

PO-CH / NL 0025

PART B

SECRET

(Circulate under cover and
notify REGISTRY of movement)



PO -CH /NL/0025



PART B

TAX REFORMS 1987 - 1988
INCLUDING INDEPENDENT
TAXATION, CAPITAL GAIN
TAX AND BENEFITS

PO -CH /NL/0025

PART B

PART B

DD's 28 years NAZIS 10/8/95

23-9-87



Inland Revenue

 COPY 1 OF 7
 Policy Division
 Somerset House

FROM: B A MACE

DATE: 22 JULY 1987

 CHANCELLOR OF THE EXCHEQUER
See also Michael Schuler's note dated 17 July 1987
22/7
TAX REFORM: INCOME TAX RATES AND UPPER EARNINGS LIMIT FOR NIC

1. Mr Kuczys' note of 17 July asked for some further information.

35 per cent higher rate

2. Reducing the higher rate of tax under Option 1 of my note of July from 40 per cent to 35 per cent would cost an additional £530 million in a full year at 1987-88 income levels. The total number of losers would be reduced from about 800,000* under Option 1 to about 650,000*. This compares with an additional cost of about £320 million in a full year (and a reduction to about 550,000* losers) for Option 1A of my note (which raised the higher rate threshold to taxable income of £24,000).

3. Reducing the higher rate to 35 per cent is less effective in reducing the number of losers than Option 1A because it gives smaller gains to those at the bottom of the higher rate band where most of the higher rate losers are to be found. Option 1A gives an additional benefit of £540 to all higher rate taxpayers with taxable incomes of £24,000 and above (and smaller amounts to those with taxable incomes between £20,400 and £24,000). For a reduction in the higher rate to 35 per cent, only those with taxable incomes above £31,200 benefit by £540 or more. A lot of the benefit goes to those with larger incomes, the majority of whom already make substantial gains under Option 1.

* As explained in paragraphs 6-8 below, all these figures could be somewhat larger.

Analysis of losers

4. I attach a revised version of Chart E, now drawn for a married man having no mortgage interest or other relief and whose income is all earned. As the Chart shows, for this individual there are still losses at some income levels under all the options, and under Option 1 losses for those with incomes from about £18,640 to £40,000.

5. You asked for an analysis of losers by reference to the reliefs (mortgage interest, pension contributions, etc) for which they qualify.

6. At present a full analysis of pension contributions and their impact is not possible. In attempting to explore this aspect we have realised that the computer model from which the costs and distributional analysis of the effects of abolishing the upper earnings limit (UEL) are derived does not yet correctly take into account the interaction between occupational pension contributions and the additional 9 per cent NIC payable by someone with earnings above the UEL. This is because the Survey of Personal Incomes on which the model is based cannot record details of employees' occupational pension contributions (which are dealt with separately by employers under the net pay arrangements). If the UEL were abolished NIC would be payable on the part of an individual's earnings above the UEL which he pays in occupational pension contributions even though these are deductible in computing income for income tax purposes.

7. I apologise that we had not identified this limitation in the estimates when I prepared my earlier submission. It affects about one million taxpayers with earnings above the UEL who make occupational pension contributions and means that the full year yield of abolishing the UEL would be higher (perhaps £100 million higher) than the figure of £1.6 billion given in my note of 12 July. It also means that the number of losers and the size of their losses would be somewhat greater than the figures given in Table 2 of my note. For a few cases losses could be substantially larger than we have so far estimated. (The number of gainers and the size of gains for those with incomes above about £15,000 shown in Table 1 of the note would, correspondingly, be slightly smaller.)

8. We are sorry about these inadequacies in the analysis. I am afraid it will take a little while to build the required modifications into the model and for the time being it will therefore be necessary to continue our analysis on the existing basis. You will, however, want to bear in mind that the resulting figures understate the number of losers and the size of their losses to some extent.

9. Subject to the caveats in the preceding paragraphs we have analysed the losers in Table 2 of my previous note by reference to (a) mortgage interest (b) other reliefs. Table A attached shows the number of losers by income range and the reliefs claimed; Table B analyses the losers by the size of loss and their reliefs.

10. Table A shows that for the 550,000 losers with total incomes up to £30,000 (which includes most of the basic rate losers) around 85 per cent claim some mortgage interest relief. But only around 40 per cent claim in excess of £3,000 of relief (and so are likely to have mortgages at or in excess of £30,000).

11 Table B shows that for those whose losses are in excess of £300 (mostly higher rate taxpayers) about two thirds claim mortgage relief in excess of £3,000.

12. We have also made a separate analysis of the basic rate losers under Option 1 and the amounts of mortgage interest relief they claim. Of the 1/2 million basic rate losers, just under 200,000 claim relief on mortgage interest in excess of £3,000. Looking at it another way, of the 150,000 or so basic rate taxpayers who lose in excess of £200 under Option 1 just under 100,000 claim mortgage interest relief in excess of £3,000.

13. At current interest rates (11.25 per cent) a £5,000 increase in the mortgage interest relief ceiling under Option 1 of my earlier paper would be worth about £140 to a basic rate (25 per cent) taxpayer with a mortgage in excess of £35,000 and about £225 to a similar 40 per cent rate taxpayer.

14. If you would like discuss these figures and their implications with me, I should, of course, be very happy to try to help.

B A Mace

B A MACE

X |

ca
Worth, perhaps, having
Brian & Michael in
to talk this through?
AWK

yes — v. imp.
M.

TASK FORCE SECRET

TABLE A

Option 1: Losers by income and reliefs

Lower limit of total income £000	No of losers 000s	% claiming deductions +	% claiming MIR *	% claiming other deductions +
0	3	80	73 (30)	45
18	100	92	89 (41)	18
20	280	86	82 (32)	23
25	170	89	83 (43)	34
30	170	94	89 (52)	44
40	50	99.5	91 (62)	67
50	20	96	78 (52)	86

* Figures in brackets show percentage of total numbers claiming mortgage interest relief in excess of £3,000.

+ Not including pension contributions (other than retirement annuity relief for the self-employed).

TASK FORCE SECRET

TABLE B

Option 2: Losers by size of loss and reliefs

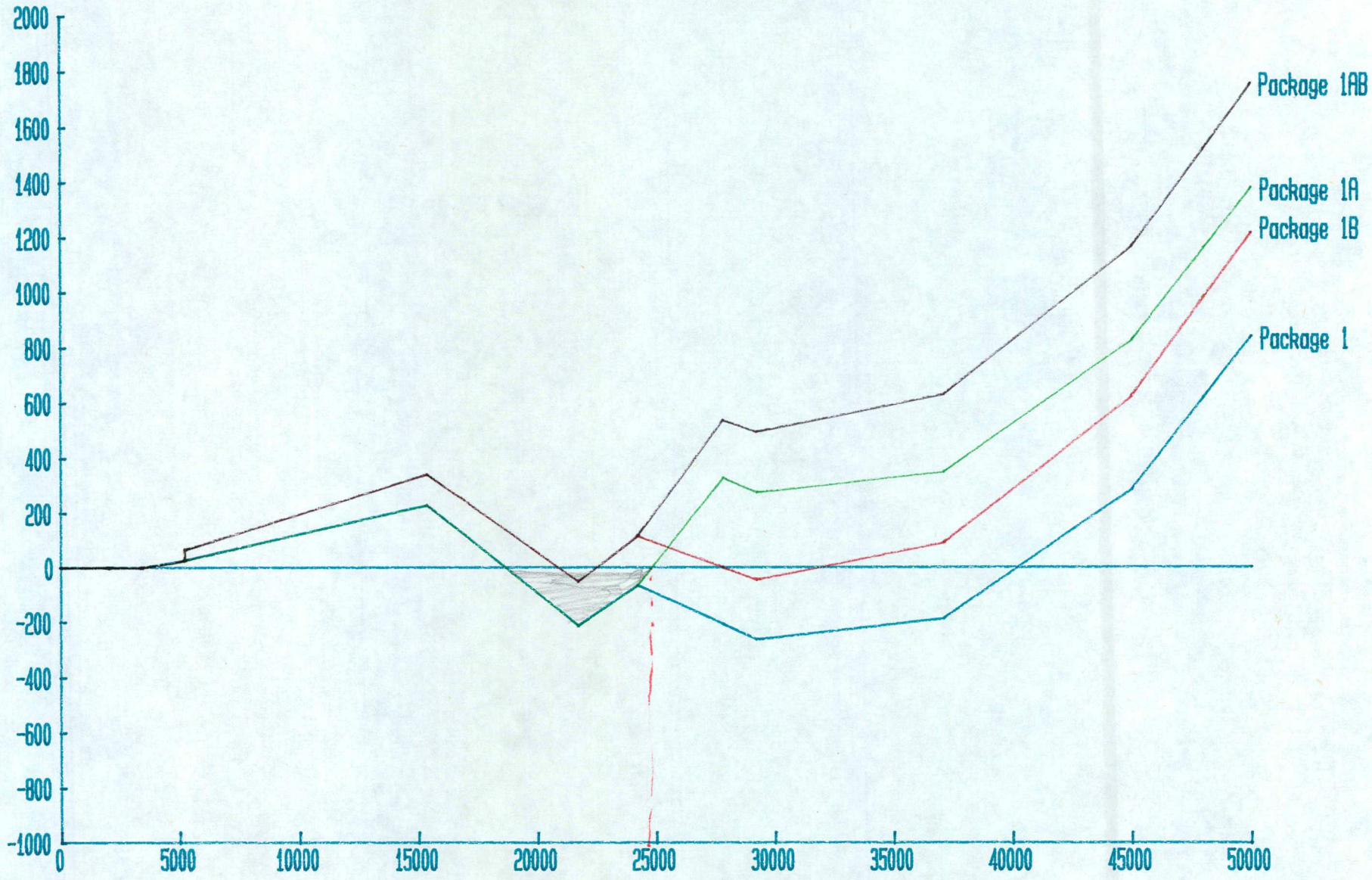
Size of loss £	No of losers 000s	% claiming deductions +	% claiming MIR *	% claiming other deductions +
0 - 50	150	79	75 (28)	26
51 - 100	130	83	78 (30)	22
101 - 200	200	89	82 (33)	27
201 - 300	130	98	92 (48)	33
301 - 500	140	100	96 (67)	42
501 +	50	100	92 (68)	85

* Figures in brackets show percentage of total numbers claiming mortgage interest relief in excess of £3,000

+ Not including pension contributions (other than retirement annuity relief for the self-employed).

Gains from the income tax and NIC packages for a married man whose income is all earned

Gain per year
£



Gross yearly income £

TASK FORCE SECRET

COPY NO 1 OF 10

FROM: MISS C E C SINCLAIR
DATE: 24 July 1987

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G P Smith

Mr Battishill -IR
Mr Issac

*Thanks - L
await X
with attached
[regarding Y, pom
dinner]*

SINCLAIR
→
CH/EX
24/7

REFORM OF CAPITAL GAINS TAX

ch Papers with you, I think

Mr Kuczys' minute of 10 July asked us to consider, with the Revenue, the likely yield from a short-term surge of unlocking as a result of rebasing; and to advise on when the Bank should be brought in.

2. I attach a note which covers the question of a surge, and its likely revenue yield, as well as other points. We are grateful for the help we have had from the Revenue in pursuing this, but feel that we need to gain a better understanding of the assumptions underlying the figures. At this stage both we and they advise you to use them with great caution. They are in any case, all estimates of the effect on accruals in 1988-89. The revenue, or FSBR, effects in that year would be considerably less. We propose to look into the costings, and the behavioural assumptions underlying them, in more depth over the summer, with a view to reporting back to you in early September.

X

3. As far as bringing in the Bank is concerned, we think that it would be best to wait until you have had this further report from FP. This should enable us better to judge how sensitive the figures may be to market assumptions. We may also find gaps in the underlying data base where the Bank may be able to help us (eg the average length of individuals' holdings of shares).

y

CAROLYN SINCLAIR

TAX REFORM: CAPITAL GAINS TAX

The proposal set out in Mr Cayley's submission of 1 July is for the taxation of gains at (reformed) income tax rates of 25p and 40p, with retention of indexation for post-1982 gains and rebasing to 1982 of all gains before that date. This proposal looks attractive. The taxation of income, and of real capital gains, would be put on broadly the same basis (though we could not allow losses to be offset against income). Taxpayers with large post-1982 gains and/or large incomes would pay more tax on them than they do now, and this would help reduce the present artificial incentive to convert income into capital.

2. Rebasing to 1982 could be presented as completing the process begun by the introduction of indexation. The alternative way of achieving a regime which taxed only real gains would be to extend indexation back to 1965. This would be very complicated in practice in the case of shares; rather less so for land. To apply indexation, information would be needed about the date, price and quantity of each addition or subtraction to a given block, or 'pool', of a share acquired before 1982. In many cases such information will not now be available. Even where it is available, the compliance cost for taxpayers in working out the indexed gain on pre-1982 shares would be pretty formidable. While the principle of a fully indexed regime for capital gains would be welcomed, there would be likely to be loud complaints about such complexities.

3. Rebasing to 1982 would of course be more generous than extending indexation back to 1965, to the extent that real gains before 1982 would be ignored for tax purposes. But given the difficulties of extending indexation, it is probably the only practical way of achieving a conceptually coherent regime which aims only to tax real, as opposed to nominal, gains. It could be presented as a one-off step to this end. Once CGT was confined to real gains, the same argument for rebasing could not arise

TASK FORCE SECRET

again. It would be desirable to devise any new arrangements for computing the tax - for example the minor simplifications discussed in the Mr Cayley's note of 6 July - in such a way as to make any further rebasing seem unlikely.

4. The generosity of the rebasing provisions seems likely to lead to unlocking of realisations, for example from people sitting on large pre-1982 nominal gains. There could also be a sizeable psychological effect from those who have always objected to the tax on principle.

5. A large amount of land purchased before 1982 would be removed from liability to all CGT, since agricultural land values have only just risen in line with inflation. But unlocking of this land would yield no extra revenue.

6. For assets (including land) which have increased in value in real terms since 1982, large scale disposals would push taxpayers into higher rate tax, thus increasing the effective tax rate, and diminishing the incentive to realise capital gains for taxpayers with significant other income. The effect of unlocking would probably be seen over a number of years, as taxpayers aimed to take maximum advantage of the CGT threshold. Pensioners or others with small incomes would be more likely to respond to unlocking.

7. Inland Revenue have made an assumption about extra realisations on a continuing basis as a result of the change. Their estimate has assumed a 1 per cent increase/decrease in realisations of land, and a 2 per cent increase/decrease in share realisations for every 1 per cent reduction/increase in the effective rate of tax.

8. This would be a smaller behavioural response than US evidence suggests, very tentatively, might follow in the US from changes in their capital gains tax regime. We do not have the necessary information to make a similar calculation for the UK. But the high level of the CGT threshold (there is nothing comparable in the US) makes it easier for individuals to phase disposals in such a way as to avoid CGT altogether. It is thus not unreasonable

** 10% on net post-1982 gain
vs 30% on nominal pre-1982 gain:
addition must be large enough to
work with*

TASK FORCE SECRET

to assume a smaller behavioural response in the UK from a change in the tax regime for capital gains, at least for individuals.

9. The Revenue estimate that the medium term cost for individuals could be £450 million; and for companies, £500 million. But clearly if the behavioural assumption were changed, the cost would change. The effects go in different directions for individuals and for companies.

10. The Revenue's model assumes that, for individuals, the reform would ^{on average} /increase the effective rate of tax on shares, but reduce it on agricultural land. So, on the behavioural assumption in paragraph 7 above, we might expect a reduction in realisations on shares, and an increase on land. The impact overall of the behavioural effect is estimated at around £50 million.

11. We have tested the sensitivity of these figures to changes in the size of the behavioural effects. If we assumed a 10 per cent response to each 1 per cent change in the effective tax rate (the outer limit perhaps of what it is plausible to accept), the Revenue's model suggests that the cost of the reform, in the case of individuals, would rise from £400 million to £750 million. This is because there would be a large reduction in share realisations; and because the increase in agricultural land realisations would not bring many individuals into tax.

12. The effect for companies would go the other way. Because rebasing would reduce the effective rate of tax for all companies owning pre-1982 assets, the model assumes that there would be a large increase in realisations, and thus a reduction in cost. But the Revenue are unable to quantify this.

13. The net effect is that a different assumption about the behavioural response could still leave the medium term cost somewhere near £950 million on an accruals basis. All these figures come from the Revenue model; as noted above, that lacks some important data.

TASK FORCE SECRET

14. The Chancellor has asked about a possible short-term surge effect as a result of unlocking of realisations. We have discussed this with the Revenue. With a medium-term cost of around £950 million, they estimate that the revenue yield from a short-term surge could lie in the range £250 million-£500 million. This would be an offset to the cost (again all figures are on an accruals basis).

15. The yield effect from a surge of disposals is an educated guess. The present yield from CGT is £2½ billion. If there were no yield from a surge, this would be reduced by the present proposal to around £1½ billion. About half the yield comes from shares, most of the rest from land.

16. A surge in disposals of land will in many cases not produce any tax. People/companies are in any case less likely to be influenced by tax considerations in selling land as opposed to shares (eg if you want a second home you hang on to it anyway). This is why the elasticity assumption is less for land than for shares.

17. In the case of shares many individuals are unlikely to find that they pay less tax under the new regime on disposals of shares unless they have held on to them for a very long time. And individuals have scope to juggle their disposals to get maximum benefit from the CGT threshold.

18. It thus seems unlikely that a surge of disposals - whether land or shares - by individuals will yield much revenue.

19. Companies are in a different position. In their case their no exempt slice of capital gains and their rate of tax will not be going up. Rebasing will thus be a straight benefit for companies which hold pre-1982 assets. The bulk of the yield from a short-term surge is expected to come from companies selling 'old' shares. To produce a yield of £300 million, the company sector would have to double its disposals of shares.

20. Over half the cost of the measure comes from rebasing companies' gains. It would be technically feasible to limit rebasing to individuals and trusts. This would substantially reduce the cost and be a shift in the tax burden from individuals to companies. On the other hand, exclusion of the corporate sector from rebasing would make it hard to take credit for a tax regime which taxed only real gains: the discrepancy would be constantly pointed up. Exclusion would also give rise to complaints from that sector, especially coming hard on the heels of the 35 per cent tax rate on capital gains introduced for medium and large companies this year. Small companies, which benefitted from this year's reform, would complain that they were being substantially disadvantaged compared with unincorporated businesses. The argument is essentially one of political judgement.

21. You will want to consider the implications of this reform for the level of the capital gains tax threshold. A reduction in the threshold - say to the level of the married man's allowance (£3,795) would produce a greater degree of alignment with income tax. And it might fit well with giving husband and wife each their own CGT threshold. A reduction in the threshold would have implications for the cost, which would need to be calculated.

22. There could also be some helpful administrative implications. If the reform took 60,000 taxpayers out of capital gains tax (total 200,000) we should look for a smaller requirement for Inland Revenue staff.

23. Taxing capital gains at reduced and simplified income tax rates would go some way to removing the incentive to convert income into capital. But because tax would be charged on real and not nominal gains, and at the same time on nominal and not real interest, there would still be some bias in the system in favour of gains rather than income. Rebasing to 1982 could be presented as completing the logic underlying the introduction of indexation and ending the taxation of nominal gains. It would be very popular, especially with farmers. Support for this part of the package would be likely to offset complaints from those taxpayers with post-1982 gains who would lose as a result of the gains being taxed at 40 per cent instead of 30 per cent.



COPY NO. 10 OF 13.

AWK
→
SINCLAIR
27/7

FROM: A W KUCZYS
DATE: 27 July 1987

① MISS SINCLAIR

- cc ② Sir P Middleton
- ③ Sir T Burns
- ④ Mr Cassell
- ⑤ Mr Byatt
- ⑥ Mr Scholar
- ⑦ Mr G P Smith
- ⑧ Mr Battishill - IR
- ⑨ Mr Isaac - IR

REFORM OF CAPITAL GAINS TAX

The Chancellor was grateful for your note of 24 July. He awaits the further report in September, looking at the costings and behavioural assumptions in more depth, with interest.

A W KUCZYS



Ch

You wanted a word with
Michael Scholar &
Brian Mace.

Only Michael & Brian
have the papers attached.

The earlier papers, which
were copied more widely,
are on the folder for
your tax reform meeting
at 5.00 pm

AJK
27/7

+ other simplifications

VERTICE ECONOMICO



VENEZIA 87

Tax Reform - rationale

A. Top tax rate too high - esp since US
Max 50% - probably less

B. At same time, fulfill program
basic rate @ 25%

Much better so for activity - (A)
by abolishing US & bring top
IT rate down to 40%:

(i) eliminates kink (two problems)

(ii) reduces value of tax breaks

Then no need for intermediate rates

C. CGT: at present cap gains
undertaxed of income (conversion
problem). (also CG v DIVS)

Bring top rate down to 40%
equals CGT @ IT rates (efco?)

D. End unfairness of pre-'82
undivided gains & will gifted

E. Deal with top 40%: what's best solution?
NIC change

F. Women & tax (smaller loss given)

TASK FORCE SECRET

pyp

Ch
 Not on here are (*)
 ① Isaac on shelter
 ② Messyn King AA

COPY NO 1 OF 9 COPIES

FROM: M C SCHOLAR
 DATE: 27 JULY 1987

CHANCELLOR OF THE EXCHEQUER

(* can supply if wanted
 but there seems plenty)

cc Financial Secretary
 Sir Peter Middleton
 Mr Cassell
 Mr Cropper
 Mr Battishill - IR
 Mr Isaac - IR

+ Bains
 Byatt
 Tyrie

TAX REFORM: MEETING ON 28 JULY

Your office asked me to provide an annotated agenda for your meeting on Tuesday.

2. The papers for the meeting are:-

Mr Mace of 14 July: Tax Reform: Income Tax rates and upper earnings limit for NIC

Mr Scholar of 21 July: Tax Reform: Income Tax rates and NICs

Mr Cayley of 1 July: Reform of Capital Gains Tax

[Mr Cayley of 6 July: CGT: Minor Simplifications of Indexation]

Mr Kuczys of 10 July: Reform of Capital Gains Tax

Mr Cayley of 21 July: Reform of Capital Gains Tax

Miss Sinclair of 24 July: Reform of Capital Gains Tax

3. I suggest that you might address, amongst others identified in these papers, the following questions -

- (i) Do you see the beginnings of a plausible reform in these papers (perhaps this should be the last question on the list)?
- (ii) Is Option 1 in Mr Mace's 14 July paper to be ruled out in its present form, as creating too many losers many of whom are unlikely to gain from either the capital gains tax changes, or from independent taxation?
- (iii) Is Option 1A an attractive and cost-effective way of eliminating most of the higher-rate losers?

- (iv) Is there any route by which the number of basic rate losers could be reduced less expensively than in Options 1B or 1AB (or in paragraphs 10, 11 and 13 of my minute of 21 July)?
- (v) Would it be worth considering an option involving a lower NIC rate above the UEL? As a temporary move, to phase in the reform while limiting the number of cash losers?
- (vi) Which, if any, of the Options in my minute of 21 July, is worth further consideration?
- (vii) Does the capital gains tax reform, with 1982 rebasing, look a worthwhile and cost-effective reform?
- (viii) Should rebasing be confined to individuals and trusts?
- (ix) Should capital gains tax be formally integrated with income tax, or should the taxes simply be aligned?
- (x) On the interaction with independent taxation, should we be looking to reductions or to increases in the annual capital gains tax exemption limit for individuals?
- (xi) If the reform as a whole looks too expensive, could it be phased-in over several years?

4. Do you want to commission further work, inter alia, on

- (i) ✓ the interactions between these different reforms, once the options have been narrowed? We might be asked to produce a matrix, mapping the distributional effects of all these measures as far as possible.
- (ii) ✓ the costing - including the estimation of the yield from a short-term surge of realisations - of the capital gains tax reform?
- (iii) ✓ the market effects of the reform (we think it is too early to bring in the Bank at this stage - see Miss Sinclair's minute of 24 July).

*3-6-92
 Oct 87
 (w/ Neil & ...)*

Mr. Scholar

*10th July -
 year-by-year*

MCS

M C SCHOLAR



FROM: A W KUCZYS

DATE: 27 July 1987

AWK
→
CAYLEY
27/7

MR CAYLEY - IR

cc: PS/FST
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G Smith
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Houghton

REFORM OF CAPITAL GAINS TAX

The Chancellor was grateful for your minute of 21 July.

2. On the costs and benefits of charging capital gains to income tax, he has asked what is the US position post tax reform?
3. On the precedents for use in dealing with complaints that CGT changes are retrospective, the Chancellor would be grateful for a note on the options for avoiding retrospection: ie
 - (a) making the 40 per cent rate apply only to future gains; and
 - (b) leaving a year in which past gains are taxable at 30 per cent before moving to 40 per cent.

A handwritten signature in blue ink, appearing to be 'AWK'.

A W KUCZYS



NOTE OF A MEETING HELD AT No.11
ON TUESDAY 28 JULY

Those present:

Chancellor
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR

TAX REFORM

The meeting followed Mr Scholar's annotated agenda of 27 July.

2. The Chancellor set out the rationale of the reform package as it now stood. First of all, there was the pledge to reduce the basic rate to no more than 25 per cent. In addition, the top marginal rate of income tax was now too high by international standards: other countries, most notably the United States, had moved since 1979. The top rate should now be, at most, 50 per cent.

3. There were two ways of going about reducing the top rate. The route the Chancellor preferred was a very substantial cut in the top rate of income tax, coupled with the abolition of the UEL. This was more complicated than a straightforward, smaller, reduction in the top income tax rate, and created some losers. But it had two major advantages: it eliminated the "kink", and the maximum value of special reliefs and tax breaks was reduced (since these reliefs did not run against NICs).



4. There was then the question of how to fit capital gains into the reformed system, and of what needed to be changed in the present CGT system. We had looked at the possibility of withdrawing indexation relief, but this would throw up problems of very large losers, and charges of retrospection. So this was now ruled out. Then there was the injustice of taxing pre-1982 paper gains. Since there was no practicable way of extending indexation back to 1965, the only way to deal with this was to rebase the tax to 1982. Finally, relative to income, gains were too lightly taxed: the rate was lower (for higher rate income tax payers) and the threshold higher. This had the unhealthy result that people invested for capital gains rather than dividends; and that in turn added to some of the more undesirable takeover practices (leveraged bids, etc).

5. The Chancellor's conclusion was that the rate of tax on gains and on dividends should be brought into line. It would be possible to go about this in the way suggested by Professor King - taxing investment income at a flat rate. That had administrative advantages, but would give rise to serious presentational problems. The Chancellor had therefore reached the conclusion that capital gains should be taxed at income tax rates - with indexation relief, and rebased to 1982.

6. There were two other elements in the reform package. First of all, there was a case for action to help those right at the bottom of the income range. The best way of doing that was through the NIC system. And second, there was a case for some action on the tax treatment of married couples. Independent Taxation would cost less in the context of the overall tax reform, and the Chancellor proposed to announce it in 1988 (to take effect from 1990). Finally, the Financial Secretary was looking at some other simplifications.



7. All this, in the Chancellor's view, made up a coherent package. But we needed to do more work on its cost (eg how the cost arose year by year) and overall impact (gainers and losers, etc).

8. In discussion, the following points were made:

- (a) Abolition of the UEL was an important part of the package, since that made it possible to tax gains at no more than 40 per cent (probably the maximum we could go for) while continuing to tax income, effectively, at up to 49 per cent. But it had the side effect of producing losers at middle income levels. It would also spotlight the discrepancy (which already existed to some extent) in the tax treatment of investment and earned income.
- (b) The basic package would not be a major simplification for the Inland Revenue, or for the tax payer. The second order simplifications which the Financial Secretary was considering might help here.
- (c) In any tax reform, if we worried too much about losers, we would never get anywhere. There was a case for adopting a "life cycle" approach: many of those who lost initially might be gainers at another stage of their lives. (And, given the overall cost of the package, the number of losers was rather surprising.)
- (d) It might be argued that removing the UEL was an assault on the contributory principle (although the Chancellor did not accept this). One option might be to give an earnings related addition to pensions in return for NICs paid above the UEL. That would have a long term public expenditure cost, and would need to be discussed with the Social Services Secretary. On the other hand, we had already abolished the UEL for employers, without breaching the contributory principle. And we would not want to stir up discussion of SERPS again. In the longer term, abolition of the UEL might help pay for the withdrawal of the Treasury supplement.



9. The Chancellor then considered the question of losers. Higher rate losers could be dealt with something on the lines of option 1A. The more serious problem was that of basic rate losers. They lost directly from abolition of the UEL, and lost further to the extent that they had reliefs which did not run against NICs. The first point might be dealt with through a transitional period, so that the rate above the UEL did not move to 9 per cent immediately. For example, the rate might be set at 6 or 7 per cent in October 1988, moving later to 9 per cent - perhaps from April 1989. The second point might be dealt with through action on mortgage interest relief - much the most important relief. A possible package would be an increase in the £30,000 ceiling, coupled with a move to a residence basis. The net effect should still be to reduce the cost of the relief.

10. The Chancellor's view was that option 1A, together with a transitional period for bringing in the full NIC charge above the UEL, and changes to mortgage interest relief, would go a long way to reducing the number of losers, and the amount of losses. It could also be done at an acceptable cost.

11. On the question of NIC changes at the bottom end, the Chancellor thought two options were worth pursuing. These were options 3 and 5 of Mr Scholar's note of 21 July. Of these, the Chancellor marginally preferred option 3. However, Mr Scholar's options would give the benefit of changes to employees only, while leaving employers' contributions on the same basis as now. The Chancellor thought that, if we were breaking the link between employees' and employers' contributions, we might as well go the whole way and withdraw the present "steps" for employers altogether. That would make more money available on the employees side. And it could be argued that, in principle, it should not matter how the NIC burden was distributed between employees and employers. Moreover, the corporate sector would have a major windfall from the capital gains changes - although of course some companies would not benefit from this.



12. Mr Battishill suggested an alternative approach, of applying the principle of option 5 (withdrawable allowances) to employees and employers. Mr Scholar was asked to work up some further options in the light of discussion. (After the meeting, the Chancellor asked whether any of these options would place an unreasonable burden on small firms: Mr Scholar to advise on this too.)

13. There was some discussion of capital gains tax reform. The Chancellor said there was a strong case for rebasing to 1982 - for reasons of equity not just tidiness. But this was not an essential part of the package. He believed there would be a yield in the early years, because of unlocking, although the Inland Revenue figuring suggested otherwise (mostly because large holdings of agricultural land had not risen much in real terms since 1982). We would need to assess the market effects after the summer break. The Financial Secretary was concerned that the change might be seen as a give-away to very wealthy land owners. It was agreed that 1982 rebasing should remain in the package for the time being, but could be dropped at a later stage. If it remained in, it would have to apply to companies: it was not practicable to confine rebasing to individuals and trusts.

14. On the question of fully integrating CGT with income tax, Mr Isaac reported that Counsel was currently considering a possible short-cut, to avoid many pages of detailed amendments. He would report back.

15. On the question of interaction between capital gains tax reform and independent taxation, the Chancellor noted that keeping the present threshold - which was only as high as it was for administrative reasons - and giving couples each an exemption, would mean that couples could realise gains of upto about £13,000 tax free. This was far too generous. Mr Isaac said that a "staff-neutral" threshold would not be very much lower than the



present threshold, because many gains were realised (in old age) by single (or widowed) people. The Chancellor concluded that, while staff cost was a factor to be taken into consideration, we also had to consider the revenue cost - and whether the result of change looked reasonable.

16. Finally, there was the question of phasing in the reform. A certain amount of phasing was already inherent: the main income tax changes would take immediate effect, the NIC changes would come in in two instalments (probably October 1988 and April 1989); the capital gains changes would not bite immediately, while the change in treatment of married couples would be delayed until 1990. The Chancellor was not attracted by any additional phasing. He asked for a note from Mr Scholar setting out the impact of the whole package year by year.

Further Work

17. The Chancellor asked for the further work set out at paragraph 4 of Mr Scholar's annotated agenda to be taken forward:

- (i) on the interactions between the different reforms, with a matrix of distributional effects;
- (ii) a costing of the whole package, including an estimation of the yield from a short-term surge of realisations following 1982 rebasing; and
- (iii) on the market effects of the reform, accepting that it was too early to bring in the Bank at this stage.

A W KUCZYS

Distribution:

PS/CST
 PS/FST
 Sir P Middleton
 Sir T Burns
 Mr Cassell
 Mr Byatt
 Mr Cropper
 Mr Tyrie
 Mr Battishill
 Mr Isaac



FROM: FINANCIAL SECRETARY
DATE: 28 July 1987

CHANCELLOR

cc Mr Cropper

TAX REFORM

1. Peter Cropper and I have been examining with a small group of officials the overall shape of the income tax/capital gains tax/NIC reform package. I do not want to sound unduly negative, but I thought you would appreciate some comments on the issues which I think need to be resolved.

Income Tax/NICs

2. The proposed 25%, 40% structure I firmly support. However, we need to examine closely the interaction between this structure and the means of paying for it (abolition of the NIC upper earnings limit). The major problem, of course, is the large number of losers that emerges from a package which we will be seeking to present as a tax-cutting reform.

3. Mr Mace's paper suggests that there will be perhaps some 800,000 losers under the basic proposal - tax units with incomes ranging from £17,780 up to £47,500 (the precise figures will obviously depend on the proportion of income which is unearned or sheltered from tax).

4. Officials have devised various - very expensive - ways of reducing the number of losers. But I do not think that they have yet been able to devise a solution which eliminates losers altogether. For instance their Option 1AB eliminates 75% of the losers but costs an enormous £4.25 billion. It hardly needs me to point out that a lot more thinking needs to be done on

TASK FORCE SECRET

TASK FORCE SECRET

this area before we have a reform which will be easy to present. I am particularly concerned about the 500,000 losers who are basic rate taxpayers - who gain the 2% off the income tax rate, but suffer an impost of 9% on their incomes over £15,340 which they did not face before. There will also be very difficult political problems with the self-employed.

5. At the lower end of the income spectrum we face the problem of the unemployment and poverty traps. It will be a great pity if a reforming budget cannot effectively crack this problem as it would politically be an excellent counterpart to the dramatic changes at the top end. Unfortunately, none of the options in Michael Scholar's paper go very far at all in helping with the traps. It is an unpalatable fact that the best way of alleviating the traps is by acting through the benefit system - either reducing out of work benefit or increasing Family Credit.

6. The scope for alleviating the traps via NICs and income tax is very limited. That does not mean the proposals are pointless as they do reduce "taxes" for the lower paid. And certainly, we must have some offset to the huge gains going to the very rich due to the falling higher rates. I note that 12% of the cost of the income tax package goes to those earning £100,000 or more!

CGT Reform

7. I am sure you are right that CGT needs reform. However, I am not myself convinced that the precise package you are contemplating can really be presented as integration with income tax, let alone simplification. The points here are familiar: separate threshold, indexation relief, no "offsettability", NICs. I have three further points.

8. First, I am a little anxious about the effect of re-basing. It does seem to me that its basic effect will be to give a substantial tax hand-out to those making gains between 1965 and 1982 rather than to help those people in the future who will be facing a marginal rate of 40% on disposals. Obviously people

TASK FORCE SECRET

TASK FORCE SECRET

disposing of assets acquired pre-1982 will enjoy the benefits of re-basing to compensate them for the higher tax rate. But people buying assets post-Budget will get no benefit from re-basing and will pay at the new rate (provided they are not basic rate taxpayers). I would be a little less concerned about this apparent inequity if it were not for the fact that £500 million or so of the benefits of re-basing will probably go to landowners.

9. Second, having read Mr Cayley's Annex 3 I firmly believe that the presentational advantages of integrating (in the strict sense) CGT and income tax are outweighed by the huge disadvantages in terms of legislative complexity and Parliamentary Counsel's time.

10. Third, one thought triggered off in my mind by the Mervyn King analysis, was that the basic incentive under existing law is to switch between investment income and capital gains (or vice versa) not between earned income and capital gains. I have not thought this through properly, but do you not think there might be some case for setting up a combined unearned income/capital gains schedule with its own separate threshold, and perhaps a single rate of 25%? Earned income would be taxed at 25% and 40% (and NICs) and therefore there would be an incentive to take income (or capital gain) in unearned form. However, there already is an incentive in this direction due to the NIC position. Moreover, a proposal on these lines could, if the threshold were fixed suitably, lead to huge administrative savings for everyone, by paving the way for an abolition of indexation relief.

11. I imagine you will not want to be side-tracked by a scheme along the lines I have just outlined. Therefore, taking the package before us, it seems to me crucial that we start to look at how the various programmes - NICs/income tax/CGT/husband and wife - all come together. We urgently need to identify the Winners

TASK FORCE SECRET

TASK FORCE SECRET

and Losers in the combined package. That is not going to be easy. The indications are that people at the top of the basic rate band are vulnerable, but we need more work on this urgently.

A handwritten signature in blue ink, appearing to be 'NL' with a small flourish below it.

NORMAN LAMONT

TASK FORCE SECRET

CONFIDENTIAL



cc. PS/chlex

PS/CST

PS/fst

PS/est

Mr Schlar

Miss Sinclair

Mr Cropper

Miss ARhodes IR

Mr Jefferson Smith

Mr E Taylor

PS/C&E

NOTE OF A MEETING

HELD IN ROOM 50/2nd, HM TREASURY ON 28 JULY 1987

Those present: Paymaster General
Miss Sinclair
Mr Cropper

Mr Jefferson Smith - C&E
Mr E Taylor - C&E

Miss Rhodes - IR

VAT: MOTORING EXPENSES

The meeting had before it Mr Jefferson Smith's submission of 17 July.

2. The Paymaster General enquired when the suggested reduction of the petrol scale would be introduced. Mr Jefferson Smith replied that, as the 1988-89 scale had already been announced, it would have to be 1989-90.

3. The Paymaster General said that he still hankered after a reduction in the petrol scale with a compensatory increase in the car scale. Miss Rhodes said that a lot of people thought that the car scale should have been increased by more than 10 per cent. The Paymaster General recognised the disadvantage of increasing the car scale more sharply.

4. The Paymaster General asked what should be done about the practical problem of correspondence from Mr Maxwell-Hyslop and others if the status quo was maintained. Mr Taylor suggested that the Customs and Excise review, which had only been mentioned in replies to Messrs Maxwell-Hyslop and Maude, could be stated more overtly in future.

NOTE
OF
MTG
28/7

CONFIDENTIAL

5. Miss Rhodes pointed out that if the 10 per cent reduction was intended to be general and not just for VAT, the Inland Revenue would need to know fairly early on, in order to adjust the PAYE codes accordingly. The Paymaster General did not think this would pose a problem: a 1989 change would be announced in the 1988 Budget.

6. Although the Paymaster General was not averse to a 10 per cent reduction in petrol charges and preferred this to a reduction just for sole proprietors, he favoured Mr Jefferson Smith's recommended course of action: we should maintain the status quo but bear in mind a 10 per cent reduction. He thought that the review should be kept low key in order to avoid too much flak during the winter.

7. Miss Rhodes said that the Revenue would put forward a submission around September. They received very few complaints about the scale charges: although the car fuel scale was perhaps a little high, most people recognised the benefits. As the Revenue received about £160 million revenue from this, they were loath to undercut it by 10 per cent. Mr Jefferson Smith pointed out that the Revenue scale only affected companies and not sole proprietors, whereas most of the complaints Customs received were from sole proprietors who were comparing their current position with the past position.

8. The Paymaster General concluded that the VAT consideration should be treated as a part of the complete issue of scale charges, with other considerations in mind, including parking and the £8500 threshold. For the time being, the status quo on petrol charges would be maintained and Mr Taylor agreed to provide a reinforced stock reply for the Paymaster General to send to correspondents on this subject.

Deborah Francis.

MISS D L FRANCIS

Assistant Private Secretary

Copy 1 of 21



INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

From: W Gonzalez
Date: 29 July 1987

- 1. MR HOUGHTON
- 2. MR ISAAC
- 3. CHANCELLOR OF THE EXCHEQUER

Thanks. Pse go ahead on this basis. ASAP. M.

(Get Michael Scholar's request)

GONZALEZ
TO
CH.
29.7.87

REFORM OF CAPITAL GAINS TAX

1. The note dated 10 July from Mr Kuczys asks that earlier work analysing who CGT payers are in relation to income tax payers may be taken further.

2. The earlier work, which I reported to you in my note of 9 January 1987, consisted of a small survey conducted at the end of last year. It had limited objectives being intended to find out the marginal rates of income tax paid by CGT payers. Further information about the nature of their income and their personal circumstances is now required.

3. We have already begun collecting additional data about capital gains chargeable to CGT and expect to have usable results by the early Autumn. These data have to be obtained from local tax offices and, in our requests to them, we already ask for information about CGT payers' sex, age and

- cc. Financial Secretary
 Sir P Middleton
 Sir T Burns
 Mr Cassell
 Mr Byatt
 Mr Scholar
 Mr G Smith
 Miss Sinclair
 Mr Cropper

- Mr Battishill
 Mr Isaac
 Mr Beighton
 Mr Calder
 Mr Houghton
 Mr Cayley
 Mr Gonzalez
 Mr Hamilton
 Mr Mace
 Mr Michael
 Mr Quinn

TASK FORCE SECRET

marital status. The best way of obtaining income information is to add questions to the CGT questionnaires. We intend to keep the income questions few and simple viz.

1. Marginal income tax rate
2. Amount of taxable income
3. Amount of employment income
4. Amount of self-employment income
5. Amount of other earned income
6. Amount of investment income

For married couples we would ask for items 3 to 6 to show the amounts of the husband's and the wife's incomes separately. Asking for additional income detail beyond that suggested above could risk delays in obtaining and analysing the returns and would imply more complex analysis requiring a larger sample than we expect to be available from the CGT exercise within the timescale required.

4. The CGT exercise will give us information about each disposal made by the taxpayers in the sample, the nature of the asset sold, when it was acquired and when it was sold, the acquisition and disposal values etc. We will be able to analyse this information about capital gains in relation to the income information suggested above. Items 1 and 2 in paragraph 3 will allow us to calculate for each taxpayer the combined effect of charging capital gains at income tax rates and of varying these rates. Items 3 and 4 will give the connection with NIC. The split of items 3 to 6 for married couples will allow us to estimate some of the effects of disaggregation between husband and wife but firm conclusions on this aspect may not be possible in our first report.

TASK FORCE SECRET

5. We already hold about 500 replies to our requests for capital gains information ready to be put on our computer for analysis. Because of the great complexity of the data this is not a negligible task. A supplementary questionnaire will be required in respect of these 500. By mid-September when we would begin preparing our report we would hope to have another 500 or so replies, complete with income information, ready for analysis. We would report results to you in mid-October. As the CGT exercise will be a continuing one we may be able to refine the results at a later stage.

6. We hope that by extending an existing survey rather than setting up a new one we may conceal the fact that the additional data are needed for an immediate policy purpose. There is of course a risk that officers in local offices will draw conclusions but the risk will have to be accepted if the data are to be obtained.

7. I shall be grateful for confirmation that you are content that the survey should go ahead and that it will provide the information you need. I should also be grateful for your authority to talk to my colleagues on the operational side so that the revised questionnaire may be prepared and sent out to local offices.


W GONZALEZ



FROM: FINANCIAL SECRETARY
DATE: 29 July 1987

(rec'd 31/7)

CHANCELLOR

cc Mr Cropper

TAX REFORM: SELF-EMPLOYED

*A good point to be
made for a while
on this, examine options.
M.*

1. I think one issue which did not receive a mention at yesterday's meeting and which will certainly require further thought is the question of the NIC-treatment of the self-employed.

2. As you know, at present, the self-employed pay:

(i) Class 2 contributions of £3.85 per week, which entitle them to retirement pension, sickness and invalidity benefits and widow's benefits; and

(ii) Class 4 contributions of 6.3% on the share of their profits above £4,590 p.a. up to the upper profits limit of £15,340. These contributions give the self-employed no additional entitlement to benefits, but 50% of their Class 4 payments can be offset against income tax liability.

3. The Class 4 contributions are particularly resented by the self-employed not least because they apparently carry with them no extra benefit entitlements. Arguably, therefore, they cannot be justified by reference to the contributory principle. It was precisely because these contributions were so unpopular that the 50% tax relief was introduced a few years ago.

TASK FORCE SECRET

FST
TO
CH EX
29 July

TASK FORCE SECRET

4. Against this background, we must be in no doubt that the current proposals on abolishing the upper earnings/profit limit - unwelcome as they will be to the employed - will be particularly fiercely criticised by the very vocal self-employed lobby. You will recall that the working assumptions of the Brian Mace paper were that:

(i) All self-employed people will pay 9% on any profits above £15,340 p.a.

(ii) There will be no tax relief on payments made in respect of profits above £15,340.

5. I thought this issue just needed highlighting, although I understand the arguments for treating employed/self-employed people consistently.



NORMAN LAMONT

TASK FORCE SECRET

Page

COPY NO. 10 OF 11.



FROM: A W KUCZYS

DATE: 30 July 1987

MISS SINCLAIR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G P Smith

Mr Battishill - IR
Mr Isaac

REFORM OF CAPITAL GAINS TAX

Your note of 24 July. This is just to confirm that the Chancellor is content with your recommendation that we should not bring in the Bank until you have produced the further report in early September.

AWK

A W KUCZYS

27



FROM: A W KUCZYS
DATE: 30 July 1987

PS/FINANCIAL SECRETARY

cc Mr Cropper

TAX REFORM

The Chancellor was grateful for the Financial Secretary's minute of 28 July, which he discussed with the Financial Secretary on Tuesday evening.

A handwritten signature in black ink, appearing to be "A W Kuczys".

A W KUCZYS

TASK FORCE SECRET

COPY NO 1 OF 12 COPIES

FROM: M C SCHOLAR
DATE: 31 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Miss Sinclair
Mr CropperMr Battishill - IR
Mr Isaac - IR
PS/IR*Thanks for
S.M. J.M.**P.S. I have had
a further talk
with X & N
M.M.A. -
Tony K
dealt***TAX REFORM: WORK PROGRAMME**

We have now completed the immediate programme of work set out in my minute to Sir Peter Middleton of 5 June. You may like to know, following your meeting on 28 July, how the programme looks for the next two months or so.

2. In August the Revenue will be putting forward papers on several Independent Taxation issues: - the link with capital gains tax reform, with costings and an appraisal of a number of options for the annual capital gains exemption limit; breadwinner wives, and elderly couples. They will also be letting you have answers to your further questions on the capital gains tax papers.

3. In the first half of September we and the Revenue will let you have a preliminary estimate of the cost of the reform as a whole, as it presently stands, showing the build-up of costs year-by-year. In the course of September the Revenue will work up the proposal to move mortgage interest relief to a residence basis, on several assumptions, indicating the cost, the distributional effects, possible transitional arrangements and so on. We hope by end-September to let you have a further paper on NICs options targetted towards improving incentives for the lower paid.

4. By the end of September, too, I hope that you will have had papers (all these from the Revenue) on a further distributional analysis of the income tax/UEL proposal, on the variants discussed on Tuesday; on maintenance payments and covenants: and on the practicability of formal integration of capital gains and income tax.

5. Other pieces of work (involving both the Revenue and the Treasury) will take us into October: preparation of a matrix showing gainers and losers from all the elements in the reform taken together (and we must not forget to keep track of any developments in the proposals on child benefit); further analysis of the cost of the capital gains tax proposals, including the effect of the short-term surge of realisations; and further work on the possibilities for removing some complex top-slicing provisions etc.

6. We are envisaging opening up discussion with the Bank after that; and you will want to consider when the best moment would be to have a word with the Secretary of State for Social Services (given the operational role of the DHSS we should not perhaps leave this too long after the summer break).

7. I have agreed this note with the Inland Revenue.

MCS

M C SCHOLAR

TASK FORCE SECRET

COPY NO OF COPIES

DRAFT

FROM: M C SCHOLAR
DATE: 31 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Cropper

Mr Battishill - IR
Mr Isaac - IR

TAX REFORM: WORK PROGRAMME

We have now completed the programme of work set out in my minute to Sir Peter Middleton of 5 June. You may like to know, following your meeting on 28 July, how the programme looks for the next two months or so.

2. In August the Revenue will be putting forward papers on several Independent Taxation issues: - the link with capital gains tax reform, with costings and ^{an} appraisal of a number of options for the annual capital gains exemption limit; breadwinner wives, and elderly couples. They will also be letting you have answers to your further questions on the capital gains tax *papers*.

3. In the first half of September we and the Revenue will let you have an estimate of the cost of the reform as a whole, as it presently stands, showing the build-up of costs year-by-year. In the same time-scale the Revenue will work up the proposal to move mortgage interest relief to a residence basis, on several assumptions, indicating the cost, the distributional effects, possible transitional arrangements and so on. We hope by mid-September to let you have a further paper on NICs options targetted towards improving incentives for the lower paid.

4. By the end of September I hope that you will have had papers (all these from the Revenue) on a further distributional analysis of the

TASK FORCE SECRET

with the variants discussed on Tuesday

income tax/UEL proposal, ~~refining the work you have already seen;~~ on maintenance payments and covenants: and on the practicability of formal integration of capital gains and income tax.

5. Other pieces of work will take us into October: preparation of a matrix showing gainers and losers from all the elements in the reform taken together (and we must not forget to keep track of any developments in the proposals on child benefit); ^{and} further analysis of the cost of the capital gains tax proposals, including the effect of the short-term surge of realisations.

6. We are envisaging opening up discussion with the Bank after that; and you will want to consider when the best moment would be to have a word with the Secretary of State for Social Services (given the operational role of the DHSS we should not perhaps leave this too long after the summer break).

7. I have agreed this note with the Inland Revenue.

M C SCHOLAR

COVERING TASK FORCE SECRET

BY FAX

COPY NO 1 OF 6 COPIES

FROM: M C SCHOLAR
DATE: 31 JULY 1987

MR McMANUS/MR BEIGHTON

cc Miss Sinclair
Mr Short

TAX REFORM: WORK PROGRAMME

Any quick comments, please, on the attached which I must put up tonight?

A. Crae

M C SCHOLAR

pp

CONQUEROR

11



FROM: J J HEYWOOD
DATE: 31 July 1987

PS/CHANCELLOR

*Many thanks.
See main comments.
A package compared A, B & C looks possible for the 1988 Budget. I agree with the proposition @ X. M.*

- cc Sir P Middleton
- Mr Cassell
- Mr Byatt
- Mr Scholar
- Miss Sinclair
- Mr Cropper
- Mr Tyrie
- Mr Battishill IR
- Mr Isaac IR
- Mr Painter IR
- Mr Beighton IR

TAX REFORM - REMOVING SHELTERS AND ANTI-AVOIDANCE PROVISIONS

1. The **Financial Secretary** has been considering Mr Isaac's minute of 16 July, having read your note of 20 July. His **initial conclusions** are set out below:

Redundancy Payments: worth considering further the abolition of the top-slicing provision. £25,000 exemption level should be retained or increased.

Premiums for Rent: provocative to DoE, but nevertheless may be worth looking at as part of any package.

Proceeds of Non-qualifying Life Policies: consider as part of the review of life assurance. **Not for 1988.**

Patent Royalties/Writers and Artists: look at whether "forward spreading" can be removed, but retain "backward spreading". Consider further.

Relief for Delayed Remittances: consider in the context of the consultative document on residence.

Lloyd's Special Reserve Fund: consider in the context of the overall approach to Lloyd's for 1988.

TASK FORCE SECRET

no
Farmers: possibly contraversial, but keep under consideration at present.

✓
Relief for Pension Contributions: not for 1988.

✓
National Savings: leave alone.

*not work
some way*
Gilts and Corporate Bonds: probably not on but Revenue to consider position of low coupon gilts with Treasury.

✓
Venture Capital Scheme: leave alone.

✓
Profit Sharing: leave alone.

*least
also who
the
proposed
income tax
and
and
reduce cost of the scheme*
Executive Share Option Scheme: the Financial Secretary is personally strongly in favour of retaining this, but he notes that £100 million may be at stake, and this may have to be looked at in the future, but not for 1988.

C ✓
Enterprise Zones: the Financial Secretary is in favour of doing something here, for example perhaps denying sideways relief for enterprise zone capital allowances. But he will want to look at this further in the light of the DoE study.

✓
Hobby Farming: the Financial Secretary thinks this is something to be considered in the future (not 1988) when it becomes clearer whether the 1984 reforms have reduced the problem.

TASK FORCE SECRET

TASK FORCE SECRET

too complex abolition
✓
Relief for Interest: to be considered further, though abolition of relief altogether is probably not an option.

✓
Residence: under review.

✓
Car Benefits: under review.

✓
Maintenance Payments: under review.

X
2. The Financial Secretary is conscious that even if all those areas still under consideration are taken forward in the 1988 Budget there would probably not be a major impact on Revenue manpower. Nevertheless, he thinks there is scope for a useful tax reform package here (in tandem with the rationalisation of the income tax rates). He also thinks that it might be worth announcing in the Budget our intention to consult on the possibility of simplifying or reducing anti-avoidance provision.

9.12

JEREMY HEYWOOD
Private Secretary

TASK FORCE SECRET

TASK FORCE SECRET

Copy No. *12* of *12* Copies



pur

FROM: A C S ALLAN

DATE: 4 August 1987

MR SCHOLAR

cc: PS/FST
Sir P Middleton
Sir T Burns
Mr Cassell
Miss Sinclair
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
PS/IR

TAX REFORM: WORK PROGRAMME

The Chancellor was grateful for your minute of 31 July, and is content with the work programme you outlined.

ACSA

A C S ALLAN



FROM: J M G TAYLOR
DATE: 3 August 1987

pwj

PS/FINANCIAL SECRETARY

cc Mr Cropper

TAX REFORM: SELF-EMPLOYED

The Chancellor has seen the Financial Secretary's minute of 29 July. He has commented that this is a good point. He would be grateful for a note on this, examining options; perhaps you would be good enough to set this in hand.

JMGT
To
FIS
3 AUG

JMGT

J M G TAYLOR



FROM: J M G TAYLOR

DATE: 3 August 1987

MR GONZALEZ - IR

cc: FST

Sir P Middleton

Sir T Burns

Mr Cassell

Mr Byatt

Mr Scholar

Mr G Smith

Miss Sinclair

Mr Cropper

PS/IR

REFORM OF CAPITAL GAINS TAX

The Chancellor was grateful for your minute of 29 July. He is content that you should go ahead as soon as possible on the basis you propose.

A handwritten signature in dark ink, appearing to be 'JMG'.

J M G TAYLOR



Inland Revenue

Policy Division
Somerset House

Thanks. Clear the only possible variation - undesirable but, as US experience suggests, separate - but simply reform on Budget day to take effect on or after 1 April 1988. There is a danger of market disruption in the US - when they did the same thing - no.

Copy No of 18.

FROM: M F CAYLEY

DATE: 4 AUGUST 1987

- 1. MR HOUGHTON
- 2. MR ISAAC
- 3. CHANCELLOR OF THE EXCHEQUER

REFORM OF CAPITAL GAINS TAX

1. This note responds to the requests in Mr Kuczys' note to me of 27 July for notes on

- (a) the US position as regards charging capital gains to income tax,
- (b) making the 40% rate apply only to future gains, and
- (c) leaving a year in which past gains are taxable at 30% before moving to 40%.

- | | | |
|----|---------------------|---------------|
| cc | Financial Secretary | Mr Battishill |
| | Sir P Middleton | Mr Isaac |
| | Sir T Burns | Mr Houghton |
| | Mr Cassell | Mr Gonzalez |
| | Mr Byatt | Mr Hamilton |
| | Mr Scholar | Mr Cayley |
| | Mr G Smith | Mr Michael |
| | Miss Sinclair | Mr Quinn |
| | Mr Cropper | PS/IR |

(a) US position on charging gains to income tax

2. The key point here is that the US position on the legal form of the charge has not altered as a result of their recent tax reform. It was a charge to income tax before the reform: it remains so after. The USA did not have our starting position of a completely separate CGT.

3. Within the US income tax, both before and after the reform:-

- a. the rules on who pays tax were and are much the same for gains and for income - the USA is not in our position of having a different set of rules for gains on who is within the tax net; and
- b. capital losses were and remain ring-fenced from income so that eg. in general capital losses cannot be set against income.

4. For capital gains the reform involved just one major change. There used to be complicated rules to ensure that only 40% of long-term gains were charged to income tax (whereas the full amount of short-term gains was so charged). Under the reform, the full amount of both long and short-term gains is brought into income tax charge. The legal provisions needed to achieve this were relatively straightforward, since the change did not involve modifying the basic legal structure of the tax regime for gains. Unlike us, the USA did not face the prospect of a large amount of technical consequential legislation to achieve a charge to income tax, since that charge already existed.

(b) Applying the 40% rate to only future gains

5. Under this option, CGT would be rebased to 1982 and gains accruing from Budget Day 1988 would be taxed at 25% or 40%: for gains accruing before Budget Day 1988 the rate would

either remain at 30% or go down to the new basic rate of 25%. Logic would point to retaining the present 30% rate for pre-88 gains, on the grounds that the corollary of not having a higher rate charge on them is not reducing the rate to the basic rate.

6. The estimated effects on yield and taxpayer numbers are summarised on the following table which relates to individuals and trusts only (there are no implications for companies):-

<u>Rate on pre-1988 gains</u>	<u>Full year cost</u>	<u>Taxpayer numbers</u>
Normal IT rates (25% or 40%)	-£m450	-70,000
30%	-£m600	-60,000
25%	-£m750	-55,000

The figures ignore the effect of any short-term increase in disposals.

7. This option would be a very major complication of the tax. It would be necessary to establish 1988 values for all taxable disposals of existing assets. This would mean:-

- i. a lot of extra work, for taxpayers and the Revenue, on valuation, in establishing 1988 values which would not otherwise be needed;
- ii. an increase of several hundred in our staff need,

- iii. probably some important implications for our computerisation programme, which would need early examination.
- iv. the creation of another batch of share pools, making three in all: pre-1982, 82-88; and post-88. Rules would be needed to establish, when disposals of shares took place, the share pool from which the shares being sold come, and indexation etc would run separately for each share pool;
- v. as a result of (iv) there could easily be another 20 pages or more of complicated legislation.

8. With a flat 30% or 25% rate on pre-88 accrued gains, CGT would have to be retained. It would not be possible to transform it into an income tax charge.

(c) Leaving a year in which past gains are taxable at 30% before moving to 40%

9. The option here, as we understand it, would be to rebase CGT to 1982 from Budget Day 1988, tax gains accrued between 1982 and 1988 at 30% for a transitional year (ie. until the end of 1988/89) but tax present gains accruing from Budget Day 1988 at income tax marginal rates. Then from 6 April 1989 all post-82 gains would be taxed at income tax marginal rates.

10. This would mean importing all the complications identified in paragraph 7 above for the transitional year. And, having established a third batch of share pools, it would be complicated - operationally (for taxpayers as well as

ourselves) and legislatively - to abolish it when the new regime bit fully in April 1989. We doubt taxpayers and their advisers would welcome two major changes in the share pooling and associated arrangements in quick succession, so it might

be better to keep the third batch of share pools indefinitely. But this would mean permanent major complications of the tax.

11. A simpler course would be, for the transitional year, to apply the 30% rate to all post-82 gains. This would avoid the complications to which I have referred.

12. Either way, CGT would have to be retained as a separate tax for at least the transitional year.

13. The estimated effects on yield and taxpayer numbers in the transitional year, ignoring forestalling, are summarised in the following table, which again is confined to individuals and trusts:-

<u>Regime for transitional year</u>	<u>Yield</u>	<u>Taxpayer numbers</u>
Normal IT rates (25% and 40%) on all gains.	-£m450	-70,000
IT rates only on gains accruing from Budget Day.	-£m600	-60,000
30% on all gains.	-£m625	-60,000

Again the figures ignore the short-term unlocking effect from rebasing.

14. In practice, assuming rebasing from 1988, there would be almost certain to be substantial forestalling, as many taxpayers sought to make disposals before April 1989 when the higher rate charge would come into - or into full - effect. The extent of this forestalling is hard to estimate. In the USA taxpayers had advance warning of the increase in the burden on long-term gains and all the evidence is that this led to a very large rise in disposals in 1986, which is likely to lead to a reduction in disposals in 1987 and later years. In the USA in general the top rate on gains rose from 20% to 28% - an increase broadly of the same order as one from 30% to 40%. But the scale of forestalling in the UK would be likely to be less than in the USA, partly because the annual gains exemption (for which the USA has no equivalent) reduces the incentive for at least more modest investors to bring forward disposals. Nevertheless, a substantial bringing forward of disposals could well occur, increasing tax receipts in the short term and reducing them in the medium term. And the corollary could be significant market disruption - particularly at the tail end of the transitional year as investors rushed to make disposals.

Melod Cayley

M F CAYLEY



pmf

FROM: J J HEYWOOD
DATE: 4 August 1987

MR McINTYRE

cc PS/Chancellor
Sir P Middleton
Miss Peirson
Mr Scholar
Mr Macpherson
Mr Cropper
Mr Tyrie
Mr Battishill IR
Mr Isaac IR
Mr Mace IR

*PS/EST
To
McIntyre
GPHUG*

TAX REFORM: SELF-EMPLOYED

I attach a self-explanatory note from the Financial Secretary to the Chancellor, sent last week.

2. The Chancellor has asked for a further note on this examining the options. We agreed that it fell to ST to provide this analysis.

J.H.

JEREMY HEYWOOD
Private Secretary



FROM: A W KUCZYS
DATE: 6 August 1987

MR CAYLEY - IR

- cc: PS/FST
- Sir P Middleton
- Sir T Burns
- Mr Cassell
- Mr Byatt
- Mr Scholar
- Mr G Smith
- Miss Sinclair
- Mr Cropper
- Mr Tyrie
- Mr Battishill
- Mr Isaac - IR
- Mr Houghton - IR

REFORM OF CAPITAL GAINS TAX

The Chancellor was grateful for your further minute of 4 August.

2. He has commented that, clearly, the only possible variant - undesirable but, as US experience suggests, wearable - would simply be to announce the reform on Budget day to take effect for realisations on or after 6 April 1988. There would clearly be some significant forestalling, but the Chancellor is not aware of "market disruption" in the US, when they in effect did the same thing.

A W KUCZYS

SECRET AND PERSONAL

COPY NO: 1 OF 4

FROM: A G TYRIE

DATE: 7 AUGUST 1987

CHANCELLOR

cc Financial Secretary
Mr Cropper

CAPITAL GAINS TAX REFORM

I support the retention of a tax on gains, mainly as an anti-avoidance measure, and see the merit of integration with income tax. But the present proposal looks defective.

2. On Revenue estimates we will be giving away approaching £1 billion without securing any simplification. Surely it would only be worth spending that kind of money if it were being used as compensation to secure the real prize - the removal of indexation. Since we have ruled this out I suggest we keep our £1 billion by dropping the proposal to rebase to 1982.

3. It may be that unlocking would substantially reduce the billion pound loss in the first year or two but that would still leave us with the longer term loss once unlocking was completed.

4. Although there are complaints about the 1965 base I am sure there would be far more complaint about a tax reform which gave £500 million to the corporate sector and another £500 million to landowners, and no simplification in sight! Nor would the reduced case load figures carry much weight. Commentators would point to reduced yield with the same revenue staff - an increase in cost per £ collected.

X is in the contribution. To take a view - to refer to the P.S. (para 3) with the proposed changes. We must not lose sight of the fact that the addition of non-retrospective. As. And class. 2000

gains for some years. The addition of non-retrospective. As. And class. 2000

X |

(The new 4 implications). As. And class. 2000

5. Incidentally, my preferred option would be rebasing to 1982 and, non-retrospectively, the abolition of indexation. The only justification for indexation was high inflation. With inflation down we could seize the prize of simplification.

AG Tyrie
AG TYRIE

Copy No. ¹²....of 13

FROM: A W KUCZYS

DATE: 4 August 1987

MR SCHOLAR (o/r)

cc: PS/FST
Mr Cassell
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Isaac
Mr Houghton
Mr Mace
Mr Cayley
PS/IR

TAX REFORM

Please could you, and other recipients of this note, please copy all future papers on tax reform to Mr Tyrie (as well, of course, as Mr Cropper), as the Chancellor has asked him to be closely involved in this work.

A handwritten signature in black ink, appearing to be 'A W K'.

A W KUCZYS



FROM: J M G TAYLOR
 DATE: 5 August 1987

pup

PS/FINANCIAL SECRETARY

cc Sir Peter Middleton
 Mr Cassell
 Mr Byatt
 Mr Scholar
 Miss Sinclair
 Mr Cropper
 Mr Tyrie
 Mr Battishill IR
 Mr Isaac IR
 Mr Painter IR
 Mr Beighton IR

TAX REFORM - REMOVING SHELTERS AND ANTI-AVOIDANCE PROVISIONS

1. The Chancellor was most grateful for your minute of 31 July.
2. He has commented that a package comprising the Financial Secretary's suggestions in relation to redundancy payments, premiums for rent, and enterprise zones, looks possible for the 1988 Budget. He agrees that it might be worth announcing in the Budget our intention to consult on the possibility of simplifying or reducing anti-avoidance provision.
3. He does not want to do anything about farmers, gilts and corporate bonds, or the executive share option scheme. On the latter, he has noted that the proposed changes to income tax and CGT rates should greatly reduce the cost of this scheme. He also thinks that, if abolition of relief for interest is not on, the alternatives in this area are too complex to be worth pursuing.
4. The Chancellor is otherwise in agreement with the Financial Secretary's conclusions.

JT

J M G TAYLOR
 Private Secretary



Inland Revenue

Policy Division
Somerset House

*Thanks. In the cases, a subject to
the views of the FST, no freeze proposed
in para 15 looks the most practical option.
2. A couple with a rebasing to 1982 is
being conducted. I should be grateful if it could
be done. See company with the
with a heavy a ~~high~~ IT & CGT rate of
35% instead of 40%.*

Copy No ... of 22

FROM: M F CAYLEY

DATE: 6 AUGUST 1987

- 1. MR HOUGHTON
- 2. MR ISAAC *68*
- 3. CHANCELLOR OF THE EXCHEQUER

CGT REFORM: HUSBAND AND WIFE

1. Mr Kuczys' note of 10 July mentioned the possibility of reducing the annual exemption when independent taxation for husband and wife comes in.

2. This note assumes a regime for gains under which in 1988

i. there is rebasing to 1982, and

ii. gains are taxed at income tax marginal rates,

and then in 1990 (simultaneously with the new arrangements for married couple's income)

iii. married couples each have a separate annual gains exemption, with no right to transfer any unused exemption to their spouse, and the exemption is the same as a single person's, and

-
- Chief Secretary (note or end) (fcl)*
- | | |
|-------------------------|---------------|
| cc. Financial Secretary | Mr Battishill |
| Sir P Middleton | Mr Isaac |
| Sir T Burns | Mr Houghton |
| Mr Cassell | Mr Cayley |
| Mr Byatt | Mr Gonzalez |
| Mr Scholar | Mr Hamilton |
| Mr G Smith | Mr Mace |
| Mr Tyrie | Mr Glassberg |
| Miss Sinclair | Mr R H Allen |
| Mr Cropper | Mr Michael |
| | PS/IR |

iv. one spouse's capital losses are not available to set against the other's gains.

3. Our data on the marital status of CGT payers is not as good as we would like. The survey described in Mr Gonzalez' note of 29 July should give harder information: meanwhile our estimates should be treated as no more than broad orders of magnitude. We have deliberately given a range.

The estimates allow for some spouses switching assets between each other to make greater use of their respective exemptions. How far this would happen in practice is extremely uncertain: what is sure is that not all spouses will want to do this. The incentive for such switches will be greater the higher the annual exemption. The ranges we have given in the next paragraph assume that, after asset-switching between spouses, between a third and a half of married couples within the tax net have arranged things to minimise the tax bill.

4. The effects on full year yield and taxpayer numbers are summarised in the following table which relates only to individuals and trusts.

	<u>Yield</u>	<u>Taxpayer Numbers</u>
Present system (1988/89 accruals).	£m2,000	200,000
Reformed system without independent taxation and with present (revalorised) exemption of £6,900.	£m1,550	130,000
Reformed system with independent taxation and exemption of:-		
- present (revalorised) exemption of £6,900.	£m1460-£m1480	120,000-150,000
- £5,000	£m1,540-£m1560	170,000-210,000
- £3,450 (ie half revalo- rised present exemption).	£m1,610-£m1630	240,000-290,000

5. It is clear from the table that the number of taxpayers would increase above the number liable under the present system. There would be a corresponding increase in our staff need. The new system would be a little more complicated than present CGT. It would take more work to establish non-liability; more attention would have to be paid to establishing 1982 values, since they would assume greater importance than now; and the final tax computation - at marginal income tax rates (instead of a flat 30%) would be a little more complex. So even if the exemption is kept at its present, revalorised, level, there may well be a small increase in our staff need. In the short term, any temporary "surge" in disposals from unlocking of pre-82 assets would

lead to a further addition to our staffing need - though the addition would, of course, depend on the size of the unlocking effect. With independent taxation a cut in the threshold to £5,000 could add over 75 to our staff need: a cut to £3,450 could add 350 or more. The figures are very much preliminary estimates: because of confidentiality and the leave season we have not fully consulted our colleagues on the manpower side. The staffing considerations are important and we shall need to return to them if you wish to pursue further the possibility of a cut in the exemption.

6. By the same token, a sizeable reduction in the exemption would create a lot of losers when independent taxation came in. These would fall into three categories:-

- i. all single people with rebased gains above the present (revalorised) exemption would pay more tax;
- ii. single people between the new and the present (revalorised) exemption levels would be brought into liability.
- iii. married couples where one spouse had few or no gains would either pay more tax (if they had rebased gains over the present - revalorised - exemption) or be brought into liability (if they had rebased gains between the new and present - revalorised - exemption levels).

7. The exemption for trusts is half that for individuals - ie. £3,450 with 1988 revalorisation. The reason for having a lower exemption for trusts is that people can have assets split between several trusts. If the trust exemption were reduced in line with that for individuals, all trusts above the new exemption would be losers.

8. For individuals, the maximum extra tax (assuming a single higher rate of 40%) would be £1,380 with a £3,450 exemption, or £760 with one of £5,000.

9. Well over half the losers would be single people who get no benefit from independent taxation. As I have indicated, we are seeking to obtain better information on the marital status of capital gains tax payers, but our present judgement is that approaching half are single. This reflects among other things our estimate that over a third of the CGT paying individuals are over retirement age, and among these will be many who have lost their spouses.

10. With a £5,000 exemption, the number of losers at the point of the switch to independent taxation would probably be over 100,000. With one of £3,450 it could be over 200,000.

11. For some of the married losers, the losses would be partly offset by savings from independent taxation of investment income: but by definition this would do nothing for the single losers, who would be in the majority.

12. With rebasing and the charge on gains at income tax rates coming in next year, there would be a two year gap before independent taxation came in 1990: so it would be readily apparent that the extra tax bill was attributable to the cut in exemption as part of the independent taxation package.

13. We have considered whether independent taxation of gains could be introduced at the same time as rebasing, so as to offset for some people the effect of a cut in exemption, in 1988, but with a charge on gains at income rates this would not be feasible, because the tax rate on gains would be determined by a couple's marginal income tax rate on income under present rules. Charging gains at income tax rates means that independent taxation of gains cannot be implemented before independent taxation of income. It would, though, be possible to give husband and wife separate exemptions in 1988, while still charging the wife's gains at the husband's marginal rate: if this were done, and at the same time the exemption were substantially cut, the effects on yield, taxpayer numbers, and staffing would not be very different from paragraph 4. The number of losers from the 1988 gains

reform would be much increased by the changes to the annual exemption arrangements: most people within the present CGT net or above the new exemption would become losers from the 1988 gains reform.

14. A further relevant point is that, if any cut in the exemption as part of independent taxation in 1990 were announced in advance next year, there would be forestalling as (particularly single) people sought to make maximum use of the higher present exemption while the going was good. This would increase bed-and-breakfast activity, particularly towards the end of 1989-90, and may point against announcing in advance any cut in the exemption on the introduction of independent taxation.

15. Given the number of losers from any sizeable cut in the exemption, there may be something to be said for freezing the capital gains exemption over the next few years at its 1987 level of £6,600, instead of giving statutory revalorisation - which, on current forecasts might raise the exemption to £6,900 in 1988, £7,200 in 1989 and £7,500 in 1990. So by 1990 this might be equivalent to a cut, in real terms, of not far off £1,000 in the exemption. This would avoid creating a large number of losers at the point when independent taxation came in. While still arousing some controversy, freezing the exemption would involve less difficulties than cutting it. With the exemption frozen at £6,600, the number of taxpayers following independent taxation in 1990 might be of the same order as the figure of some 200,000 for the present system: and each year of non-revalorisation might cut the cost of CGT reform by something under £m10. Allowing for the extra work under the reformed system, even freezing the exemption in nominal terms could add over 50 to our staff requirement.

Michael Cag

M F CAYLEY

It seems to me that it is a very serious consideration, against the background of the Chief Secretary's letter to the Chairman on our PES provision.

CFCT

I may be prejudiced, since I myself introduced the scheme in 1984. But I retain no opinion. No u-turn aspect. No prejudice - quite the opposite. I've taken a public tax position, although I'm not in a position to say no to self-avoidance work.

FROM: A G TYRIE
DATE: 7 August 1987

CHANCELLOR

cc Financial Secretary
Mr Cropper

TAX REFORM: SHELTERS AND ANTI-AVOIDANCE PROVISIONS

Are we not being a little pusillanimous about tackling these?

2. The next Budget is our golden opportunity to get rid of many shelters created, at least in part, because of absurdly high rates of tax. Should we not be scrutinising each one to see whether there are compelling reasons for it to stay rather than putting many of them on the back burner for a subsequent Budget. Once detached from top rate reduction I can't imagine we could summon the political will to act on these later.

3. In particular, I cannot think of compelling reasons to keep hobby farming, venture capital relief or executive share option schemes. The last is an acknowledged racket. With lower top rates in place companies can keep staff by paying them more, or promising them more in subsequent years, contractually. At the very least we should find out exactly who is benefiting from the executive share option schemes.

4. Nor do I think we should console ourselves with the argument that after the next Budget the revenue cost goes down (because the scheme becomes less attractive and because of the increased yield from a new higher marginal CGT rate). Without absurdly high marginal rates I can't believe these schemes would have been invented. The logical corollary would be to abolish them now: we shouldn't tolerate any revenue cost at all. Only the politically very tricky ones should be candidates for retention.

5. I would put maintenance payments in the "politically sensitive" category. But the combined attraction of a 35p top rate and the simplification which could be claimed for the removal of shelters would, I think, make it possible to act on almost all of these reliefs, including maintenance and covenanting.

6. The combined yield from the removal of some shelters would go a long way towards the cost of reducing the top rate from 40 to 35 pence (the executive share option scheme alone is costing £100 million a year and rising). This would be a much more handsome prize.

AGT.

A G TYRIE

TASK FORCE SECRET

Copy No. ¹⁶ of ~~17~~ Copies

FROM: J M G TAYLOR
DATE: 10 August 1987

MR CAYLEY - IR

cc: CST
FST
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G Smith
Miss Sinclair
Mr Tyrie
Mr Cropper
Mr Isaac - IR
Mr Houghton - IR
PS/IR

CGT REFORM: HUSBAND AND WIFE

The Chancellor was grateful for your minute of 6 August. He has commented that, in the circumstances, and subject to the views of the Financial Secretary, the freeze proposed in paragraph 15 looks the most practical option.

2. He has also commented that a careful costing of the rebasing to 1982 is being conducted. He would be grateful if this could, in addition, be compared with the cost of having a higher IT and CGT rate of 35 per cent instead of 40 per cent.

A handwritten signature in black ink, appearing to be 'JMG'.

J M G TAYLOR



FROM: J M G TAYLOR
DATE: 13 August 1987

MR TYRIE o/r

cc: PS/FST
Mr Cropper o/r

CAPITAL GAINS TAX REFORM

The Chancellor has seen your minute of 4 August. He has commented that dropping the proposal to rebase to 1982 is under consideration.

2. On your paragraph 3, he has commented that we clearly need, inter alia, to take a view in the light of the figures.
3. He has also commented that your paragraph 5 proposal is replete with presentational difficulties, and that most of the simplification gains are lost if - for good reasons - the abolition of indexation is non-retrospective.
4. Finally, he has commented that clearly we cannot both raise the CGT rate and abolish indexation (even retrospectively); there is a choice between the two.

A handwritten signature in dark ink, appearing to be 'J M G TAYLOR' in a stylized, cursive script.

J M G TAYLOR



FROM: J M G TAYLOR

DATE: 13 August 1987

MR TYRIE o/r

cc: PS/FST
Mr Cropper o/r**TAX REFORM: SHELTERS AND ANTI-AVOIDANCE PROVISIONS**

The Chancellor has seen your minute of 7 August. He has commented that he may be prejudiced, since he himself introduced the Executive Share Option scheme in 1984. But he retains that prejudice - quite apart from the U-turn aspect. Moreover, the present tax treatment, although lighter than its predecessor, is by no means self-evidently wrong.

A handwritten signature in black ink, appearing to be "J M G TAYLOR".

J M G TAYLOR



Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 26 AUGUST 1987

- M 26/8*
1. MR HOUGHTON
 2. CHANCELLOR OF THE EXCHEQUER

CAPITAL GAINS REFORM :
COMMENCEMENT ARRANGEMENTS

1. This note seeks your views on what the commencement arrangements should be for the new capital gains regime under which

A - the base date is moved forward from 6 April 1965 to 31 March 1982, and

B - the gains of individuals (fully indexed) are charged under the new income tax rate structure (a basic rate of 25% and a single higher rate).

2. There are two options.

i. The first option is to apply the new regime to disposals on or after Budget Day 1988 (with transitional rules for disposals before 6 April 1988).

Thanks. I await X. This shd discuss the effect of a package cover only B. I shd do a group for the various points. I have to see how much. But sample volume option (ii). M.

Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G Smith
Miss Sinclair
Mr Cropper
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Houghton
Mr Gonzalez
Mr Hamilton
Mr Glassberg
Mr R H Allen
Mr Boyce
Mr Mace
Mr Cayley
Mr Michael
Mr Quinn
PS/IR

- ii. The second option (your Private Secretary's note of 6 August) is to announce the changes on Budget Day but to take effect for disposals on or after 6 April 1988.

We discuss each of these in turn.

Budget Day commencement date

3. The argument in favour of a Budget Day start date is that it would prevent forestalling with the consequent possibility of a reduction in the long-term yield. It was for this reason that Ministers decided that the companies' changes this year should take effect from Budget Day 1987 rather than the start of the current financial year. Moreover, the then Financial Secretary (Mr Moore) had warned the House the year before that in future it might well be necessary to implement changes from the start of Budget Day itself.

4. If Ministers wish to go for a Budget Day 1988 implementation date we shall require transitional rules to apportion the annual exempt amount etc for the current year between gains chargeable under the old and new regimes respectively. More importantly, we shall need to ensure that gains realised in the tail-end of the current year are not subjected to the full rigours of the present higher rates (the new income tax rates will, of course, only apply from 6 April 1988). Subject to the views of Parliamentary Counsel the simplest solution mechanically might be to retain CGT for the whole of 1987/88 but to charge post-1982 gains at 27% (the current basic rate) or the new higher rate as appropriate: the rate or rates of tax applicable in individual cases would depend on the level of the taxpayer's taxable income. This approach would ensure that no-one pays tax on gains in the interim period at a rate in excess of the new higher rate which will apply from 6 April 1988. For disposals on or after 6 April 1988 the full new regime would apply - but the

only effective further change for gains would be the cut in the basic rate from 27% to 25%.

6 April 1988 commencement date

5. You were not attracted by this but felt that it might do something to defuse criticisms of retrospection.

6. The main difficulty with a deferred start date is that there would be significant forestalling although in the nature of things it is not possible to say what the extent of this would be. There are, however, other considerations.

7. First, some people, particularly those who received incorrect investment advice, would make the wrong decision on whether to sell or bed and breakfast in the tail-end of the current year. And we know from our work on gainers and losers that it is not always the easy task it seems to work out where the balance of advantage lies. The responsibility for any misguided decisions would rest with taxpayers and their advisers but they might allege that they had not been given enough time to make a proper appraisal.

8. Secondly, other investors might not all be able to get out in time even where it was beneficial to do so. For assets such as real estate, the period between Budget Day and 6 April would generally not be long enough to arrange and complete disposals.

9. On the other hand a 6 April start date is easier operationally for both ourselves and taxpayers and would shorten the legislation required by several pages.

10. There is a good deal of CGT -associated ^{activity} ~~certainty~~ in the markets at the tail end of the tax year. A 6 April start would be bound to increase it. The Treasury will be

commenting separately on the possible market implications of this option. |X

Conclusion

11. We should be grateful to know in due course whether Ministers would prefer a Budget Day or 6 April implementation date and in the event of the former, whether you are content with the proposed transitional arrangements under which for the tail end of the current tax year gains would be charged to CGT at 27% or the new higher rate.

Michael Clegg

M F CAYLEY



COPY NO. 16 OF 17 .

FROM: A C S ALLAN
DATE: 1 September 1987

BF
8/9
pyp

MR M F CAYLEY - Inland Revenue

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Mr G P Smith
Miss Sinclair
Mr Cropper
Mr Tyrie

Mr Battishill - IR
Mr Isaac - IR
Mr Houghton - IR
PS/IR

CAPITAL GAINS REFORM: COMMENCEMENT ARRANGEMENTS

The Chancellor was grateful for your minute of 26 August.

2. He awaits the further advice from the Treasury on the possible market implications of a 6 April start. He would be grateful if this could distinguish between the effect of a package containing both (a) the base date being moved forward from 6 April 1965 to 31 March 1982 and (b) the gains of individuals being charged under the new income tax rates structure, and the effect of a package containing (b) only. He would also be grateful for the views of the Financial Secretary.

3. Subject to those, his present inclination is in favour of the very much simpler option of a 6 April start.

ACSA

A C S ALLAN

Mr ACS Allan

FROM: M C SCHOLAR
DATE: 2 SEPTEMBER

MISS PEIRSON

We spoke. I think the approach in para 3 is necessary to get us through the autumn review and the Autumn Statement without articles in the Guardian etc.

cc Miss Sinclair
Mr McIntyre
Mr McPherson

NATIONAL INSURANCE CONTRIBUTIONS

MCS 3/9

I took the opportunity during a meeting with the Chancellor this morning to suggest that he should speak soon to Mr Moore about national insurance contributions. I said that if he did not, I imagined there would soon be an approach (if there had not already been one at official level) from the DHSS with proposals in the context of the annual review of the NICs, before the Autumn Statement.

2. The Chancellor said that he would talk to Mr Moore soon - after his return from the US, I think next week. He did not ask for any briefing; but you may well be asked for (or think it right to volunteer) some.

3. From the point of view of security the less said now, in my view, the better - so that if Mr Moore is shaping up to proposing some reductions in National Insurance contribution rates the Chancellor might be advised to head these off on the basis that it would be imprudent and premature to think of any reductions now, given the threatening public expenditure prospect and the commitment to move when possible to a 25p basic income tax rate - ie not disclosing to Mr Moore that he has any ideas of his own at this stage.

4. This, I know, will be unwelcome to you, since you will want to be authorised by the Chancellor sooner rather later to discuss with the DHSS the administrative feasibility of the NIC options we are considering. But it is the course I myself would recommend.

SCHOLAR
TO
PEIRSON
2/9

Ch
I have been discussing this with Michael. I think X above is right in principle. But is it OK by you?
MCS
M C SCHOLAR
AT
Yes.



FROM: A C S ALLAN

DATE: 3 September 1987

MR SCHOLAR

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Miss Peirson
Mr McIntyre
Miss Sinclair
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
PS/IR

NIC REFORM

The Chancellor would be grateful if one additional NIC option at the lower end could be considered. This would be simply to raise the lower earnings limit, without raising the thresholds for the reduced rates. He would be grateful for costings for various options for the size of the increase, and for figures on how the LEL as a proportion of average earnings has changed over time.

A handwritten signature in black ink that reads 'ACSA'.

A C S ALLAN

HUSBAND
+
WIFE



FROM: A C S ALLAN
DATE: 4 September 1987

MR CAYLEY - Inland Revenue

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
Mr Houghton - IR
PS/IR

CGT ON SALE OF PRINCIPAL RESIDENCE

The Chancellor would be grateful for a note on the scope for withdrawing CGT exemption from the sale of the principal residence. In addition to all the usual consideration, he would be grateful if this could cover:

- (i) the rollover option; and
- (ii) the practice in the US.

2. He would imagine that removing this particular tax break would be practicable only if we were rebasing on 1982.

ACSA

A C S ALLAN

CAYLEY
10.9.87

TASK FORCE SECRET



Inland Revenue

Policy Division
Somerset House

Many thanks. I agree with X. I will provide a copy to Mr. Schott and Mr. Isaac for the meeting.

CAYLEY
To
CH. EX
10 SEPT

FROM: M F CAYLEY
DATE: 10 SEPTEMBER 1987.

1. MR HOUGHTON
2. MR ISAAC
3. CHANCELLOR OF THE EXCHEQUER

John Isaac's postnote promises further advice on completely parallel criteria AA.

CGT REFORM

1. This note responds to your request for a paper on the possibility of a reform under which gains of individuals and trusts would be taxed at the rates that would apply if they were the top slice of income with a rate scale of 25% and 35%. It looks at two variations - one under which the tax base is unaltered, and the other under which the charge on gains is rebased to 1982 (with rebasing extending to companies too). It reviews how the effects of this reform might compare with the option (discussed in my note of 1 July) of a similar reform with the higher rate set at 40%. We have again assumed a higher rate threshold of £20,400.

There is a package to a state income tax

- | | | |
|----|---------------------|-----------------|
| cc | Financial Secretary | Mr Battishill |
| | Sir P Middleton | Mr Isaac |
| | Sir T Burns | Mr Beighton |
| | Mr Byatt | Mr Calder |
| | Mr Cassell | Mr Houghton |
| | Mr Scholar | Mr Cayley |
| | Mr G P Smith | Mr Gonzalez |
| | Miss Sinclair | Mr Hamilton |
| | Mr Cropper | Mr R H Allen |
| | Mr Tyrie | Mr Mace |
| | | Mr Glassberg |
| | | Mr Boyce (M2/3) |
| | | Mr Michael |
| | | Mr Quinn |
| | | PS/IR |

Without rebasing, integration will represent for some taxpayers a higher charge (even with a 35% top rate) on largely pre 82 gains. Rebasing will dispose of this - but at a considerable cost.

Mr 10/9

2. As you know, we are conducting a survey to improve the basis of our statistics. The results of this survey may alter some of the figuring in this note - as may in due course changes in the forecasting assumptions.

Key statistics

3. The table on the next page summarises the key statistics for individuals and trusts. The figures relate to 1988-89 accruals. On current forecasting assumptions we would expect a relatively small decline in yield, on an accruals basis, over the next two or three years. The figures do not take account of the effect of independent taxation of husband and wife in 1990 - this was discussed in my minute of 6 August. The figures assume revalorisation of the annual exemption: if it was frozen at its present level, the yield would be slightly higher. There are some marginal refinements from figures quoted in my note of 1 July.

*opposite
page*

TASK FORCE SECRET

	Yield (£m)	Taxpayer Numbers ('000)
(a) Present CGT on 1988/89 disposals.		
- shares etc	1,370	200
land	630	
total	<u>2,000</u>	
(b) Effect of reform with 40% higher rate and without rebasing.		
- shares etc	+140	-10
land	+110	
total	<u>+250</u>	
(c) Effect of reform with 35% higher rate and without rebasing.		
- shares etc	+70	
- land	+50	0
total	<u>+120</u>	
(d) Effect of reform with 40% higher rate and with rebasing.		
- shares etc	+50	-70
- land	-500	
total	<u>-450</u>	
(e) Effect of reform with 35% higher rate and with rebasing.		
- shares etc	-30	-60
- land	-520	
total	<u>-550</u>	

Companies

4. Without rebasing there would be no change in the yield on companies' gains. Rebasing might reduce the tax take, on an accruals basis, by some £m500.

Aggregate effect for Corporate and Non-Corporate Sectors

5. In very broad terms, with a 40% higher rate, the reform might yield some £m250 without rebasing and cost approaching £m1,000 with rebasing. A 35% higher rate would pull down the yield by something of the order of £m100 or a bit over.

Short-term effects

6. The figures just quoted ignore short term effects. Without rebasing, we would not expect a temporary surge in disposals. With rebasing, there would be some unlocking of pre-1982 assets. Miss Sinclair's note of 24 July indicated our view that this could reduce the cost of reform in the first year (on an accruals basis) by as much as a quarter - but would be very unlikely to do so by as much as a half. The Treasury have undertaken to report further to you on the basis of our costings in the light of further discussion with us.

Staffing and compliance costs

7. Without rebasing, there would probably be a small increase in our staff need, because of the extra work in bringing together gains and income in order to establish the tax rate. With rebasing, taxpayer numbers would fall, but we doubt there would be much if any staff saving because, as explained in my minute of 1 July, rebasing would complicate the work on pre-82 assets and would tend to lead to longer negotiations on 1982 values for land and other assets which do not have a regularly-quoted price. For similar reasons, there

would be some (generally fairly small) increase in compliance costs for those remaining in liability.

Distributional effects

8. Annexes One and Two contain the usual graphs, illustrating the distributional effects of reform with a 35% higher rate on hypothetical model assumptions.

9. Looking at tax on gains alone, setting the higher rate at 35% rather than 40% would make little difference to the numbers of gainers and losers from the reform. What it would do is reduce the amount of extra tax which the losers would have to pay - with a 40% rate their tax bill would increase by up to a third; with a 35% rate, by up to a sixth. This aside, the analysis in my note of 1 July would be little changed.

10. Without rebasing, there would be likely to be a high proportion of losers. The gainers would be basic rate taxpayers with gains that did not take them, or took them only a little way, into the higher rates. Basic rate taxpayers with large "lumpy" gains would tend to lose, and Ministers might wish to consider special sweeteners to help them: but the cut in the top rate to 35% would very substantially reduce the "lumpy asset" problem.

11. With rebasing, land which had moved in line with average farmland values would generally be taken out of tax. The tax on land would on the whole be confined to development gains, second homes, and commercial and other real estate that has appreciated in real terms since 1982. While this must be a matter for speculation, one area where there might be some unlocking is in relation to underutilised business land which has been held for many years. On shares, basic rate taxpayers would generally pay less tax, except on large disposals, whereas higher rate taxpayers would often pay more: but if rebasing formed part of the package, there would be somewhat fewer people paying more tax on their gains with a 35% higher rate than with a 40% rate. Some higher rate people with

shareholdings acquired in the 1960's and 1970's would emerge as gainers.

12. In many cases, the extra liabilities would be offset by reductions in tax on income. But there could be a group currently towards the top of the basic rates many of whom at the lower end of the higher rates who would frequently emerge worse off overall - as would some people further up the higher rates who had large gains. The number of CGT payers who emerge as overall losers when one takes account of the changes for income would clearly be substantially increased if rebasing did not form part of the package.

Legislative implications

13. You have mentioned the possibility that the 35% higher rate might apply immediately for gains, but that for income the higher rate might be 40% in 1988/89 reducing to 37.5% the following year and 35% in 1990/91.

14. We are examining with Parliamentary Counsel the feasibility of making the reformed tax on gains a charge to income tax (rather than charging CGT at marginal income rates). Phasing in the 35% rate for income would complicate next year's legislation for gains because of the need to provide for a special rate on gains in the transitional period. This could well add to the difficulties of converting CGT to an income tax charge.

15. Rebasing would involve some long and complex rules for pre-82 assets, interaction with the existing rules for assets held in 1965 when CGT came in, and so on. If the rebasing did not form part of the package, this might reduce the length of legislation from our current guesstimate of up to 40 pages to perhaps around 20. (These figures do not include the provisions required to achieve independent taxation of husband and wife.)

Conclusion

16. Setting the higher rate at 35% rather than 40% would reduce the yield on gains by some £m100 plus. It would have relatively little impact on the number of people paying more tax, or less tax, on their gains, but it would reduce the extra liability of those paying more.

17. With rebasing most people remaining in liability would probably pay more tax on their gains, but (once any short-term unlocking effect had passed) the number of taxpayers might fall by 60,000 or more. Without rebasing, a very high proportion of people above the annual exemption would pay more tax - but for many higher rate taxpayers this extra liability would be offset by reductions in tax on income.

18. The lower the higher rate the more feasible it is to consider reform without rebasing - indeed with a 35% rate such a reform would parallel what has been done this year for companies. And without rebasing, CGT reform could result if anything in a small extra yield for the Exchequer instead of a cost of around £m1,000. Against this, by definition it would do nothing to ease complaints about the burden of tax on pre-82 gains (a matter on which considerable strength of feeling is often expressed) - and these complaints might be strengthened by the extra tax which many people would have to pay on their gains.

19. Without rebasing, the reform with a 35% rate would involve increases of up to a sixth in the tax bills of most CGT payers. A key question must be whether you consider increased liabilities of this order acceptable. If you do not, then reform on these lines without rebasing must be ruled out.

Michael Cayley

M F CAYLEY

*NB Mr Isaac's
footnote, over.*

As Mr Cayley says, a 35% top rate would halve the amount of the largest increases in tax on capital gains - as compared with a 40% top rate - but would not affect the number of people paying additional tax under the reform. As Mr Cayley says, one important question is whether you see that pattern as likely to be acceptable, without rebasing to 1982.

The further work from Statisticians will help to throw light on the number of people likely to pay more tax on capital gains as a result of the reform - and the extent to which the additional tax on capital gains may be offset by reductions in tax on income; though the estimates here will necessarily remain pretty tentative.

We shall be sending you a separate note in answer to your question about a 25%/35% regime for capital gains tax, not integrated with the income tax. By contrast with the option discussed in the present note, this could of course affect not only the amount of CGT "losses", but also the number of "losers" (depending on the choice of thresholds and rate bands). You may wish to consider these three notes together.

A.J.G.

A J G ISAAC

ANNEXES ONE AND TWO

1. Annexes One and Two contain illustrative graphs for a revalorised gains threshold level next year of £6,900. Annex One assumes no rebasing. Annex Two assumes that the base date is moved forward to April 1982. Both Annexes assume that the system is reformed from April 1988 and that the higher rate IT threshold is £20,400. with a single higher rate of 35%. They show, for a disposal in 1988/89 the resulting change in tax as a percentage of the unindexed gain and illustrate how the change varies according to the size of the disposal and the date the asset was acquired. They take no account of any offsetting reduction in tax on income - the extent of which will of course vary according to the level of income.

2. Separate graphs are given for shares and for agricultural land. The value of shares is assumed to have moved in line with the FT Actuaries All Share Index, and the value of land in line with our own index for agricultural land. For assets acquired in the 1960's, the vast bulk of the disposal proceeds represents nominal capital gain. For assets acquired in the last few years, the nominal gain element in

the proceeds is very much less. The graphs thus illustrate the relative effect of the changes on people with large inflationary gains from the 1960's and 1970's.

3. Three different sizes of disposal are illustrated: £20,000, £100,000 and £250,000. The taxpayer is assumed to make only the one disposal in 1988/89. Two different examples of taxpayer are taken. First, someone whose income (before adding on gains) is £10,000. Secondly, someone whose income would be taxable at ~~30%~~ under the new rate structure. The graphs would be the same for anyone with a ~~30%~~ marginal rate.

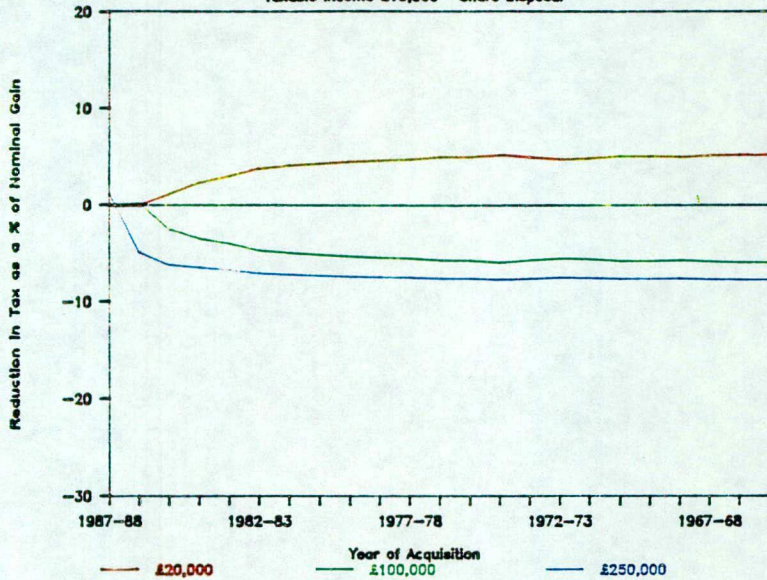
4. The graphs are in terms of the reduction in tax as a percentage of the nominal gain. This means that gainers appear above the zero line, and losers below.

5. Although not apparent from the graphs themselves (which show changes in tax as a percentage of nominal gains as opposed to actual tax payable) a highly significant point emerges in connection with Annex Two. This is that for agricultural land which has moved in line with average prices no tax would be payable under the changes with 1982

rebasing - except on acquisitions in the last year or so. Indeed, in many cases disposals would give rise to losses which could either be set against gains elsewhere in the same year or carried forward indefinitely. Accordingly, the arguments for special measures for agricultural land as part of the package would be extremely weak.

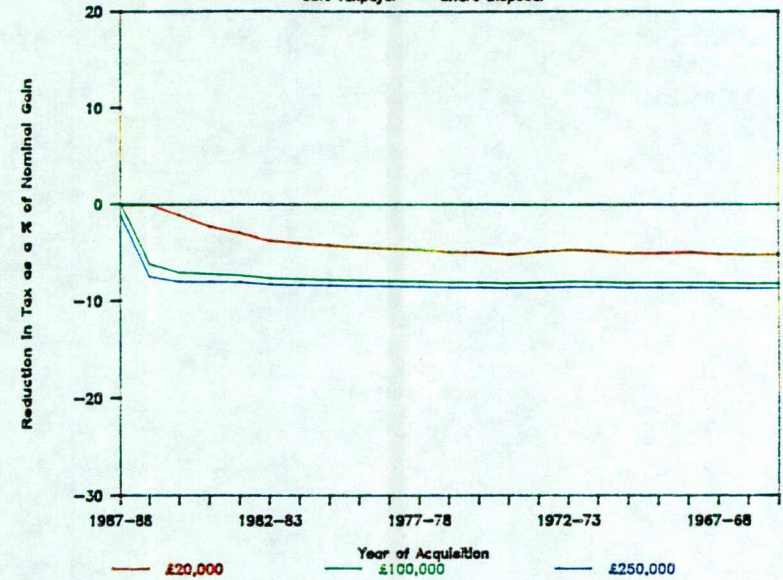
GAINS TAXED AT INCOME TAX RATES 1988-89

Taxable Income £10,000 Share Disposal



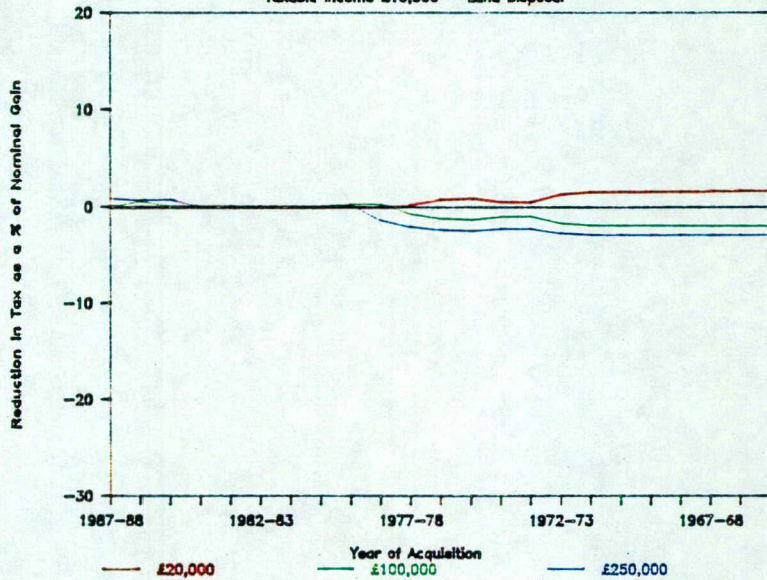
GAINS TAXED AT INCOME TAX RATES 1988-89

35% Taxpayer Share Disposal



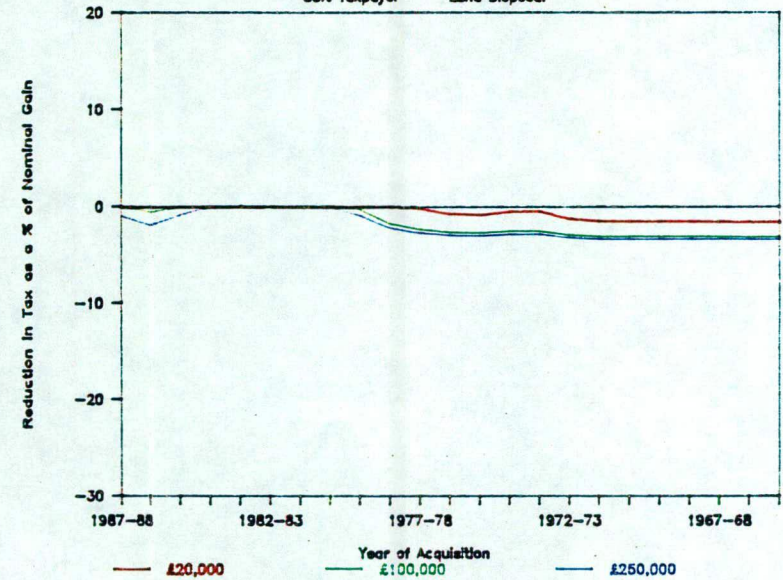
GAINS TAXED AT INCOME TAX RATES 1988-89

Taxable Income £10,000 Land Disposal



GAINS TAXED AT INCOME TAX RATES 1988-89

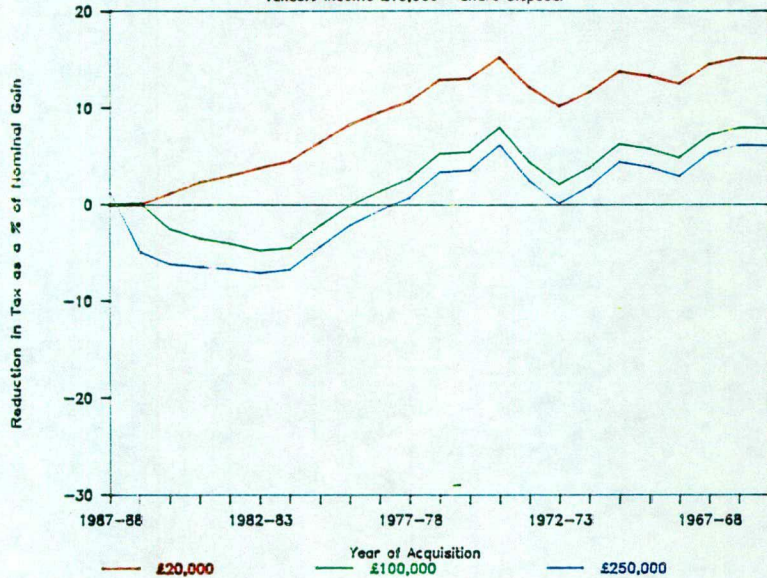
35% Taxpayer Land Disposal



ANNEX ONE
NO PERMISSIVE

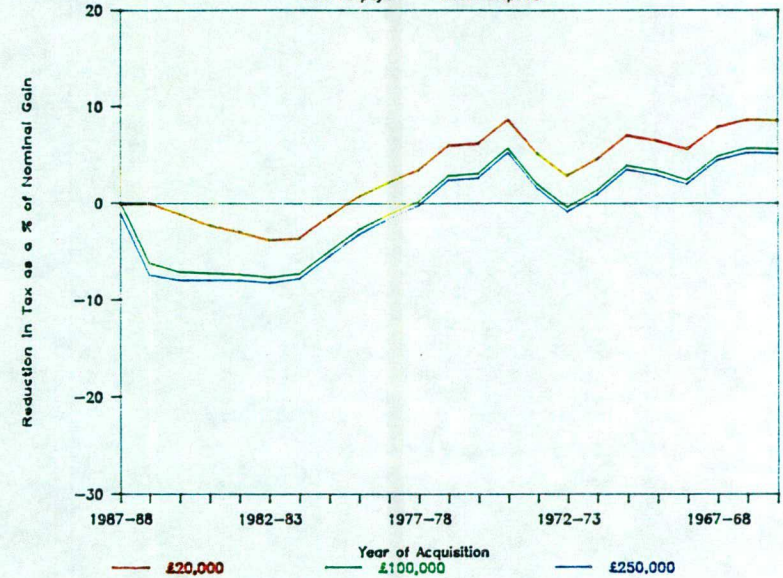
GAINS TAXED AT INCOME TAX RATES 1988-89

Taxable income £10,000 Share Disposal



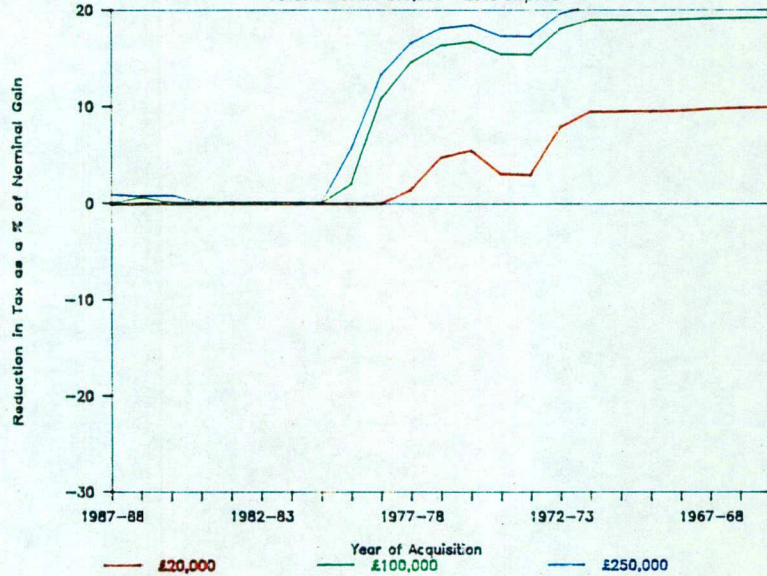
GAINS TAXED AT INCOME TAX RATES 1988-89

35% Taxpayer Share Disposal



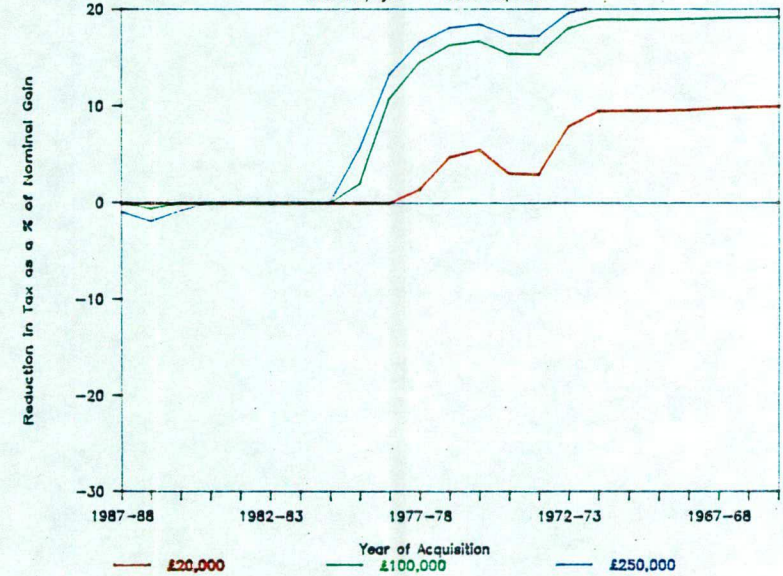
GAINS TAXED AT INCOME TAX RATES 1988-89

Taxable income £10,000 Land Disposal



GAINS TAXED AT INCOME TAX RATES 1988-89

35% Taxpayer Land Disposal



ANNEX TWO
REFASING TO 1982

CONFIDENTIAL**FROM: M C SCHOLAR****DATE: 11 SEPTEMBER 1987****MR A C S ALLAN**cc Sir Peter Middleton
Miss Sinclair**TAX REFORM: MEETINGS**

You asked for some ideas on future meetings.

I suggest we put in a meeting in early October to consider the papers which will by then have been circulated with the revised distributional analysis and costings of the main package; together with the papers you have commissioned from Mr Cayley.

In late October you already have a meeting arranged on benefits in kind which can consider the FP paper I mentioned this morning on benefits in kind, together with anything from the Revenue. I suggest you arrange another in early November to take stock generally, and in particular to consider the new survey and analysis, with matrix of gainers and losers and appraisal of the 'surge' which is being done by Mr Riley and Mr Cayley with the Revenue statisticians.

After that we will certainly want one or two further meetings of the main group before Christmas. It is a bit soon to say how many, when, or on what. But it would do no harm to pencil in meetings at the end of November and in the week beginning 14 December - we can easily cancel if we wish.

*MCS.***M C SCHOLAR**



FROM: A C S ALLAN

DATE: 11 September 1987

SIR T BURNS

cc: Sir P Middleton
Mr Byatt
Mr Cassell
Mr Scholar
Mr Riley
Mr Cropper
PS/IR

ECONOMIC EFFECTS OF TAX PACKAGE

The Chancellor would be grateful if you could let him have a preliminary analysis of the likely economic effects of the present tax package - particularly the micro effects, on savings etc.

A handwritten signature in black ink, appearing to read "ACSA", with a horizontal line underneath.

A C S ALLAN



Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 11 SEPTEMBER 1987

- Thanks. I agree with Mr Isaac's suggestion. But the gains won't be covered. Mr. See also FST's comments*
1. MR HOUGHTON
 2. MR ISAAC
 3. CHANCELLOR OF THE EXCHEQUER

CGT ON SALE OF PRIVATE RESIDENCE

1. Mr Allan's minute of 4 September asked for a note on the possibilities of abolishing the CGT residence exemption and replacing it either with an immediate tax charge or with rollover.

INTERNATIONAL PRACTICE

2. Almost all OECD countries provide either total exemption or very substantial relief from tax on gains on the sale of the main home. Some countries require the exemption or relief to be conditional on either (as in the UK) a qualifying period of owner-occupation or reinvestment of the sale proceeds in a replacement residence.

cc	Financial Secretary	Mr Battishill
	Sir P Middleton	Mr Isaac
	Sir T Burns	Mr Beighton
	Mr Cassell	Mr Houghton
	Mr Scholar	Mr Cayley
	Miss Sinclair	Mr Gonzalez
	Mr Riley	Mr Hamilton
	Mr Cropper	Mr Michael
	Mr Tyrie	Mr Weeden
		Mr Boyce
		Mr R H Allen
		Mr Glassberg
		PS/IR
		Mr Quinn

3. A note on the US position is attached. Very briefly, it provides rollover with:-

- exemption for those aged 55 plus of gains attributable to the first 125,000 dollars of sale proceeds, on one occasion only, and
- effective exemption if the replacement home is held until death

COST OF THE EXEMPTION

4. Under the present system, we estimate that the exemption may cost around £m2,500. If CGT were rebased to 1982, this figure would probably become over £m1,500. Because we do not now obtain information on the gains component in sales of people's main homes, the data underlying the figures is exceedingly uncertain, so the estimate should be treated with caution. The figures do not take account of the market and behavioural responses that would result from bringing homes into the tax charge.

GAINS ALREADY ACCRUED

5. If the exemption were abolished or replaced with rollover, there would be very strong arguments for continuing to exempt gains that have already accrued. This would be on three main grounds:-

- i. retrospection. People would argue that their decisions on home purchase had been taken on the assumption of CGT exemption, and that to withdraw exemption from already-accrued gains would impose a retrospective penalty. (Even with rebasing, indexation relief would fall well short of the rise in house prices in much of the country since 1982).
- ii. equity. If gains accrued earlier were brought into account, someone who had moved home shortly before

the change would have a much smaller contingent CGT liability than someone who had lived in the same home for many years. This would give rise to allegations of unfairness.

- iii. practicality. If gains accrued before 1988 were taxable, it would be necessary to obtain 1982 valuations for homes owned at March 1982, and this would impose substantial administrative and compliance costs. In addition, allowance should be made for expenditure on home improvements, extensions and so on: but the records to establish this for expenditure before 1988 - and possibly many years in the past - would often not be available.

6. There are in principle two ways in which pre-88 gains could be exempted:-

- i. Taxing gains on homes only where the home was bought on or after Budget Day or 6 April 1988. This would however give a major advantage to existing home-owners and new first-time buyers would see themselves as unfairly penalised.
- ii. Taxing gains only insofar as they accrued from Budget Day or 6 April 1988. This would arguably be more equitable than (i), but it would significantly increase our staff costs in the Valuation Office since it would be necessary to establish a 1988 value in relation to all disposals of homes acquired before the start date.

Either course would mean that the yield on disposals in the first year following the change would be fairly low. If the exemption were simply abolished, the initial yield might be possibly under £m5 with option (i) and £m20 with option (ii). The yield would build up thereafter - but obviously much faster with the second option. With rollover, the initial

yield would probably be negligible, and build up much more slowly.

ABOLISHING THE EXEMPTION WITHOUT ROLLOVER

7. The figures in paragraph 4 do not give a reliable indication of the long-term yield from abolishing the exemption. This is because there could be major behavioural and market effects: the volume of home sales could reduce and prices (and hence the level of gains) might be depressed relative to the level that might otherwise prevail - though the abolition of domestic rates is likely to produce pressures in the other direction; and if the locking in effects of removing the exemption seriously reduced the availability of homes for first-time buyers, this too could exert some upward pressure on prices. So in practice the extra yield in the long term could be expected to be ^{less} than paragraph 4 might suggest. Assuming protection for pre-88 gains, it would anyway be many years before that yield built up.

8. The argument for abolishing the exemption might be:-

- i. that in principle the home should, like other assets, be within the CGT net, and
- ii. that its exemption contributes to the upward pressures on house prices and encourages people to lock up more capital in their homes than they otherwise would.

9. On the other hand, removing the exemption would tend to lock people into existing housing. As a result:-

- i. it could discourage people from moving residence in search of work;
- ii. it could make it more difficult for employers to persuade managers ^{and} staff to transfer job location; and

iii. the elderly could be discouraged from moving to smaller accommodation more suited to their needs; and

iv. the supply of homes for first time buyers might fall.

10. At a more detailed level, there would often be complications in establishing the base cost for CGT. This is because many owners would have spent money on home improvements and extensions which would qualify as "enhancement expenditure" and ought to be taken into account. Both the amount and the timing of this expenditure would affect CGT computations, but records of these would not always have been retained and even where they were the calculations could be complex. The only practicable answer might well be to exclude an arbitrary proportion of the gain from charge, while recognising that this would be insufficient in some cases and too much in others.

11. Removing the exemption would add substantially - by hundreds - to our staff cost. This is because the number of taxpayers would be likely to increase by at least several hundred thousand and because (unless the change is confined to homes acquired after the announcement) we would have to establish 1988 values. There would be corresponding compliance costs for taxpayers.

12. There could well be pressure for a special exemption of the first £X,000 of gain on the main home. This might be additional to or in place of an allowance for enhancement expenditure (see paragraph 10). Were this to be pursued, we would need to examine further how the special exemption might apply to married couples (for instance where the husband owned one home and the wife another, would two exemptions be available?) and to homes jointly owned by two or more unmarried persons. An exemption of this kind would substantially reduce the yield on homes.

13. Following the precedent of the USA, it might be suggested that there should be a special high exemption for the elderly. The aim of this would be to reduce the likelihood that the elderly would be deterred from moving out of accommodation too large for their needs. On the other hand, it can be argued that if moving to a cheaper home releases capital for other purposes, this is a proper occasion for a tax charge and no special relief for the elderly should be given. Again, we would need to examine the details further if you wished to pursue this. And again such an exemption would substantially reduce the yield.

ROLLOVER

14. Very broadly, rollover operates by allowing the gain to be deferred where a taxpayer acquires a qualifying replacement asset within a period running from 12 months before a disposal of a business asset to two years after. Deferral is restricted where the replacement asset costs less than the asset of which the taxpayer has disposed. The deferred gain has to be computed at the time of the disposal. In the absence of a CGT charge on death, if the taxpayer holds on to the replacement asset until he dies, rollover is equivalent to exemption.

15. If the residence exemption were extended to homes, it would be necessary to decide whether homes should be ring-fenced (as in the US) so that rollover was not available when someone disposed of a business asset and used the proceeds to acquire a home, or vice versa. Ring-fencing would have some logic, but it would complicate the legislation and in practice make little difference to the yield.

16. Allowing for behavioural reactions, the long-term yield from replacing the exemption with rollover for homes could well be less than £m200. There might be some - probably smallish - reduction in the volume of disposals. If pre-88 gains continued to be exempt, it would take many years for the yield to build up.

17. The arguments for replacing exemption with rollover are:-

- i. that in principle it is right to tax the gains insofar as they are not needed for a replacement home but are available for other purposes, and
- ii. that it might reduce the market and behavioural distortions to which CGT exemption contributes.

18. On the other hand, unless a CGT charge on death is introduced, tax would be paid on the main home only where the owner trades down to a cheaper home. This would inevitably deter people from trading down while doing nothing to reduce the fiscal incentives for them to move to more expensive housing. As long as someone keeps trading up in the housing market, their home would effectively be exempt; and people would be locked into housing more expensive than they needed. For the elderly needing to unlock some of the capital tied up in their home, there would be a strong incentive to use their existing residence as collateral for an annuity rather than move to smaller and cheaper accommodation. There would be adverse effects on mobility of labour from high cost areas like London and the South East to lower cost areas like the North - particularly where there was a possibility of a return move South.

19. The gain would have to be computed at the time of rollover even though no tax would be payable. This means that there would be some complications over expenditure on improvements as with an immediate tax charge (see paragraph 10 above). Because we would not expect any great reduction in the volume of disposals, the increase in our staff need would be greater than with an immediate charge - and most of the work would be on quantifying, and keeping records of, the rolled-over gain in cases where in the end no tax would be paid because the gains would in due course be "washed" by death. There would be corresponding compliance costs for taxpayers.

20. Again there might be pressure to exempt the first £X,000 of gain and provide a special high exemption for the elderly. Both these measures would substantially pull down the yield.

Conclusion

21. There are arguments for regarding the CGT exemption for the main home as anomalous and it is almost certainly one factor influencing decisions on home purchase and encouraging people to tie up capital in their homes. But removing the total exemption for the principal private residence would obviously be a very controversial move. Whether it was replaced with an immediate tax charge on disposals or with rollover, there would be major market effects. The former could well lead to a sizeable drop in the volume of disposals, and possibly ^{have} a depressing effect on property values. The latter would do nothing to reduce the incentives to trade up in the housing market and, with gains eventually washed on death, for many people would be tantamount to exemption. While rollover has a certain logic, it is for question whether it would be sensible unless gains became taxable on death. Both options would be likely to have a significant locking-in effect, inhibiting labour mobility and deterring the elderly from moving to cheaper smaller accommodation.

22. Both options would involve a heavy staff cost, with corresponding compliance costs for taxpayers. With rollover, the bulk of these costs would relate to computing deferred gains that would eventually yield no tax, being exempt on death.

Michael Cagley

M F CAYLEY

The question is whether this game, even for a level playing field, is worth the candle.

C.F. Cagley
8 . . . 11.9.

TAXATION OF CAPITAL GAINS ON THE DISPOSAL
OF A PRINCIPAL PRIVATE RESIDENCE IN THE USA

The United States tax system, like most others, makes provision for a substantial relief for gains arising on the disposal of a taxpayer's principal private residence subject to strict conditions.

First, the relief is not available unless the taxpayer replaces the residence with another, within a period beginning two years before the disposal and ending two years after it. If this condition is not met, any capital gain is taxable (at income tax rates).

The second condition is that for full relief to apply the new residence must be of equal or greater cost than the old. If the sale price of the old residence exceeds the cost of purchasing or building the new one, tax is payable in the normal way on the gain up to the amount of the excess. Sales costs, commission and expenditure on improvements are allowable as deductions in arriving at the chargeable gain.

The relief given is a deferment of the tax rather than an exemption, the gain being "held over" and deducted from the acquisition cost of the new residence. It follows, therefore, that if ultimately a taxpayer sells his residence and takes rented accommodation he becomes liable to tax on the whole of the gains which he has realised on successive residences throughout his life, so far as he has not chosen to pay tax on them at the time of realisation. If he is still an owner-occupier at his death, the gain becomes exempt.

There is, however, an outright exemption for taxpayers who are aged 55 or older, who may exclude capital gains attributable to the first \$125,000 of the sale price of the residence. This "once-in-a-lifetime" exclusion is available provided that the house has been owned and used as the principal private residence for a total of three years during the five years ending on the date. (Married couples are only entitled to one such

relief; if they subsequently separate, no further relief is available to "top-up" each party to the full sum, but two individuals who both obtain the full amount and subsequently marry do not lose one half of the relief.)

General points

Capital gains in the USA are aggregated with taxable income and thus taxable at rates (from 1988) of 15 and 28 per cent. There is no provision for indexation.

CGT REFORM

RJ8.31

TASK FORCE SECRET



Copy No 15 of 16

BF with
other pm
or 30/9

FROM: J M G Taylor
DATE: 14 September 1987

MR CAYLEY - INLAND REVENUE

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Mr G P Smith
Miss Sinclair
Mr Cropper
Mr Tyrie

Mr Isaac - IR
Mr Houghton - IR
PS/IR

CGT REFORM

The Chancellor was most grateful for your minute of 10 September.

2. He agrees with Mr Isaac's suggestion that he should consider this minute alongside the further note from statisticians, and the separate note in answer to his question about a 25 per cent/35 per cent regime for capital gains tax not integrated with income tax. He will hold a meeting on this in due course, and he would be grateful if Mr Scholar could provide an annotated agenda for that meeting.

A handwritten signature in dark ink, appearing to be 'JMG'.

J M G TAYLOR



Copy No 14 of 15

php

FROM: J M G Taylor

DATE: 14 September 1987

MR CAYLEY - INLAND REVENUE

cc Financial Secretary

Sir P Middleton

Sir T Burns

Mr Cassell

Mr Scholar

Miss Sinclair

Mr Riley

Mr Cropper

Mr Tyrie

Mr Isaac - IR

Mr Houghton - IR

PS/IR

CGT ON SALE OF PRIVATE RESIDENCE

The Chancellor was grateful for your minute of 11 September.

2. He has noted Mr Isaac's manuscript observation that: "The question is whether this game, even for a level playing field, is worth the candle". He agrees with the implied conclusion that it is not.

A handwritten signature in black ink, appearing to be "JMG".

J M G TAYLOR



FROM: FINANCIAL SECRETARY
DATE: 15 September 1987

CHANCELLOR

Many Thanks. I note X. I am happy to look again @ a means of simplifying CAT by abolishing it; but we would have to find answers to the objections (see) which emerge when we look at this before you present papers: you might also like to discuss with Mr. Hargrave before (Hargrave) that area).

THE REFORM OF CAPITAL GAINS TAX

1. Further to our conversation this morning, I do think that there is a golden opportunity for tax reform in this Budget and that it is important politically that we are seen to seize this opportunity. Everyone is expecting an innovative Budget and I am sure there would be an adverse reaction to the absence of major reform.

2. I am somewhat sceptical about the view that capital gains and earned/unearned income are the same thing and can be made the same for tax purposes. I think that that view will be shared by a number of Conservative MPs. But this is not a make or break issue and most people will not worry too much about the theory. They will accept an apparent simplification provided it is a simplification and, frankly, does not increase substantially the burden of "capital" taxation or damage the savings of the new investor.

3. I think there are two areas of concern:

(i) The high rate (40%) confronting investors making substantial gains post-1982 on share acquisitions. I think that the market reaction to this change may be much more dramatic than we have been assuming. (And on the income tax side, 40% will not appear a very dramatic reduction in top rates when people realise the implications of the UEL changes. So there is a double reason for going to 35%, if at all possible).

TASK FORCE SECRET

(ii) The cost and distributional effects of re-basing to 1982. I remain slightly uneasy that £500 million or so of the benefits of re-basing will probably go to "landowners".

4. We tend to talk as if all pre-1982 gains were nominal gains. But some will be real gains and I do not see why they should be tax-free. I appreciate the devastation of inflation in the early 1970s but it is a curious view that Governments should compensate for the mistakes of previous regimes. Obviously, the main justification for re-basing is to compensate for a marginal rate of 40%. Why not just alter the 40% instead? Re-basing is backward looking. It only compensates for gains made before 1982. It does nothing for people buying assets post-Budget who will nonetheless be confronted by a 33% increase in the tax rate.

5. My own preference would be reform along the following lines.

Either

(i) Introduce the proposal currently on the table (with rates of 25% and 35% or with just one rate of 25%) but not re-basing. Announce that indexation relief will be abolished for disposals made after March 1989 or possibly 1990 but will be available for any disposal made before then.

or

(ii) Give investors a choice for one year between the existing regime and a new regime comprising no indexation, re-basing to 1982 and taxation at marginal rates of 25% and 35% (or just one rate of 25%). After one year dismantle the existing regime.

TASK FORCE SECRET

TASK FORCE SECRET

or

(iii) Move straight to the new regime envisaged in (ii) without giving investors a one-year choice.

6. Although options (i) and (ii) would leave us with one or two years of further complications (investors would have a choice of tax regimes) I do not see that this is a major drawback. What I am proposing is a short transitional period which would allow us ultimately to attain a much "cleaner" tax.

7. The highly-successful 1984 company taxation reforms, and indeed the US tax reforms, were not built in a day. Both would have been much less feasible had they been introduced without a transitional period. Why should not a major reform of personal taxation also be introduced in stages? Are we not straight-jacketting ourselves by looking for a reform which can be introduced in one year?

8. Naturally all of my proposed options would bring problems of their own. One would need to look carefully at the market consequences of the first (although a one or two year period of grace for indexation would spread the forestalling effects after a longer period). The new regime envisaged in (ii) and (iii) would probably produce isolated groups of losers, and special reliefs might have to be contemplated even if a year's grace is offered (as in (ii)).

9. Nevertheless, I do feel that the removal of indexation relief is the single most important simplification of the tax system achievable in the 1988 Budget. It would, for example, yield manpower savings of around 300 (approximately one-third of the current CGT complement). And the proposals I have in mind would, I suspect, be very much cheaper in terms of revenue than the current proposal (basically re-basing and retention of indexation).

TASK FORCE SECRET

TASK FORCE SECRET

10. The arguments against abolishing indexation seem to be that "landowners" (which I appreciate also means second-home owners) would be locked in because even a grace period is of no use to property owners who cannot bed and breakfast. But if we accept that as an overriding obstacle in the path of a major reform, it would mean that indexation is with us for ever. Do we really think that second-home owners have such a strong case? These people would undoubtedly benefit from the reduction in income tax rates.

X | 11. I am getting some information on the costings of these proposals. My hope would be that the removal of indexation would go a long way towards paying for re-basing.

12. I have not copied this to anyone at this stage.

N.

NORMAN LAMONT

TASK FORCE SECRET



COPY NO 2 OF 3 COPIES

FROM: J M G TAYLOR
DATE: 15 September 1987

PS/FINANCIAL SECRETARY

THE REFORM OF CAPITAL GAINS TAX

The Chancellor was most grateful for the Financial Secretary's minute of 15 September.

2. He has noted that the Financial Secretary is getting some information on the costings of his proposals. The Chancellor is happy to look again at a means of simplifying CGT by abolishing indexation. He has commented, however, that answers will need to be found to the objections that emerged when this was looked at before (these are set out in the earlier papers). He suggests that the Financial Secretary might also like to discuss this with Mr Houghton before he leaves this area.

A handwritten signature in black ink, appearing to be 'JMG'.

J M G TAYLOR

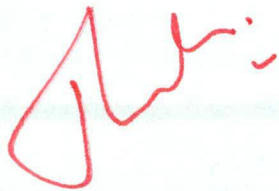
TASK FORCE SECRET

*Paper
past*

COPY NO 1 OF 12 COPIES

FROM: M C SCHOLAR
DATE: 14 SEPTEMBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Cassell
Mr Riley
Miss Sinclair
Mr Cropper
PS/IR**ECONOMIC EFFECTS OF TAX PACKAGE**

You have asked (Mr Allan's minutes of 9 and 11 September) for an analysis of the rationale and likely economic effects of the present tax package.

2. We had, in fact, already put this work in hand. We (the task force - mainly Messrs Riley and G P Smith) will be letting you have an analysis on these lines next month. We shall be consulting the Revenue, and Sir Peter Middleton's steering group (of which Sir Terence Burns is a member) will oversee the work.

MCS

M C SCHOLAR

CAYLEY
17.9.87

Copy no 24 of 24

TASK FORCE SECRET



Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 17 SEPTEMBER 1987

- 1. MR HOUGHTON
- 2. MR ISAAC
- 3. CHANCELLOR OF THE EXCHEQUER

*A see note at end of letter,
17/9*

[Task Force]

*(CAYLEY
TO
CH-EX
17.9.87)*

CAPITAL GAINS REFORM

1. Mr Allan's minute of 8 September asked for a note on a scheme under which

- CGT was kept as a separate tax, and the level of income did not affect the charge on gains, and
- CGT was taxed on a scale of 0% on the first £6,600, followed by a slice at 25% and the rest at 35% or 40%.

2. This note considers such a scheme, both with and without rebasing.

cc Financial Secretary
 Sir P Middleton
 Sir T Burns
 Mr Cassell
 Mr Scholar
 Miss Sinclair
 Mr Cropper
 Mr Tyrrie

Mr Battishill
 Mr Isaac
 Mr Beighton
 Mr Houghton
 Mr Cayley
 Mr Hamilton
 Mr Michael
 Mr Glassberg
 Mr Gonzalez
 Mr Mace
 Mr Yard
 Mr R H Allen
 Mr Boyce
 Mr Quinn
 [Redacted]

TASK FORCE SECRET

3. A key question here is the width of the 25% band. For illustrative purposes, we have assumed that the 25% rate would apply to the first £5,000 above the annual exempt amount (ie. between £6,600 and £11,600 of chargeable gain); but I comment on some of the implications of having a wider 25% band.

*1 better
£5,000*

Yield and Taxpayer numbers

4. The following table summarises the effect on yield and taxpayer numbers on an accruals basis. It is confined to individuals and trusts. With rebasing, there would be a loss to the Exchequer of a further £m500 in tax receipts from the corporate sector. The usual caveats apply to the figures.

Does it matter if top rate of capital gains comes in at a lower level than top rate of income tax? I think not - we would in any event have a different 0-25% threshold (albeit higher not lower).

TASK FORCE SECRET

	Yield (£m)	Taxpayer Numbers ('000)
PRESENT SYSTEM (Tax on 1988/89 disposals) <i>ie payments for loss rule</i>	- shares 1,330 etc - land 670 total 2,000	200
EFFECT OF REFORM WITH		
(a) 35% rate and <u>no</u> rebasing	- shares +100 etc - land +70 total +170	0
(b) 35% rate and <u>with</u> rebasing	- shares 0 etc - land -530 total -530	-60
(c) 40% of rate and <u>no</u> rebasing	- shares +180 etc - land +140 total +320	-10
(d) 40% rate and <u>with</u> rebasing	- shares +90 etc - land -530 total -440	-70

TASK FORCE SECRET

5. Increasing the width of the 25% band would increase the cost of the reform. For instance, if the band were £15,000 instead of the £5,000 we have assumed, then the additional cost would be between £m50 and £m100.

Distributional Effects

6. The usual graphs are attached: Annex One assumes no rebasing; Annex Two assumes reform with rebasing.

7. Without rebasing, there is a figure of chargeable gain below which all taxpayers would pay less tax and above which they would be worse off. The level of this crossover point depends on two variables:-

- i. the width of the 25% band, and
- ii. whether the higher rate is 35% or 40%.

This is illustrated by the following table which shows the crossover points on various permutations of these variables. The figures for gains include gains covered by the £6,600 annual exemption.

Width of 25% band	Higher rate	
	35%	40%
£5,000	£16,600	£14,100
£10,000	£26,600	£21,600
£15,000	£36,600	£29,100
£20,000	£46,600	£36,600
£25,000	£56,600	£44,100

With rebasing, the crossover points (expressed in terms of gains as computed under the present system) would be the same if there were no pre-82 gains and higher to the extent that some of the taxpayer's gains had accrued before 1982.

TASK FORCE SECRET

8. We estimate that around three quarters of CGT payers have chargeable gains of less than £15,000. So even without rebasing and with a 25% band of only £5,000, most taxpayers would be better off. The following table gives some idea of the percentage of taxpayers who would emerge as gainers under the combination of options in paragraph 7, still assuming no rebasing.

Width of 25% band	Percentage of taxpayers better off	
	35% higher rate	40% higher rate
£5,000	70	60
£10,000	80	75
£12,000	85	80
£20,000	90	85
£25,000	90	90

Losers would be those with large gains, who would fall into two main categories:-

- i. rich investors and
- ii. people with large one-off gains on "lumpy" assets such as second homes and agricultural land.

Without rebasing, sweeteners of the kind identified in Annex Three to my minute of 1 July might need to be considered for lumpy assets. The case for them would be less with a higher rate of no more than 40% than with a more steeply progressive scale, and would obviously be weaker if the higher rate were 35% rather than 40% and/or if the 25% band were wider than £5,000.

9. As has been established in relation to earlier options, rebasing takes much agricultural land out of tax altogether, and tends to give substantially less benefit to eg. shares (reflecting the time-pattern of price movements and the fact that shares tend to be turned over more frequently than land).

TASK FORCE SECRET

So with rebasing the case for special reliefs for lumpy assets would be weak.

10. Analyses of earlier options have shown that, if gains are taxed at the rate that would apply were they the top slice of income, people whose income currently takes them near the higher rate threshold or a little way into the higher rates and who have chargeable gains above the exemption would often be losers on both gains and (from the abolition of UEL) income. The option considered in this paper, by keeping gains separate from income, would reduce to very low levels the number of people who would be losers on both income and gains.

Staffing Implications and Compliance Costs

11. Without rebasing, the package would be staff neutral with a 35% higher rate and would produce eventual staff savings of around 20 units with a 40% higher rate. With rebasing, taxpayer numbers would fall, but we doubt there would be much if any staff saving because, as explained in my notes of 1 July and 10 September, rebasing would complicate the work on pre82 assets and would tend to lead to longer negotiations on 1982 values for land and other assets which do not have a regularly quoted price. For similar reasons, there would be some (generally fairly small) increase in compliance costs for those remaining in liability.

Treatment of Trusts

12. A reform of this kind would raise one important second-order question. This is the treatment of trusts.

13. At present for most trusts the annual exemption is half that for individuals. This is to allow for the fact that one person may have both gains of his own and interests in one or more trusts: so if trusts had the same exemption as individuals, such people would in effect have the benefit of two or more full annual exemptions. On the other hand there are others who may have an interest in a trust but no or few

TASK FORCE SECRET

gains of their own, and to give trusts a zero or very small threshold would be unfair to these individuals. Setting the exemption for trusts at half that for individuals represents a pragmatic compromise between these considerations.

14. Similar argument would apply in relation to the width of the 25% band, and there would be a case - particularly if the band was fairly wide - for halving its width for trusts.

Commencement Date

15. Even without rebasing, the vast majority of CGT payers would pay less tax, so a 6 April (rather than Budget Day) start would if anything tend to encourage most people to defer some disposals they might have made in the last few weeks of the current tax year. Deferring the start to 6 April should therefore not pose significant practical problems for the markets.

Legislative Implications

16. As Mr Allan's note of 8 September recognised, with a reform of this kind, CGT would have to remain a separate tax. There could be no possibility of converting it to income tax.

17. The legislation required would be much simpler than that needed to bring income and gains together in tax computations. Without rebasing - allowing for some technical consequentialia for Lloyds and assuming a 6 April start - it would probably run to no more than 3 pages of the Bill, as against perhaps 20 to tax gains at the rates that would apply if they were income. Rebasing could add a further 20 pages.

Conclusion

18. This option would be very much simpler than bringing income and gains together. Even without rebasing and with a 25% band as narrow as £5,000, the overwhelming majority of CGT payers would be gainers, and the number of people emerging

TASK FORCE SECRET

worse off from the overall Budget reform on both income and gains would be small. If rebasing is added in, or if the 25% band is substantially wider than £5,000, the reform for gains would be exceedingly generous, with only a very small proportion of people paying more tax and most seeing (often large) tax reductions.

19. It thus looks much less difficult with this option to consider reform without rebasing. But even though the vast majority would gain, in the absence of rebasing there would still be complaints about the tax burden on pre-82 gains.

20. By definition, the tax on gains would not be affected by the level of income, so people with large incomes would often pay tax on their gains at 25% rather than the higher rate. But the progressive CGT rate structure would mean that rich investors with large gains, including people who arrange to have large gains instead of income, would face the same marginal rate on their indexed gains as they would on income.

Michael Cayley

M F CAYLEY

This is an attractive approach and with a 35% top rate makes it easier to dispense with expensive rebasing.

he

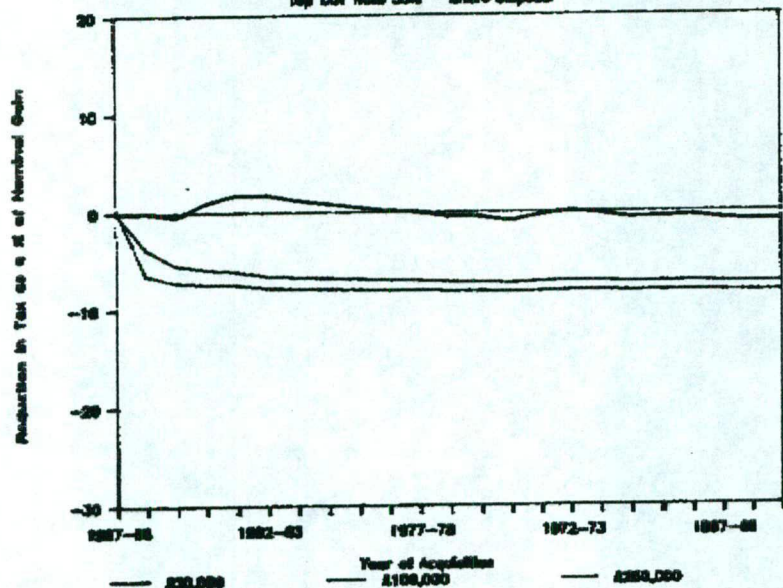
B T HOUGHTON
17 September 1987

I don't see this conclusion. You will now to see how the distributional package comes out. Meanwhile, however, it would be very helpful, if you could give us guidance on what option you would like further to concentrate.

*C L CSI
17. 07*

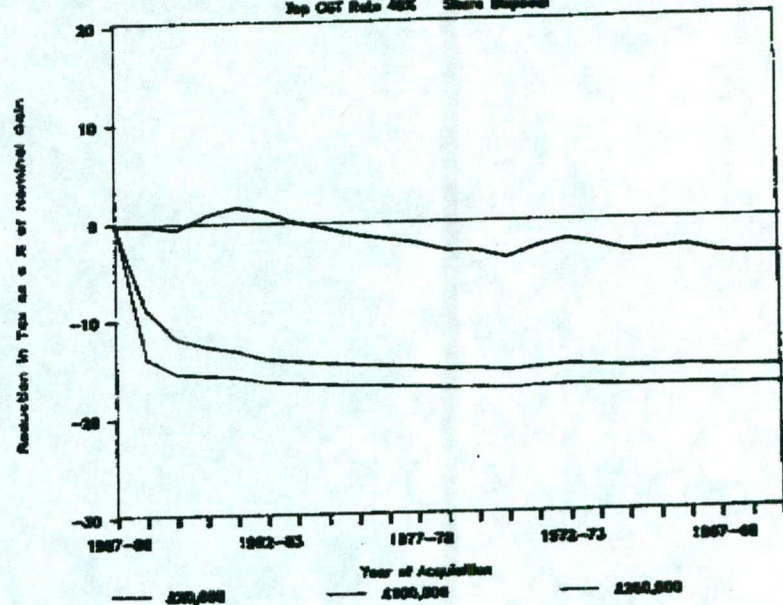
GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 35% Share Disposal



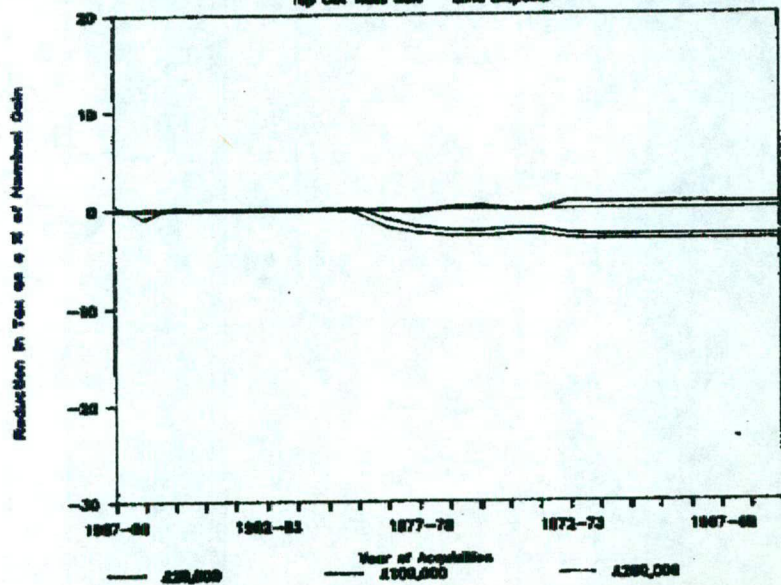
GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 40% Share Disposal



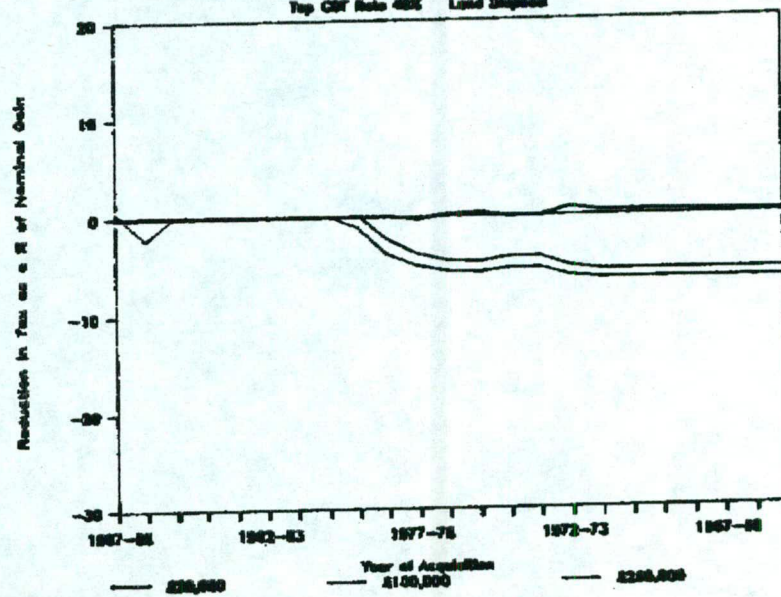
GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 35% Land Disposal



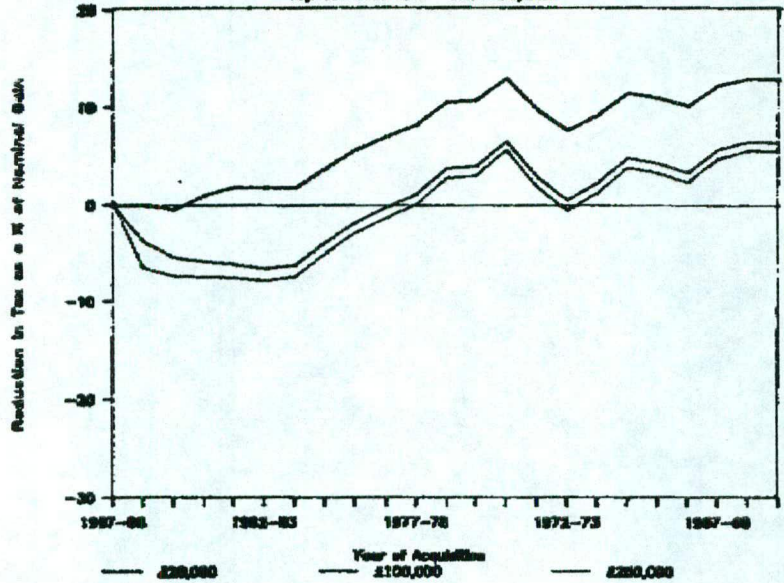
GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 40% Land Disposal



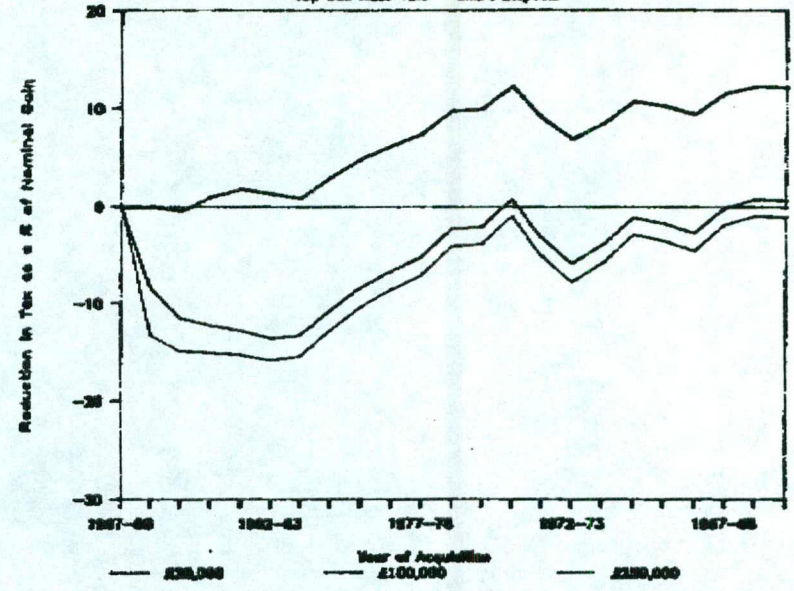
GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 30% Share Disposal



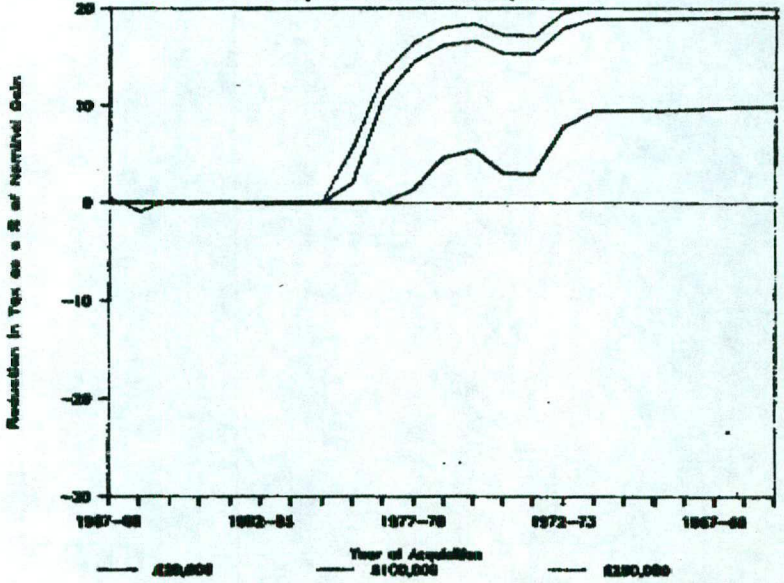
GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 40% Share Disposal



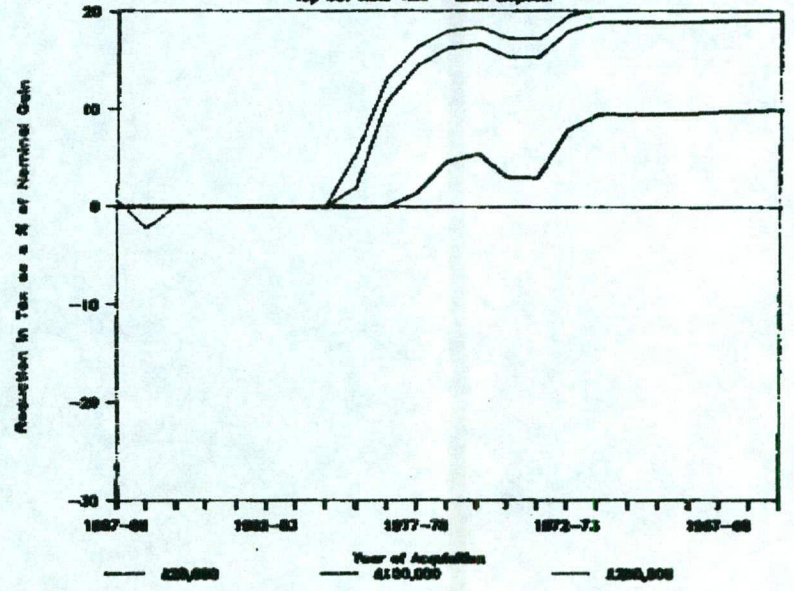
GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 30% Land Disposal



GAINS TAXED AT TWO CGT RATES 1988-89

Top CGT Rate 40% Land Disposal





FROM: J J HEYWOOD
DATE: 18 September 1987

PS/CHANCELLOR

*Thanks.
Para (iv) is not necessary
MGL comparison
Sally if not done
we may not head to collect
Mr Houghton IR
Mr Cayley IR
Mr Cropper
Mr Tyrie
71050 million
Mr a yield of 7100 million.*

REFORM OF CAPITAL GAINS TAX

1. Further to your minute of 15 September, the Financial Secretary has now spoken to Mr Houghton and others about his proposals for CGT reform.

2. The Financial Secretary is not convinced that Mr Houghton came out with knock-down arguments against the proposals, but he did think that the following points were worth recording:

(i) Any proposal which provided taxpayers with a choice of regimes for a limited period would not necessarily be welcomed by investors. They would have to do two sets of calculations and would have to weigh up whether it was sensible to make a tax-driven disposal now rather than later. Often investors would find it sensible to have some of their disposals taxed under one regime and other disposals taxed under the alternative regime. It would certainly not be a simple matter for investors to make a choice.

(ii) Although abolishing indexation would save the Revenue a significant number of staff in the longer run, it was not self-evident that abolition was desirable. It would, for example, bring in 40,000 new taxpayers (unless the threshold were increased) and would cause problems for people with certain lumpy assets. Moreover the Bank's view was that the markets would react very adversely indeed to the removal of a protection against future inflation.

TASK FORCE SECRET

- (iii) As time went by, the problems for taxpayers caused by indexation would gradually diminish. Essentially, there would be a gradual reduction in the number of disposals of assets acquired pre-1982, for which a 1982 valuation had to be obtained in order to calculate the indexation relief.
- (iv) Against this, the Financial Secretary's option (iii) - a regime comprising no indexation, rebasing and taxation at marginal rates of 25% and 35% - would cost only £150 million, compared with £1050 million for a similar regime with indexation retained.

J.H.

JEREMY HEYWOOD
Private Secretary

TASK FORCE SECRET

TASK FORCE SECRET

COPY NO 1 OF 17 COPIES

FROM: MISS C E C SINCLAIR
DATE: 18 SEPTEMBER 1987

- 1. MR CASSELL
- 2. CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
 Sir Peter Middleton
 Mr Scholar
 Mrs Lomax
 Mr Ilett
 Mr Riley or
 Mr G Smith
 Miss Hay
 Mr Sparkes
 Mr Cropper
 Mr Tyrie
 Mr Call
 PS/IR
 Mr Cayley - IR

Oh
 This tells you what effect
 but not estimates of revenue.
 Is it really very attractive
 to bring revenue from 1988-89
 into 1987-88? AA

*Thanks - PSC
 but we have
 a rough
 sketch of
 an amount of
 text revenue
 that would
 be possible from
 June 1985-89 in
 option (b).
 Ms*

CGT REFORM: MARKET IMPLICATIONS OF 6 APRIL 1988 START DATE

Your Private Secretary's minute of 1 September to Mr Cayley asked the Treasury to assess the market implications of a starting date of 6 April 1988 for the CGT reform (which would be announced in the Budget) on two bases:

- (a) (i) gains of individuals being charged under the new income tax rates structure and (ii) the base date being moved forward from 6 April 1965 to 31 March 1982;
- (b) a package containing (i) only (ie without rebasing to 1982)

2. This note, put together with much help from FIM, ETS and the Revenue, makes a preliminary assessment of the likely extent of forestalling, and possible disruption of the stock market, under either option. We will be testing our assessment on the Bank.

3. A separate submission from Miss Evans on the date of the Budget outlines possibilities in March. In practice the options suggest a period of between 2 and 4 weeks in which forestalling could take place. Since, as you will see, our preliminary conclusion is that serious market disruption is unlikely under either option, it

probably does not much matter from a market point of view whether the period is 2 weeks, 3 weeks or 4 weeks (though 3/4 weeks might be preferable). But presentationally you will want to consider whether a longer period makes it easier to dispose of charges of retrospection ie because potential losers will have had a reasonable time in which to dispose of shares (though not land) in order to "beat the budget" measure. This could affect your choice of Budget dates.

Assessment of likely behavioural response to 6 April start date

4. Companies as well as individuals would be affected by option (a), which includes rebasing. Only individuals would be affected by option (b).

Option (a)

5. For both companies and individuals:

- (i) The size of chargeable gains on assets acquired since April 1982 would be unchanged;
- (ii) Chargeable gains on assets acquired before April 1982 would generally be reduced (but some assets which fell in nominal value before 1982 and have continued to fall in real terms, would yield smaller losses);
- (iii) For companies the tax rate on chargeable gains would be unchanged at 35 per cent;
- (iv) For individuals and trusts the tax rate on chargeable gains would depend on their income tax position. Basic rate taxpayers and non-taxpayers, whose disposals do not take them into higher rate tax, would pay at 25 per cent while higher rate taxpayers would pay at 40/35 per cent.

6. The net result is that the great majority of equities held by companies would face the same, or less harsh, CGT regime if disposed of in 1988-89 than if they were disposed of in 1987-88. The potential for forestalling by companies is therefore small: indeed many companies would have an incentive not to realise gains before 6 April, because they would benefit from rebasing. The Revenue do not consider that there will be many who will suffer significantly from having smaller losses.

7. In the case of individuals there would also be substantial numbers for whom either the benefit of rebasing would outweigh any increase in the tax rate, or who would pay at 25 per cent instead of 30 per cent. Such people would have no incentive to forestall. Others with equities purchased since 1982 and who were higher rate taxpayers (or individuals who would be pushed into higher rate by their capital gains) would be subject to a higher rate of tax in 1988-89 than in 1987-88. Some pre-1982 equities would also face a higher effective tax rate if the reductions from rebasing were less than the increase in tax rate as a result of gains being charged under the new income tax rates structure.

8. At the end of 1986, 27 per cent of the total stock of equities was held by persons and trusts. This is equivalent to £128 billion at end June 1987 if the proportion remained constant. Taking the average rate of turnover of equities by individuals, this would imply that about half of this total has been acquired since 1982.

9. For about half of the holdings of post-1982 shares, realisations would not give rise to any CGT liability because the individual's total gains would fall below the £6,600 CGT exemption. Of the remaining half, only those shares held by higher rate taxpayers, or by those whose gains pushed them above the higher rate threshold, would face higher tax rates. About 35 per cent of realisations outside the company sector are by higher rate taxpayers. If the same proportion of post-1982 shares in portfolios large enough to generate CGT liability are with them, then perhaps £11 billion of shares acquired since 1982 could face increased taxes. This, however, does not take account of those who would be pushed above the higher rate threshold if they sold their post-1982 holding in sufficient amounts. (For the assumptions underlying this paragraph, see Annex A.)

10. By no means all those holding shares which faced increased taxes would find it worthwhile to forestall. Transactions costs would have to be taken into account and many individuals would plan to avoid tax altogether by scheduling disposals to take advantage of their annual exemption. Other people would not want to accelerate the actual payment of tax by bringing forward disposals. We cannot say with any great degree of certainty how large these effects might be. But such

vestigial evidence as we have about the effect of capital gains tax changes suggests that no more than about one fifth of the £11 billion worth of shares would be realised. This means extra transactions worth perhaps £2 billion.

11. The whole amount of transactions would be concentrated in a two to four week period. Assuming an average bargain size for these disposals of £12,000, this would mean around 150,000 extra bargains. In June 1987 average daily customer turnover in domestic equities was £0.6 billion (counting each transaction only once and excluding intra-market deals) representing about 50,000 bargains a day.

12. There are two types of possible market disruption to which forestalling might give rise. One occurs from the number of bargains and the paperwork involved and the effect of this on the settlement system. There were about 250,000 bargains in British Gas in the first three weeks after dealing started, so the extra transactions under option (a) would be considerably less than a large privatisation. In addition, many transactions would be bed and breakfast deals not requiring delivery of stock. Thus, the settlement system should not be put under further strain.

13. The second possible disruption could come from large price swings. Bed and breakfast deals should not normally influence price, but if a number of outright disposals or stock switches are brought forward there would be pressure on prices. The value of deals envisaged would be considerably more than in a privatisation stock in the first weeks after dealing started, though they would, of course, be spread throughout the market. An additional consideration is that if some companies were induced by rebasing to stay out of the market during this period, and felt less able to switch into temporarily cheap stock this would reduce liquidity and lead to somewhat less damping of price swings.

14. Taking all these effects into account, our judgement is that on the scale envisaged the market could absorb any pressure on prices without undue disruption although there might be localised difficulties with some of the less liquid stocks (as of course with property and land which could not be disposed of readily within a few weeks).

Option b

15. Individuals only would be affected:

- (i) The size of chargeable gains on assets would be unchanged
- (ii) For individuals and trusts the tax rate on chargeable gains would depend on their income tax position. Basic rate taxpayers and non-taxpayers whose disposals did not take them into higher rate tax, would pay at 25 per cent while higher rate taxpayers would pay at 40/35 per cent.

16. Under this option many individuals would face a tougher tax regime and more people would have an incentive to forestall than under option (a). Higher rate taxpayers (or individuals pushed into the higher rate band by capital gains) would all be losers (though the proposed increase in the higher rate threshold to £25,000 would offset this a bit). Against this, the scope for avoiding tax on gains by keeping realisations below the annual threshold would still be there, as well as the other considerations mentioned in paragraph 10.

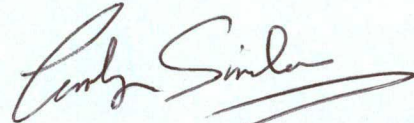
17. On the same basis of calculation as above, we estimate that with option (b) there might be £4-5 billion of transactions which might mean perhaps 400,000 extra bargains. These are substantially larger effects than under option (a). Although many would be bed and breakfast deals, there would be more risk of some market disruption with option (b) than with option (a).

Conclusion

18. As you have noted, the reform of capital gains taxation in the USA, which was unequivocally worse for all individuals, does not seem to have led to market disruption there even though it was announced well in advance of the date of implementation. There was, however, a surge in the level of disposals producing revenue from capital gains exceeding official estimates. It is not clear that all the disposals were due to forestalling as opposed to profit-taking. This experience suggests that in the UK, where the level of the threshold for CGT makes it easier than in the US to avoid paying tax on gains, serious market disruption as a result of forestalling is unlikely.

19. The market will also react to your Budget package as a whole. This could independently affect the volume of disposals. All in all, given the arguments for a 6 April start date, we see no reason to dissuade you on market grounds - though we can say this more confidently in the case of option (a).

20. Finally, you will wish to be aware that, by way of background, we are doing some research in the Treasury on what did happen in the stock market following the introduction of indexation for CGT in 1982. If we come up with anything interesting we will report to you on it next month.



MISS C E C SINCLAIR

CONFIDENTIAL

ANNEX A

	£bn
Domestic equity as at end June 1987	474
Less holdings by institutions and overseas (346) leaves holdings by individuals and trusts	128
Less shares acquired by them before 1982 (64) leaves post-1982 shares	64
Less shares in this category which if disposed of would realise gains below CGT annual exemption* (32) leaves post-1982 shares with a potential CGT liability	32
Less shares in this category held by basic rate taxpayers or non-income taxpayers (21) leaves shares on which forestalling might be advantageous	11
Less 80% who will decide not to sell (9) leaves	2

*

This proportion is derived as follows. To incur a CGT liability, gains greater than £6,600 have to be realised. On an average holding of all shares this would require the disposal of a total of £12,500 of shares. However, capital gains on post-1982 shares are on average lower, because held for a shorter period, and an average mix of £18,000 worth of post-1982 shares would have to be sold before a CGT liability was incurred. If pre- and post-1982 shares are held in average proportions this would require a total portfolio of £37,000. Thus, typically, it is only individuals with a total portfolio of greater than £37,000 who would incur a CGT liability by selling all their post-1982 shares.

We have no direct way of knowing what proportion of individuals' shareholdings is in portfolios of greater than £37,000. There is survey evidence on the distribution of transactions by value by individuals and trusts. 65% of transactions by value by individuals were for bargain sizes greater than £10,000. Assuming that it is only such transactions that give rise to CGT liabilities gives an estimate for 1986 CGT yield reasonably close to the actual take. Thus, there is some justification for taking the proportion of transactions greater than £10,000 as an estimate for the proportion of portfolios by value whose transactions give rise to CGT. This gives us an estimate of 65% of portfolios by value as being greater than £12,500, if we assume that not many portfolios would incur CGT in this forestalling exercise who did not incur it in the past. Assume that a similar relationship between portfolio size and value of transactions by bargain size holds at higher levels. 55% of transactions by value by individuals were for sizes greater than £20,000, and 41% for sizes greater than £50,000. Thus, perhaps half of shares held by individuals are in portfolios greater than £37,000.

TASK FORCE SECRET

COPY NO / OF COPIES

FROM: MISS C E C SINCLAIR
DATE: 18 SEPTEMBER 1987

- 1. MR SCHOLAR
 - 2. CHANCELLOR OF THE EXCHEQUER
- cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr G Smith
Mr C Riley
Miss Evans
Mr Cropper
Mr Tyrie
PS/IR
Mr Beighton - IR
Mr Calder - IR

Oh
Quite a lot of options not covered here (yet). Helpful to have them identified in next scenario, even if not yet costed.
AA

TAX REFORM: FIRST "SCORECARD" COSTINGS

Mr Scholar's minute of 31 July said that we and Revenue would let you have a preliminary estimate of the cost of the reform package as a whole, on the basis of the current options in play, showing the build up of costs year by year.

2. Table 1 shows our first, highly provisional, estimates of the total cost of the package in 1988-89, 1989-90 and 1990-91. Table 2 breaks down the cost of the income tax, employees' UEL and independent taxation package. Table 3 shows the costings for the capital gains proposals.

3. These figures are very crude indeed and will be subject to further refinement and change. The income tax and NIC figures are at 1988-89 income levels and are given against an indexed base (ie the usual scorecard presentation). The independent taxation costs assume protection for cash losers. The figures for income tax/UEL/independent taxation give an indication of the likely receipts pattern in each of the three years (at 1988-89 income levels).

4. We have put in a figure of £0.7 billion as the full year cost of possible NIC changes at the lower end. A further paper from

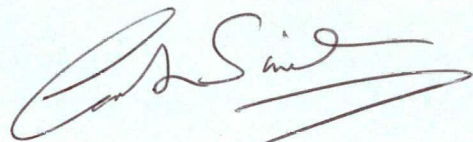
Many thanks to Mr Scholar for his prompt reply to my letter of 12/9. I shall be pleased to discuss the options in more detail. In the meantime, I shall be looking at the tables with a view to releasing them to you as soon as possible. (This is to be done by 3.15.87 - see pattern).

SINCLAIR
TO
CH EX
18 SEP 87

the Task Force at the end of this month will look at options here, as well as the possibility of withdrawing the "steps" in employers' contributions.

5. The costings for the capital gains tax proposals require considerable further refinement, including the outcome of our work in the 'surge' effect. This work is some way still from completion and will not be ready until mid-October or so. The costings in Table 3 are therefore on the basis you saw in July, but they take account of a 35 per cent higher rate (in Option 2) and of the proposal to increase the higher rate threshold to £25,000 (ie Option 1A in Mr Mace's submission of 14 July revalorised to 1988-89 income levels) to reduce the number of higher rate losers from abolition of the employees' UEL. The CGT figures relate to disposals in 1988-89 and show a path of receipts based on the pattern under the present regime. The figures make no attempt to model changes in receipts flows as a result of changes in the regime, and exclude any first year surge effects.

6. This minute is the first in a series of minutes - in effect early editions of the usual post-Chevening scorecard. We and the Revenue will continue work refining and updating these costs and will let you have further 'scorecards' in due course.



MISS C E C SINCLAIR

TASK FORCE SECRET

TABLE 1

Total cost of tax reform package (1)	cost(-)/yield(+)		£ billion
	1988-89	1989-90	1990-91
Option A			
Income tax rates 25 per cent/40 per cent, phased abolition of employees' UEL, independent taxation	-3.4	-3.9	-4.1
Changes to NICs at lower end	-0.4 (2)	-0.7	0.7
Capital gains: rebased to 1982, gains taxed at 25 per cent/40 per cent	-0.2	-0.4	-0.9
Total	-4.0	-5.0	-5.7
Option B			
Income tax rates 25 per cent/35 per cent, phased abolition of employers' UEL, independent taxation	-3.7	-4.4	-4.6
Changes to NICs at lower end	-0.4	-0.7	-0.7
Capital gains: rebased, to 1982, gains taxed at 25 per cent/35 per cent	-0.2	-0.6	-1.0
Total	-4.3	-5.7	-6.3
Option C			
Income tax rates 25 per cent/40 per cent in 1988-89; 25 per cent/37½ per cent in 1989-90; 25 per cent/35 per cent in 1990-91 + phased abn of UEL + indep tax	-3.4	-4.1	-4.6
Changes to NICs at lower end	-0.4	-0.7	-0.7
Capital gains: rebased to 1982, gains taxed at 25 per cent/35 per cent	-0.2	-0.6	-1.0
Total	-4.0	-5.4	-6.3

(1) Figures highly provisional

(2) Assumes changes start in October, with full year cost of £0.7 billion

TABLE 2

Income tax changes, abolition of employees' UEL and independent taxation

<u>Option A</u>	Cost(-)/yield(+)		£ billion
	1988-89	1989-90	1990-91
Reduce basic rate by 2 points	-2.4	-2.8	-2.8
Abolish higher rates above 40 per cent in 1988-89	-0.8	-1.6	-1.6
Raise higher rate threshold to £25,000	-0.5	-0.8	-0.8
<u>Phase in NIC charge above UEL/UPL</u> ⁽¹⁾	+0.5	+1.5	+1.8
<u>Raise mortgage interest relief ceiling to £35,000 and restrict to residence basis</u> ⁽²⁾	-0.2	-0.2	-0.2
Independent taxation ⁽³⁾	-	-	-0.5
Total cost	-3.4	-3.9	-4.1
<u>Option B</u>			
Reduce basic rate by 2 points	-2.4	-2.8	-2.8
Abolish higher rates above 35 per cent in 1988-89	-1.3	-2.3	-2.3
Raise higher rate threshold to £25,000	-0.3	-0.6	-0.6
<u>Phase in NIC charge above UEL/UPL</u> ⁽¹⁾	+0.5	+1.5	+1.8
<u>Raise mortgage interest relief ceiling to £35,000 and restrict to residence basis</u> ⁽²⁾	-0.2	-0.2	-0.2
Independent taxation ⁽³⁾	-	-	-0.5
Total cost	-3.7	-4.4	-4.6

<u>Option C</u>	Cost(-)/yield(+)		£ billion
	1988-89	1989-90	1990-91
Reduce basic rate by 2 points	-2.4	-2.8	-2.8
Abolish higher rates above 40 per cent in 1988-89; 37½ per cent in 1989-90 and 35 per cent in 1990-91	-0.8	-1.8	-2.2
Raise higher rate threshold to £25,000	-0.5	-0.8	-0.7
Phase in NIC charge above UEL/UPL ⁽¹⁾	+0.5	+1.5	+1.8
Raise mortgage interest relief ceiling to £35,000 and restrict to residence basis ⁽²⁾	-0.2	-0.2	-0.2
Independent taxation ⁽³⁾	-	-	-0.5
Total cost	-3.4	-4.1	-4.6

- (1) Assumes 7 per cent charge above UEL from October 1988, 8 per cent from April 1989 and 9 per cent from April 1990; and that self-employed treated on a par with employees
- (2) Subject to further refinement and currently excluding any behavioural effect.
- (3) No allowance has been made for the proposal to withdraw the married man's allowance over incomes above the higher rate threshold.

TABLE 3

CAPITAL GAINS

	cost (-)/yield(+)	£ billion
<u>Option 1</u>		
		Full year cost/yield on 1988-89 disposals
Rebasing to 1982 (including companies) ⁽¹⁾)		
Gains taxed at 25 per cent/40 per cent)		
Higher rates threshold of £25,000)	- 1.0	
Exempt amount frozen at £6,600)		
 <u>Option 2</u>		
Rebasing to 1982 (including companies) ⁽¹⁾)		
Gains taxed at 25 per cent/35 per cent)	- 1.1	
Higher rates threshold of £25,000)		
Exempt amount frozen at £6,600)		
 Option 1 <u>without</u> rebasing	+ 0.3	
Option 2 <u>without</u> rebasing	+ 0.1	

(1) Rebasing for companies on either option costs £0.5 billion



FROM: J M G TAYLOR

DATE: 21 September 1987

df 30/9

MISS SINCLAIR

cc: FST
Sir P Middleton
Mr Scholar
Mrs Lomax
Mr Ilett
Mr Cassell
Mr Riley
Mr G Smith
Miss Hay
Mr Sparkes
Mr Cropper
Mr Tyrie
Mr Call
PS/IR
Mr Cayley - IR

CGT REFORM: MARKET IMPLICATIONS OF 6 APRIL 1988 START DATE

The Chancellor was grateful for your minute of 18 September.

2. He would be grateful for a rough estimate of the amount ^{of} tax revenue that might be brought forward from 1988-89 to 1987-88 under option (b).

A handwritten signature in dark ink, appearing to be 'JMG'.

J M G TAYLOR

TASK FORCE SECRET

Copy No. ⁶...of. ⁷..Copies



FROM: J M G TAYLOR

DATE: 21 September 1987

PS/FINANCIAL SECRETARY

cc: Mr Houghton - IR
Mr Cayley - IR
Mr Cropper
Mr Tyrie

REFORM OF CAPITAL GAINS TAX

The Chancellor was grateful for your minute of 18 September.

2. He has commented that the comparison in your paragraph (iv) is not necessarily the right one since if we are retaining indexation we may not need or wish to rebase, which would turn the cost of £1050 million into a yield of £100 million.

A handwritten signature in black ink, appearing to be 'J M G Taylor'.

J M G TAYLOR

TASK FORCE SECRET

Copy No. ¹⁵ of ¹⁶ Copies

FROM: A C S ALLAN

DATE: 21 September 1987

MISS SINCLAIR

cc: PS/FST
 Sir P Middleton
 Sir T Burns
 Mr Cassell
 Mr Scholar
 Mr G P Smith
 Mr C Riley
 Miss Evans
 Mr Cropper
 Mr Tyrie
 PS/IR
 Mr Beighton - IR
 Mr Calder - IR

TAX REFORM: FIRST "SCORECARD" COSTINGS

The Chancellor was most grateful for your minute of 18 September.

2. He would be grateful if the further scorecards promised in your paragraph 6 could include a check list (and wherever possible the costing) of the further options which are at present being explored.

3. In the meantime, however, he would be grateful to see as soon as possible how Table 1 would look without the CGT rebasing (this is not derivable from Table 3, which does not show the year-by-year pattern).

ACSA

A C S ALLAN

ACSA
 To
 SINCLAIR
 21 SEPT

TASK FORCE SECRET

COPY NO 1 OF 4 COPIES

FROM: M C SCHOLAR
DATE: 21 SEPTEMBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Cassell
Mr Riley
Miss Sinclair
Miss Evans

Thanks. Useful; see X of course. No concern of course. Until we have info. Can't work out if we prefer

Stage or think in terms of IT/NIC changes

TIMING OF TAX AND COMMUNITY CHARGE CHANGES

Before the summer break Sir Peter Middleton asked us to work out a timetable which would show the phasing in of the community charge and the Budget measures now under consideration. Accordingly Miss Evans produced the attached note, and Sir Peter Middleton has suggested that we put it forward to you now.

X 2. As you will see, we hope to let you have the distributional analysis of the impact of all these changes, which you requested at your meeting on independent taxation on 17 July, later on in the autumn.

MCS

M C SCHOLAR

TASK FORCE SECRET

COPY NO 4^① OF 5 COPIESFROM: MISS C EVANS
DATE: 16 SEPTEMBER 1987

1. MR SCHOLAR

cc Miss Sinclair
Mr G P Smith

2. SIR PETER MIDDLETON

TIMING OF TAX/COMMUNITY CHARGE (CC) CHANGES

You asked at PCC before the holiday for a timetable showing the phasing of the community charge and the Budget measures now under consideration. I attach at Annex 1 a timetable which includes a compressed account of the local government finance changes. For reference the more detailed local government timetable (Annex 2) and note on terminology (Annex 3) provided by LG are helpful.

2. To see the significance of these dates we need an assessment of the combined distributional effects of the changes. Because of the wide variation in the level of the CC between households and between authorities and because the impact of the tax changes will depend on individual circumstances within income groups, these effects are complex. ETS are working on a distributional analysis which will be ready later in the autumn. We have included the CGT changes in the timetable for completeness, but it is likely to be very difficult to assess the implications of these for individuals by income group.

3. LG have provided some useful illustrations of average rates and CC bills (Annexes 4-6). As you know the general pattern is that ratepayers will be better off as domestic rates are phased out and replaced by the CC, but new contributors will be worse off. The effect on households depends on the number of new contributors. The average CC bill (taking England as a whole) in a 2 adult household (£448) would be virtually the same as the average rates bill (£440) assuming no change in authorities' real spending. But the range of gainers and losers is very wide (range of full CC (£135-£782). Annex 5 shows the position of the average ratepayer in three different types of authority and Annex 6 shows the position of a two

adult household in the same authorities (ie the combined effect of phasing out of rates and 2 CC bills). Both tables assume steady cash spending - for the total bills this will be the same as steady real spending but the balance between the CC and rates will be determined by the constraints which have been set in nominal terms. (These tables are likely to be under-estimates because they allow for no real growth in LA spending.)

4. The timetable shows the following combination of events:

- (a) in Scotland: the introduction of the CC will follow shortly (5 months) after the NICs UEL abolition. This means that households with more than one CC contributor and earner will be affected by both in a short time although the current options on NICs phasing will mitigate the impact.
- (b) in England and Wales: there will be a gap of 17 months between the NICs measures and CC introduction. Phasing of the CC over 4 years will dilute its impact but in some high spending areas eg Camden it will rise from at least £100 a year to around at least £800 a year in 4 years.
- (c) independent taxation of husband and wife will be introduced at the same time as the first phase of the CC in England, and its full implementation in Wales. Thus in some households gains from independent taxation could offset losses from higher combined rates/CC bills. However wives with significant investment income are perhaps more likely to live in high rateable value properties and would thus gain from rates abolition.



MISS C EVANS

TIMETABLE FOR 1988 BUDGET PROPOSALS/COMMUNITY CHARGE (CC)

April 1988	CGT changes
May 1988	Income tax changes*
November 1988	NICs changes*
April 1989	Scotland: domestic rates abolished, CC introduced in full
April 1990	Wales: domestic rates abolished, CC introduced in full, first phase of grant redistribution England: first stage of phasing out domestic rates, phasing in community charge (ie rates reduced by £100, community charge of £100 (plus or minus increase or reduction in real spending since 1989-90)
April 1990	Independent taxation of husband and wife
April 1991	England: domestic rates reduced by 25 per cent, community charge increased in line with lower domestic rates, higher spending and first phase of grant redistribution Wales: second phase of grant redistribution
April 1992) April 1993)	England: as for April 1991 Wales: as for April 1991
April 1994	England: domestic rates abolished, England and Wales: no grant redistribution, CC fully reflects LA spending relative to assessed need.

* assumes one-stage introduction

TimingDateEvent

1 April 1989

Scotland: domestic rates abolished.
 : community charge introduced in full.
 : likely to be a safety net, which phases in changes in burden between areas (but not between individuals in the same area).

1 April 1990

Wales : domestic rates abolished
 : community charge introduced in full
 : a four year safety net

England : domestic rates reduced by equivalent in each area of a community charge of £100.
 : Community charge introduced of £100 plus or minus the increase (or reduction) in real spending since 1989-90.
 : four year safety net for phasing in changes in burdens between areas in the total of domestic rates and the community charge.

1 April 1991

Wales : safety net phased out by one quarter.

England : domestic rates reduced by one quarter (in nominal terms) from those rates prevailing in 1990-91.
 : safety net phased out by one quarter
 : consequent changes to community charge from reduction in rates, phasing out of safety net and changes in grant and LA spending.

1 April 1992)

) As for 1 April 1991, so that by

1 April 1993)

1 April 1994

Wales : no safety net. Community charge fully reflects
 & LA spending relative to assessed need.

England

No changes to rates or local government finance are currently planned in Northern Ireland.

Terminology

The Green Paper "Paying for Local Government" envisages (separately for England, Scotland and Wales) a simplified grant system, a uniform business rate and the replacement of domestic rates by a community charge.

2. These policies will change the income received by local authorities. Grant will no longer be affected by aggregate rateable values of an area; and non-domestic rates will be paid at a single rate and distributed to LAs at a flat rate per adult. They will be applied in full from April 1990 in England (after a transition) and Wales, but in Scotland there will not be a uniform business rate.

3. If these changes were introduced immediately, it is thought that LAs and their residents would have insufficient time to adjust. The safety net will offset the redistribution of grant and non-domestic rate income between areas so that in 1990-91, the first year of the scheme in England and Wales, each LA can raise the same amount from all their residents in real terms as they did in 1989-90 (assuming that their spending is constant in real terms). The safety net will then be phased out over the following few years, so that one quarter of the effects of the new system will feed through in 1991-92, half in 1992-93, three quarters in 1993-84 and all in 1994-95.

4. A safety net alone would not protect individual residents from large changes in their bills because the community charge implies a different distribution of the burden within areas to that entailed by domestic rates. There is therefore, in England alone, a transitional period when both domestic rates and the community charge will be levied, so that individuals have time to adjust.

Illustrative effects

The table below indicates the average and the range of the full community charge, had it been introduced in Wales and Scotland in 1987-88 with a full safety net.

	RANGE OF COMMUNITY CHARGES (£ per adult per annum)		
	Lowest	Average	Highest
Wales	77	136	188
Scotland (excluding water charge)	107 (84)	253 (233)	289 (263)

2. Changes in the charge should reflect inflation and any increase in real spending by local authorities. But projections of the charge would also have to make an assumption about the increase in government grant. If grant formed a falling proportion of LA spending, the charge would rise faster.

3. In England the position is more complicated. The table below shows the range of average rates bills per household by district, and the full introduction of the community charge.

	ENGLAND		
	Lowest*	Average	Highest
Rates bills by district (per <u>household</u>)	237 (Pendle)	440	843 (Camden)
full community charge (per <u>adult</u>)	135 (Bromsgrove)	224	782 (Camden)

* Excludes the Isles of Scilly, which would have a community charge of £93.

4. If LAs did not change their ^{nominal}~~real~~ spending (and grant and the non-domestic rates pool met the same proportion of spending), an average ratepayer would see the following pattern of bills.

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
Rates	440	244	183	122	61	-
CC	-	100	131	162	193	224
Total	440	344	314	284	254	224

The new contributor to local government revenue would simply see an increase from zero in 1989-90 to £100 in 1990-91 and £224 in 1994-95.

The tables below show the position of the average ratepayer in Camden, Pendle and Bromsgrove.

	Camden	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
<i>high spend high rateable value</i>	Rates	843	658	494	329	165	0
	CC	-	100	271	441	612	782
	Total	<u>843</u>	<u>758</u>	<u>765</u>	<u>770</u>	<u>777</u>	<u>782</u>
	Pendle						
<i>high spend low rateable value</i>	Rates	237	57	43	28	14	0
	CC	-	100	128	156	184	212
	Total	<u>237</u>	<u>157</u>	<u>171</u>	<u>184</u>	<u>198</u>	<u>212</u>
	Bromsgrove						
<i>low spend high rateable value</i>	Rates	433	226	170	113	57	0
	CC	-	100	109	118	127	135
	Total	<u>433</u>	<u>326</u>	<u>279</u>	<u>231</u>	<u>184</u>	<u>135</u>

New contributors would face steady increases from £100 a year to the final community charge.

In practice the community charge is likely to grow faster because of inflation and real growth in LA spending. As rate poundages will be fixed to decline in nominal terms, the increasing nominal burden borne by residents will all fall on the community charge.

District: average

Household: 2 adults; 1 times average rateable value

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
Rates	440	244	183	122	61	0
CC	0	200	262	324	386	448
Total	440	444	445	446	447	448

Inflation assumption: 0.0%

District: Camden (high spend, low rateable value)

Household: 2 adults; 1 times average rateable value

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
Rates	843	658	494	329	165	0
CC	0	200	541	882	1223	1564
Total	843	858	1035	1211	1388	1564

Inflation assumption: 0.0%

District: Pendle (high spend, low rateable value)

Household: 2 adults; 1 times average rateable value

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
Rates	237	57	43	29	14	0
CC	0	200	256	312	368	424
Total	237	257	299	341	382	424

Inflation assumption: 0.0%

District: Bromsgrove (low spend, high rateable value)

Household: 2 adults; 1 times average rateable value

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
Rates	433	226	169	113	56	0
CC	0	200	218	235	253	270
Total	433	426	387	348	309	270

Inflation assumption: 0.0%



FROM: J M G TAYLOR

DATE: 22 September 1987

MR SCHOLAR

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Riley
Miss Sinclair
Miss Evans

TIMING OF TAX AND COMMUNITY CHARGE CHANGES

The Chancellor was grateful for your minute of 21 September. He looks forward to the distributional analysis of the impact of these changes.

A handwritten signature in dark ink, appearing to be 'JMG'.

J M G TAYLOR

COPY NO 1 OF 15 COPIES

FROM: MISS C EVANS
DATE: 22 SEPTEMBER 1987

- 1. MR SCHOLAR
- 2. CHANCELLOR OF THE EXCHEQUER

- cc Financial Secretary
- Sir Peter Middleton
- Sir Terence Burns
- Mr Cassell
- Mr G P Smith
- Mr Riley
- Miss Sinclair or
- Mr Cropper
- Mr Tyrie
- PS/IR
- Mr Beighton - IR
- Mr Calder - IR

*Man Rankin.
1 SW like to
see year O.R.
(Mansfield)*

TAX REFORM: FIRST "SCORECARD" COSTINGS

As requested in Mr Allan's minute of 21 September, I attach an alternative version of Table 1 (Miss Sinclair's minute of 18 September), without cgt rebasing.

MISS C EVANS

*do no tag
table acct of no
costings (25%)
change of no
Share Co's CT rate?
PS. NB also omission
@ X*

EVANS
To
CH. EX
22 SEPT

Total cost of tax reform package (1)	cost(-)/yield(+)			£ billion
	1988-89	1989-90	1990-91	
Option A				
Income tax rates 25 per cent/40 per cent, phased abolition of employees' UEL, independent taxation	-3.4	-3.9	-4.1	
Changes to NICs at lower end	-0.4 ⁽²⁾	-0.7	-0.7	
Capital gains: gains taxed at 25 per cent/40 per cent: no rebasing	+0.1	+0.2	+0.3	
Total	-3.7	-4.4	-4.5	
Option B				
Income tax rates 25 per cent/35 per cent, phased abolition of employers' UEL, independent taxation	-3.7	-4.4	-4.6	
Changes to NICs at lower end	-0.4 ⁽²⁾	-0.7	-0.7	
Capital gains: gains taxed at 25 per cent/35 per cent: no rebasing	+0.1	+0.1	+0.1	
Total	-4.0	-5.0	-5.2	
Option C				
Income tax rates 25 per cent/40 per cent in 1988-89; 25 per cent/37½ per cent in 1989-90; 25 per cent/35 per cent in 1990-91 + phased abolition of UEL + indep tax	-3.4	-4.1	-4.6	
Changes to NICs at lower end	-0.4 ⁽²⁾	-0.7	-0.7	
Capital gains: gains taxed at 25 per cent/35 per cent: no rebasing	+0.1	+0.1	+0.1	
Total	-3.7	-4.7	-5.2	

(1) Figures highly provisional

(2) Assumes changes start in October, with full year cost of £0.7 billion



Inland Revenue

Policy Division
Somerset House

b.f. (with response of ... 30/9)

CONFIDENTIAL

FROM: C GORDON

DATE: 23 SEPTEMBER 1987

- MR 23/9*
1. MR CAYLEY
1A Mr Gordon
 2. FINANCIAL SECRETARY

CGT ROLLOVER : MILK QUOTA

1. Capital gains tax rollover relief enables a trader to defer the gain on certain trade assets where some or all of the proceeds are reinvested in new trade assets. The relief is however confined to a limited set of qualifying assets: most importantly land, goodwill and fixed plant and machinery.

2. Following recent representations Treasury Ministers decided to extend - with immediate effect - the capital gains tax rollover relief provisions to include satellites and spacecraft. As was pointed out in Mr Cayley's note of 13 July following such an extension Ministers would undoubtedly come under greater pressure for further extensions. There is one area in particular in which pressure for rollover relief is increasing and we would be grateful for guidance from Ministers on this.

cc PS/Chancellor
Mr Scholar
Mr Cropper
Mr Jenkins
(Parliamentary Counsel)
Miss Sinclair

Mr Isaac
Mr Pitts
Mr Beighton
Mr Cayley
Mr Hamilton
Mr C Gordon
PS/IR

Milk Quota

3. In order to ensure that only specified quantities of various agricultural products are produced the Ministry of Agriculture operates a number of "quota" schemes. Broadly, these schemes serve to discourage farmers etc from producing more than a specified quantity of a particular product by imposing a levy on sales above a certain amount. Milk quota for example represents the right to produce specified levels of milk without incurring an additional levy on disposal. These quotas - and we are currently seeking details from the Ministry of Agriculture of other quotas - are considered to be chargeable assets separate and distinguishable from the land to which they relate and consequently fall outside the list of qualifying assets and do not therefore qualify for rollover relief.

4. A number of representative bodies, including the NFU and CLA, have made representations (including a new clause in the Summer Finance Bill) suggesting that the absence of rollover relief - particularly on milk quota - inhibits the expansion of farming activities particularly where it is intended to move to a larger farm. A capital gains tax charge - which could be substantial - would be faced immediately on the sale of the quota, whereas the gain on land etc could be rolled into the new farm.

5. We do have some sympathy with this view. We think, however that it would be very difficult in principle to confine any extension of the relief to milk quota. As mentioned above there are several other types of "quota" about which we are aware - and there may be others about which we are not yet aware. We are in the process of ascertaining from the Ministry of Agriculture exactly what other types of quota do exist and of establishing to what extent they perform a similar function to milk quota. Although milk quota has been the main subject of all the representations we have seen we think that if any change was confined to milk quota

Ministers would very quickly come under pressure to extend the relief to all similar assets. We know of two others - potato quota and EEC fishing rights - and during this year's Finance Bill proceedings a backbench New Clause was tabled suggesting that rollover relief should be extended to both of these as well as to milk quota. It is also quite possible that new "quotas" may well be introduced in the future - in which event consideration would have to be given to extending rollover to them: so if the principle of extending rollover to agricultural quotas is accepted now, further amendments to the legislation may be needed in future years.

6. In addition some representations have suggested that any changes should be retrospective ie to deem milk quotas always to have been an asset qualifying for relief. On balance we would recommend against this. It would be very unusual to have retrospection for a change of this kind, and we doubt there are special circumstances here to justify retrospection. And there would be the practical problems of identifying and reopening cases that had already been settled. But there would undoubtedly be some pressure for retrospection.

7. One factor which is relevant is that if the relief is extended next year not only to satellites but also to agricultural and other quotas, Ministers are likely to come under intensified pressure for further extensions, which might be much more costly. For example agricultural landlords could well press harder for the relief to extend to their holdings of land.

Cost and Staffing

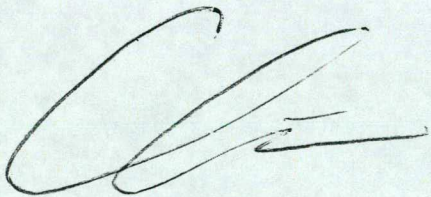
8. The cost of extension of the relief to agricultural and fishing quotas is likely to be under £m10. There would be negligible impact on our staff need.

Conclusion

9. Against this background, we would be grateful to know if Ministers wish to extend the capital gains tax rollover relief to milk quota and if so:

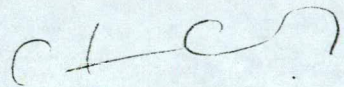
(i) whether the relief should also be extended to other similar existing types of quota; and

(ii) if they agree that any change should not be retrospective.



C GORDON

you will wish to consider the separate questions, here
- the merits
- the priority - for which looks likely to be a
pretty formidable 1988 Finance Bill.



23-9



FROM: J M G TAYLOR

DATE: 23 September 1987

MISS C EVANS

cc Financial Secretary

Sir P Middleton

Sir T Burns

Mr Cassell

Mr G P Smith

Mr Riley

Miss Sinclair o.r.

Mr Scholar

Mr Cropper

Mr Tyrie

PS/IR

Mr Beighton - IR

Mr Calder - IR

JMG
To
EVANS
23 SEPT**TAX REFORM: FIRST "SCORECARD" COSTINGS**

The Chancellor was most grateful for your minute of 22 September.

A handwritten signature in dark ink, appearing to be "JMG".

J M G TAYLOR