; many of the latter will have a corporate form, and perhaps only a majority state shareholding.

Other points

14. Some consequential changes are required to ensure that where profit from investments in deep discount bonds is taxed as income, it is no longer subject to capital gains tax. (Paragraph 31.)

15. The paper also contains proposals for dealing with transitional problems that arise for investments in existing deep discount stocks including low-coupon gilts (paragraphs 40-44). And there is a discussion of problems that could be raised by the issue of subsequent tranches of stocks that were not originally issued at a deep discount. (Paragraphs 45-49.)

16. The starter may well be seen outside as part of a "bonds package" also involving Starter 262 (corporate bonds and capital gains tax) on which Mr Cayley is today sending you a submission. We have sought to ensure that, where relevant, the approach on the two starters is consistent. It would be desirable for the commencement arrangements for both starters to be, so far as possible, in line with each other, in particular as regards whether the changes apply (gilts aside) to disposals on or after Budget Day or whether a year's grace is given.

Exchequer effects

17. The measures are designed to avoid potentially large losses of revenue following the abolition of COBO. If you decide against the Lloyds Starter 258, these could be as much as £m50 (paragraphs 36 and 37).

What the proposals do not do

18. In assessing the proposals, Ministers will need to bear in mind that:

a. While the proposals represent a more coherent system than at present, there would still be differences between indexed and non-indexed stocks and between "variable" deep discount stocks and "non-variable" deep discount stocks.

b. The legislative consequences will, on the other hand, be more extensive than was generally envisaged when the decision to abolish COBO was taken. The 1984 legislation (which runs to 9 pages) will need to be amended, perhaps quite extensively; and a new regime introduced to treat as income the profits of other deep discounts. If Ministers wanted something less, there are only two real possibilities. One would be to legislate the income regime only for the foreign public sector bonds released by the abolition COBO - which could be criticised as discriminatory and, as stated above, might well run into severe (even insuperable) definitional problems. The other course would be to do nothing - ie let the foreign bonds be issued on favourable terms, and wait and see whether they are in fact exploited before acting - which would be a high risk strategy.

c. Although the proposals do something towards reducing the ability for Lloyds (and others) to invest in deep discount bonds in a way which allows them largely to escape tax, they do not offer a fully comprehensive solution, even if you are prepared to include certain types of indexed bonds.

Conclusion

19. I am sorry that this has turned out to be such a complicated and wide-ranging issue. A wide spectrum of interests have been involved - the Treasury, the Bank and within the Revenue - but we have at least been able to reach broad agreement on the proposals. No doubt you will want to discuss them with us.

C W CORLETT

STARTER 262

chex.md/jmt/48 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 20 January 1989

Bf 3/2

(pr ssy bf with letter with from FST, for mtg. next week)

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Ilett
Mr Neilson

Mr Isaac IR
Mr Painter IR
Mr Bush IR
Mr Corlett IR
Mr Cayley IR

CGT AND CORPORATE BONDS - STARTER 262

The Chancellor has seen Mr Cayley's note of 18 January. He has commented that it seems essential to take action to exempt sterling non-qualifying corporate bonds from CGT in order to prevent the creation of capital losses.

2. He assumes that this will be scored as a yield.

J M G TAYLOR

JMGT TO PS/FST 20 JAN

CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

This seems a must. (I assume it will be seen as a good, sensible not as creating a precedent.) N.

FROM: M F CAYLEY
DATE: 18 January 1989

1. MR CORLETT 18/1
2. FINANCIAL SECRETARY

CGT AND CORPORATE BONDS - STARTER 262

1. The purpose of this note is to seek Ministers' views on whether they want to exempt sterling non-qualifying corporate bonds from CGT in order to prevent the creation of capital losses. Large sums are potentially involved. We are also seeking authority to correct a substantive printing error in the legislation on qualifying corporate bonds.

2. The note reflects discussion with official Treasury and the Bank. They are in agreement with its conclusions.

Note, also today, on Starter 453

3. We are letting you have a separate submission on the related issue of the implications for the tax treatment of deep discount and indexed bonds of abolishing the Control of Borrowing Order controls on foreign public sector borrowers.

---

cc. Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Ilett
Mr Neilson
Mr McConnachie (Bank of England)
Mr Jenkins (OPC)
Mr Isaac
Mr Painter
Mr Bush
Mr Corlett
Mr Deacon
Mr Johns
Mr McGivern
Mr Pitts
Mr Cayley
Mr J F Hall
Mr Hamilton
Mr Hunter
Mr O'Connor
Mr Skinner
Mr Michael
PS/IR

CAYLEY TO FST 18 JAN

corlett

Background

4. In 1984 and 1985, sterling "qualifying corporate bonds" were taken outside CGT in a two stage process. In 1984, they were exempted if held for more than twelve months. This brought them into line with the then rules for gilts and was intended largely to give a fillip to the UK bond market. In 1985, both gilts and qualifying corporate bonds were exempted totally from CGT. The reasons for ending up with total exemption were

(i) simplification, and

(ii) that, over the life of the bonds, the Exchequer would have ended up relieving more in losses than it taxed in gains. This resulted from the 1985 CGT change under which indexation relief was allowed to give rise to losses.

5. As far as bonds are concerned, the exemption is limited to "qualifying corporate bonds". Broadly, these are non-convertible sterling bonds either

- issued or dealt in on the UK Stock Exchange or USM, or

- issued by a UK quoted company or other body with shares or securities dealt in on the Stock Exchange or USM.

6. This means that sterling bonds issued abroad by a foreign company (including a foreign subsidiary or parent of a UK company) are normally not qualifying corporate bonds. They are therefore within the scope of CGT, and of CGT indexation.

Floating Rate Notes

7. The Stock Exchange have recently approached us with evidence that this position is being exploited to give lenders capital losses (resulting from CGT indexation). The cases they have identified involve the issue of floating rate notes by specially - created Luxembourg companies. Since the value of a floating rate note stays relatively constant, any nomimal or loss to the lender will be negligible. But because the floating rate notes are within CGT, indexation will give lenders liable to CGT a capital loss: and the Stock Exchange believe that an increasing proportion of the issues is being taken up by companies liable to UK tax on gains.

8. The sums involved are sizeable. The Stock Exchange have concentrated their research on mortgage companies, and have identified issues totalling over £m3,500 since June 1987. The Bank's information is similar. Some lenders will be banks (whose transactions will be dealt with in the computation of income, not gains), foreigners, and exempt pension funds. But if, say, half the lenders (and the Bank think that, to date, the actual figure may be less than half) were ordinary UK companies, indexation losses are accruing at some £m90 a year.

9. These figures will not be the full story, because there will be other issues which the Stock Exchange have not identified. And the Stock Exchange consider that the figures are likely to grow because, as the gilts market contracts, floating rate notes represent an attractive substitute for investors: if the demand grows, so will probably the supply. Some forecasts are that the volume of new issues involved may double each year. In addition, recent press reports of a £m368 deal by LASMO (and recent information on some takeover bids) suggest that sterling FRN's issued abroad are beginning to be used in deals involving the sale of subsidiaries and large shareholdings and in takeovers.

Other Bonds

10. As far as the Stock Exchange are aware, the problem is at present mainly confined to floating rate notes.

But there is clearly a risk that we may at some point start seeing large foreign issues of fixed interest bonds in order to give holders indexation losses for CGT- and the risk would be increased if action were taken now only on floating rate notes.

The case for action, and its possible form

11. The 1984 exemption of qualifying corporate bonds was designed, as I have said, to give a fillip to the UK bond market. What we now have is a position where foreign issues of sterling bonds have a tax advantage (CGT indexation) over UK issues. This cannot make sense and is leading to business going offshore (which is the concern of the Stock Exchange). And the result is that almost certainly sizeable indexation losses are clocking up in the hands of UK holders of foreign issues of sterling bonds.

12. Against this background, we think there is a strong argument for removing the CGT advantage which sterling foreign issues have over UK issues - and doing so for both floating rate notes and other sterling bonds (we suspect it would anyway be hard to target action on floating rate notes, because of problems of definition). Official Treasury are likely to be suggesting to Ministers changes to ease the regulatory regime for short-term bonds. If those changes go ahead, the case for early action would be strengthened: one purpose of regulatory relaxations would be to encourage more bond issues in the UK, and that purpose

would be frustrated if there were significant CGT advantages in issuing sterling bonds overseas.

13. We would envisage action taking the form of extending the present CGT exemption of sterling qualifying corporate bonds to other non-convertible sterling bonds. This would be a CGT simplification, and give parity of treatment between UK and foreign issues of sterling bonds.

14. As we have mentioned to Ministers on previous occasions, taxpayers are likely to go on finding ways to exploit CGT indexation in order to obtain the benefit of capital losses. It is quite possible that, if we act now on foreign issues of sterling bonds, other forms of security will be developed and used for this purpose. As ever, all we can do is to watch out for this and report to Ministers when we detect developments of this kind.

Implications for company finance

15. The Stock Exchange do not consider that action would make it more difficult for companies to raise finance. In their view the issues would be commercially attractive without the tax break of indexation losses: and indeed some holders of the bonds are foreigners, pension funds and others outside the scope of CGT, who get no benefit from indexation. Official Treasury and the Bank would not disagree with the Stock Exchange's judgement.

Commencement

16. We would suggest that any change in the rules should apply to disposals on or after Budget Day.

17. The issue that arises is whether there should be some protection for existing holders of bonds. When, in 1985, gifts and qualifying corporate bonds were exempted from CGT, a twelve-month period of grace was given. The 1985 approach would be cited as a precedent for giving existing holders a year's grace; and adopting this approach would make it easier to counter allegations of retrospection and upsetting existing holders' legitimate expectations. The Bank would favour this approach.

18. On the other hand, one reason for giving twelve-months' grace in 1985 was problems with gilt prospectuses. That reason does not apply here. CGT changes normally apply immediately to disposals by existing holders of assets - and indeed when indexation was denied on Building Society shares from 1987, and, this year, on intra-group loans the change applied immediately to existing owners of the assets concerned. To give a period of grace might increase pressure for similar transitional relief if, on some future occasion, indexation was further restricted or there was some other CGT change disadvantaging taxpayers; and it could be seen by the Opposition as giving unnecessary extra life to a tax break. Against this, the other argument for giving twelve months' grace in 1985 - to give taxpayers a period in which to adjust their affairs with the full benefit of the old rules - is relevant here: but in 1985 one was concerned with large investors and large sums (eg Life Companies' substantial holdings of gilts): whereas in the present instance the sums and effect of the change are very much smaller, and as far as at least FRN's are concerned one is on the fringes of tax avoidance.

19. In Exchequer terms, it is uncertain what the effect of a year's grace would be. If many holders within the gains change disposed of their holdings within the period, it is possible that there might be a

once-and-for-all cost of over £m25. In practice, many might well not do so, and the tax cost might therefore be quite a bit less.

20. It is doubtful if market considerations are a major factor in the decision. The number of FRN issues involved is small and only some investors in them would be affected. The Treasury and Bank do not think there will be much price effect or market disruption; and the Bank believe that issuers will not be able to call the bonds. As regards non-FRN foreign issues of sterling bonds, the evidence suggests that investors are predominantly foreigners outside the UK tax net, who would be unaffected.

Compliance and staffing

21. For those concerned, there would be a slight reduction in compliance costs from exempting these bonds from CGT. The effect on our staff need would be negligible.

Yield

22. There would be no immediate yield to the Exchequer: the life of these bonds is typically five or so years, so we are concerned with tax losses that would generally not crystallise until a few years' time.

Printing error in existing legislation

23. You will recall from Starter 253 that the legislation on qualifying corporate bonds allows CGT to be deferred where shares are exchanged for qualifying corporate bonds. The bonds themselves are exempt from CGT but the deferred gain is brought into charge when

the bonds are sold. If the bonds are transferred between husband and wife or within a group of companies, the deferred gain is not charged until the transferee disposes of the bonds. But if there is a second such transfer, the deferred gain escapes tax. This is because the word "not" was left out at a key point as a result of a printing error which was not picked up. This gives an easy way of taking the deferred gain on the original shares out of tax: for example one spouse can give the bonds to the other, who then a little later gives them back again; or one company in group can transfer the bonds to another group member who in turn transfers them to a third member. By playing "pass the parcel", people can take gains on the original shares out of tax.

6

24. As far as we know, this mistake has not been noticed outside (we have only just identified it ourselves), but it will be only a matter of time before it is spotted and advantage starts to be taken of it on a substantial scale. We would therefore be grateful for authority to rectify the omission where the ultimate transferee disposes of the bonds on or after Budget Day 1989.

Length of Legislation

25. Our provisional estimate is that, if legislation is on the basis we suggest, it would probably come to between a few lines and about two-thirds of a page, depending on whether there was transitional protection for existing investors.

Conclusion

26. We would be grateful for Ministers' views on whether the present CGT exemption for qualifying corporate bonds should be extended to non-convertible

sterling bond issues generally, and if so whether the change should apply immediately to existing investors, or whether there should be a year's grace for them. Is it agreed that we should rectify the printing error in the qualifying corporate bond provisions (paragraphs 23 and 24 above)?

M F CAYLEY

Bf 1/2

Inland Revenue

Savings and
Investment Division
Somerset House

CONFIDENTIAL

FROM : B O'CONNOR
24 January 1989

This is relevant to the COBO meeting tomorrow (Wed) morning GWb 24/1

1. MR CORLETT

2. MR ISAAC 24.1.

3. FINANCIAL SECRETARY

Alex
I had thought we were going to get rid of COBO. Quite a significant Budget measure. Let's have it as one of the batch of starters.

DEEP DISCOUNTED BONDS : ABOLITION OF COBO : BUDGET STARTER 453

1. The Chancellor asked for advice (Mr Taylor's note of 20 January) on the present tax advantage of converting income into capital gains on these bonds and the likely Exchequer loss (aside from Lloyds).

THE TAX ADVANTAGE TO THE INVESTOR

2. Under existing rules, if a deep discount bond outside the 1984 company regime is sold before maturity, the profit on disposal, including any discount that has accumulated, is treated as a capital gain rather than as income for tax purposes. CGT rules allow the taxable gain to be reduced by indexation - a provision which will sometimes produce losses which can be offset against other gains. For individuals only, the first £5,000 of capital gains each year are also exempt from tax.

---

cc. Chancellor
Chief Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Mr Scholar
Mr Peretz
Mr Culpin
Mr Ilett
Mrs Chaplin
Mr Tyrie

Chairman
Mr Isaac
Mr Beighton
Mr Bush
Mr Johns
Mr Pitts
Mr Houghton
Mr Deacon
Mr McGivern
Mr Corlett
Mr O'Connor
Mr Davenport
Mr Cayley
Mr Templeman
Mr Pardoe
Mr Orhnial
PS/IR

O'CONNOR TO FST 24 JAN

3. The size of the tax saving in any particular case will depend on a number of factors including yields, the rate of inflation, the investor's marginal rate of tax, the availability of relevant gains elsewhere against which to offset losses and the amount of any unused annual exemption. It also depends on whether the bond is exempt from CGT so that the profit is tax free.

4. The following example illustrates the significant benefit to the investor in a non-sterling foreign public sector bond issued outside the UK (and therefore not subject to the COBO restrictions).

Example : zero-coupon bond (outside 1984 regime)

Bought at 100, held for one year and sold at 110.

Inflation 6%; tax rate 40%.

(a) Taxing all profit as income

Profit 10 @ 40% = 4.0

(b) Taxing as capital gains with indexation

Sale proceeds 110
Cost 100
Indexation 6 106

Gain 4 C.G. Tax 1.6

(c) Advantage to investor of present rules 2.4

(d) If a "qualifying" corporate bond - ie. CGT exempt - advantage to the investor 4.0

In short, even with tax rates aligned, there is a substantial benefit to be obtained by investors able to convert income into capital.x

x ie the tax charge can commonly be halved, or more than halved; & in certain circumstances it can be eliminated altogether.
C.J.C.?

5. The advantage at (c) is at present available to investors in foreign public sector deep discount bonds issued outside the UK and in corporate variable deeps wherever issued.

6. The additional benefit at (d) applies to very few deep discount bonds at present - other than UK gilts.

7. If the COBO restrictions are removed without the tax rules being tightened, the advantages at (c) and (d) will both be more widely available.

8. In addition, if Starter 262 (necessary for non-discounted bonds) goes ahead, the benefits at (d) will apply to all sterling non-convertible issues wherever issued.

SCALE OF EXCHEQUER LOSS

9. The scope for tax loss at present arises primarily from holding foreign currency deep discount bonds and the data is not available to estimate the current scale of the problem. If COBO is relaxed without the tax advantage being removed, the potential tax loss will depend upon the reaction of investors and issuers to this new opportunity. That is very difficult to estimate. However, this is the sort of area where, once the tax advantages become publicised, a lot of money can very rapidly be invested in a new vehicle.

10. First, Lloyds is a special problem. If you legislate directly on Lloyd's (Starter 258), all loss from conversion of income into capital by them will be prevented. If you do not legislate direct on Lloyd's and decide to apply this starter (453) to short term indexed bonds, as well as to other deep discount bonds, there is no short term loss of tax but there is a risk, in time, that Lloyd's will use preference shares to convert income to gains. If you neither legislate on Lloyd's nor on short term indexed bonds, but do apply this starter to deep discount securities, our best estimate of the loss of tax from

CONFIDENTIAL

Lloyd's is £50 million, but in the worst case losses could exceed £100 million. If you do not legislate at all in this area, Lloyd's would have a wider range of options for converting income to capital and we would expect the loss to move nearer to the worst case than the central case.

11. Second, apart from Lloyd's, other investors would be interested in converting income to capital, including other high net worth individuals, life companies and corporate treasurers. Life assurance companies in particular up to 1985 engaged heavily in bond washing at a cost to the Exchequer estimated at £150 million. They are not interested in non-sterling deep discounts but could find sterling domestic deep discounts very attractive if there were tax advantages, and the cost here could therefore easily run into £10's of millions. It will also be necessary to find issuers to meet this demand. As well as US public sector issuers (like Sallie Mae), there also are signs that UK corporate issuers are showing interest in short term deep discount variable bonds (outside the 1984 rules). So we would expect to find enough issuers and investors to cost the Exchequer some £10's of millions (in addition to the tax at risk through Lloyd's), but we cannot rule out the possibility that it could be a good deal more.

B O'CONNOR

FROM: J M G TAYLOR
DATE: 20 January 1989

27/1

PS/FINANCIAL SECRETARY

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

Sir A Battishill IR
Mr Isaac IR
Mr Beighton IR
Mr Corlett IR
Mr O'Connor IR
PS/IR

DEEP DISCOUNTED BONDS: ABOLITION OF COBO: BUDGET STARTER 453

The Chancellor has seen Mr Corlett's note of 18 January, and the enclosed paper by Mr O'Connor.

2. He awaits the Financial Secretary's advice. He would be grateful if that could, inter alia, cover the question of how big the tax advantages to the investor of converting income into capital gains through investment in these bonds are now, and what is the likely scale of the loss to the Exchequer (aside from the Lloyds aspect).

J M G TAYLOR

JMGT TO PS/FST 20/1

8/2

CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	COBO, BONDS AND LLOYDS (STARTERS 262, 453, 258)
DATE	WEDNESDAY 8 FEBRUARY
TIME	4.00 PM
VENUE	Chancellor's Room, Treasury/~~No.11/Conference Room/House of Commons~~
PAPERS	FST → CH/EX 31/1 ILETT → FST 26/1 JMGT → PS/FST 20/1 (STARTER 262) CAYLEY → FST 18/1 O'CONNOR → FST 24/1 JMGT → PS/FST 20/1 (STARTER 453) CORLETT → FST 18/1 attaching O'CONNOR → FST 18/1 JOHNS → FST 16/1 JMGT → FST 6/1 BEIGHTON → FST 4/1 MPW → PS/FST 30/12 FST → CH/EX 21/12 JOHNS → FST 15/12 BEIGHTON → FST 30/11 JMGT → PS/FST 30/11 FST → CH/EX 28/11
THOSE ATTENDING	FST SIR P MIDDLETON MR SCHOLAR MR CULPIN MR GILHOOLY MR ILETT MRS CHAPLIN MR TYRIE MRS RYDING MR BEIGHTON MR ISAAC MR CORLETT MR CAYLEY MR O'CONNOR MR TEMPLEMAN } I.R. CC: MR ODLING-SMEE MR PERETZ MR JOHNS MR TAYLOR

Tony pl get this
meeting confirmed
for Wed at 4.00pm.
Terry is moving his
meeting.
I have already
confirmed with
Elizabeth.

Julie.

CHANCELLOR OF THE EXCHEQUER

Archie -

Pse fix a meeting on:

COBO, ~~Corporate~~ Banks, Lloyds (Starters 262, 453, 258). for next week.

~~the~~ - FST

PEM

Scholar

Culpin

Odling Smee

Peretz

Gilhooly

Heal

Chaplin

Tyrie

Beighton

Isaac

Corlett

Johns

Cayley

O'Connor

IR

PPS overleaf.

FST → CHEV 31/1
ILETT → FST 26/1
JMGT → PS/FST 20/1
CAYLEY → FST 18/1
O'CONNOR → FST 24/1
JMGT → PS/FST 20/1
CORLETT → FST 18/1 (attaching)
O'CONNER → FST 18/1
JOHNS → FST 16/1
JMGT → FST 6/1
BEIGHTON → FST 4/1
MAW → PS/FST 30/12
FST → CHEV 21/12
JOHNS → FST 15/12
BEIGHTON → FST 30/11
JMGT → PS/FST 30/11
FST → CHEV 28/11

Ch/

I suggest you take the three action notes immediately behind in the order in which I have put them on the folder (Mr Illett's note is to some extent overtaken by the FOTs of 3/12, however).

2. Background pps. – to which there is no need to refer – are set out behind the dividers, separated into their subjects.

AF

7/2

SUBJECT: COBO, Bonds, Lloyds (Starters 262, 453, 288)

LOCATION: HMT.

CAST LIST.	PHONE NO.	DATE + TIME. 4.00pm Wed 8/2. ✓	IF NO GIVE REASON	10.00 Frid 10/2. ✓	IF NO GIVE REASON	~~11.30am~~ [illegible] ✓	IF NO GIVE REASON	✓	IF NO GIVE REASON
✓ PST.		✓	rather not [illegible] date [illegible]	✓	Preferable				
✓ Pem	5158	✓		✓					
MCS.	5181	X	Days MTFS 3.00 with T. Burns	✓					
✓ RC	5204	✓		✓					
Osmee	5397	✓		✓					
Perek	4591		leave		not back until 13th				
Gilhooly	4914	✓		✓					
✓ Ulett	4495	✓		x	Smith NEDC Group				
✓ Chaplin	5027	✓		✓					
✓ AGT.	5025	✓		✓					
Baughton.	7012	✓ 2.30		✓					
✓ Isaac	6760	✓		✓					
Corlett	7793	✓		X					
Johns	7497	x		x					
✓ Caley	7762	✓		✓					
O'Connor.	6798	✓		✓					

PAPERS: See below.

rs/30.1

BUDGET: CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 31 JANUARY 1989

FST → CHEX 31/1

CHANCELLOR

Thanks. We will discuss @ projects mtg!

Ch
(We have back papers on all three starters if you want them)
We are having small meeting on all this next week.
AA

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Odling- Smee
Mr Peretz
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC
Mr Beighton)
Mr Isaac)
Mr Corlett)
Mr Johns) IR
Mr Cayley)
Mr O'Connor)
Mr Templeman)
PS/IR

STARTERS 262, 453 AND 258: BONDS, COBO AND LLOYD'S

Given their interaction, I have considered these 3 starters together.

Starter 262: CGT and Corporate Bonds

This starter deals with leakage from the tax yield caused by manufactured capital losses on bonds. Since it would apply to all bonds, (ie. not just deep discount or indexed ones) the revenue effects are potentially greater. As Mr Cayley's minute makes clear, the scope for creating indexation losses on sterling non-qualifying non-convertible bonds is both real and large. I therefore agree that we should close this loophole by exempting these bonds from CGT.

Starter 453: COBO and Deep Discount Bonds

The imminent abolition of COBO will remove the present restriction on the issue in the UK of sterling deep discount bonds by foreign governments and parastatals. Because of the current tax rules for such bonds, which allow a simple conversion of income into capital gains (with its more advantageous tax treatment), there is every reason to believe that this could lead to a flood of new issues and a resultant revenue loss of tens of millions of pounds.

It is the joint view of the Bank, Treasury and Revenue that we should do something to prevent this. Furthermore, we should at the same time take the opportunity to tidy up the tax treatment of deep discount bonds in general, which is a particularly messy and complicated part of the tax system. The basic idea, with which I agree, is as follows:

- where the return on the bond can be mathematically split between income and capital, then it should be done so, and each element taxed accordingly. This would mean extending the special 1984 regime for corporate non-variable deep discount bonds to all other non-variable bonds;

- but where the return on the bond cannot be split in this way (ie. for all variable bonds), then all of it should be taxed as income.

This is the softer of the two options put forward by the Revenue. It should not be controversial, since any issuer would have the option of avoiding the harsher income tax regime by tailoring the issue accordingly. It would mean that new issues of deep discount gilts would not continue to have their long-standing income tax exemption. And it would put Government issues of these bonds on a par with those of foreign Governments. But arguably that is right, in an era when the Government is a net redeemer of gilts. However, for technical reasons associated with the prospectus, existing issues of deep discount gilts will continue to have the exemption.

NB

There are a couple of minor wrinkles with this approach. First, for foreign currency bonds, there is a foreign exchange component in any gain or loss, which is normally liable to CGT. The proposal is to tax this bit of the equation as income, on the grounds of simplification. This seems sensible. Since deep discount bonds is such a specialised area of the tax system, taxing the foreign exchange component in this way would not affect the wider review of the subject, where we are issuing a consultative document. (Note that this would not be true of foreign exchange gains and losses under - the much broader - Starter 262).

Secondly, we should not allow income tax losses. Given our moves to deny (much more widely) CGT losses under starter 262 and to stop income being converted into capital for deep discount bonds, it would look very odd indeed if we were to do so. There is a precedent here in the offshore funds legislation. Thirdly, we must obviously ensure that those bonds whose return is taxed wholly as income are legislatively removed from the CGT net, if not already exempt. And fourthly, further tranches of existing issues of bonds or gilts ought to have the same tax treatment as that of the original issue. Where the tranches call for different tax treatment (because for instance one is a normal bond and one a deep discount), we should apply that of the majority stock to <u>all</u> the tranches.

We also need to coordinate the start dates of the two starters. I shall put forward a recommendation on this when I have received Mr Ilett's forthcoming advice on the abolition date for COBO.

behind

<u>**Starter 258: Lloyd's**</u>

I find this the trickiest problem to deal with. The Revenue are in favour of doing Starter 258, which would remove Lloyd's special (and, among financial traders, unique) concession whereby its financial returns from the sale of securities are not subject to taxation under Case I of Schedule D as "trading" profits. Such a move would solve the Lloyd's issue at a stroke, as I said when I minuted you about this on 21 December. All returns would be taxed as income; and policing the income/capital divide would no longer be necessary.

However, as I also pointed out, such a bold move would be very difficult politically. I strongly believe it would be a mistake to do this at a time when Lloyd's are facing genuine difficulties and a sharp diminution in names. I have looked at possible "sweeteners" to compensate Lloyd's for such a radical change. But I doubt if they would satisfy Lloyd's. Moreover, one of them in particular, increasing the Special Reserve Fund limit, is, I believe, unattractive in principle from our point of view. Last year, as you recall, we considered abolishing it.

The alternative way of dealing with the latest problem in Lloyd's perennial attempts to convert income into capital is by legislating directly on indexed bonds as part of the COBO package, by treating them as a subset of deep discount bonds. Since we outlawed bondwashing in 1984, this has become Lloyd's favoured route. Indexed bonds are currently specifically excluded from the 1984 rules for corporate deep discount bonds, so we have to do something on indexed bonds if they are to fit into the general deep discount regime. And in framing our policy on this, it is possible to deal with Lloyd's as well. The Revenue believe that this solution will only be temporary, and that the problem may return to haunt us with new devices thought up by Lloyd's. I believe we have to accept this.

The proposal for indexed bonds is to exempt those over a certain maturity from the all-income provisions for variable deep discount bonds and leave them to be treated as capital gains (if not exempt from CGT). I firmly believe that politically, this is the better way to tackle the Lloyd's issue. It could be presented as sorting out the tax treatment of indexed bonds in general, and not as a direct assault on Lloyd's. But in deciding where the cut-off point should be, there is a tension between setting it low enough to give the Government maximum flexibility over issuing indexed gilts, and high enough to make indexed bonds where the return is treated as capital unattractive to Lloyd's, who require relatively short-term instruments which are liquid and offer a guaranteed return. There is a difference of views in where the line should be drawn; the Treasury and Bank would settle for 3 years, the Revenue would prefer 5.

One possibility if we went down this road would be to include in the legislation a power for the cut-off to be amended by Order in the light of market developments. We have never in fact issued indexed gilts with a maturity of less than 6 years. But the argument for starting at 3 years would be that short-term indexed bonds are so close in practice to ordinary deep discount bonds that they need to be given the same tax treatment, in order to prevent tax avoidance. If it turned out in the event that a 3-year limit still left scope for significant avoidance, by Lloyd's and others, then the figure could be raised by Order. The Revenue on the other hand believe that it would be better to start at 5 years so that issuers of (say) 4-year bonds could neither avoid tax in the first place, nor lose out by the raising of the limit, if we had to do so. On balance, I would start at 3 years.

Tackling Lloyd's via the indirect route of indexed bonds means that the case for giving them a "sweetener" in return is minimal. However, one very minor possibility would be to allow Lloyd's to carry out stock lending. I have asked the Revenue/FIM to provide further advice on this.

R.C.M.S.

pp NORMAN LAMONT

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY

DATE: 3 February 1989

CHANCELLOR

cc
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Beighton)
Mr Isaac)
Mr Corlett)
Mr Johns) IR
Mr Cayley)
Mr O'Connor)
Mr Templeman)
PS/IR

STARTERS 262, 453 AND 258: BONDS, COBO AND LLOYD'S

As foreshadowed in my minute of 31 January, I have considered with officials the start dates for these various starters.

The unanimous view of the Revenue and Treasury (and, I understand, the Bank) is that Budget Day would be the best time for the abolition of COBO. The market arguments point that way. And (contrary to the position outlined in Mr Ilett's submission of 31 January) the Revenue say that the backdating of the tax changes in the Finance Bill to Budget Day by way of a Resolution should not be too difficult to draft. I therefore recommend we go ahead on that basis.

That would certainly be beneficial as far as the Lloyd's issue is concerned. Any gap between the date of announcement and the effective date would create forestalling problems at Lloyd's, as Names sought to sell bonds which would have been eligible for CGT treatment under the old regime, but which were now subject to income tax treatment.

As far as Starter 262 on the CGT treatment of sterling non-qualifying non-convertible bonds is concerned, the start date should follow that for the COBO issue, that is Budget Day. I also recommend that we do <u>not</u> have a 12-month transitional period for this change, unlike what happened when gilts and qualifying corporate bonds were exempted from CGT. The new regime would thus come into effect immediately.

R.C.M.S.

pp NORMAN LAMONT

PAPER

Inland Revenue

Savings and
Investment Division
Somerset House

CONFIDENTIAL

FROM : B O'CONNOR
18 January 1989

1. MR CORLETT 18/1

2. MR ISAAC 18.1.

3. FINANCIAL SECRETARY

DEEP DISCOUNTED FOREIGN GOVERNMENT AND PARA-STATAL BONDS : BUDGET STARTER 453

INTRODUCTION

1. The Chancellor has decided to abolish the Control of Borrowing Order (COBO) which prevents the issue of deep discount bonds in the UK by foreign public sector borrowers. As such bonds offer investors a significant tax advantage the abolition of COBO is likely to lead to a substantial flow of new issues (as borrowers take advantage of the demand) resulting in loss of Exchequer revenue. This paper outlines the nature of the problem, and examines the options for resolving it.

---

cc. Chancellor
Chief Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Mr Scholar
Mr Peretz
Mr Culpin
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Plenderleith - B/E
Mr Jenkins - Parliamentary Counsel

Chairman
Mr Isaac
Mr Beighton
Mr Bush
Mr Johns
Mr Pitts
Mr Houghton
Mr Deacon
Mr McGivern
Mr Corlett
Mr O'Connor
Mr Davenport
Mr Cayley
Mr Templeman
Mr Pardoe
Mr Orhnial
PS/IR

O'Connor TO FST 18 JAN