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PART C

SECRET

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PART C

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

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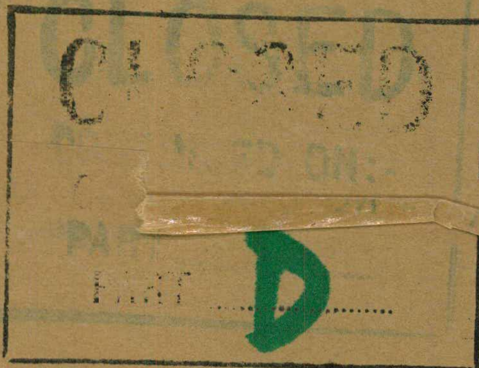
PART C

12.10-87



TASK FORCE SECRET

Copy No 1 of 16

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Ch/ Mr Isaac to set in hand detailed work? (NB also Mr Lewis's background note of 25/9, below) 26

2/10

FROM: A J G ISAAC
23 September 1987

CHANCELLOR OF THE EXCHEQUER

TAX ON BENEFITS IN KIND

1. I attach (itself classified Confidential) our promised note on the suggestion that the tax on certain benefits in kind should be collected from employers, not employees.

2. In this (more restrictively classified) covering note I add some comment, and try to see how the idea could relate to the wider Budget objectives.

3. I have thought it right to put up a quick note on the main policy implications, without holding it up to commission a lot of detailed work on its operational and management implications (though these would be important - for employers as much as the Revenue - and crucial for the earliest date of implementation). We should need to set detailed work in hand very quickly, if you wanted to pursue this option for the 1988 Budget, rather than the changes to the present system which you have asked us to look at.

ISAAC → CH/EX 23/9

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cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Cropper
Mr Tyrie

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Miss Rhodes o/r
Mr R H Allen
PS/IR

An employer based tax or disallowance?

4. I agree with Miss Sinclair that an employer based tax is a much more promising approach than a disallowance. For the reasons I summarised in my note of 25 June, I see the latter as tilting with a broken reed at the wrong windmill.

Objectives of an employer based tax

5. The objectives of a new employer based tax might include

- reduced compliance costs (certainly for employees, and possibly for the Revenue; the potential impact on employers is much more anxious);

- minimising the tax/NIC incentive for employers to provide benefits for their employees, rather than cash (bearing in mind possible changes to the UEL);

- mitigating so far as possible the political sensitivity of the benefit charge, by shifting the impact from (sometimes low-paid) individuals towards (largely, but not necessarily) impersonal employers.

- a more broadly based charge on benefits - such as subsidised meals - which are impossible to tax at the level of the individual employee, but might be taxed in the aggregate on the employer (cf our earlier discussions on Third Party Entertainment).

6. My very tentative assessment - on the basis of the very limited work that we have been able to do in the time available - is that an employer based charge could be constructed, which could in principle meet most of these objectives (though I am troubled by the possible impact on compliance costs of employers).

7. Such a charge could cover a more or less wide range of benefits and expenses - though the note suggests that it could become unworkable, if we tried to extend it to all expenses, including in particular flat rate expense allowances. It would therefore be necessary to continue to handle some expenses - as the Australians and New Zealanders do - outside the employer tax.

8. At the same time, you will wish to consider whether the other "Task Force" measures in your Budget, and the wider economic prospect more generally, make it possible to handle the other implications of the change, which had previously seemed to us to rule out an initiative of this kind.

9. First, it implies a switch of several £hundred million in the tax burden from employees to employers. Given the time that both employers and we would need to adjust to the change, this is not an immediate problem, if you legislate in 1988. But is the prospect of a shift of this order acceptable for a later transitional year, in the light (eg) of the forecasts of business profitability?

10. Second, the tax would of course be collected at a flat rate (not related to the different marginal rates of employees in receipt of benefits). This implies a new measure of rough justice.

- Either employers will continue to pay something like the present burden of tax on benefits for high-paid employees - or something more if you wish to tackle the NIC/UEL problem (in which case there will be a very big increase in the burden of tax relating to other employees, and in the yield of tax on benefits generally). Would this be consistent with your objectives for benefits generally, and for tackling the present advantage which benefits enjoy for NIC purposes? or

- or the tax rate must be set at some lower - perhaps average - rate (in which case the yield of tax on benefits might remain broadly constant, but there would be a new tax advantage for employers extending benefits to their high-paid employees and directors over and above the NIC/UEL advantage).

Budget reductions in the top rates of tax would narrow the spread between the horns of this dilemma. Would they narrow it enough?

11. Third, I believe that there would need to be other simplifications in the present tax laws, to minimise additional compliance work for employers. Examples might be abolition of the P11D threshold and of the special rules for high and low mileage business cars. Could enough be done to make the compliance costs acceptable to employers? Where simplification produces a measure of "rough justice", would this be acceptable in the context of the wider Budget reforms? And, in the same context, what would be the presentational considerations in making benefits apparently tax-free to the employee?

12. Fourth, either employers would need to remit the tax monthly - or perhaps quarterly (which would obviously be at least some additional compliance burden for them, over the present annual returns, even if the interim returns could presumably be on some simplified basis); or there could be a cash flow loss to the Exchequer in the region of (say) up to £700-800 million or so (less on a quarterly basis) in the transitional year. Which of these alternatives look more promising?

Australian and New Zealand precedents

13. I think that it might well be worth picking the brains of the Australian and New Zealand authorities, if you are minded to go ahead. Their position is a little different from ours (they are effectively imposing a tax, where none previously existed). In the past, however, I have found it helpful to consult other

national (both US and Australian) tax authorities, when considering adopting their legislation.

14. Ideally - if we can find the money - I should like someone to go out and consult at first hand. People will tell us far more than they are willing to put down on paper; and it is (if anything) easier to keep the discussions confidential. I would not like to define the precise questions, until we have all done a bit more homework, and identified a little more precisely what we need.

Ch

Michael thoroughly supports X - and would like someone from the Treasury to go along too (I volunteer!)

AA

A J G ISAAC

BENEFITS IN KIND

1. The Chancellor has asked (Mr Allan's note of 16 September) for a note on the possibility of adopting in this country something like the Australian/New Zealand system - under which the tax in respect of certain benefits in kind and expenses is levied on employers, not employees.

2. This note seeks to offer a quick first response, and to identify some main issues for Ministers to consider. A number of these issues will be familiar to Ministers from our earlier papers on a possible employer-based charge to collect tax on Third Party entertainment - though this charge would, of course, have a much wider base. If Ministers find the ideas discussed in this note attractive, and subject to any provisional guidance which Ministers give us on the main issues we try to identify in this note, we could then set work in hand on a more substantive proposal, and take a more considered look at the possible staff and compliance costs.

3. It would be most helpful to have early - even if provisional - guidance from Ministers on these proposals. If adopted, they would cut across a number of initiatives in this area currently under discussion with Treasury Ministers.

4. I attach at Annex A a sketch outline of the kind of scheme being considered.

FEATURES INHERENT IN THE SCHEME

5. I think that there are a number of features inherent in any scheme of this kind.

i. Shift in the tax burden

6. On the face of it, the scheme presupposes a formal shift in the burden of tax, from employees to employers. The yield of tax on benefitsat current tax rates is estimated to be in the region of £750 million in 1988-89 - perhaps well over £800 million in 1989-90. But this indicates no more than the possible order of magnitude of a new charge.

7. I describe this as a "formal" shift. It may be argued that

a. most tax in respect of benefits in kind is now collected through coding adjustments. Thus, at present, the tax is collected by employers, in effect deducting additional amounts of PAYE tax and remitting it to the Revenue. To that extent, it may be argued that employers could to a greater or lesser extent immediately shift the burden back again - in effect, remitting less PAYE, but more of the new charge (see illustration in Annex B);

b. in any event, to the extent that the shift would initially imply additional costs for employers, and additional net-of-tax income for employees, this would over time be reflected in the relevant wage and salary contracts.

8. Nevertheless, it is perhaps prudent to assume that the change would imply some substantial net costs to employers, at least in the short term (see Annex B); and perhaps some significant shift of this kind even over the medium term.

9. The effects on employers' behaviour might be complex:

- The increase in employers' costs (paragraph 8 above) should, at least in the short term,

discourage the provision of benefits, except to the extent that the cost could be shifted back on to employees (paragraph 7a).

- Over the longer term, contracts between employers and employees should in principle increasingly reflect the new incidence of tax (paragraph 7b) - so as to restore something nearer to the status quo ante. However, this might depend crucially on whether the total tax burden was heavier or lighter than the present tax burden (paragraphs 14 and 19).

- Other things being equal, there would be a lightening of the relative tax burden on high paid employees, compared with middle management and the lower paid (paragraph 15).

10. There could also be a problem of "perception", if it appeared to public opinion that very high paid employees were receiving large benefits on which they themselves paid no tax; and that employees with apparently equal earnings paid very different amounts of tax, according to the mix of benefits and cash. A certain amount might depend on both the rate of the tax and the form it took (see paras 15 and 26 below).

ii. Cash flow

11. As I have said, most tax on benefits is collected through PAYE, and therefore comes in monthly through the year. A change to a quarterly basis would therefore have a significant cash flow cost to the Exchequer; and an end-year system would mean forgoing virtually the whole of the yield of perhaps £700m-800m or so for the transitional year. If Ministers wished to avoid this, there would need to be a continuing system (which might be more or less sophisticated) of monthly remittances from employers,

followed by an end-year review and settlement (again see para 27 below).

iii. Simplification

12. The Financial Secretary has emphasised on many occasions his desire for a simpler system of taxing benefits, accepting the cost of some "rough justice". As I see it, this might be an essential element of the proposed new approach. The experience of 1981* suggests that otherwise employers would be faced with an increase in their compliance costs which they would find wholly unacceptable.

13. Simplification might arise in three main areas.

14. (a) Rate of tax:

There would be a single rate of tax - not (as under the present system) different rates of tax, corresponding to the marginal rates of individual employees. At present it costs an employer different amounts of money to put (say) £2,000 (in cash or in kind) into the hands of employees "free of tax", according to their different marginal tax rates:-

60% taxpayer	£5,000
50%	£4,000
40%	£3,333
27%	£2,740

It is largely a matter of presentation, whether one describes the rate for (say) the 60% taxpayer as 60% (on a "tax inclusive" basis - cf VAT) or 150% (on a "tax

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*When, in order to reduce Revenue staff costs, the Government introduced legislation requiring employers to apply PAYE directly to car benefits but were subsequently forced to withdraw it because of employer opposition.

exclusive" basis). The tax rates would, of course, need to be higher than these illustrative figures, if it was desired to offset the benefit of the present immunity of benefits from NIC.

15. There are difficult choices here:

i. In previous discussions the Chancellor has said that he would like to see a more effective tax burden on benefits of the very highly paid. If that is the objective, the rate needs to be fixed at least at a level which would collect the same amount of tax as the present system, in respect of benefits for the very highly paid (for example, 150% on a "tax exclusive" basis for a 60% taxpayer). In that event, however, the rate could be seen as penal for employers of those on middle incomes and the lower paid* and the overall yield should be a good deal higher than the present yield.

ii. Alternatively, the rate could be set at a compromise level: for example, to collect broadly the present yield from employees as a whole. In that event, however, there would be a new tax advantage where employers wished to give new benefits, to replace more highly taxed cash, for their very highly paid employees and directors.

16. (b) Threshold: In the 1981 discussion

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*Only in the special case of the scale rate for cars does there seem to be scope for an alternative approach - raising the unrealistically low scale charges, to offset a reduction in the rate of tax.

employers argued that they would find it intolerably expensive, if not unworkable, to have to decide whether their employees were above or below the P11D threshold. More generally, it is arguable that under an employer based scheme the threshold would lose much of its relevance. There would therefore be a case for abandoning the threshold and applying the new rules to all employees. (But some special arrangements might be needed to keep out of charge the tiny employers, at least those not operating PAYE).

17. (c) Rules: There might need to be some further simplification of the rules. In particular, it might be necessary (as in a. and b. above) to remove any rules which would otherwise require the employer to collect and process information from his employees of a kind with which he does not need to bother at present. Examples might be the complications in the present car benefit rules, where there is a "surcharge" for exceptionally low business mileage and a "reduced rate" for exceptionally high business mileage.

18. Changes in these areas would be designed to simplify the system and reduce what could be very strong opposition from employers to the potential increase in their compliance costs. If we can judge from past experience, the most sensitive areas in this respect include anything which required employers to "self-assess" a liability to tax (rather than - as now - simply record the facts and leave it to the Revenue to assess where appropriate); and any need to tot up benefits monthly or quarterly, rather than (as now) annually. There is also the more general point that simplification would inevitably make the system more "rough" and less "just" - and could thus generate other kinds of controversy.

OTHER MAIN ISSUES FOR DISCUSSION

19. Other main issues, on which it would be helpful at this stage to have Ministerial guidance, or to know whether Ministers see any obvious difficulties in what we provisionally have in mind, include:

Coverage

20. A crucial question is whether we should seek to make the new charge cover all benefits and expenses or (like the New Zealanders and Australians) charge only certain benefits and expenses - and if so, which.

21. We suggest that any new charge should include the range of expenses which clearly are of benefit to the employee, and for which the employee is very unlikely to substantiate a claim that the costs were incurred "wholly, exclusively and necessarily in the performance of his duties". These include

- Cars (on the assumption that the benefit consists in a car being available for his private use, regardless of how much or how little private mileage he actually incurs).

- Fuel

- Medical expenses and insurance.

22. At the other extreme, our initial thinking is that we clearly should exclude lump sum expense allowances and we note that New Zealanders (the Australian position is not quite clear to us) have reached the same decision. An example might be a £10,000 "representational allowance", or a £5,000 "entertainment allowance". It is of the essence of them, that the employer does not now require the employee to account for precisely how he has spent these; and to bring

these within the tax would therefore be an additional compliance burden on employers. Moreover, much of the expenditure may be on things which the employer may consider desirable, but which are not (and should not be) deductible for tax: clothes built by a good London tailor, a 'good' address in Central London, being seen at the best restaurants and the opera; and so forth. Finally, it is here above all that it is essential to keep a clear balance between tax on pay and tax on expenses: the difference between

- £50,000 pay and

- £40,000 pay and £10,000 representational allowance

may represent no more than a stroke of the employer's pen.

23. In between these two extremes there comes the range of very common expenses and reimbursements which very often represent genuine business expenditure but which can quite commonly be used to confer a benefit. The most obvious example here is travel and subsistence. It would clearly be intolerable to impose a new charge on all such expenses, including genuine business travel. On the other hand, there is (I suggest) a self-evident need to maintain a tax charge on home to office travel, holiday and wife's travel, mileage allowances containing a large profit element, etc. Under the present arrangements most substantial employers have dispensations in this area, under which they need to include in their P11Ds only those travel and subsistence expenses etc which fall outside the approved guidelines, or exceed approved financial limits. The question is whether similar arrangements could be developed to form the basis of a new charge, and extended to employers generally. If so, this would reduce the scope of the residual P11D system. But this is an area where employers could be most sensitive in relation both to their compliance costs and to their tax exposure; and further work would be needed before we could

give firm advice. I attach at Annex C the revised P11D and Notes, which list the main types of benefit, and we should need to consider each of these with Ministers.

NATURE OF THE TAX

24. An important - though second order - question is whether a tax of this kind would be formally a tax on the employer or a tax in respect of the employee paid by the employer. A decision on this is not essential at this stage; but it has implications for the concept of the tax, its presentation and its handling in practice.

25. For obvious reasons (noted in paragraph 26 below) the tax could not be part of the existing taxes on employers (corporation tax, Schedule D etc). A possibility might be some entirely new "special charge"; but this might be a bit cumbersome, in relation to the yield.

26. Our initial conclusion (but we shall wish to think further about this) is that the best approach might be to regard the new tax as a lump sum income tax paid by the employer to "compound" the tax liabilities of his employees.* This could have a number of advantages:

- It reflects the correct approach in principle: that it is being paid in respect of benefits which (on a strict analysis) should form part of the employee's income.

- It could thus help somewhat with the presentational problem (that high paid employees might appear to be escaping from tax on their

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*In some ways an analogy might be the composite rate of Building Societies and Banks - though this charge would differ in a number of important respects.

benefits, paragraph 10 above); and the corresponding potential discontinuity in the series of public sector financial statistics, with PAYE receipts falling by several £hundred million).

- More substantively, it would deal with the situation where the new charge was being paid by employers who are liable neither to corporation tax nor to Schedule D income tax - Central Government, local authorities, individuals who are employers and so forth.

- It could also sit more easily with the administrative arrangements that we - very tentatively - envisage.

HANDLING IN THE REVENUE

27. Again, we are not seeking a decision from Ministers at this stage. Indeed, we ourselves will need to have a much clearer view of the shape of the possible scheme before we could reach any firm view on its management implications. At first sight, however, we are inclined to think that much the most straightforward way might be to handle the new charge alongside PAYE income tax (and NIC). Thus:

- Employers might (if you wanted monthly remittances) remit their (self-assessed) instalment of the new charge alongside their PAYE remittances - much as they already remit NIC - in a single lump sum. As with PAYE, NIC, statutory maternity pay, statutory sick pay, etc, the exact liabilities could be determined, and amounts

divided between the different heads of charge, after the end of the year.*

- On this basis, the in-year remittance and accounting requirements might (subject to further study) reduce to the necessary minimum the new contnuing administrative burden on employers and on the Revenue.

- The processing of end-year returns and audit work would then naturally fall to tax offices and PAYE audit offices accordingly (not to the CT or Schedule D tax districts): that is, to people with the appropriate qualifications to do the work, and alongside (as should be the case) the work on taxing cash wages and allowances etc and on claims for deduction of employment expenses against cash wages and allowances etc.

ADMINISTRATIVE COSTS

28. At this stage, it is impossible to hazard anything more than the most tentative qualitative judgment of the administrative implications of a scheme of this kind - and we should need to have worked up a scheme in some detail before we could begin to attach to it even a broad range of figures. Meanwhile - and emphasising that reservation - our present expectation is that the new scheme

- should significantly reduce compliance costs for employees;

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*Unlike NIC etc, however, there would be no attempt to allocate the total of the new charge between individual employees.

- should reduce the cost for the Revenue in handling P11Ds and coding etc; there would be an offset for costs of administration and enforcement of the new charge, in particular for the additional area for selective audit;

- has at this stage uncertain implications for employers. On the one hand, they would be absolved from completing individual P11Ds in some cases and taking in PAYE coding changes for some benefits. On the other hand, the Australian and New Zealand systems require employers to continue to maintain a good many detailed records (and these seem in some respects to be more detailed than those we now require). It is difficult to see how such records could be avoided here, if there was to be any effective audit by the Revenue of employer compliance, even on a selective basis. Depending to some extent on the coverage of the scheme, employers would have to take at least some initial responsibility for deciding whether certain expenses incurred by or for an employee were "allowable" or not. And, again depending on the arrangements, there would be some extra work for employers if you wanted monthly/quarterly remittances. There would also be setting-up costs for employers.

TIMING OF INTRODUCTION AND THE TRANSITION

29. Again, until the scheme is worked up in more detail, it is difficult to do more than hazard a guess.

30. Employers would need time to adjust their accounting systems, including possibly a capability to make their monthly/quarterly returns. They could do little on this until the legislation was passed. If the new tax were announced in the 1988 Budget, it would on present evidence

be unrealistic to expect employers to be in a position to implement it, at least in 1988-89.

31. The aim, so far as the Revenue is concerned, would be to make the new collection system as simple as possible. But it would have to dovetail with existing collection systems, on which extensive computerisation work (BROCS) is proceeding. Crucial questions would be whether

a. it would be technically possible to enhance the present collection computer system to take on the new charge in advance of BROCS; and, if so, whether that could be done without putting back the BROCS timetable generally. (As you know, one of the problems of the present computer system is that it is obsolescent and resistant to change; and to meet the tight timetable for BROCS an important section of the relevant user requirement has already been completed and handed over for programming, which it would be necessary to call back.); or

b. implementation should wait until at least Phase 1 of BROCS is available, effectively April 1991 - and, if so, whether the additional requirement would impact on other aspects of the BROCS timetable.

These are all matters on which we should need to do a lot more detailed work.

32. Miss Sinclair mentions the possibility of transitional arrangements to phase in a new charge. We have considered:

progressively reducing the P11D/PAYE coding charge over a period of years, whilst building up the new employer charge. However, the compliance costs of running two systems side by side for the same benefits - both for employers and for the Revenue - seem to rule that out;

whether, if Ministers are prepared to accept the potential cash flow cost to the Exchequer of (say) £700-800m in the transitional year, that could be used to sugar the pill for employers. Unfortunately, the whole of the benefit seems to go to employees. The ending of PAYE coding adjustments would entail a cash flow cost to employers in the transitional year.

33. A more promising approach - and consistent with our own constraints until we have BROCS under our belts - would be to leave a good interval between announcement/legislation and implementation of a new charge; and to use that interval to consult with employers on how best to define both the detailed rules and the operational requirements, so as to minimise its costs and maximise its effectiveness.

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ANNEX A

OUTLINE OF POSSIBLE NEW CHARGE

Statutory basis

1. Legislation would define certain benefits and expenses as coming within the potential scope of the new charge (others would remain in the existing P11D system).

2. The legislation would distinguish between (a) such expenses, to the extent that they were incurred wholly, exclusively and necessarily in the performance of the employee's duties, and to the extent that they met official guidelines (eg rates of mileage allowance) and (b) other such expenses. It would impose a charge to tax on the total amount of (b) paid by each employer.

3. The legislation might simplify some of the present rules (eg thresholds, car scales).

Employers

4. Employers would keep records of benefits and expenses within the scope of the new charge, distinguishing between (a) and (b) above.

5. Each month (if that is what Ministers wished) employers would remit to the Revenue a lump sum, representing their (self-assessed) liability in respect of benefits at (b) for the month. The "self-assessment" might be on a more or less simplified basis. This might be remitted with and alongside the monthly PAYE and NIC remittances.

6. In any event, at the end of the year, employers would provide summary information in a prescribed form, alongside any possible (and possibly self-assessed) adjustment for overpayment or underpayment of the charge. This might be at the same time as their end-of-year PAYE returns (P35).

7. Employers would maintain underlying records, available to monitoring and audit by Revenue staff, on the same basis as existing records for PAYE purposes.

Revenue

8. The Revenue would receive (possibly) monthly remittances from employers, accounting for them under the heading of Income Tax on employment income. Where necessary, a provisional allocation might be made between PAYE, NIC and other elements on the basis of a broad statistical estimate.

9. After the end of the year, the allocations under the different sub-headings would be adjusted in the light of employers' end-year information.

10. Tax offices would handle end-of-year returns from employers, on broadly the same lines as employers' end-of-year PAYE returns.

11. There would be a selective audit of employer compliance, again broadly on the same lines as PAYE audit.

ANNEX B

1. This annex seeks to illustrate the effects of the suggested new charge on

- the cost to the employer of providing remuneration to his employees by way of

  (a) cash and

  (b) a mixture of cash and benefits;

- and the net (post-tax) income of the employees accordingly.

Employers

2. We look at two different classes of employer:

(a) a company paying corporation tax at 35%

(b) an employer not paying corporation tax or other tax on business profits (for example Central Government, local government, a tax-exhausted nationalised industry, a company with a large amount of double tax relief, a private individual).

The precise figures would, of course, change somewhat for a small company or a Schedule D employer.

Employees

3. The examples take an employee liable at the top rate of tax, currently 60%. For simplicity, we look at tax on the top slice

of his income, all taxable at 60%.* In the initial example, this top slice is £50,000. In Case A this £50,000 is paid wholly in cash. In Case B it is paid as to £48,000 in cash and £2,000 in benefit.

The illustrations

4. The example begins by looking at the present position. It shows that the cost to the employer and the net income of the employee are the same, whether the remuneration is paid in cash or in kind; but the cost to the employer is (obviously) greater if he is not liable to corporation tax (or for that matter Schedule D income tax), and cannot therefore set the cost of that remuneration against his own business tax liability.

5. The illustration then moves on to look at the position under the new charge. For this purpose it starts from the basis that (at present) it costs an employer £5,000 to put £2,000 into the hands of an employee "free of tax", if the employee's marginal rate is 60%. As paragraph 4 notes, the figures are the same for remuneration in cash or in kind. For purposes of illustration the example assumes that the new charge reproduces the same effect - so that if the employee receives a benefit of £2,000 "free of tax", the employer pays a tax charge of £3,000 (60% of the "gross", or 150% of the "net"). It assumes that the charge is deductible against corporation tax.

6. In the first instance, at Example I, the illustration assumes that the charge is borne by the employer, and there is no

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*In principle, this may be regarded as the top slice of income, over and above the tax threshold, the basic rate tax band and the lower rate tax bands. The main note quotes figures for other marginal tax rates. For simplicity the examples ignore the NIC position. If the objective were to align the treatment of cash and benefits more closely for both tax and NIC, the rates of the new charge would of course need to be higher than these illustrative rates.

offsetting adjustment in the employee's nominal cash income. As a result, it shows that

a. the cost to the employer increases

b. at the same time the employee's net income (after tax) also increases.

c. the total tax burden increases.

The effects at a. and b. reflect the shift in the tax burden from employee to employer (described in the main note) on the assumption that the cost of the charge is in practice borne by the employer. The effect at c. simply reflects the fact that the employee is enjoying an increase in his disposable income (and his marginal tax rate is higher than his employer's).

7. The illustration then moves on at Example II to examine the case where the new tax charge is borne by the employee. That is, where the employer pays his employee a chargeable benefit, he reduces his employee's nominal cash salary by the amount of the new charge. The illustration shows that on this basis (with a tax charge of 150%) the cost to the employer and the net income of the employee are unchanged as a result of the new tax charge. In substance, the new tax charge precisely replaces part of the previous PAYE charge (deducted by the employer from the employee's cash salary), leaving the employee with the same net post-tax) monthly pay cheque as before.*

8. Examples I and II may be seen as the two extremes. There would be some other (second order) consequences. Because the new charge would be paid as a lump sum by the employer, and not

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*Note that the arithmetic is correct only for a 60% marginal rax payer. As the main note emphasises, no single rate can be revenue neutral for all taxpayers, so long as different employees have different marginal rates.

allocated to individual employees, the employees' "gross income" would often appear to be reduced (by up to the amount of the new charge). This would have advantages in some respects for employees (eg means test for student grants) and disadvantages in others (eg maximum pension contributions).

EXAMPLE I

Case A	Case B
Employee receives salary of £50,000 after having exhausted his tax threshold and lower income rate bands Nil benefit	Employee as in Case A, but salary of £48,000 benefit £ 2,000

PRESENT POSITION (Cost, -; Benefit, +)

Cost to employer

(a) Paying CT

Case A			Case B		
Net salary	-20,000		Net salary	-18,000	
			Benefit	- 2,000	
PAYE	-30,000		PAYE	-30,000*	
		-50,000			-50,000
CT relief at 35%		+17,500	CT relief at 35%		+17,500
Net cost		-32,500	Net cost		-32,500

(b) Not paying CT

Case A			Case B		
Net salary	-20,000		Net salary	-18,000	
			Benefit	- 2,000	
PAYE	-30,000		PAYE	-30,000	
Net cost		-50,000	Net cost		-50,000

Net income of employee

Case A		Case B	
Gross salary,	50,000	Gross salary	48,000
		Benefit	2,000
PAYE tax at 60%	-30,000	PAYE tax at 60%	-30,000
Net income	20,000	Net income	20,000

*£28,800 in respect of cash salary, and £1,200 in respect of benefit collected through PAYE coding adjustment

UNDER NEW CHARGE: cost borne by employer

	CASE A (all salary) (No change)		CASE B (salary + benefit)	
Cost to employer				
(a) Paying CT	£		£	
Net salary	-20,000	Net salary	-19,200	
PAYE	-30,000	PAYE	-28,800	
	-50,000		-48,000	
CT relief at 35%	+17,500	Benefit	- 2,000	
		New charge	- 3,000	
		CT relief at 35%	+18,550	
	-32,500		-34,450	A[1]
(b) Not paying CT				
Net salary	20,000	Net salary	19,200	
PAYE	30,000	PAYE	28,800	
			-48,000	
		Benefit	- 2,000	
		New charge	- 3,000	
	-50,000		-53,000	A[2]
Net income of employee				
Gross salary	50,000	Gross salary	48,000	
PAYE at 60%	30,000	Tax at 60%	28,800	
		Benefit	2,000	
	20,000		21,200	B

Note that both A^1/A^2 and B are higher in Case B than in Case A

EXAMPLE II

UNDER NEW CHARGE: Cost borne by employee

Case A, (no change)		Case B	
Salary £50,000		Salary	£45,000*
		Benefit	£ 2,000

Cost to employer

(a) Paying CT

Case A		Case B		
Net salary	-20,000	Net salary	-18,000	
PAYE	-30,000	PAYE	-27,000	
	-50,000		-45,000	
CT relief at 35%	+17,500	Benefit	- 2,000	
		New charge	- 3,000	
		CT relief at 35%	+17,500	
	-32,500		- 32,500	A^1

(b) Not paying CT

Case A		Case B		
Net salary	-20,000	Net salary	-18,000	
PAYE	-30,000	PAYE	-27,000	
			-45,000	
		Benefit	- 2,000	
		New charge	- 3,000	
	-50,000		-50,000	A^2

Net income of employee

Case A		Case B		
Gross salary	50,000	Gross salary	45,000	
PAYE at 60%	-30,000	Tax at 60%	-27,000	
		Benefit	2,000	
	20,000		20,000	B

* 48,000 as in Example I, less 3,000 new charge.

Note that A^1, A^2 and B are the same in both Cases A and B, and the same as under the existing system in Example I.

Inland Revenue
Income Tax

(Draft of 1988 Edition)

Guidance Notes on completion of form P11D-(Return of expenses payments and benefits etc to or for directors and "higher-paid" employees.

References to "Notes" are to Inland Revenue Booklet 480 - "Notes on Expenses Payments & Benefits for Directors and Certain Employees" where more information is given

General

You are required by law at the end of each tax year to give particulars of the expenses payments, benefits and facilities provided for each director and higher-paid employees (or members of their respective families or households)

Individuals for whom a form is required

Please use a separate form P11D for

- each director whatever his or her rate of remuneration except one earning at a rate of less than £8,500 a year who is a full time working director without a material interest in the company or a director of a non-profit making concern or a charity *(Notes paras 1.7-1.16).*
- each employee earning at a rate of £8,500 a year or more including all expenses payments and benefits before deducting allowable expenses other than ordinary annual contributions to an approved superannuation fund. *(Notes paras 1.7, 1.17 & 1.18).*

Family or household

For most purposes this is defined as "the employee's spouse, his sons and daughters and their spouses, his parents and his servants, dependants and guests". *(Notes para 1.21).*

Dispensations

Expenses payments covered by a dispensation given by the Inspector of Taxes need not be shown on form P11D *(Notes Chapter 2).* Pamphlet IR69 describes how a dispensation may save you work.

Nil Returns - form P11D(b)

Do not complete form P11D if there are no expenses payments, benefits etc to be returned for an individual. Use form P11D(b) to confirm that all necessary forms P11D have been completed and sent to the Inspector of Taxes. *(Notes para 22.4).*

Effects of VAT

Include the full amount of VAT on form P11D whether or not it may be recovered in whole or in part by you from HM Customs and Excise *(Notes para 23.6).*

Penalties

There are penalties for failing to make returns or for making incorrect returns on form P11D *(Notes paras 23.11 and 23.12).*

Schedules

Where there is insufficient space on form P11D for entry of all the relevant information attach a separate schedule.

The table below is designed to help you to complete Section A-D on forms P11D but if difficulties arise you should refer to the Inland Revenue Booklet 480 to which the Notes refer.

Item	Nature	Guidance	Notes (Booklet 480)
A1	Remuneration	You are asked to give details of payments included in total pay on the End of Year Return for 1987-88 which relate to periods commencing before 6 April 1987 or ending after 5 April 1988.	
B2	Cars made available for private use - scale charge	If you do not know whether the car was used for business travel of 2500 miles or less a year or 18,000 miles or more a year leave the "Yes" and "No" boxes blank.	Chapters 10-12 Appendix 1
B3	Car fuel-scale charge	No scale charge will arise if a mileage allowance is paid covering no more than the cost of fuel used on business travel. If an allowance is paid which covers fuel costs for other travel - for example between home and work - a scale charge will arise.	Chapter 14 Appendix 2
B4	Car owned or hired by director/employee	Allowances to the director/employee in respect of the use of the car and running and overhead expenses borne by you include chauffeur's wages, licence, insurance, petrol, oil and repairs as well as the cost of work done or petrol etc supplied by you.	Chapter 13
C5	Loans	If you do not wish to calculate whether the benefit of the loans exceeded £200, tick the "don't know box"at item (b) and provide the further information required. As a guide to whether interest on a loan would be eligible for relief see Appendix 3 in booklet 480.	Chapter 15 Appendix 3 Appendix 4

Item	Nature	Amounts to be included on form P11D	Notes (Booklet 480)
D6	Private medical, dental etc treatment or insurance against the cost of such treatment	Enter the cost of all medical, dental expenses paid by you and all premiums paid for insurance against such treatment.	Chapter 17
D7	General Expenses Allowance	Enter the amount of any round sum allowance not exclusively for entertaining	
D8	Travelling and subsistance	Enter the total of fares, hotels, meals, etc including travel between home and the normal place of employment for United Kingdom employments and employments performed wholly outside the United Kingdom.	Chapters 8 and 9
D9	Entertainment	Enter all payments made exclusively in respect of entertaining including (a) the amount of any round sum allowance (b) sums reimbursed (c) specific allowances for entertaining (d) sums paid to third persons. Entertaining expenses which do not relate to the entertaining of overseas customers will often be disallowed in computing your tax liability. Nevertheless the full amount of allowances paid under any of the sub-headings relating to entertainment should be shown.	Chapter 20
D10	Home telephone	Enter the expenses incurred in connection with the provision of a telephone at the home of the director or employee. Rental charges should be shown separately from those relating to telephone calls.	
D11	Subscriptions	In addition to subscriptions to professional and learned societies related to the employment, entries under this heading should include initial and annual subscriptions to London and provincial clubs and to other societies and clubs catering for leisure or sporting etc activities where the expense of the subscription or levy is borne by you or on your behalf.	Para 23.10
D12	Goods and services supplied free or below market value	Enter the market value or the cost to you, whichever is the higher. Market value in the case of goods is the secondhand value in the hands of the employee.	
D13	Vouchers and credit cards	Enter the expense incurred in the provision of any vouchers (including season tickets) which are capable of being exchanged for money, goods or services and any additional expense incurred in providing the money, goods or services for which the vouchers have been exchanged. Give details of all expenses (other than those relating to the car(s) at section B2 and B3) met by credit cards provided by you unless returned under a previous heading. Expenses directly relating to the car(s) at Section B2 and B3 met by vouchers and credit cards can be ignored.	
D14	Cars, property etc given or transferred to the director or employee	Enter the market value of the asset as at the date of transfer.	Para 6.6
D15	Educationl assistance	Enter the cost of all educational assistance provided. Include the value of any scholarships first awarded to the director/employee or to members of his family or household on or after 15 March 1983. Do not include payments for training covered by Section 35 Finance Act 1987.	Chapter 18
D16	House, flat or other living accommodation provided for the director or employee	Enter the address of the property, its cost and the greater of - • the gross value for rating of the property or • the rent borne by you. Include expenses borne by you which are the liability of the director/ employee eg rates, heating, lighting, insurance, cleaning, maintenance, decoration, upkeep of gardens, wages, keep and accommodation of domestic or other staff hire of furniture and the current value of use of furniture and fittings owned by you.	Chapter 21
D17	Income tax paid to the Collector	Enter the amount of income tax paid to the Collector in the year ended 5 April 1988 which the company failed to deduct from remuneration paid to the director irrespective of the year in which that remuneration was paid.	Chapter 19
D18	Other expenses and benefits etc	In addition to the items specified on the form P11D you should include here expenses incurred in or in connection with the provision for the director/employee of any benefits or facilities of whatever nature not returned under any previous heading. This includes the use of an asset such as a boat and the cost of work carried out at the director/employee's own home or on his property or assets by your own workers or contractors.	

Further information

If difficulties.arise in completing forms P11D or if further informmation is needed, the Inspector of Taxes will give any necessary advice or information.

Inland Revenue
Income Tax

For Official use
Assessing point reference
if elsewhere

Employer's name ______________________ PAYE reference ______________

Employee's/director's name ______________________ NI number ______________

Return of expenses payments and benefits etc - directors and "higher-paid" employees - year ended 5 April 1988

You should read form P11D (Guide) before completing this form.

You must make a return by 6 May 1988 of all expenses payments and benefits relating to -

- directors - *for certain exceptions see form P11D (Guide)*
- employees who are paid at a rate of £8,500 or more including expenses and benefits.

You should not show expenses covered by a dispensation *see form P11D (Guide).*
You are also asked to give details of certain remuneration in Part A below.

A Remuneration

1 You are asked to give details of remuneration paid in the year to 5 April 1988 but earned in another year.

Description and period ______________________ Amount £ ______________

B Cars and car fuel

2 **Cars made available for private use**
If more than one car made available during the year, give details of each car at (a) and (b)

Make and model (a) ______________ ______ cc (b) ______________ ______ cc

	(a) "√"	(b) "√"
Value when new £19,250 or less	☐	☐
£19,251 - £29,000	☐	☐
more than £29,000	☐	☐
First registered on or after 6.4.84	☐	☐
before 6.4.84	☐	☐

Made available to director/employee from ________ to ________ from ________ to ________

The amount of any wages paid to a driver provided for the director/employee in respect of private journeys £ ________

Payment received from the director/employee for the private use of the car £ ________

	Yes	"√" No	Don't know
Was the car, to your own knowledge, used for business travel - for 2,500 miles pa or less?	☐	☐	☐
- for 18,000 miles pa or more?	☐	☐	☐

3 **Car fuel "scale charges" - cars available for private use**

	Yes	No
Was fuel for the car(s) provided other than for business travel?	☐	☐
If "yes" was the director/employee required to make good the cost of all fuel used for private motoring including travel between home and normal place of work?	☐	☐
If the director/employee was required to make good the cost did he actually do so?	☐	☐

4 **Car owned or hired by director/employee**

Allowances paid to the director/employee in respect of the use of the car and/or running and overhead expenses £ ________

Sum contributed by you towards the purchase price, depreciation or hire of a car £ ________

For official use

C Beneficial loans

5 Enter details of loans made to, or arranged for, a director/employee (or any of his relatives) on which no interest was paid or on which the amount of interest paid was less than interest at the official rate.

	Yes	"√" No	Don't know
(a) Were there any loans the interest on which was (or would have been if interest had been payable) not wholly eligible for relief?	☐	☐	☐
(b) If the answer to (a) is "yes" did the benefit of the loans exceed £200?	☐	☐	☐

Unless the answer to both (a) and (b) is no -

- add all the loans together and state the total amounts outstanding at 5.4.87 ______ at 5.4.88 ______
- If the loan was made on or after 6 April 1987 state the amount and the date it was paid. £ ______ *Date* ______
- If the loan was discharged on or before 5 April 1988 on what date was it discharged? *Date* ______
- What was the amount of interest paid by the borrower in the year to 5 April 1988? £ ______
  Enter "NIL" if none was paid.

(c) If any loans made by you were waived or written off in the year to 5 April 1988 what was the amount waived etc? £ ______

D Other expenses payments and benefits etc

		£
6	Private medical dental etc attention and treatment or insurance against the cost of such treatment	
7	General expenses allowance	
8	Travelling and subsistence	
9	Entertainment	
10	Home telephone — Rental	
	Calls	
11	Subscriptions	
12	Goods or services supplied free or below market value	
13	Vouchers and credit cards	
14	Cars, property, furniture and other assets given or transferred to the director/employee	
15	Educational assistance provided for the director/employee or members of his family	
16	House, flat or other living accommodation provided for the director/employee. *Please show address* ______ Cost	
17	Income tax paid to the Collector in the year to 5 April 1988 which a company failed to deduct from a director's remuneration	
18	Other expenses and benefits not shown above eg National Insurance contributions, holidays, private legal, accountancy etc expenses, nursery facilities, contributions towards house purchase, rates and other household expenses such as wages and keep of personal or domestic staff and gardening expenses. *Please give details* ______	
	Total	

Less (i) So much of the items entered above as have been made good by the director/employee
(ii) Amounts included above from which tax has been deducted under PAYE

\+ ______ =

Net total ______

Declaration

I declare that all particulars required are fully and truly stated according to the best of my knowledge and belief.

Signature ______ Date ______

Capacity in which signed ______

SECRET COVERING TASK FORCE SECRET

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE
DATE: 28 SEPTEMBER 1987

1. MR ISAAC

2. CHANCELLOR OF THE EXCHEQUER

INDEPENDENT TAXATION: VARIANTS OF THE MARRIED MAN'S ALLOWANCE

1. The two notes attached respond to your recent requests for advice on options involving variants of the married man's allowance within Independent Taxation.

Vanishing Exemption

2. The first note by myself examines the proposal in Mr Allan's note of 3 September that the married man's allowance should be progressively withdrawn over incomes above the higher rate threshold. In its simpler form (where withdrawal would be based only on the husband's income) the proposal would not add significantly to administrative costs. But as the note explains, withdrawal on this basis would give rise to a number of anomalies and disparities of treatment between couples which would not be easy to justify. An alternative option, with more satisfactory distributional consequences, would be to base withdrawal in some way

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cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Jenkins (Parliamentary Counsel)
Mr Battishill
Mr Isaac
Mr Lewis
Mr Beighton
Mr Mace
Mr J C Jones (MCA only)
Miss Dyall
PS/IR

on the combined income of husband and wife. This would ensure that withdrawal would be reasonably closely targeted on couples previously making the wife's earnings election. But this approach would impose extra administrative costs since additional links would need to be maintained between the records of partners in those couples who would be potentially affected by withdrawal. The main drawback is that this option would be inconsistent with the basic objective of Independent Taxation. It would deprive wives, in couples affected by withdrawal, of the privacy which they would otherwise obtain. We do not think that either of the options could be recommended.

Married Couple's Allowance

3. The second note, by Miss Dyall, considers the suggestion in Mr Kuczys' note of 4 August that the married man's allowance should be converted into a "married couple's allowance" (as we have called it) which would not discriminate on grounds of sex. The note examines two possible forms of this option, one in which couples would be allowed to allocate the married couple's allowance either wholly to the husband or wholly to the wife, as they wished, and an alternative approach in which they would also be allowed to share the allowance equally between them. The note also looks briefly at a third, essentially cosmetic, option (Scheme A) under which the married couple's allowance would automatically go to the husband, except in certainly narrowly defined circumstances where he was unable to make full use of it. This would not remove sex discrimination but would get rid of the "married man's" allowance as such.

4. The options for the married couple's allowance discussed in the submission are by no means the only forms which such an allowance could take. But we think the schemes illustrate the general issues which arise in considering an approach of this kind. We have not had the opportunity to develop all the detailed rules which would apply to the allocation of the allowance. A lot more work would be needed before either of the schemes discussed in the submission could be regarded as fully developed.

5. A married couple's allowance has the initial attraction that it goes some way to remove the present sex discriminatory aspects of the married man's allowance. But on closer inspection we think that it has a number of significant drawbacks:

(a) A balance has to be struck between keeping the staff costs of the scheme within bounds and allowing couples flexibility to allocate the allowance as they choose. Whatever the initial rules there would inevitably be pressure to allow couples even greater flexibility.

(b) A particular aspect of the scheme which could come under pressure is the scope for couples to revoke or change their allocation of the allowance during or after the end of the tax year. Handling such changes is likely to be very staff intensive. The schemes described in Miss Dyall's note allow couples to change their allocation of the allowance only after the end of the tax year where a revised allocation would reduce their overall tax bill.

(c) Any scheme of this kind faces an inherent difficulty where the partners cannot agree on how the allowance should be allocated. There can never be a wholly satisfactory resolution of the dilemma which arises in these circumstances. The schemes described in the note both assume that where the partners cannot agree the allowance will be shared equally between them. This is probably the least unsatisfactory solution.

(d) The schemes are complex for the taxpayer but particularly so for the elderly since the choice of which partner receives the allowance can affect a couple's tax bill if one partner is in the age allowance withdrawal band and the other is not. Elderly people would often find it very difficult to make the right choice.

(e) A married couples allowance does not of course solve the imbalance in the distribution of allowances between two-earner married couples (who get the equivalent of $2^{1}/2$ times the single allowance) and one earner couples (who get the equivalent of $1^{1}/2$ times the single allowance).

(f) Generally, it is by no means clear that it would be easier to deal with criticism of a married couple's allowance (which would have to be defended on its own terms) than criticism of the married man's allowance (where you could accept the force of the criticism but point to the difficulty over many years in finding an alternative which commands general support). We consider in more detail in paragraphs 9-13 below how the retention of the married man's allowance within Independent Taxation might be presented and defended.

In the light of these points our conclusion would be that a married couple's allowance is not attractive on merits.

Implications for staff costs and timetable

6. Introducing a married couple's allowance would be a major change to the structure of the tax system and we have not yet been able to make a full evaluation of its effect on staff costs and the implementation plans for Independent Taxation. Miss Dyall's note sets out our first preliminary assessment. At this stage the staff costs do not look decisive but the potential impact on the implementation timetable and the consequential effects on other computer work are very worrying.

7. There is also an immediate difficulty in that attempting to build a married couple's allowance into the structure of Independent Taxation at this stage would disrupt the programme of work for preparing the legislation on Independent Taxation. As you will have seen from the Annex attached to my note of 16 September to the Financial Secretary we are planning a substantial series of submissions over the next few weeks on aspects of Independent Taxation which require Ministerial decision. (The list is not exhaustive at this stage; there could well be other issues on which we need to seek decisions). This is a heavy programme of work both for us and for Ministers. But on present plans we think it is manageable and we must maintain this sort of momentum in settling the policy outlines of the scheme if the legislation for Independent Taxation is to be properly prepared in time for the 1988 Finance Bill. The work of developing a scheme for a married couples

allowance and appraising its impact would be a very substantial additional task and would put the timetable at severe risk. The extra work would fall on the same small team in Head Office who are engaged on working up the details of Independent Taxation (and on other areas of tax reform) and would inevitably seriously delay the preparation of the legislation. Until the shape of the proposal for a allowance had been fairly fully worked up it would not be possible to finalise a number of aspects of the basic Independent Taxation scheme. Although work on some parts of the scheme could continue unaffected the approach on a number of major issues, including the treatment of the elderly and breadwinner wives, the tax treatment in the year of marriage, separation and bereavement (which could be a lot more complicated with a married couple's allowance), and aspects and collection of enforcement would be determined by whether or not there was to be a married couple's allowance. The scope of the changes in introducing Independent Taxation is very wide and it was therefore most helpful to have your decision that we should plan on the basis of introducing legislation for Independent Taxation (retaining the married man's allowance) in 1988 at an early stage. This has enabled us to carry forward a lot of the work and our thinking during the course of the summer. Attempting to build a married couple's allowance into the framework at this point would jeopardise the progress which has been made.

8. Against this background, I am afraid our advice has to be that (other than the purely cosmetic Scheme A) it is not now practicable to seek to build a married couple's allowance into the structure of Independent Taxation if you wish to maintain the option of legislating for Independent Taxation in 1988 (and implementation in 1990).

Retention of the Married Man's Allowance

9. In the light of our conclusions about the difficulty at this stage of introducing a married couple's allowance into the structure of Independent Taxation, we have been giving some preliminary thought to how the retention of the married man's allowance within the system could be presented and defended.

10. The first point to make is that in presenting the move to Independent Taxation it will be important to take full credit for the very wide scope of the changes which are being made. Independent Taxation will mean the abolition of the aggregation rule and the repeal of the provisions which deem a married woman's income to be her husband's for tax purposes. This is an absolutely fundamental change, getting rid of a rule which has existed in the income tax in roughly the same form virtually since the tax was first introduced in the early nineteenth century. It has been the object of criticism by women for almost as long, but particularly since the Married Women's Property Act of 1882, and in modern times many women regard it as offensive.

11. In addition to removing women's long-standing grievance about the aggregation rule Independent Taxation will, of course, give married women complete privacy and independence in their tax affairs. These are major improvements and deal thoroughly with those aspects of the taxation of husband and wife where there is a wide agreement both that changes are necessary and on the directions which these changes should take.

12. Independent Taxation does not, of course, tackle the married man's allowance, which is the other aspect of the taxation of husband and wife on which there is agreement that change is necessary. This will undoubtedly attract criticism. But in response the following points might be made:

- the Government's statement during the 1987 Budget debates made clear that Ministers were seeking a half way house solution that would not resolve all the issues discussed in the Green Paper.

- While there is agreement - which the Government also shares - that the married man's allowance is unsatisfactory, the response to the 1986 Green Paper showed there is as yet no general agreement or support for any alternative approach.

- In these circumstances the Government consider it right to tackle as quickly as possible those long-standing issues where there is general agreement on the direction of change but to reflect further on the future of the married man's allowance.

- In the meantime the Government's proposals do not disturb the present structure of allowances, so leaving open for the future the options for changes to the married man's allowance.

- And unlike the schemes put forward by the Opposition parties the Government's proposals achieve independence and privacy for married women, without reducing the tax threshold for millions of married men and while retaining an element of support within the tax system for all couples where one partner is, for whatever reason, dependent on the other.

This is a key point. AH

13. We think that something along these lines could provide a reasonable case for retaining the married man's allowance within Independent Taxation. In our view this would be a more satisfactory position to defend than a scheme which sought to tackle only a part of the problem posed by the married man's allowance and which you would have to seek to justify on its terms. The married man's allowance is not your own creation and you can therefore distance yourself to some extent from the problems it poses, particularly given the long history of proposals to change the allowance during which no generally acceptable solution has been found.

! AH

14. We are, of course, available if you would find it helpful to discuss the various options with us.

B A Mace

B A MACE

I agree throughout with Mr Mace's and Ms Dyall's assessment of the 'vanishing exemption'. To get results which are (reasonably) internally consistent, one needs to relate withdrawal to the couple's aggregate income; and that both is administratively expensive and runs counter to independence.

On the married couple's allowance (MCA), I agree with the assessment of options B+C. They threaten a high cost (both to the initial timetable and to the continuing administration), without delivering any very attractive result.

I myself see the case for the - admittedly cosmetic - Option A as more open. On the one hand, it could be simpler (eg in the case of breadwinner wives) to explain a discrete MCA, than a partially transferable married man's allowance; and it would lose the provocative title of "married man's" allowance. On the other hand, it may be more provocative to change the title and retain the substance, than to retain both title and substance unchanged - and defend the position as in para 9-13 of Mr Mace's note.

Whatever your decision on this last point, it could of course be presented as an interim course. There would be no need to - and no profit in - presenting it as a final solution.

C + E 2/x/?

TASK FORCE SECRET

Inland Revenue

Policy Division
Somerset House
FROM: B A MACE
DATE: 28 SEPTEMBER 1987

Ch
I'm sure a combined income option is not on. But I don't find the arguments against husband's income only, wholly persuasive
AA

MACE TO CH/EX 28 SEPT

CHANCELLOR OF THE EXCHEQUER

INDEPENDENT TAXATION: MARRIED MAN'S ALLOWANCE

1. You asked for advice on the scope for treating the married man's allowance under Independent Taxation in the same way as the age allowance so that it would be progressively withdrawn over incomes above the higher rate threshold. (Mr Allan's note of 3 September.) The purpose would be to limit the benefit of the married man's allowance to high earning couples, particularly those currently making wife's earnings elections. This note considers the structure of such a scheme, and looks at the operational implications and the effects on taxpayers.

Specification of the scheme

2. Mr Allan's note indicated that you would like to examine a scheme in which the difference between the married man's allowance and the single allowance was withdrawn above the higher rate threshold in such a way that no more than 2 percentage points was added to marginal rates. You asked for advice on the precise speed of withdrawal.

3. For the purpose of this note we have assumed that the higher rate threshold would be at £24,000 of taxable income at 1987-88 income levels as in Option 1A of my submission of 14 July) and that there would be a single higher rate above this level of 40% or 35%. The effect on marginal rates of the withdrawal of the allowance is determined by the combination of the rate at which the allowance is withdrawn as income rises and the rate of tax applying to incomes in the withdrawal band. In order to keep the addition to marginal rates at no more than 2 percentage points a fairly slow rate of withdrawal is necessary and it would be convenient to choose a rate

which could be expressed in reasonably round numbers. With a 40 per cent higher rate of income tax a rate of withdrawal of £1 of allowance for every £20 of additional income would give a marginal rate of precisely 42 per cent over the withdrawal band. With withdrawal starting at £24,000 of taxable income taxpayers would still get some benefit from the married man's allowance until their taxable income was in excess of £51,400 (on the basis of the current excess of the married man's allowance over the single allowance of £1,370). Assuming a withdrawal rate of £1 for every £25 of additional income would reduce the marginal rate over the withdrawal band to 41.6 per cent, that is 1.6 percentage points greater than the underlying higher rate. There would still be some benefit from the married man's allowance until the individual's taxable income exceeded £58,250. With a top income tax rate of 35 per cent, withdrawal rates of £1 for £20 of additional income would give marginal rates over the withdrawal band of 36.75 per cent and 36.4 per cent respectively. The "run out" points would be the same as for the corresponding examples with the 40 per cent top rate.

4. Withdrawal rates of this order are very much slower than the corresponding rules for age allowance which take away £2 of allowance for every £3 of income. This implies an marginal rate over the withdrawal band of 45 per cent (with the present 27 per cent basic rate), an additional marginal rate of 18 percentage points (with a 25 per cent basic rate the withdrawal would be 41.67 per cent). There would be a rather obvious contrast between this and the withdrawal rate for the married man's allowance. However, altering the age allowance rules to bring them into line with what was proposed for the married man's allowance would be costly both in revenue and manpower and would increase very substantially (from perhaps 150,000 to approaching 700,000) the numbers of elderly people affected by what is in practice a troublesome feature of the present system.

Income for the purposes of withdrawal

5. Mr Allan's note suggested that withdrawal of the married man's allowance would need to be phased out on the basis of the husband's

income alone. The following paragraphs looks at the effects of that approach. But we have also looked briefly at the possibility of withdrawal based an a couple's combined income since this would enable the withdrawal to be targeted more closely on couples currently making a wife's earnings election.

Withdrawal based on the husband's income only

6. Operating a withdrawal based solely on the husband's income would simplify the operational consequences of the scheme. Withdrawal would not be affected by the size of the wife's income so close links would not need to be established and maintained between husbands' and wives 'tax records. Operating a withdrawal rule would inevitably impose some additional administration costs. We would need to make provisional PAYE coding adjustments on the basis of an estimate of the taxpayer's income and review the position after the end of the tax year. But since the tax affairs of many higher rate taxpayers are in any case subject to end-of-year review we do not think that the additional need to ensure that the correct amounts of allowance had been withdrawn would add significantly to the administrative burden. The additional revenue yield from withdrawal of the allowance at the rate of £1 for every £20 of additional income with a 40% higher rate would be about £80 million.

7. Operating withdrawal based only on the husband's income would, however, have a number of consequences.

(i) The operation of the withdrawal rule would reduce, for the majority of couples previously making a wife's earnings election, the extent to which they would benefit on the change to Independent Taxation from the restoration of the married man's allowance. But unless the husband's income was very high (in excess of £50,000) he would still obtain some new benefit from the married man's allowance. Very few couples would have the benefit of the allowance withdrawn completely. And some couples, previously making elections, whose joint income was substantial but who were individually below the higher rate threshold (a couple earning £20,000 each for example) would still have the married man's allowance restored in full.

So what?

(ii) Because withdrawal would affect all husbands liable to the higher rate there would be a significant number of additional losers on the change to Independent Taxation (about 300,000 under Option 1A of my 14 July submission). These would be mainly couples where the husband was a higher rate taxpayer and the wife had no income of her own. We are not sure how the withdrawal of the married man's allowance could be explained in those cases. The justification for the married man's allowance both under the present system and under Independent Taxation is that it recognises the reduced taxable capacity of a married man who has a wife to support (compared with, say, a single person with the same income). That principle applies at all levels of income. (Under transferable allowances a husband who was a higher rate taxpayer could similarly have received the full benefit of his wife's allowance if she was unable to use it, so recognising his obligation to support her.)

But they will nearly all be big gainers under the IT package ✓

(iii) The effect of withdrawal would be to limit the extent to which the disparity of allowances between one-earner couples and two-earner couples making wife's earnings election would be widened on the change to Independent Taxation. But amongst higher rate taxpayers generally the result would be to improve the already favourable relative position of two-earner couples compared with one-earner couples. Under Independent Taxation all two-earner couples will receive the equivalent of $2\frac{1}{2}$ times the single allowance against their income whereas all one-earner couples will get only $1\frac{1}{2}$ times the single allowance, a relative advantage to the two-earner couple of about $1\frac{2}{3}$:1. But the effect of withdrawing the married man's allowance as income rises would be that two-earner couples liable to higher rates would get between 2 and $2\frac{1}{2}$ times the single allowance while one-earner couples would get between 1 and $1\frac{1}{2}$ times the single allowance, a relative advantage to the two-earner couples, at the limit, of 2:1. In the special case comparing, for example, a two-earner couple where the partners earn, say £24,000 each, with a one-earner couple where the husband earns £48,000, the two-earner couple (who

funny concept

would not be affected by withdrawal) would have the equivalent of $2^{1}/_{2}$ times the single allowance whereas the one-earner couple would get only slightly in excess of the single allowance. (The relative position of this two-earner couple would in practice improve compared with all one-earner couples liable at the higher rate). Overall the effect would be to tend to move away from the neutral position which would have been achieved under transferable allowances where both one-earner and two-earner couples would have a total of twice the single allowance, whatever the size of their incomes.

(iv) There would be disparity of treatment where the wife was a higher rate taxpayer and her husband was liable only at the basic rate compared with a couple where the roles were reversed. The latter would have part of the married man's allowance withdrawn but the former would be unaffected. This disparity would be even sharper where the husband had no income of his own and transferred the benefit of his married allowance to his wife under the proposals for breadwinner wives outlined in Miss Dyall's note of 16 September. The effect would be that the small minority of one-earner couples with breadwinner wives liable at the higher rates would be in a more favoured position than the much larger number of one-earner couples with higher rate breadwinner husbands.

8. These results look very difficult to explain and justify.

Withdrawal based on the combined income of husband and wife

9. In order to avoid some of the awkward consequences of withdrawal based only on the husband's income it would be necessary to base withdrawal in some way on the combined income of husband and wife. To ensure that the scheme did not affect couples who are not at present making a wife's earnings election one option would be to withdraw the married man's allowance to the extent that the husband's taxable income exceeded the higher rate threshold but only if his wife had taxable income of her own of a certain minimum

amount (say £5,000)*. A rule of this kind would, however, strike at the principles of Independent Taxation for couples with substantial incomes. It would derogate from the wife's privacy in that, if her husband's married man's allowance was restricted he could deduce that his wife's income was in excess of a certain amount, much as he can at present where an election is in force. That would be a very unattractive consequence as part of package would otherwise give wives complete privacy in their tax affairs. The rule would also have administrative costs since close links would need to be maintained between the records of husbands and wives where the husband was, or was likely to be a higher rate taxpayer. These would otherwise not be necessary. Even so the rule would not ensure that withdrawal would extend to all couples currently making a wife's earnings election. Withdrawal would not apply, for example, to a couple where both partners were earning around, say £20,000 even though a wife's earnings election would almost certainly benefit such a couple under Option 1A of my 14 July submission. A significant proportion of the couples previously making elections (perhaps as many as a third) would be likely to be similarly unaffected by withdrawal. The rule would also produce some awkward effects at the margin. Thus a married man earning £45,000 whose wife earned £4900 would retain the married man's allowance in full but if his wife was earning £5100 he would lose a substantial part of the allowance.

10. It would be possible to ensure that withdrawal applied smoothly to most of the couples previously making a wife's earnings election (and to few others) only by developing the rule in the previous paragraph so that withdrawal of the married man's allowance was based on the joint income of husband and wife. But this would, make the departure from the principles of Independent Taxation for couples with higher incomes even more acute. It would, in some respects, recreate the aggregation rule which Independent Taxation is designed to get rid of. Most importantly it would mean that

(*However large the husband's income his wife has to be earning at least £4,916 in 1987-88 for a wife's earnings election to be beneficial).

many wives would no longer obtain any privacy at all in their tax affairs as a result of Independent Taxation. Where a husband's married man's allowance was restricted by reference to the combined income of the couple he would be able to deduce the precise amount of his wife's income. In a number of cases she would have less privacy even than under the present system. We think this would be unacceptable, particularly since the wives and couples affected are likely to be amongst those most concerned about the privacy issue.

Conclusion

11. As our previous submissions have recognised the effect of the change to Independent Taxation in restoring the married man's allowance to couples currently making the wife's earnings election is not completely logical. But in the context of a system where the aggregation rule is abolished for everyone (and the married man's allowance retained) restoring the married man's allowance to previously electing couples does no more than put them on the same footing as all other two-earner couples. We think that the result can be defended against the basic principles of Independent Taxation.

12. Superimposing a system of withdrawal of the married man's allowance on the basic structure of Independent Taxation raises a number of issues. Basing the withdrawal solely on the husband's income would have wide distributional effects which do not seem easy to justify. It is not possible to avoid these difficulties and produce a system which is reasonably consistent in its treatment of different couples (and which incidentally might replicate the present effect of the wife's earnings election reasonably closely) unless the withdrawal is determined in some way on the basis of a couple's combined income. But that would strike at the basis of Independent Taxation for high income couples and breach the privacy which wives in such couples would otherwise obtain.

13. You will want to weigh these considerations in the balance with the difficulties that you perceive with the retention of the married man's allowance. The number of couples currently making wife's earnings elections (about 300,000) is relatively small

compared with the current total of about 1 million married couples liable to higher rates. The 300,000 electing couples include about 100,000 who cease to be liable at higher rates as a result of making the election). Under Option 1A of my submission of 14 July the number of married couples liable at higher rates would fall to around 1/2 million and the number of couples making wife's earnings elections to about 150,000 of which perhaps no more than 100,000 would include a partner liable at the higher rates.

B A Mace

B A MACE

Inland Revenue

Policy Division
Somerset House
FROM: MISS R A DYALL
DATE: 28 SEPTEMBER 1987

CHANCELLOR OF THE EXCHEQUER

DYALL TO CH/EX 28 SEPT

INDEPENDENT TAXATION: ALTERNATIVE TO THE MARRIED MAN'S ALLOWANCE

1. Mr Kuczys' minute of 4 August asked for a note discussing how the married man's allowance might be converted into a married person's allowance which would not be sex discriminatory. This would involve splitting the married man's allowance (currently £3,795) into two parts; the part equal to the single person's allowance (£2,425) which would be retained by married men and another part representing the balance (£1,370) which would be available to either partner in a married couple (but only one allowance per couple). In this note we call this allowance the "married couple's allowance" (MCA) rather than "married person's allowance" since not all married people (as opposed to married couples) would be able to claim it.

Objective

2. The objective of the change would be to meet the criticism that the retention of the married man's allowance under Independent Taxation would preserve one form of sex discrimination in the tax system. We have acknowledged in earlier notes that the married man's allowance is likely to be a pressure point under the new system, particularly as in other respects Independent Taxation should give married women equality of treatment with married men. However the conversion of the married man's allowance into an MCA would not deal with all criticism of the allowance. Objections to the allowance arise only partly on grounds of sex discrimination. There is also criticism arising from the imbalance in the distribution of allowances between married couples where both partners work (who receive allowances of about $2^{1/2}$ times the single allowance) and those where only the husband works (who

receive about $1^{1}/2$ times the single allowance). Unlike transferable allowances Independent Taxation does not tackle this distributional problem and the conversion of the married man's allowance into MCA would do nothing to alleviate it either.

Proposal under Independent Taxation

3. At present it is proposed that under Independent Taxation the married man's allowance should be retained as the husband's allowance. However where the husband was unable to make use of the allowance because his income was insufficient to absorb it the part equal to the difference between the married and single allowance (or MCA) - £1,370 - would be transferable to the wife. This proposal is discussed in the note on breadwinner wives which we sent to the Financial Secretary on 16 September.

Married Couple's Allowance
Scheme A

4. It would be possible to modify the proposals in the submission on breadwinner wives to incorporate the concept of an MCA. The married man's allowance could be split into its component parts (single allowance and MCA). As with the married man's allowance the MCA would be allocated automatically to the husband except in certain strictly defined circumstances, where he was unable to make full use of it. In these circumstances it could be allocated to the wife, in accordance with the rules in the submission on breadwinner wives. This scheme (which we call Scheme A) would not, of course, meet the objective of removing the sex discrimination in the present married man's allowance. But you might perhaps feel it has some attraction on other grounds. We consider it further in paragraphs 24-26 below.

6. We have devised two alternative schemes, which do meet the objective of removing at least some of the sex discrimination in the present system and in the proposals for Independent Taxation. There are discussed in the paragraphs below. In formulating these schemes we have had the following criteria in mind:-

(a) the need to keep down staff costs as far as possible;

(b) the need to have rules which would be acceptable to the public generally and which you would be able to defend to Parliament, so that the necessary legislation could complete its parliamentary stages without radical amendment.

The more flexible the scheme in allowing taxpayers greater freedom of choice, the higher the staff cost is likely to be; but the stricter the rules, the less attractive the scheme would be presentationally. We have tried to strike a balance here but any scheme which did not allow married taxpayers a fairly free hand in allocating the MCA between them would almost certainly come under pressure.

Scheme B

7. Under this scheme married men would be entitled to the single person's allowance and an MCA equal to the difference between the married and single allowances would be available to married couples and could be claimed by either partner. A joint election would be required to determine the allocation of the allowance but whichever partner the couple elected should have it would have to have the whole of it. Elections would have to be made on marriage or by 15 February before the beginning of the tax year (so that there would be time to include the allowance in the relevant partner's PAYE coding.) Elections once made would run on until changed. To reduce the setting-up costs on the change to the new allowance couples receiving the married man's allowance in the year before the change would be deemed to have elected for the husband to receive the new allowance unless they notified the Revenue otherwise. This approach might be criticised as less neutral than inviting all married couples to make an election and as unfair to married women. Contacting all married couples in the year before

the change and inviting them to make an election would, however, be very staff intensive. To counter the criticism, at least in part, we could contact couples with breadwinner wives who in the year before the change had had part of the married man's allowance set against their earnings, and invite them to make an election.

8. A problem would arise where a couple could not agree on an election. In these circumstances we propose that they would be unable to get the benefit of the allowance in the tax year (a powerful incentive to reach an agreement) but at the end of the year the allowance would be split between them and given by making a repayment of tax or setting the allowance against any further liability for the year. We accept that it would be unsatisfactory to permit a split of the allowance in these circumstances when the option of dividing the allowance would not available to couples generally. But it is difficult to find any other solution which is neither sex discriminatory (for example automatic allocation to husband or to wife), nor involves problems with privacy (for example allocation to the partner with the higher income). We have considered the possibility that some couples would deliberately claim that they were unable to agree on the allocation of the allowance in order to get the MCA divided equally between them. But we concluded that the cash flow disadvantages of losing the benefit of the allowance against PAYE tax deducted during the year would discourage a trend of this sort.

9. The scheme would work in the same way for the elderly except that the rate of MCA they received would be higher (£1,715 for couples ages 65-79 and £1,775 for those aged 80 and over, at current levels). The allowance would be subject to the income limit if the recipient's income was high enough. A problem would arise in determining the level of the MCA in mixed age group couples, for example where one partner was under 65 and the other over 65. We think it would be difficult, presentationally, to make the amount of the allowance dependent on which partner claimed it (especially as the choice would not always be straightforward). We have therefore assumed that mixed age

group couples would be entitled to the level of MCA appropriate to the older partner. (This would reduce the revenue costs of making transitional provision for married men under 65 married to women over 65 under either of the options outlined in my submission of 16 September to the Financial Secretary. However, it would do so at the price of an additional ongoing revenue cost.)

10. A major factor in the cost of the scheme would be the extent to which taxpayers could alter the decisions they had made about the allocation of the MCA. Couples would, of course, be permitted to change their election for a future tax year. But to keep costs down we think it would be necessary to deny the opportunity to change elections, once made, for the current or a previous tax year to any couple where the total amount of tax they had to pay as a couple (though not the allocation of liability between partners) would not be affected. In other words we would not allow a husband and wife to swap the MCA between them merely to reduce the liability of one partner and increase the liability of the other by the same amount. There would however be certain circumstances in which couples would not be able to make full use of the allowance unless some form of retrospective adjustment at the end of the tax year was permitted.

Low income couples

10. A couple might not get the maximum benefit of the MCA where both couples were on such low incomes that neither was individually able to make full use of the MCA in addition to their single allowance. A similar situation would arise where couples made an election which subsequently became disadvantageous because of an unforeseen change of circumstances, for example because the partner to whom MCA had been allocated lost their job. These could be cases of genuine hardship and it would be difficult to deny the possibility of retrospective adjustment to allow any unused portion of MCA to be set against the income of the other spouse. Indeed you might find it difficult to hold the line on postponing any adjustment until the end of the year.

The elderly

12. The allocation of MCA to the best advantage would be complicated for the elderly by the application of the income limit rules and uncertainties about their likely future income. Calculating which partner should take the MCA would be difficult even when the partners' incomes were known after the end of the tax year and could be virtually impossible to predict in advance. Many elderly couples would be ill-equipped to make the necessary decisions. We think it would be very hard not to permit retrospective adjustment in cases where the election had proved, in the event, not to be the most advantageous. In these circumstances we would not unscramble the relief already given but would recalculate the amount on the basis of an election in favour of the other partner and give the additional relief to that partner.

Higher rate taxpayers

13. A further group where the amount of tax paid by a married couple could be increased as a result of a "wrong" decision about MCA would be higher rate taxpayers. The choice might be relatively straightforward where one partner was a higher rate payer and the other had only a relatively small income but would be more difficult where both partners had substantial incomes around the higher rate threshold. A case might be made out for denying a retrospective adjustment to this group. They would generally benefit more than other taxpayers (except possibly the elderly) from the change to Independent Taxation and disaggregation of investment as well as earned income. You might feel that there was no need to go further and ensure that they received the full benefit of MCA to the last £. On the other hand higher rate taxpayers and their advisers could argue that because their tax affairs are generally more complicated than those of other taxpayers decisions about the MCA could be more difficult for them especially where their incomes fluctuated for reasons which could not easily be predicted. For the present purpose we have assumed that retrospective adjustments would be allowed for higher rate taxpayers. The additional staff cost involved is not a decisive

factor. The affairs of most higher rate taxpayers have to be reviewed annually and this would be an extra step in the process rather than a trigger for a review which would otherwise be unnecessary. The adjustment would be made by giving the partner with the higher marginal rate the difference between the relief due at his or her marginal rate and that already given to the other partner. The relief already given would not be reallocated.

14. We think these retrospective adjustments could only be made at the request of the couples concerned. Making the necessary retrospective adjustments would inevitably involve some breach of the privacy of the partners so the initiative for making the change would have to come from them. In any case it would not be practicable for tax offices to identify all the cases where an adjustment of this kind would be beneficial. This might lead to criticism that taxpayers were failing to get the full benefit of MCA either because they were ignorant of the possibility of retrospective change or failed to realise that it would be beneficial in their case. There could be unproductive work for tax offices if taxpayers were encouraged (for example by articles in the press) to apply for retrospective adjustments on the off-chance that they qualified. Even if it were fairly obvious that they did not, there would be a cost in processing the applications.

The elderly and breadwinner wives: transitional provisions

15. The transitional provisions to protect cash losers amongst the elderly and breadwinner wives on a change to Independent Taxation which are discussed in my notes of 16 September to the Financial Secretary would have to be reviewed if an MCA were introduced at the same time as Independent Taxation or shortly thereafter, but the need for such protection would remain. Our proposal for the long-term treatment of breadwinner wives under Independent Taxation (Option A) would be subsumed in the structure of an MCA.

Scheme C

16. We would expect that a major criticism of Scheme B would be the "all or nothing" approach in the allocation of the MCA. It would end sex discrimination in the sense of giving married men and women equal access to the married allowance but it could not offer de facto equality in terms of the value of allowances married people could claim. For this reason we feel it would be inevitable that there would be pressure from two-earner couples to allow a division of MCA between them. We have therefore considered another Scheme, Scheme C, which would allow a split of the MCA on a 50/50 basis between the partners as an alternative to the 100/0 division. The 100/0 basis would have to be retained as an option under Scheme C because one-earner couples would otherwise effectively lose the benefit of half the MCA and be worse off in comparison with two-earner couples than they are now.

17. Under Scheme C we would require an election from a newly married couple only where the allocation of the MCA they wanted was the 100/0 basis. Otherwise all newly married couples would have the MCA split between them 50/50. As with Scheme B married couples in receipt of the married man's allowance in the year before the change would be deemed to have elected for the husband to receive MCA unless they notified the tax office otherwise. Cases where the couple could not agree on the allocation of the MCA would be dealt with in the same way as under Scheme B but it might be reasonable to expect there would be fewer disagreements. Otherwise the rules for Scheme C would be the same as Scheme B with the same groups allowed to have a retrospective adjustment of the allocation of the MCA. The 50/50 option would, however, mean that a wider number of adjustments would have to be considered. Adjustments would have to cover moves from the 50/50 basis to 100/0 and vice versa, as well as switching the whole allowance between partners.

Other possible schemes

18. One drawback of both Schemes B and C is the need for couples to make an election about the allocation of the allowance (although

this problem is greater with B than C) and the difficulty of dealing with the situation where they cannot agree or one partner chooses to be deliberately awkward. We have therefore considered other possible bases for allocating the MCA which would not depend on taxpayer choice. Allocating the MCA to the partner with the highest income would carry a heavy staff cost because links would need to be established between the tax records of husbands and wives and because estimates of the incomes made before the start of the tax year could often turn out to be wrong. Such a scheme would also pose obvious problems of confidentiality. Automatic allocation of the MCA to the husband or the wife would be sex discriminatory and other criteria such as age would have no logical basis. We found all these possibilities unsatisfactory in one way or another and have not therefore pursued them further.

Evaluation of Schemes B and C

19. The outline of Schemes B and C in the preceding paragraphs shows that some difficult decisions would be required if the staff costs of the options were to be kept within bounds. Even so there would be pressure at the margins, under Scheme B to allow the MCA to be split, under Scheme C to allow a division other than 50/50, under both schemes to allow elections to be changed under a wider variety of circumstances or for changes in elections to be given effect during the course of the tax year. Our assessment is that these pressures would be particularly difficult to resist in relation to Scheme B because the 100/0 allocation of MCA would be more rigid and likely to prove unacceptable to a greater number of taxpayers. The dilemma posed where there is disagreement between husband and wife on the allocation of the allowance would also point towards splitting the MCA. Unless you were prepared to take an exceptionally firm stand we think it inevitable that you would have to concede some amendments to the scheme as the legislation went though the House.

20. We think Scheme C would be easier to defend but the effect of the changes here could be very substantial. We would expect that over time an increasing proportion of two-earner couples would opt

Quite. That's the whole point! AH

for a 50/50 split of the MCA. There would then be three basic allowances instead of two, a single person's allowance, an allowance for married people in two-earner couples about $1^{1}/_{4}$ times the single allowance and an allowance for the earner in a one-earner couple about $1^{1}/_{2}$ times the single allowance. The change could also undermine still further the grounds for having a married allowance. At present it can be related to the husband's legal responsibility to support his wife even if as a matter of fact his wife is financially independent; but split 50/50 between the partners it could become little more than a tax bonus on marriage.

I don't think this cuts much ice these days. AH

Future policy options

21. Another factor is the extent to which a change to an MCA (particularly on Scheme C lines) would act as a constraint on future policy options. The likely change in the pattern of allowances which we outline in paragraph 20 would mean that Scheme C could point more naturally to mandatory separate taxation than to transferable allowances.

Really? The [illegible] of TA was precisely that married people started with 1¼ old single allowances each. AH

Operational Implications

22. Because of the need, first, to work out a possible structure for the married couple's allowance we have not yet been able to complete our assessment of the additional staff needed for the scheme or its impact on both the timetable for introducing Independent Taxation and our other computer projects. Our preliminary view is that the ongoing staff cost of a scheme with the fairly strict rules of Scheme B or Scheme C might not be much more than two hundred or so, though this depends on some very tentative guesstimates about the number of changes to elections and claims for retrospective adjustments which couples might make and the figure might well be higher. The once-for-all transitional cost of introducing Scheme C could be as much as 300 man years. As you know the timetable for implementing Independent Taxation in 1990 is already very tight. Our previous advice to you about the implementation timetable has, of course, been based on the assumption that the married man's allowance would

be retained. Introducing an MCA would be a major change in the structure of the system, which would add significantly to the existing risks to the 1990 timetable and might make it impracticable. The work would have to be carried out in a period when our computer resources will already be severely stretched and might mean that some of our other computer projects had to be postponed to accommodate it. There could be a conflict of priority with some of the development work needed on the wider reform package. The task could be more manageable if we were able to take on additional computer staff for the work. But the necessary recruitment would have to begin soon and there would be significant additional expenditure, above the present PES baseline, in particular during 1988-89 and 1989-90, for which additional funding would be required.

23. In practice we could not give you a final assessment of the full impact of the scheme on the implementation plans for Independent Taxation until the proposals had been worked up in more detail and the implications studied much more thoroughly. There could then be some difficult decisions to take at what would be a very late stage.

24. If you wished we could examine the option of introducing Independent Taxation in 1990 as planned but deferring the introduction of MCA until 1991 or 1992 to give the new system a chance to bed down. This would not, however, mean that the decision on whether to introduce an MCA could be deferred. As we have explained the form of the transitional protection for cash losers on the change to Independent Taxation would have to take account of the introduction of MCA and the rules would be different in some respects.

Scheme A

25. If you were to decide that the approaches in Scheme B or Scheme C did not, in the event, look attractive you might wish to consider the minimal change to the structure of the allowances

under Independent Taxation described in paragraph 4 (Scheme A). As we explained this would allocate the MCA automatically to the husband (as with the present married man's allowance) except where he could not make full use of it.

26. The change in Scheme A would be essentially cosmetic. It would not meet the objective of removing the sex discrimination in the prevent system nor could it be presented as doing so; the allowance would retain most of the characteristics of the present married man's allowance and that would have to be recognised.

27. The change would, however, get rid of the "married man's" allowance as such and enable you to substitute a more neutral terminology. And since it would in practice involve no change to the basic structure of allowances under Independent Taxation it could be accommodated within the present plans for legislation and implementation without significant difficulty. It is not clear, however, how far just a change of name would alter taxpayers' perception of the allowance. And there would be a risk that breaking the married man's allowance into its constituent parts would lead to greater pressure from couples to allow them to allocate the MCA component between them as they chose, raising again the issues discussed above in the context of Schemes B and C.

Conclusion

28. Introducing an MCA on the lines of Schemes B or C would be a major change to the structure of Independent Taxation and a lot more work would be needed in developing the proposals before we could advise you on its full implications and in particular on the impact on the timetable for implementing Independent Taxation. As the scheme was developed we would need decisions on the rules which you consider would be acceptable in operating the scheme and which you think you could defend in the House.

29. The question at this stage is whether, in the light of the options discussed in this paper, you feel that the MCA is sufficiently attractive on policy grounds to be worth pursuing

further. Any scheme of this kind is likely to have a number of awkward features and the risk is that you might in practice find an MCA more difficult to defend than the retention of the married man's allowance. You have already paved the way for a halfway house solution which would not attempt to resolve all the problems discussed in the Green Paper. There might be advantages in making a virtue of this and separating the question of the future of the married man's allowance, and the associated distributional issues, from the introduction of Independent Taxation of husband and wife and the removal of the tax penalties on marriage.

Robin Dyall.

MISS R A DYALL

TASK FORCE SECRET

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE

DATE: 29 SEPTEMBER 1987

1. MR ISAAC

2. CHANCELLOR OF THE EXCHEQUER

TAX REFORM: INCOME TAX AND NIC

1. This note provides a further distributional analysis of the package of changes to income tax and NIC currently under consideration, including the options mentioned in Mr Allan's note of 4 September.

2. The note takes as its starting point Option 1A of my submission of 14 July and looks fairly fully at the costs and distributional effects of a version of this option (called Option A) uprated to 1988-89 income levels. This provides a base for the subsequent analysis (paragraph 16 onwards) of variants of the option in which, alternatively, either

(a) the new NIC charge above the UEL/upper profits limit is phased in over three years (paragraphs 16-24); or

(b) the top rate of tax is reduced further from 40 per cent to 35 per cent (again combined with phasing-in of the NIC charge) (Option B, paragraphs 25-28); or

(c) the top rate of tax is reduced in stages from 40 per cent to 35 per cent at the same time as the new NIC charge is phased-in (Option C, paragraphs 29-35).

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

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Calder
Mr Eason
Mr Mace
Mr Cayley
Mr R H Allen
Dr Keenay
PS/IR

Basic Assumptions

3. For this further stage of the work we have moved the analysis of the costs and distributional effects of the options on so that they are now at 1988-89 income levels rather than at 1987-88 levels as in my submission of 14 July. During the summer we have also upgraded the computer model from which the analysis is obtained so that it now takes account of occupational pension contributions (see my note of 22 July (not copied to all)) and also incorporates fuller and more satisfactory estimates of the distribution of investment income. However, we have not yet developed a facility to enable us to analyse the effect of increasing the mortgage interest relief ceiling on the numbers of gainers and losers and the size of their gain or loss, though this work is in hand. For the moment this note looks only at the distributional consequences of the basic income tax and NIC reform. We comment in general terms on the effect of raising the mortgage interest relief ceiling in paragraphs 37-40 below.

4. For convenience and speed the distributional analysis uses unrounded estimates direct from the computer model. Rounding would be needed if any of the figures were eventually required for wider use.

3. At this stage we have not attempted to bring into the analysis the further effects of the introduction of Independent Taxation in 1990-91. As I said in my previous submission, in general Independent Taxation seems unlikely to alter significantly the distributional effects of the proposed changes to income tax rates and NIC in these options.

Option A (without phasing)

6. As the starting point for this analysis we look at an option (Option A) corresponding to Option 1A of my note of 14 July uprated to 1988-89 levels. The assumptions are:

(i) Reduce basic rate from 27 per cent to 25 per cent.

(ii) Abolish all higher rates above 40 per cent.

(iii) Set new 40 per cent threshold at taxable income of £25,000.

(iv) Charge NIC at 9% above the UEL/upper profits limit (£15,860 for 1988-89.) As in my previous submission it is assumed throughout that the self-employed would be treated in exactly the same way as employees as regards the NIC charge above the UPL (and in particular that there would be no income tax relief on the Class IV NIC charge above the UPL).

(v) Index personal allowances in line with prices (3.7 per cent).

7. This option represents the position reached in 1990-91 under Option A in Tables 1 and 2 of Miss Sinclair's note of 18 September (excluding the effects of Independent Taxation).

Costs

8. The full year direct revenue cost at 1988-89 income levels of each of the components of this package compared with indexation of the 1987-88 tax and NIC regime is as follows

	£ billion
Reduce basic rate by 2 points* (including ACT etc effects)	2.80
Abolish higher rates above 40 per cent*	1.57
Raise 40 per cent threshold*	0.86
Total Income Tax	5.23
Extra 9% NIC (on earnings/profits above £15,860 per individual.)	1.88
	3.35

* Costs of the separate tax changes assume that they are made in the order shown.

9. These full year figures are included here to provide a comparison with the full year figures given in my submission of 14 July. (They are consistent with the figures for receipts given in Miss Sinclair's note of 18 September). The comparison shows that the overall cost of this option, at 1988-89 levels, is some £300 million higher than the full year cost of Option 1A in my previous note (£3.05 billion). The main reasons for this increase are a rise in the cost of the income tax component of some £600 million (due mainly to the expected growth in incomes between 1987-88 and 1988-89 of 6 per cent compared with indexation of 3.7 per cent) offset by an increase of nearly £300 million in the yield from abolition of the UEL (again due mainly to real growth in earnings but also in part to the effect of taking account of pension contributions on the computer model).

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ie base from which these changes are measured has increased very considerably (net revenue may be tangle).

Distributional effects

A. Comparison with indexation in 1988-89

Gainers

10. Table 1 shows the numbers of those who would gain from Option A (with the full 9 per cent NIC rate above the UEL in place) compared with indexation. The pattern of gains is very similar to the picture under Option 1 of my previous submission with the great majority of tax units (counting husband and wife as one) with incomes under £20,000 per annum gaining less than £200 per year. About 650,000 tax units with incomes above £20,000 would gain more than £500. On the other hand nearly 400,000 units with incomes above £20,000 would gain less than £200.

11. Chart A illustrates the overall picture for gainers. As before the great majority are on low incomes and gain small amounts while a small number on very high incomes gain £5000 or more.

Losers

12. Table 2 shows the number of losers under Option A (with the full 9 per cent NIC rate above the UEL) compared with indexation. The total number of losers is just under 800,000 of which only about 50,000 would be higher rate taxpayers under the Option. The main reason for the increase in the number of

losers (compared with the figure of 550,000 for the analysis of Option 1A at 1987-88 levels in my submission of 14 July) is the expected real growth in earnings between 1987-88 and 1988-89, which increases the numbers and the incomes of those in the "kink" between the UEL and the higher rate threshold. The inclusion of pension contributions on the computer model is also partly a factor. Nearly all the additional losers under Option A (compared with the earlier Option 1A) are basic rate taxpayers under the new regime. The number of higher rate losers is virtually the same (50,000) on both the analyses.

13. Chart A shows the overall picture for losers (not on the same vertical scale as for the gainers). There is a concentration of losers in the income range £15,000 - £35,000 and some large losses for very limited numbers of very high earners.

14. The table below summarises the position for both gainers and losers compared with indexation. It gives the percentages of taxpayers within particular income ranges who gain or lose by particular amounts. It shows, for example, that of the just under 2 million tax units with incomes in the range £20-30,000 nearly 30 per cent would be losers. But overall, only about 3 1/2 per cent of the total of just over 21 million tax units would be losers.

Option A: Percentage Distribution of Losers and Gainers By Income

Lower limit of total income £'000	Percentage Distribution						Tax units (thousands)
	Loss (£)*			Gain (£)*			
	over 400	200-400	less than 200	less than 200	200-400	over 400	
0	-	-	-	100	-	-	9,900
10	-	-	1	83	16	-	8,300
20	3	9	17	15	44	11	1,900
30	3	4	10	14	20	48	530
40	2	2	4	6	9	77	390
All	1/2	1	2	82	11	3 1/2	21,100

* Compared with indexation

B. Comparison with 1987-88

15. Tables 3 and 4 correspond to Tables 1 and 2, but give comparisons with the 1987-88 tax regime and therefore show cash gains and losses. The number of losers in cash terms is 560,000, (compared with 800,000 against indexation), and their total loss is about £100 million compared with £150 million. Virtually all the cash losers are basic rate taxpayers under the new regime with 375,000 having incomes below £25,000 per year. The table below compares losers in cash terms and against indexation.

Lower limit of total income £000	Number of losers in cash terms 000s	Number of losers compared with indexation 000s
10	0	0
15	50	92
20	326	388
25	138	183
30	31	62
35	9	31
40	6	14
45	3	7
50	5	10
Total	568	786

Phasing in Option A

16. In the following paragraphs we look at the effect of phasing-in Option A over 3 years by initially imposing the NIC charge above the UEL/upper profits limit at 7 per cent in 1988-89, then increasing it to 8 per cent in 1989-90 with the full 9 per cent charge being reached in 1990-91. This is in line with the pattern for Option A described in Miss Sinclair's note of 18 September.

Costs of phasing

17. The full year effect at 1988-89 incomes levels of imposing a NIC charge at 7 per cent rather than 9 per cent under Option A is to increase the cost of the package by some £400 million in 1988-89. There is then an additional yield of £200 million (at 1988-89 income levels) in 1989-90 when the rate above the UEL is raised to 8 per cent; and a further yield of £200 million in 1990-91 when the full 9 per cent charge is reached that year. I should perhaps emphasise that all these figures are full year effects: Tables 1 and 2 of Miss Sinclair's note of 18 September show the effect on receipts of the proposed phasing in each of the years affected, and allow for the new NIC charge to start in October 1988.

Distributional effects

18. We have looked at the distributional effects of the proposed phasing of Option A in terms of full year tax and NIC liabilities throughout. In particular we have not sought to take account of the fact that in 1988-89 the NIC component of the change would not come into effect until October 1988 at the earliest. (Another way of viewing the analysis for 1988-89 is to regard it as showing a comparison of the individual's weekly or monthly liability after October 1988 (against either the 1987-88 tax regime or with indexation in 1988-89, as appropriate.) For convenience, however, all the figures are expressed in annual terms).

19. As far as gainers are concerned the effect in 1988-89 of phasing in the NIC charge is simply to increase the size of the gains of those with earnings above the UEL compared with introducing the full 9 per cent charge immediately. In subsequent years the size of the gains of those with earnings above the UEL is reduced and some previous gainers are converted into losers.

20. The table below shows how the pattern of losers compared with the 1987-88 tax regime changes over the three year phasing-in

period, assuming, for simplicity that all the years are at 1988-89 income levels. The figures for 1990-91 in this table (and in paragraph 21) are, of course, the same as for Option A in 1988-89 without phasing.

Lower limit of total income £000s	Number of losers Compared with 1987-88 000s		
	1988-89	1989-90	1990-91
10	0	0	0
15	5	15	50
20	190	264	326
25	91	114	138
30	13	21	31
35	2	4	9
40	1	3	6
45	1	2	3
50	2	3	5
Total	305	427	568

21. There is a similar pattern for the build up in the total number of losers compared with indexation:

	1988-89	1989-90	1990-91
Total number of losers compared with indexation (000s)	461	627	786

22. Chart B shows the effect of the phasing-in for a married man paying mortgage interest of £3000 whose income is all earned. (For convenience we have used the suffixes T1, T2, T3 to denote the transitional years 1988-89, 1989-90 and 1990-91 respectively). The comparison is with indexation of the 1987-88 tax and NIC regime.

23. In short phasing mitigates the losses in the short term for everybody and delays the loss for 1 or 2 years for to up to 260,000 tax units (~~200~~ 320,000 compared with indexation).

24. At mentioned in paragraph 20 the figures for losers in the transitional years 1988-89 to 1990-91 are on the assumption that all the years are analysed at 1988-89 income levels. The pattern of losers in 1989-90 and 1990-91 could look different if the analysis for each year was in money-of-the-day terms taking account of the growth in incomes and changes in prices. We have not attempted to undertake such an analysis, however, since it would be complex and require forecasts to be made of earnings and prices some 3 years from now.

Option B

25. Option B is a variant of Option A with the higher rate set from the outset at 35 per cent rather than 40 per cent. (See Miss Sinclair's note of 18 September). The full year cost of this further reduction in the higher rate (on top of Option A) would be about £1/2 billion at 1988-89 income levels. Tables 1 and 2 of Miss Sinclair's note show the effect of the option on receipts, with, again, the NIC charge above the UEL phased in over a three year period.

26. We have not looked in detail at the distributional effects of this option since they are the same as those for Option A with phasing except for people above the higher rate threshold. Higher rate taxpayers who are gainers under Option A would have the size of their gains increased further, but since there are already very few higher rate losers under Option A the change to Option B would reduce the numbers of losers only marginally. (The number of losers in cash terms would fall by only about 5000).

27. The table below compares the gains in cash terms (that is compared with 1987-88) made by those with incomes in excess of £30,000 under Options A and B once the full 9% NIC charge is in place. Below this level the effect of the two options is virtually identical.

Lower Limit of Total income £000s	Option A		Option B		
	Number of gainers 000s	Average gain £	Number of gainers 000s	Average gain £	Average increase £
30	309	731	309	770	39
35	178	827	179	970	143
40	109	1161	110	1479	318
45	65	1456	66	1985	529
50	196	4987	198	6826	1839

28. The main beneficiaries of Option B (compared with Option A) would therefore be the 200,000 tax units with incomes over £50,000 who would gain on average an additional £1800 each, a total of about £360 million.

Option C

29. This option is the one described in Mr Allan's note of 4 September. The higher rate is initially set at 40 per cent but falls in subsequent years first to 37 1/2 per cent and then to 35 per cent. We have looked at the effect of this in combination with a phased increase in the NIC charge above the UEL, 7 per cent, 8 per cent, 9 per cent, as before (and as in Option C of Miss Sinclair's note).

30. The full year cost at 1988-89 income levels of each of the three regimes implied by this phasing pattern is about £3.9 billion, some £1/2 billion greater than the annual cost of Option A (with full 9 per cent NIC in place). In broad terms the full year cost of reducing the higher rate at each step is matched by the additional (full year) yield from raising the NIC rate above the UEL. The effect on receipts is shown in Miss Sinclair's note.

31. Chart C shows the effect of Option C compared with indexation for each of the transitional years for a married man paying £3000 mortgage interest whose income is all earned. (It also shows the position under Option A with the full 9 per cent NIC charge in place).

32. As the chart shows there is a turning point (for this individual at income of around £42,500) where the additional gain from each of the phased cuts in the higher rate equals the additional charge from increasing the NIC rate above the UEL. Above this level the individual gains further at each stage of the phasing-in while below this level (down to the UEL) his gains are reduced (or his loss increased) because the additional NIC charge exceeds the additional higher rate relief (if any). This differential movement during the phasing — increased relief for those at the top of the income distribution but increased burdens for those at middle incomes — might have some presentational awkwardness.

33. Below the higher rate threshold the distributional effects of Option C are the same as those of Option A (with phasing) since both incorporate the phased introduction of the NIC charge above the UEL. Above the higher rate threshold the additional gains from the cutting of the higher rate are phased in over three years. The ultimate effect of Option C for higher rate taxpayers is of course the same as for Option B (see the figures in paragraph 27).

34. The table below shows the number of losers under Option C in both cash terms (compared with 1987-88) and compared with indexation for each of the transitional years.

Number of losers 000s	1988-89	1989-90	1990-91
compared with 1987-88	305	425	563
compared with indexation	461	623	760

35. The build up of losers during the phasing under Option C is virtually identical to the pattern under the phased Option A (compare the figures in paragraph 34 and paragraphs 20 and 21). This is because the further reduction in the higher rate under Option C has no impact on the basic rate losers and little impact on the small number of higher rate losers.

Marginal Rates

36. Under all the options the vast majority of taxpayers would see a reduction in their marginal rates of tax and NIC. Most people would see a reduction of 2 points from the basic rate cut. With the higher rate threshold set at £25,000 (which is slightly lower than the present 50 per cent threshold) only a very few present higher rate taxpayers would face an increase in marginal rates compared either with indexation or with 1987-88. (With the 35 per cent higher rate all higher rate taxpayers would face lower marginal rates.) As in my previous submission, however, some 1.3 million

taxpayers in the "kink" between the UEL and the present higher rate threshold would see an increase in their combined marginal rate of tax and NIC as a result of the abolition of the UEL. With phasing-in of the NIC charge the increase would be from 27 per cent to 32 per cent (25+7) in 1988-89 rising to 33 per cent and then 34 per cent in the two subsequent years.

Mortgage Interest Relief

37. As I have explained we are not yet able to model the effect on the number of gainers or losers of an increase in the mortgage interest relief ceiling from £30,000. We have, however, made an analysis of the losers in cash terms under Option A by reference to the existing mortgage interest they claim. The results are shown in Tables 5 and 6.

38. Table 5 shows that of the just over 550,000 losers compared with 1987-88 under Option A (with full 9 per cent NIC in place) only about one-third claim mortgage interest relief in excess of £3000 and so might be helped, at least to some extent, by an increase in the mortgage interest relief ceiling. The size of the help will, however, be quite small since virtually all these losers would be liable at the basic rate under the reform. At current interest rates the maximum relief available from an increase in the ceiling to £35,000 would be about £140 for a basic rate taxpayer. This would reduce the number of losers perhaps by up to 100,000 if nearly all those with small losses were able to take full advantage of the extra relief. In practice the effect is likely to be smaller.

39. Of those who lose more than £200 about 40 per cent could gain at least some benefit from an increase in the mortgage interest relief ceiling, if they had mortgages in excess of £30,000.

40. If we look instead at the position under the transitional regime for Option A in 1988-89 (with 7 per cent NIC above the UEL), of the total of some 300,000 losers about 25 per cent have losses less than £150 and claim mortgage interest relief in excess of

£3000. So an increase in the mortgage interest relief ceiling by £5000 could, at the most, reduce the number of losers in 1988-89 by about 80,000. About half of those with losses in excess of £200 would gain some benefit from the increase, if they had mortgages in excess of £30,000.

41. As mentioned in my previous submission some of those who would lose from abolition of the UEL would also lose from the proposal to tax capital gains at income tax rates. Major changes to the taxation of benefits in kind could also have a significant impact on the overall distributional consequences of the reform package.

and see below X

Further work

42. There is a large range of distributional material which might be produced about each of the Options currently under consideration, particularly when the variations involving phasing are brought into the analysis. In this note we have focussed on a few features of the proposals, particularly the impact on losers. If there is any aspect on which you would like further information at this stage we should, of course, be pleased to try to help.

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X As we discussed with the Financial Secretary earlier this week, some of the Treasury's options on student maintenance could also have important implications for the person on about £20,000.

[illegible] 22.9

Table 1 Option A: Gainers compared with Indexation

Gainers by range of income and amount of gain (000s)

Income range (lower limit) £000s	Amount of gain (£ per year) 0-50	50-100	100-200	200-300	300-400	400-500	>500	TOTAL
0	2870	0	0	0	0	0	0	2870
5	1704	3699	1658	0	0	0	0	7062
10	118	1111	3817	348	0	0	0	5394
15	85	149	1648	906	44	0	0	2833
20	55	47	107	496	166	13	22	907
25	24	18	43	51	129	41	144	450
30	9	9	27	36	31	31	134	278
35	6	10	15	24	16	13	73	156
40	2	4	6	9	9	10	61	102
45	1	1	3	4	5	3	43	61
50	1	1	3	3	3	6	176	192
TOTAL	4875	5049	7329	1877	404	117	653	20304

Gainers ranged by total income (lower limit)

Range of total income £000s	Amount of gain £million	Number of gainers 000s	Average gain £
0	60	2870	21
5	515	7062	73
10	726	5394	135
15	503	2833	178
20	223	907	246
25	206	450	459
30	176	278	631
35	111	156	714
40	99	102	974
45	75	61	1234
50	901	192	4698
TOTAL	3596	20304	177

Note: Estimates of gains/losses cover individuals only and exclude ACT, etc effects.

Table 2 Option A: Losers compared with indexation

Losers by range of income and amount of loss (000s)

Income range (lower limit) £000s	Amount of loss (£ per year) 0-50	50-100	100-200	200-300	300-400	400-500	>500	TOTAL
0	0	0	0	0	0	0	0	0
5	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0
15	61	24	7	0	0	0	0	92
20	61	65	142	71	40	8	0	388
25	18	13	29	34	31	24	34	183
30	8	11	12	9	7	6	8	62
35	10	6	7	3	1	1	2	31
40	2	3	4	2	1	0	2	14
45	1	1	1	1	1	1	1	7
50	1	0	1	1	1	1	4	10
TOTAL	162	125	203	122	82	40	52	786

Losers ranged by total income (lower limit)

Range of total income £000s	Amount of loss £million	Number of losers 000s	Average loss £
0	0	0	0
5	0	0	0
10	0	0	0
15	4	92	43
20	61	388	158
25	55	183	301
30	16	62	254
35	5	31	167
40	3	14	244
45	2	7	264
50	6	10	632
TOTAL	153	786	194

Note: Estimates of gains/losses cover individuals only and exclude ACT, etc effects

Table 3 Option A: Gainers compared with 1987-88

Gainers by range of income and amount of gain (000's)

Income range (lower limit) £000s	Amount of gain (£ per year) 0-50	50-100	100-200	200-300	300-400	400-500	>500	TOTAL
0	1869	1224	0	0	0	0	0	3092
5	134	3117	3859	0	0	0	0	7111
10	0	175	3808	1412	0	0	0	5395
15	66	104	662	1836	208	0	0	2875
20	55	55	85	254	434	37	49	969
25	16	16	37	49	79	78	220	494
30	5	7	23	24	30	38	181	309
35	3	4	13	18	21	16	103	178
40	1	2	3	4	10	5	84	109
45	0	0	2	2	2	3	54	65
50	1	1	1	1	2	3	188	196
TOTAL	2152	4704	8492	3602	785	181	879	20794

Gainers ranged by total income (lower limit)

Range of total income £000s	Amount of gain £million	Number of gainers 000s	Average gain £
0	140	3092	45
5	748	7111	105
10	944	5395	175
15	639	2875	222
20	284	969	293
25	273	494	552
30	226	309	731
35	147	178	827
40	127	109	1161
45	95	65	1456
50	980	196	4987
TOTAL	4602	20794	221

Note: Estimates of gains/losses cover individuals only and exclude ACT, etc effects

Table 4 Option A: Losers compared with 1987-88

Losers by range of income and amount of loss

(000s)

Income range (lower limit) £000s	Amount of loss (£ per year) 0-50	50-100	100-200	200-300	300-400	400-500	>500	TOTAL
0	0	0	0	0	0	0	0	0
5	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0
15	40	9	1	0	0	0	0	50
20	69	73	104	59	18	3	0	326
25	11	19	24	27	25	23	9	138
30	5	4	7	7	3	2	4	31
35	2	2	1	2	1	0	1	9
40	2	1	1	0	1	1	1	6
45	0	0	1	1	1	0	0	3
50	0	0	1	1	1	0	2	5
TOTAL	129	108	139	96	49	29	17	568

Losers ranged by total income (lower limit)

Range of total income £000s	Amount of loss £million	Number of losers 000s	Average loss £
0	0	0	0
5	0	0	0
10	0	0	0
15	1	50	30
20	44	326	134
25	36	138	263
30	8	31	247
35	2	9	247
40	2	6	253
45	1	3	290
50	4	5	776
TOTAL	98	568	172

Note: Estimates of gains/losses cover individuals only and exclude ACT, etc effects

TABLE 5

Losers by income and mortgage interest relief

Lower limit of total income £000	No of losers 000s	% claiming MIR	% claiming MIR in excess of £3000
15	50	84	49
20	326	69	21
25	138	69	50
30	40	72	55
40	9	50	40
50	5	60	40
TOTAL	568	70	35

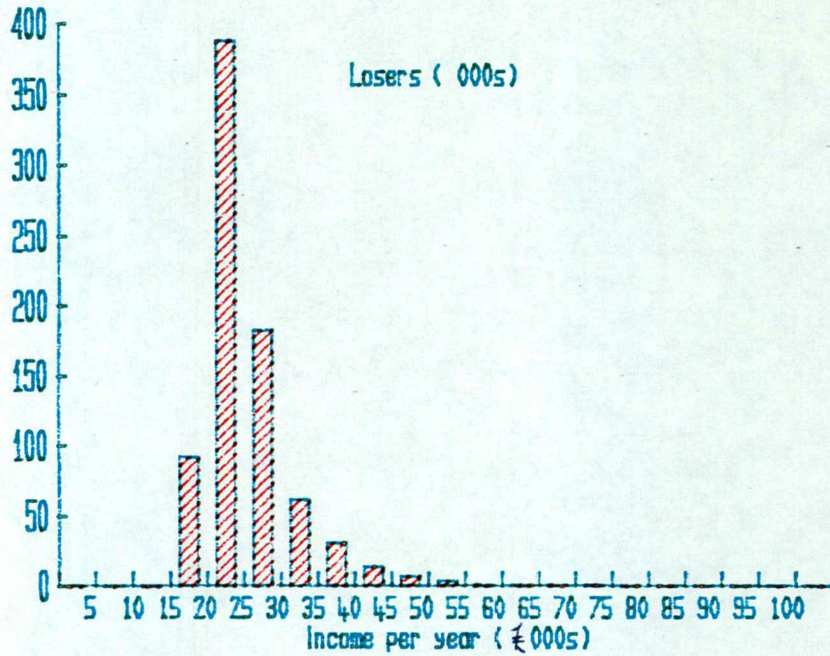
TABLE 6

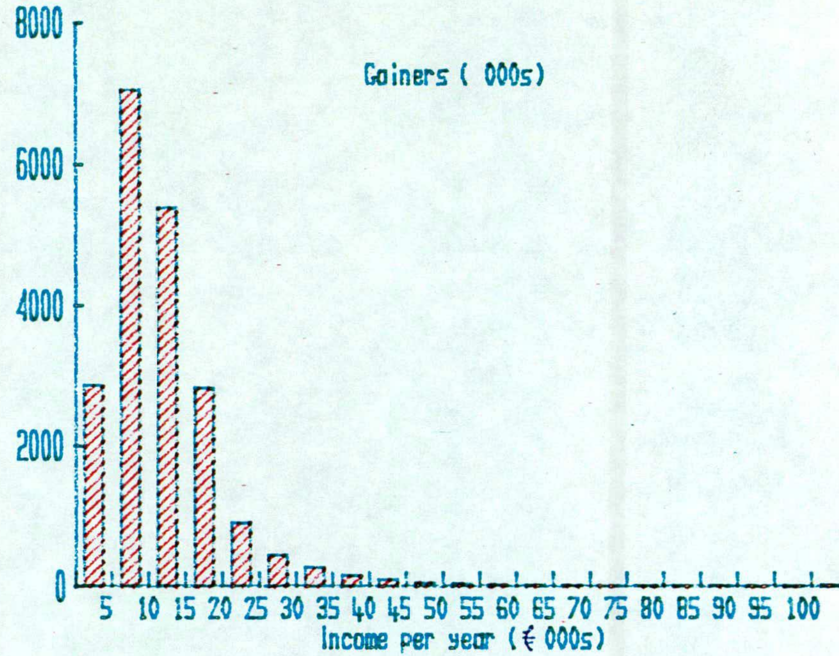
Losers by size of loss and mortgage interest relief

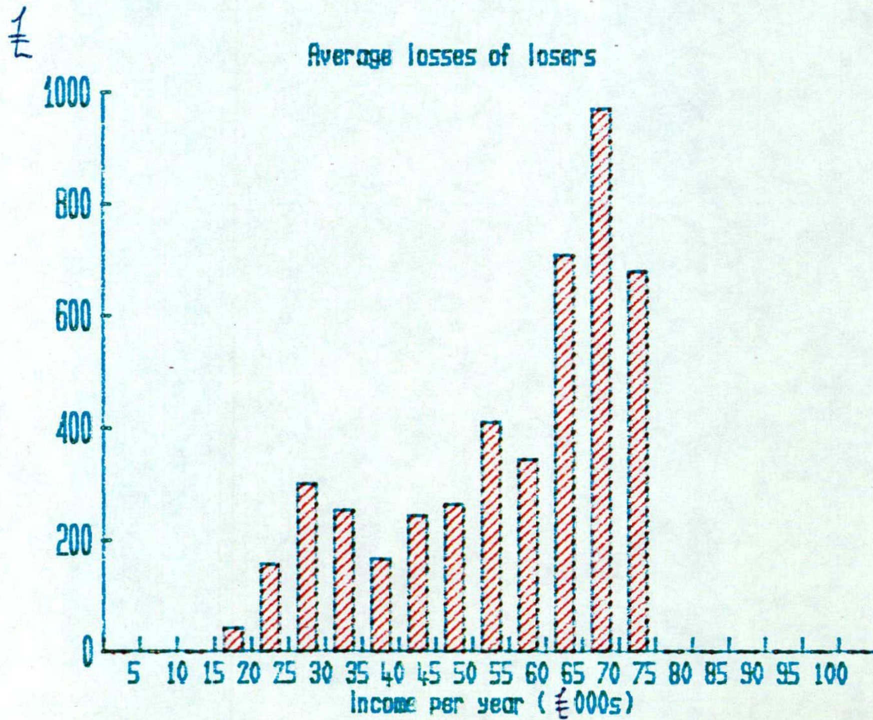
Size of loss (lower limit) £	No of losers 000s	% claiming MIR	% claiming MIR in excess of £3000
0	129	63	29
50	108	72	36
100	139	70	29
200	96	73	35
300	78	74	50
500	17	70	59
TOTAL	568	70	35

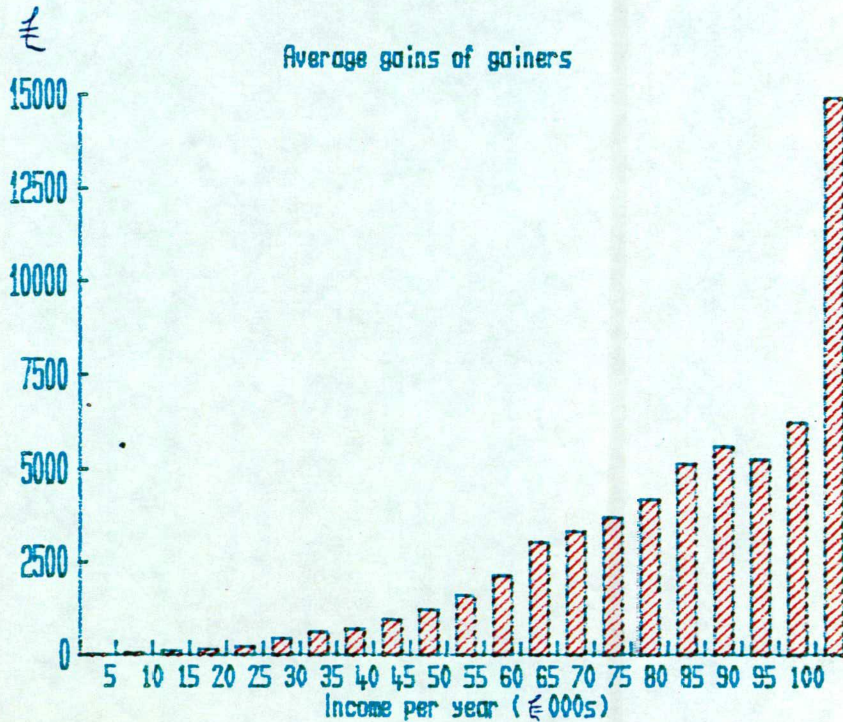
Gainers and losers and their gains and losses by range of income

OPTION A





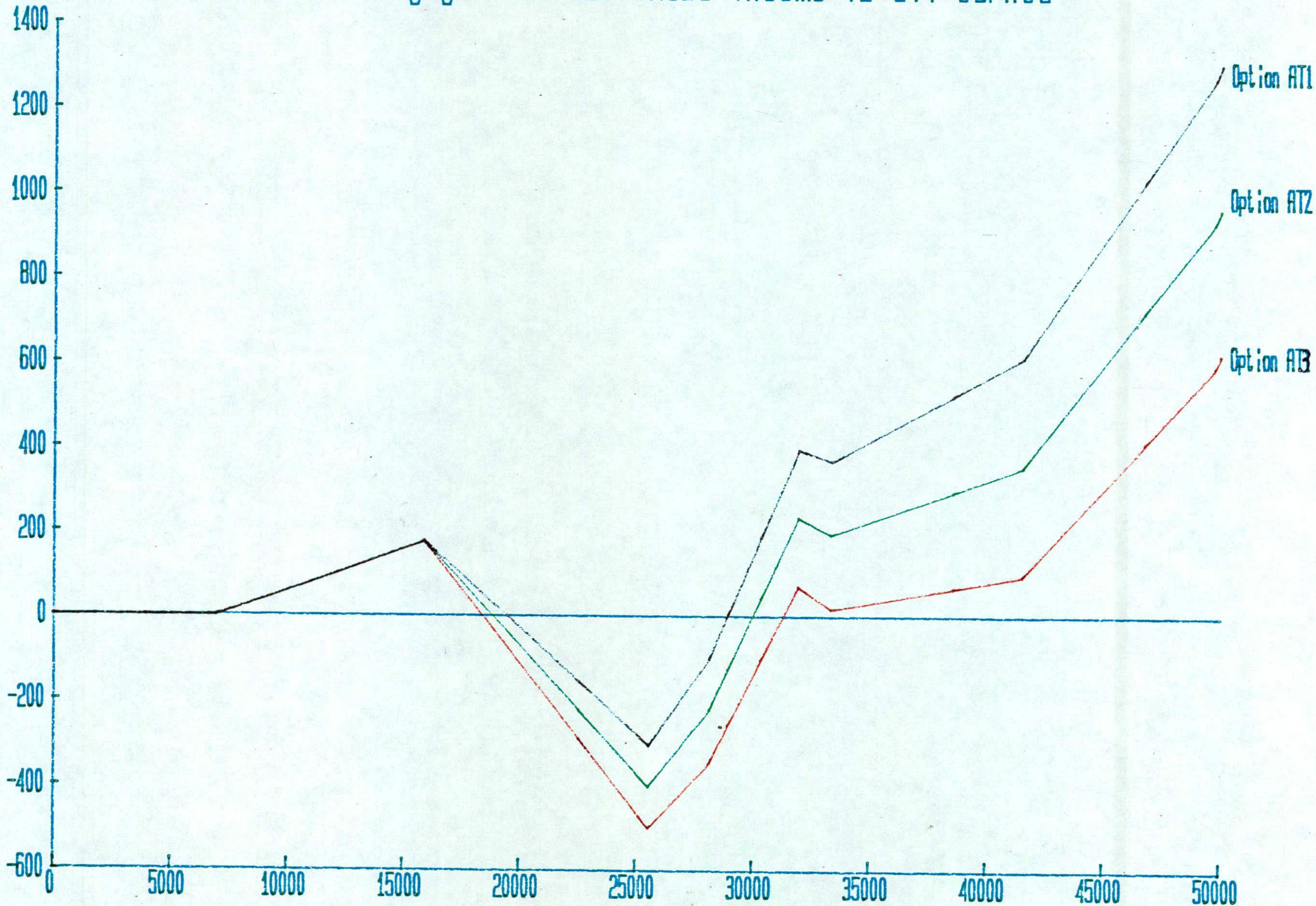




TASK FORCE SECRET

CHART A

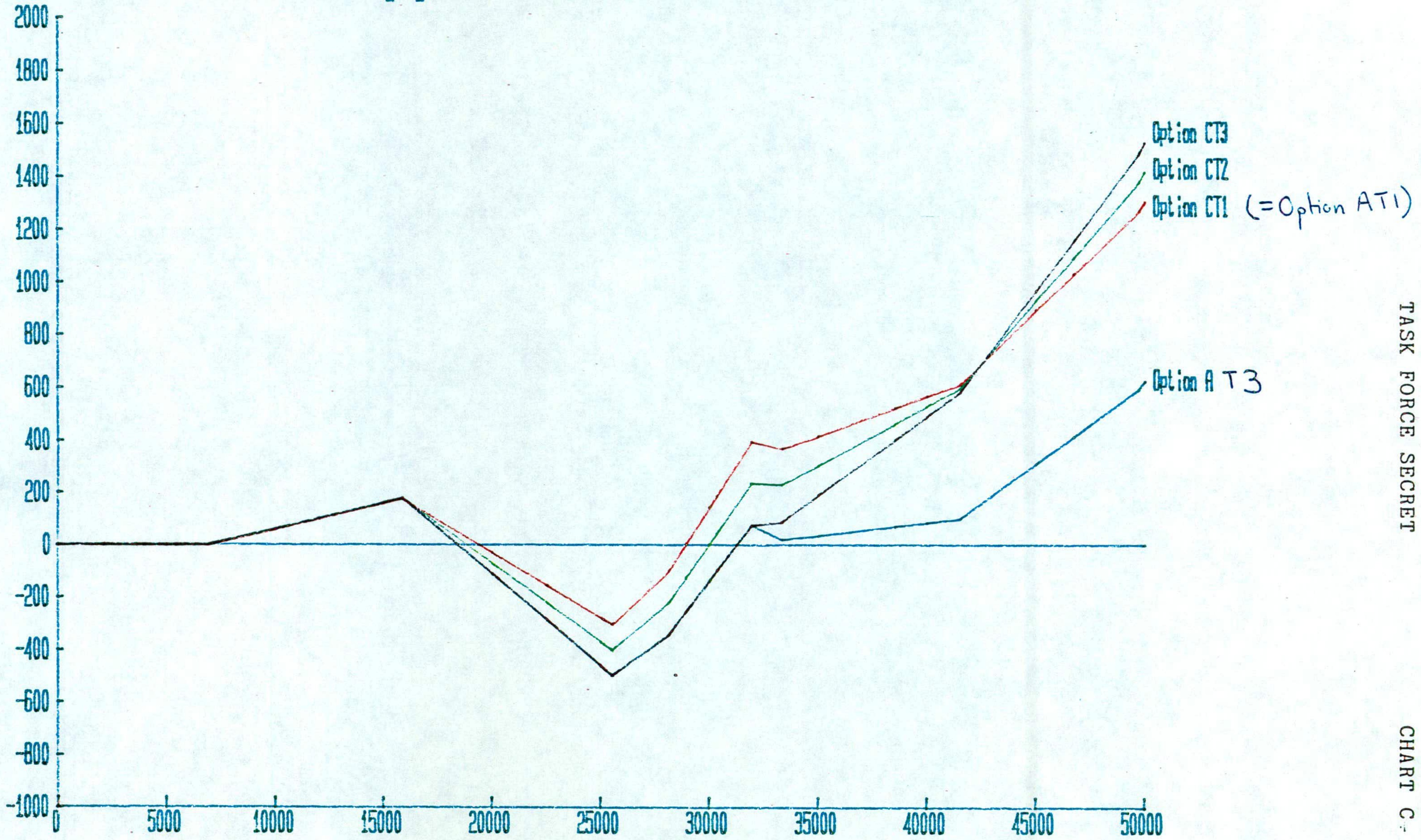
Gains from the income tax and NIC packages (cf indexation) for a married man with £3000 mortgage interest whose income is all earned



TASK FORCE SECRET

CHART B

Gains from the income tax and NIC packages (cf indexation) for a married man with 3000 mortgage interest whose income is all earned



TASK FORCE SECRET

CHART C

Copy NO 2d of 12.

TASK FORCE SECRET

Inland Revenue

Policy Division
Somerset House

From: M F CAYLEY
Ext: 7427
Date: 30 September 1987

cc Miss Sinclair
Mr Riley
Mr Smith
CMr

Mr Sparkes
Foreshadows advice on CLA Budget rep.
CC
5/10.

1. MR ISAAC Seen in draft. [initials] 30/9/87

2. FINANCIAL SECRETARY

CAPITAL GAINS TAX: ANOTHER OPTION

1. You asked (Mr Heywood's note to me of 24 September) for a quick minute on a reformed CGT with

- abolition of indexation;
- gains taxed as the marginal slice of income on a rate scale of 25% and 35%; and
- exemption of either all assets, or assets acquired post-Budget-Day, which have been held for more than 6 years.

Any scheme of this kind would involve very major practical difficulties: but before coming to these, this note looks first at the yield and the more general implications.

CAYLEY TO FST 30/9

cc	Mr Scholar	Mr Isaac
	Mr Cropper	Mr Pitts
	Mr Tyrie	Mr Cayley
		Mr Gonzalez
		Mr Hamilton
		Mr Michael
		Mr Quinn
		PS/IR

10/Ci

2. In preparing this quick response, we have not had time to undertake full costings, so the figures quoted should be regarded as no more than indicative. The survey we are undertaking to improve our CGT data should give us more information on the length of time for which people hold assets.

3. Ignoring the lock-in effects (see below), the effect on yield accruing on 1988/89 disposals might be as follows:-

<u>(a) Over 6-year exemption applying to all assets</u>

Individuals and Trusts	- £m1,600
Companies	- £m1,050
	- £m2,650

The cost is greater than for rebasing because this proposal would exempt altogether any asset held for six years, whereas with rebasing gains accruing from 1982 would remain in charge.

<u>(b) Over 6-year exemption confined to new assets</u>

Individuals and Trusts	+ £m650
Companies	+ £m500
	+ £m1150

With the second alternative, still ignoring lock-in effects, the extra yield would begin to disappear (on an accruals basis) at the six year point, and eventually a heavy cost to the Exchequer would build up. Taxpayer numbers would fall substantially with (a), and in the short and medium term would increase with (b).

4. With (a) our staff need might fall because of the disappearance of indexation and of the need to establish 1982 values and the reduction in taxpayer numbers, by several hundred over the next few years. With (b), there would be a very much smaller fall in our staff need in the short-term, because of the increase in taxpayer numbers, but the staff saving would build up thereafter.

Distributional Effects

5. A high proportion of disposals, particularly of shares, currently are of assets acquired within the previous six years. Almost everyone making such disposals would be worse off because of the abolition of indexation and the application of a higher rate charge. Much agricultural land acquired in the 1980s is currently sheltered by indexation: it would often start to generate tax liabilities. If the exemption of assets held more than six years were confined to new assets, virtually all those paying tax on disposals of existing assets would be worse off.

Lock-in Effects

6. A system of this kind would have sizeable lock-in effects. People would be encouraged to hold on to assets for at least six years and a day in order to get exemption. It is not practicable to estimate the size of these effects, but because of them the cost of the reform would almost certainly be significantly above the figures quoted above. These effects would be exacerbated by the abolition of indexation.

Equity

7. Those who were compelled to dispose of assets within the six years would be likely to complain that the system penalised them. Hard cases would be cited, where for example someone fell unexpectedly on hard times and had to sell assets to make ends meet shortly before the six years were up.

8. For assets held more than six years, the scheme would often exempt large real gains, including development gains. For assets held less than six years tax would fall on inflationary as well as real gains.

Practicality

9. To make a scheme of this kind work, it would be necessary to know the dates of acquisition of assets. This raises two particular areas of difficulty:-

(i) share pools. The pooling arrangements for shares which simplify record-keeping etc could not continue. Where blocks of shares in a company were acquired in stages and sold in stages, we would need complex rules to relate particular disposals to particular acquisitions. We know from past experience that there would be complaints from institutional investors and others making very frequent acquisitions and disposals that it would be difficult for them to operate the system: such investors would prefer some form of pooling and the 1985 reforms, which reintroduced general share pooling, were very much welcomed. These 1985 simplifications would have to be reversed. Rebasing to 1982 is possible because information on 1982 values is obtained for indexation purposes. Since 1985, information on dates and costs of acquisition of individual blocks of shares has ceased to be built into the system. If the exemption for assets held more than 6 years extended to all existing assets, the records would often not be available to unscramble existing share pools in order to find out the precise dates on which blocks of shareholding had been acquired (the problem is very similar to that of extending indexation back beyond 1982).

(ii) deferred charges. Where tax had been deferred (for example business rollover relief) there could also be acute difficulties in applying the 6 year time limit. Where business assets had been replaced, for example, there might well have been a succession of occasions on which rollover relief had been given, with some of the deferred charges being triggered at some point when not all the proceeds from the sale of one asset were reinvested in other qualifying assets, with some assets being transferred to other companies in the same group, and so on. Unscrambling all this would be impracticable in the more complicated cases. For existing assets the only workable answer might be to say that the exemption applied only where the particular asset that was being sold had been owned by the taxpayer (or group) for at least six years - with the full CGT charge applying in all other situations, even if the asset had replaced an earlier asset acquired more than six years in the past. Some at least would see this as unfair. For new assets, complex rules would be needed.

Michael Cayley

M F CAYLEY

TASK FORCE SECRET

FROM: J P MCINTYRE
DATE: 30 September 1987

FINANCIAL SECRETARY

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

TAX REFORM: SELF EMPLOYED

Mr Heywood's minute of 4 August asked for a note on the NICs proposals for the self employed in the reform package. I attach a paper prepared by Mr Macpherson, which has been discussed with FP and the Revenue. You may wish to consider it along with Mr Macpherson's other paper, also being submitted this week, on NIC options for employees at the lower end.

2. The first part of the paper (paragraphs 1-10) reviews the current arrangements and explains how these involve a subsidy to the self employed of over £1 billion a year. GAD estimates that, if this subsidy were to be eliminated in 1988-89, the Class 2 rate would have to rise from £3.85 to £10.60 and the Class 4 rate would have to go up from 6.3 per cent to 11.6 per cent.

3. The paper then describes the current reform proposal to abolish the Upper Profits Limit (UPL) for the self employed in parallel with abolition of employees' Upper Earnings Limit (UEL) (paragraphs 11-13) and examines variants on this proposal which could sweeten this reform for the self employed, if Ministers thought that desirable. These are:

i. Lowering the Class 2 rate;

ii. Increasing the Lower Profits Limit (LPL);

iii. Cutting the Class 4 rate.

4. The paper also examines (paragraphs 15-17) an alternative to the current proposal, under which the NIC rate above the UPL would be the same (6.3 per cent) as below the UPL.

5. Paragraph 18 raises the question of whether tax relief on the self employed Class 4 contributions might not be abolished as part of the reforms. Under the current proposal, no tax relief would be given on contributions above the UPL but it would be retained for half the contributions below the UPL. Parity with employees might point to abolition.

6. Paragraphs 19-22 deal with implementation of the reforms. The Revenue are going to provide a separate note on this. But the key points are;

a. it may not be possible for the Revenue to implement the reforms for the self employed in October 1988; they might have to be deferred until April 1989.

b. As on other aspects of reforms as they affect NICs, we need to bring DHSS into our thinking at the earliest opportunity, both to resolve any operational problems they might have and to ensure that the necessary social security legislation is prepared in time.

7. Finally, the paper looks at two options for the medium term which could merge Class 2 and Class 4 (paragraphs 23-29). The Revenue's advice is that they could not be implemented until the 1990s because they would require the computerisation of Schedule D Income Tax (CODA) and the new computerised collection system (BROCS) to be in place first. Each would involve abolition of Class 2 and the lowering of the Class 4 LPL to the level of the

small earnings exception (currently £2125). But the second option would reduce the subsidy to the self employed by making the LPL a step, at which NICs would become payable on all profits, not just profits above the threshold as at present.

8. While these more radical options are not available for the reform package next year, you may like to be aware of the longer term possibilities for rationalising self employed NICs. It is a subject on which further work might be done after the package has been announced and implemented. None of the options put forward for the 1988 Budget package would preclude merging of Class 2 and Class 4 in the longer term.

9. The annex to the paper illustrates the effect of the current proposal to abolish the UPL on three typical self employed people, earning £3,000, £15,000 and £60,000 a year respectively. It also shows the impact of the variants discussed in the paper and the reduced rate option. For comparison, the effects of withdrawing the NIF subsidy completely and of introducing the medium term options are also shown.

10. You may wish to discuss.

J P MCINTYRE

SELF EMPLOYED NIC OPTIONS

In his minute of 4 August, Mr Heywood asked for a note on self employed NIC options, in the light of the Financial Secretary's concern about the proposal to abolish the Upper Profits Limit (UPL). This paper examines the background to the current self employed NIC structure, and the main proposal being considered in the reform package. It goes on to look at possible variants to this proposal which might reduce criticism from the self employed, if Ministers decided it was necessary to ease the impact of the reform package for them. Finally, the paper assesses more radical options for the medium term which would be left open by the reforms.

<u>Background</u>

2. The current system for the self employed is as follows:

Class 2: <u>a weekly flat rate payment of £3.85.</u> This is collected by DHSS. Self employed with earnings below the low earnings exception of £2125 a year are exempt, and if necessary can reclaim their contributions after the end of the year. Total Class 2 contribution income in 1988-89 is expected to be £440 million. Class 2 contributions, but not Class 4, carry entitlement to benefits.

Class 4: <u>an annual earnings related contribution of 6.3 per cent of the balance of earnings between the Lower Profits Limit (LPL) of £4,590 and upper profits limit of £15,340 a year.</u> This is assessed and collected by Inland Revenue (on behalf of DHSS) at the same time as Schedule D income tax. It is payable half on 1 January in the year of assessment and the other half on the following 1 July. Total Class 4 contribution income is expected to be £450 million in 1988-89, but exchequer receipts are reduced by the tax relief, given on half of Class 4 contributions, which in 1988-89 is likely to be around £75 million.

3. Class 2 and 4 were originally intended to be broadly equivalent to Class 1 contributions, paid by employees and their employers. Thus, the small earnings exception and UPL were roughly 52 times the lower earnings limit and upper earnings limit respectively. The Class 2 and 4 contribution rates were the same as the Class 1 rate, actuarially adjusted to reflect the self employed's ineligibility for certain benefits (unemployment benefit, SERPs, industrial injury and EPA benefits). Class 2 and 4 were never intended to be independent instruments. The flat rate nature of Class 2 was designed to facilitate collection; calculating and collecting earnings related contributions from those self employed on low earnings would have been an expensive business. The Class 2 flat rate was therefore a proxy for Class 4 contributions on income below the LPL, being roughly equivalent to the Class 4 rate times the LPL.

4. Although Class 4 does not confer benefit entitlement, it plays an important role in financing self employed benefits. Even if the subsidy on Class 2 were removed (see below), and the rate became £10.60 a week, it would still fall short of the level actuarially necessary to finance the flat rate benefits to which the self employed are entitled. Class 4 enables those self employed with low profits to be subsidised by those self employed with high profits. To this extent, it is similar to the Class 1 system where payment of NICs on the first £39 of earnings confers entitlement to flat rate benefits, but falls well short of financing them, cross subsidy being necessary from the higher paid.

The Emergence of a Subsidy

5. Over the last four years the interdependence of Class 2 and 4 contributions has been steadily weakened and a NIF subsidy to the self employed has emerged. The Class 2 flat sum first became inconsistent with Class 4 in 1983-84, when a 6.3 per cent Class 4 rate and an LPL of £3800 pointed to a Class 2 rate of £4.60 a week (.063 x 3800 / 52). Instead, a rate of £4.40 was chosen.

The abatement of 20p implied a subsidy to the self employed of between £15m and £20m.

6. Further decoupling of the Class 2 and 4 rates occurred in the 1985 restructuring. With the combined employer and employee rate falling to 10 per cent at the lower earnings limit, it was judged necessary to lower the Class 2 rate to £3.50 a week (10 per cent of the LEL minus 5p to allow for lower benefit entitlement). This move was necessary for the low earning self employed, if they were not to make a higher contribution than Class 1 contributors, despite being entitled to less benefits. However, the blanket nature of Class 2 contributions meant that the higher earning self employed also benefited in a way Class 1 contributors did not. Despite this, the Class 4 rate was left unchanged, implying a subsidy of around £300 million.

7. Recent developments have further increased the NIF subsidy to the self employed. The EPA contribution, the contracted out rebate and the element of Class 1 contributions GAD attribute to paying for unemployment and industrial injury benefits either have been or are to be reduced.

8. If the Class 2 rate were simply uprated next year to £4.05 and Class 4 kept at 6.3 per cent, the self employed would be receiving a subsidy of over £1 billion. If, in addition, we take into account the fact that the self employed pay no contributions above the UPL (whereas employers pay Class 1 contributions on their employees' earnings above the UEL), the subsidy would rise to £1.2 billion.

9. GAD estimate that a Class 2 rate of £10.60 a week and a Class 4 rate of 11.6 per cent would be necessary in 1988-89 if the subsidy were to be eliminated. (The self employed would still benefit however, from tax relief on half their Class 4 contributions.)

10. These changes would increase net contribution income by £380 million in the first year and £940 million in the second. However, the self employed would suffer considerable losses, with

the less profitable faring proportionately worse. For example, someone with profit of £3,000 a year would pay £340.60 more in contributions (See Annex)

The Current Proposal

11. In the context of the present tax reform package, the proposal for the self employed is to abolish the Class 4 UPL and introduce a 9 per cent NIC rate (with no tax relief) on profits above the UPL (likely to be £15,860 a year in 1988-89). This matches the proposal to introduce a 9 per cent NIC rate above the UEL for employees.

12. The proposal would ensure that employees and self employed are treated in the same way under the reforms, both facing the same combined marginal tax and NIC rate on earnings/profits above the UEL/UPL. (Though of course the self employed would still be treated more favourably below the UEL/UPL). The proposal would increase contribution income by around £160 million in the first year and over £410 million in the second. In the long run, it would cut the subsidy to the self employed to around £650 million.

13. Its disadvantage is that the self employed would argue that it was an additional burden without justification, since there will be no increase in benefit entitlement. In particular, they would focus on the threshold at the UPL, where the self employed could go from paying a Class 4 NIC rate of 6.3 per cent, with tax relief on half the contributions, to 9 per cent with no tax relief. The counter argument is that employees would also be paying NICs above the UEL with no increase in benefit entitlement as a result. Phasing in the increase for both self employed and employees could help. The charge for the self employed could go from 6.3 per cent (with tax relief on half contributions) to 7 per cent (with no tax relief) in the first stage, subsequently moving to 8 per cent and later 9 per cent.

Variants on the Current Proposal

14. If Ministers wanted to retain the structure of the current reform proposal to abolish the UPL but wished to do something to

reduce the additional burden on the self employed, there are a number of options. We have looked at options which would reduce NICs for all the self employed compared with the current proposal but which would give particular help to those at the bottom end (in parallel with measures being considered for employees NICs). For illustrative purposes, each option has been designed to have the same net cost, namely a reduction in revenue of £25 million in the first year and £60 million in the second, compared with the revenue expected under the current proposal.

(i) Lower the Class 2 rate

A cut of 60p in the Class 2 rate to £3.45 a week* would result in all self employed gaining £31.20 a year. This would ensure that those earning less than £16,206 a year would be net gainers from the NIC reform package. The advantage of this variant is that the low earning self employed would gain considerably; for example, someone with profits of £3000 a year would experience an increase in net (earned) income of over 10 per cent. The disadvantage is the lack of targeting, since all the self employed would benefit.

(ii) Increase in the LPL

An increase of £1000 in the LPL to £5790 would ensure that all those earning between £4790 and £16,465 a year would pay less NICs (net of tax relief) than under the reform package as it stands. Those earning between the LPL and UPL (£5,790 to £15,860) gain the most, £54.50 a year net of tax relief. This variant is better targetted than (i) and would also reduce the number of self employed paying Class 4. Its disadvantage is that the self employed on very low earnings would not gain at all.

(iii) Cut Class 4 rate

A 1 per cent cut in the main Class 4 rate to 5.3 per cent

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* The base case assumes a Class 2 rate of £4.05 a week in 1988-89, an LPL of £4,790 a year and a UPL of £15,860.

would ensure that all those earning between £4,790 and £16,924 a year would pay less NICs (net of tax relief). Those with earnings at the UPL would gain the most, a net £95.75 a year. However, those on low earnings would gain little; for example, someone on £5,000 a year would gain a net £1.82 a year, and like variant (ii) it does nothing for those earning below £4,790 a year.

An Alternative to the Current Proposal

15. Abolishing the UPL on the basis described in paragraph 11, plus one of the variants in paragraph 14 to help the self employed at the lower end, would be on a par with the proposals for employees - though the self employed would continue to get a subsidy from the NIF. If Ministers nevertheless felt that they had to give further favourable treatment to the self employed, they could introduce a 6.3 per cent rate above the UPL, with tax relief on half the contributions above (as well as below) the UPL.

16. This would meet with less criticism from the self employed than the current proposals because it would involve no increase in the marginal rate at the UPL. However, it would be hard to justify against a decision to levy a 9 per cent employees NIC on earnings above the UEL. Moreover, it would reduce net contribution income, compared with the proposal in paragraph 11, by £70 million in the first year and £170 million in the second. In the long run, the annual subsidy would be £100 million higher than if the paragraph 11 proposal were implemented.

17. A variant would be to charge a NIC rate of 6.3 per cent above the UPL but without tax relief; this would reduce the difference in cost between this option and that in paragraph 11 to £50 million in the first year and £120 million in the second.

Tax Relief

18. The above options all assume that tax relief will continue to be given on half of Class 4 contributions between the lower and upper profits limits. The rationale for such relief is that employers get tax relief on their share of Class 1 contributions

(roughly half the total Class 1 contributions in respect of any employee). However, the objective of the proposal outlined in paragraph 11 is to bring treatment of the self employed into line with that of employees. Ministers may therefore want to take this opportunity to remove relief on Class 4 altogether; as mentioned in paragraph 4, it currently costs the Exchequer around £75 million a year.

Implementation

19. The Revenue's present view is that it will be difficult to implement the current proposal for NIC for the self-employed in 1988-89 because a number of quite significant changes are required to the Schedule D computer system (CODA). Other systems development work would need to be deferred to make room for the change and work would need to start in the near future if the Inland Revenue are to meet the implementation date. The Revenue are looking further at these problems and will let Ministers have a separate note on the issue shortly.

20. There is a transitional problem in 1988-89 if the changes to Class 4 NIC are to apply only from the middle of the year. Unlike Class 1, which is assessed weekly, Class 4 is assessed for the whole of the tax year in question. The only practical way of handling the transitional year operationally would be to charge half the NIC rate that would otherwise be imposed on the profits above the UPL. (For example if the annual rate on profits about the UPL were 9 per cent the 1988-89 charge would be 4½ per cent). This option would, of course depend on the Revenue's ability to make the structural changes to their computer systems in time to meet an 1988-89 start.

21. DHSS may also have operational problems and should be brought into discussions at the earliest possible opportunity, if we are to be sure of solving all of the problems, both as regards the transitional year and subsequent years, in time for announcement and implementation on schedule.

22. Any changes to the NIC system will require separate social security legislation.

Medium Term Options

23. There are more radical options for changing self employed NICs which could not be implemented next year for administrative reasons. These would be aimed at rationalising the current system by combining Class 2 and Class 4 in a single rate. The possibilities are outlined below: neither are precluded by the options described above.

24. **A. Abolish Class 2 and lower the Class 4 LPL to the level of the small earnings exception;**

This would be broadly revenue neutral, once tax relief on Class 4 is taken into account, both in the first and second years. The NIF subsidy would be reduced marginally in the long run but would still be in the region of £1 billion. This option has the attraction of ensuring that all those with profits under £16,647 a year (using next year's figures) would pay less NICs, while once tax relief is taken into account all those with profits under £17,150 would be likely net gainers. The biggest benefits would go to the low earning self employed; for example, those with profits of £2235 a year would gain £210.60 a year.

25. Other advantages include:

a) the abolition of a 'tax';

b) Class 4 counting towards benefit entitlement, thus addressing the standard complaint of the self employed. DHSS would have to work out how such entitlement would be calculated;

c) administrative simplification. Inland Revenue would become solely responsible for assessment, collection and enforcement of self employed NICs. There would be DHSS staff savings of around 1200 (worth over £14 million a year). But this would be offset (possibly more than offset) by a need to increase Inland Revenue staff. At present, the Revenue need to collect NICs only on profits about the LPL

(£4,590). If Class 2 and Class 4 were combined, they would have to collect on profits below that. The net effect on administrative costs is unclear, although DHSS are currently working on a Class 2 abolition option in consultation with the Inland Revenue as part of a separate exercise.

26. The disadvantage of this option is its failure to reduce the NIF subsidy to the self employed significantly.

27. **B: As in A but make the LPL similar to the LEL, ie it would become a step, at which NICs became payable on all profits, rather than a threshold.**

This would increase contribution income, net of tax relief, by £110 million in the first year and by around £250 million in the second. Most of Option A's advantages would be retained, while the NIF subsidy to the self employed would be reduced in the long run to around £700 million. It would also bring the self employed NIC structure more into line with that of Class 1, assuming the latter remains intact.

28. However, it would have the disadvantage of losers at the lower end of the profits scale. For example, any self employed with annual profits of over £3342 would be paying more NICs, with maximum gross losses below the UPL of £91.17 a year. Losers could be limited by introducing a reduced rate band. A reduced rate of 4.4 per cent would ensure no gross losers below the upper end of a reduced rate band. One option would be to align such a band with the Class 1 reduced rate system, running it from the LPL at £2235 to £8060 (52 x £155). However, this would still result in those earning between £8060 and £15860 (the UPL) sustaining gross losses of £91.17 a year and those earning over the UPL even more.

29. The Inland Revenue advise that options of this kind could not be implemented until the mid 1990s because they would require the computerisation of Schedule D income tax (CODA) and the new computerised collection system (BROCS) to be in place first. There would also be a number of policy issues that would need to

be settled before work on the administrative structure could begin. These include the scope of the tax relief on the new combined charge (tax relief is not available on Class 2 contributions), the treatment of individuals who are categorised differently by the Inland Revenue and DHSS for employment/self-employment and the confidentiality of information about the self employed held by DHSS and the Revenue, which would have to be exchanged under the new system.

Health warning

30. Finally, the usual health warning should be registered in relation to the estimates given in this paper, which are all subject to confirmation by GAD.

ETS division

September 1987

ANNEX

Gainers and losers: effect of different NIC regimes on annual take home pay (£) of illustrative self employed

Profits in 1988-89	£3000	£15000	£60000
No subsidy	-340.60	-808.66	-751.30
Reform package proposal	0	0	-3972.60
variant (i)	+31.20	+31.20	-3941.40
variant (ii)	0	+54.50	-3928.50
variant (iii)	0	+88.32	-3895.11
Reduced Rate (6.3%) above UPL	0	0	-1946.57
MEDIUM TERM OPTIONS			
Option A	+162.40	+71.36	-1848.65
Option B	+21.60	-50.43	-1947.21

Notes

The tax rates assumed for Class 4 relief purposes are zero, 27% and 60% for the self employed with profits of £3000, £15000 and £60000 respectively.

The base case assumes a Class 2 rate of £4.05 a week, a Class 4 rate of 6.3%, a LPL of £4790 and a UPL of £15860 a year.

COPY NO. 1 OF 24

TASK FORCE SECRET

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

FROM: R J EASON

DATE: 30 SEPTEMBER 1987

Amended MJ7 30/9.

1. **MR ISAAC**
2. **CHANCELLOR OF THE EXCHEQUER**

TAX REFORM : INCOME TAX AND NIC

I regret two incorrect statistics were included in paragraph 23 of Mr Mace's submission of 29 September.

I would be grateful if you would amend

'160,000' in the second line to '260,000' and
'200,000' in the third line to '320,000'.

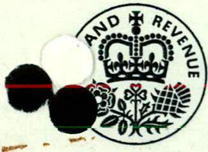
RJE.

R J EASON

---

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Miss Sinclair
Mr G P Smith
Mr Cropper
Mr Tyrie
Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Calder
Mr Eason
Mr Mace
Mr Cayley
Mr R H Allen
Dr Keenay
PS/IR

SECRET



Inland Revenue

Policy Division
Somerset House

FROM: MISS R A DYALL

DATE: 30 SEPTEMBER 1987

PS/CHANCELLOR OF THE EXCHEQUER

INDEPENDENT TAXATION: ALTERNATIVE TO THE MARRIED MAN'S ALLOWANCE

CORRECTION ✓ Amended

My note of 28 September "Independent Taxaton: Alternative to the Married Man's Allowance" (which was circulated under cover of Mr Mace's note of the same date "Independent Taxation: Variants of the Married Man's Allowance") unfortunately contained an error. In paragraph 22, on the operational implications of Schemes B and C, the tentative staff cost in line 8 should have been "two hundred or so "not" a hundred or so". I apologise for this error and should be grateful if you would correct your copies of the note.

pp
R Kent

MISS R A DYALL

---

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Jenkins (Parliamentary Counsel)

Mr Battishill
Mr Isaac
Mr Lewis
Mr Beighton
Mr Mace
Mr J C Jones
Miss Dyall
PS/IR

1234/39

TASK FORCE SECRET

COPY NO 1 OF 17
FROM: MISS C E C SINCLAIR
DATE: 30 September 1987

CHANCELLOR

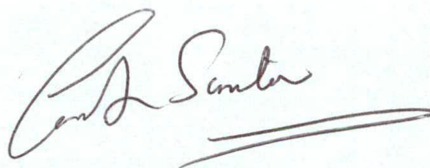
cc
Financial Secretary
Sir P Middleton
Mr Scholar
Mrs Lomax
Mr Ilett
Mr Cassell
Mr Riley
Mr G P Smith
Miss Hay
Mr Sparkes
Mr Cropper
Mr Tyrie
Mr Call

PS/Inland Revenue
Mr Cayley - IR

CGT REFORM: MARKET IMPLICATIONS OF 6 APRIL START DATE

Your Private Secretary's minute of 21 September asked for a rough estimate of the amount of tax revenue that might be brought forward from 1988-89 to 1987-88 as a result of forestalling under option (b).

2. The answer is none. Though we would expect additional CGT liabilities to accrue in 1987-88 as a result of forestalling under option (b), no revenue would be collected until December 1988, and much of it would come later. The Revenue estimate that roughly 40 per cent might be collected in 1988-89, 40 per cent in 1989-90 and most of the remainder in 1990-91.



CAROLYN SINCLAIR

TASK FORCE SECRET

COPY NO 1 OF 20 COPIES

FROM: M C SCHOLAR
DATE: 2 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Cassell
Mr Monck
Miss Peirson
Mr Riley
Miss Sinclair
Mr G P Smith
Mr Macpherson
Mr Cropper
Mr Tyrie
Mr Isaac - IR
Mr Mace - IR
PS/IR

TAX REFORM AND NICs AT THE LOWER END

At your meeting on July 28, and by Mr Allan's minute of 3 September, you asked me to work up some further NIC options. I attach a paper by Mr Macpherson which analyses six new options on the lines you have indicated.

Switching the burden from employees to employers

2. On 28 July you said that of the five options in our 21 July paper your preference was for options 3 and 5, but that you wished to explore the possibilities for some switching of the NICs burden from employee to employer, given that we were anyway contemplating further breaking the symmetry between employers' and employees' contributions. Two arguments are available in defence of a move in this direction: first, that in principle it does not matter how the NIC burden is distributed between employees and employers; second, that it is at the present time particularly beneficial, for improving incentives, to lower employees' contributions. There is some tension

between these arguments. But - provided we take care that the combined employers' and employees' NIC burden is at no point in the earnings distribution more onerous than at present - I think we could make use of both arguments, drawing on the short-run/long-run distinction suggested in paragraphs 5-7 of Mr Macpherson's paper. But raising employers' contributions so soon after 1985 would undoubtedly be very controversial, and we would need to develop a powerful defence.

The Options

3. If you accept the constraint that the combined NIC burden should not increase, and if we are to avoid the administrative problems of employee rates below 2 per cent (which would mean negative NICs for the contracted-out - see paragraph 11 of the paper), we may rule out Options 3A and 5B. Option 5A as it stands would also be ruled out on this basis, although it would be possible to modify it to ensure that there was no extra combined NIC burden at any point in the earnings distribution.

4. I see no very clear balance of advantage as between Option 3B and 5A thus modified. It is an advantage of Option 5A that the very high marginal rates at several points in the distribution - the steps - are done away with. But the price of this is that there are somewhat higher marginal rates across the distribution. Options 6 and 6A cleanly remove an attractively large number of people from the NIC net and the unemployment trap, at (relatively) modest cost. But Option 6 causes an uncomfortably large number of people to lose their rights to all the contributory benefits, and Option 6A creates acute new difficulties for the contributory principle. The balance of advantage may therefore be for Option 3B, perhaps modified to make it less expensive, as suggested in paragraph 13 of the paper -unless you think that the advantages of Option 5A, whose novelty might distract some attention from the added burden it would place on employers, give it the edge.

5. Some will say that the benefits of any of these Options are too small, and the effects on the unemployment trap too insignificant to make these changes worth pursuing. This is a dangerous argument:

an attack on work disincentives by reductions in marginal rates tends to be expensive and diffuse in effect, and any single move relatively small in impact . But that does not mean that a programme of reductions in marginal rates is not worthwile, and we have attempted to target these reductions on those people whose disincentives to work are very strong. Furthermore, and on a different tack, any of these options would show up in some useful reductions, compared with 1978-79, in the combined NICs and tax burden for those below average earnings in the sensitive tables on this we publish from time to time (see Table 5).

Administrative consequences

6. You asked at your 28 July meeting if we could check whether any of the options were likely to place an unreasonable burden on small firms. We think this unlikely. But we cannot be certain of this without checking the point with DHSS. This raises the general question of the timing of consultations with the DHSS about the NICs reforms to make sure there are no operational problems (and to resolve any that do emerge) and to set in hand preparation of a Social Security Bill to enable abolition of the UEL and the Treasury Supplement. Such a Bill would have to be passed by the Summer Recess if the reforms were to be implemented next Autumn, and there is of course no slot for it in the current timetable.

7. For these reasons, we think it would be prudent to consult DHSS as soon as you are reasonably sure of the changes you want to make. ST think that such consultation should desirably take place no later than December, leaving 3 months or so before the Budget, since a shorter consultation period could leave too little time for unforeseen problems to be resolved satisfactorily.

Contributory principle

8. You will wish to assess the strength of the case we will be able to put forward, that the various NICs options currently under consideration can be squared with the contributory principle. We (ST) are accordingly preparing a paper on this, anticipating the

arguments which will be put forward and suggesting how they can best be met. We will let you have this as soon as possible.

9. You will, no doubt, wish to discuss with us.

MCS

M C SCHOLAR

OPTIONS AT THE LOWER END

This paper puts forward further options for changing NICs at the lower end, exploring Options 3 and 5 of Mr Scholar's submission of 21 July further and identifying possible options for employer NICs. It also examines the option set out in Mr Allan's minute of 3 September, i.e. increasing the lower earnings limit (LEL) so as to remove the low paid from NICs altogether. To put the options into context, the state of the NIF is first reviewed and the economics of shifting the NIC burden from employees to employers examined.

NIF finances

2. Since Mr McIntyre's submission of 8 September which set out ST's latest view of the state of the NIF, a new set of economic assumptions has been sanctioned and outturn data has been revised with the result that the surplus in 1988-89 is likely to be £600 million higher than previously thought. The latest NIF projection is shown in Table 1. It assumes an Autumn Review in line with the Chancellor's preferences (Mrs Ryding's minute of 9 September), i.e. minimum necessary changes in the contribution bands and limits, a 2 per cent p.a. reduction in the Treasury Supplement, a 0.1 per cent rise in both the employees' and employers' NHS allocation and an EPA holiday.

Table 1: Projection of NIF finances at Autumn Review (£ billion)

	1988-89	1989-90
Treasury Supplement	1.6	1.0
- %	5	3
Surplus	1.9	1.5
Balance	8.7	10.3
- as % of outgo	32.6	36.5

However, the reform package currently includes abolition of the Upper Earnings and Upper Profits limits on Class 1 (employee) and Class 4 contributions from October 1988. Assuming a 9 per cent NIC rate on earnings above the UEL/UPL, this is likely to increase contribution income by £600 million in 1988-89 and £1.9 billion in 1989-90.* Not all this increase in revenue will feed through to the NIF; some will go into the consolidated fund via the NHS allocation. It is also possible that the Treasury Supplement will be abolished from October 1988, as a means of keeping the NIF surplus within manageable bounds. The effect of both these policy changes on the NIF is shown in Table 2. It is this projection which is the base run for the costings in this paper.

not a [illegible]

Table 2: Projection of NIF finances - UEL/UPL and Treasury Supplement abolished in October 1988; £ billion

	1988-89	1989-90
Treasury Supplement	0.8	0
- %	5% to 1 Oct; 0 thereafter	0
Surplus	1.55	2.2
Balance	8.3	10.5
- as % of outgo	31.1	37.0

4. Given the current intention that the measures at the lower end should have a full year cost in the region of £3/4 billion, a large surplus would remain. This presents a choice for Ministers. Either they could take further action to reduce the size of the surplus and the balance in 1989-90 and later years, which could take the form of removing the legal limit to the rise

*These costings are based on Inland Revenue estimates. The GAD model suggests a far smaller effect with contribution income rising by £0.4 billion in 1988-89 and £1.4 billion in 1989-90.

the NHS allocation (0.1 per cent p.a.) or reducing NIC rates. Or they could maintain a high NIF surplus on the grounds that this was prudent in view of the increasing pressure on the fund from the ageing of the population. However, the decision can be delayed to next year's Autumn Review if Ministers agree that the prospective size of the surplus next year does not require any further action.

The economics of shifting the NIC burden from employees to employers

5. In a well functioning labour market one would expect a switch of NICs between employer and employee to have no significant economic effect in the long run. Higher employer NICs offset by lower employee NICs would eventually mean somewhat lower wages, but labour costs and disposable incomes would remain broadly unchanged. The effects on the traps and the implications for employment would be virtually nil.

6. However, in the short run wages tend to be sticky. This means that a cut in employee NICs would feed largely into take home pay while the compensating increase in employer NICs would tend to raise labour costs. This would help somewhat with the traps, but at the cost of providing firms with some disincentive to employment. Although there is some evidence that the 1985 restructuring had little effect on companies' behaviour, it is not clear what the net effect on incentives would be. Yet conventional calculations of the numbers taken out of the traps, assuming fixed wages, would show an unambiguous improvement.

7. The effects on the traps are therefore presented on two different bases: with nominal wages fixed, as in the conventional calculation; and with wages adjusted to reflect any switch between employers and employees, as might be expected in the longer term. The latter calculation focuses essentially on the overall burden of NICs rather than its distribution between employers and employees. The range established by these two estimates should give a reasonable indication of the likely effect on incentives.

Option 3 : Enlarging the reduced rate bands

8. In its original form, this involved extending the upper limit of the 5 per cent band for employees to £105 a week* and shifting the 7 per cent band from £70-£105 to £105-£155. Employer rates were left unchanged. Assuming introduction in October 1988, it would result in a £280 million reduction in contribution income in 1988-89 and £810 million in 1989-90. Outlined below are two variants. In Variant A the reduced rate system for employers is abolished, while in Variant B the employers' bands are shifted in parallel with employees', while the latter's reduced rates are cut further.

Variant 3A

9. Variant A gives the following structure :

	Employees % rate		Employers % rate	
£ per week	now*	proposed	now*	proposed
41-70	5	5	5	10.45
70-105	7	5	7	10.45
105-155	9	7	9	10.45
155-305	9	9	10.45	10.45

Approximate cost (in terms of contribution income)

1988-89 £110 million saving.(This, as do all the costings assumes implementation in October).

1989-90 £300 million saving.

The advantage of this variant is that much of the benefits of the reduction in employee NICs still accrue, at least in the short term, but at a saving to the exchequer. 24000 tax units are taken out of the unemployment trap and the average replacement

*The reduced rate bands in 1988-89 on unchanged policies are assumed to run from £41 to £70, £70 to £105 and £105 to £155.

io is reduced by 0.7% in the short term, these numbers falling to zero and -0.2% in the long run (see Table 3 attached). Contributions would be reduced by between £1.40 and £3.10 a week for 6.1 million low paid workers earning between £70 and £155 a week. The removal of the reduced rate bands for employers simplifies the NIC system.

10. The disadvantage is that it would be represented to be an admission that the 1985 NIC restructuring had been a failure. Firms which had changed their employment practices would have justifiable cause for complaint, while it could be argued that given the lags involved two and a half years was too short as an experiment. The combined NIC burden in the £41 to £70 band would rise by over half, while in the £70 to £105 band it would rise by over 10 per cent. Although this effect would be partially offset by a 3 per cent reduction in the £105 to £155 band, the effect on employment would almost certainly be adverse. In terms of the NIF, this variant would be hard to explain, since contribution income would be being increased at both the lower and upper end at a time when the Fund is in an already embarrassingly healthy state (for effect on NIF see Table 4 attached).

11. Further lowering the employee reduced rates would lessen these problems. For example, a 3 per cent band between £41 and £105 and a 5 per cent band between £105 and £155, costing £200 million in 1988-89 and £620 million in 1989-90, would give significant increases in take home pay, ranging from 82p a week at £41 to £6.20 at £155. However, a negative rate would be necessary in the the £41 to £75 band, if a 10.45 per cent employer rate were not to increase the aggregate burden. Having very low employee rates, i.e. below 2 per cent, also causes problems with the contracted out rebate, creating the possibility of contracted out employees paying negative NICs on marginal earnings. Low rates also exacerbate the step problem; the 5 per cent band above would result in a 4 percentage point - i.e. £6.20 - step at £155 a week, a well populated point on the earnings distribution.

Variant 3B

12. Variant B gives the following structure :

£ per week	Employees % rate now	Employees % rate proposed	Employers % rate now	Employers % rate proposed
41-70	5	4	5	6
70-105	7	4	7	6
105-155	9	6.5	9	9
155-305	9	9	10.45	10.45

Approximate cost 1988-89 £410 million.
1989-90 £1160 million.

This variant has a greater effect on the tax burden for those on half average earnings than any other option in this paper (see Table 5 attached). It also has a greater effect on the unemployment trap than the original Option 3. The number of tax units removed rises to 36,000 and the average replacement ratio falls by 1.1 per cent in the short run. Gains in terms of lower contributions would range from 41p to £3.87 for over 7½ million workers earning between £41 and £155 a week. This option gives some consistency to the reduced rate structure: not only do employees and employers have the same bands but the employer rates are higher throughout. This is achieved without increasing the aggregate NIC rate in any band. The cost remains lower than the increase in contributions generated by UEL abolition, and so simultaneous Treasury Supplement abolition could still easily be afforded, the surplus being around £1 billion both in 1988-89 and 1989-90 (see Table 4).

13. The main disadvantage of this variant is its cost, which offsets much of the revenue generated by UEL abolition, although the cost could be reduced considerably by setting the employers' rates above £70 a week somewhat higher than in Variant B. Another disadvantage relates to the employee step at £155 a week; at £3.87 it is 78p higher than the original Option 3.

Option 5 : a Withdrawable Allowance

14. Uprating the original Option 5 to 1988-89 NIC rates gives an allowance of £41 a week to employees earning between £41 and £195 a week. The marginal NIC rate remains the same at 11.4 per cent, while for those earning over £195 a week the present system still applies. This option is now estimated to cost £210 million in 1988-89 and £620 million in 1989-90 (the downward revision in the full year cost of around £200 million reflecting different lagging factors). The attraction of Option 5 was that it abolished the steps, without generating losers, and lowered the tax burden for those on 75 per cent of average earnings as well as those on 50 per cent. It is a cost effective way of taking people out of the trap, 25,000 sprung at a cost per head of £24,800. However, the 'quality' of those affected, including more part-timers and married women, remains lower than in Option 3.

15. Two variants, designed to address the problem of what to do with employer NICs, are outlined below. The first involves a reduced rate system for employers to run parallel to the employee system. The second abolishes the reduced rate system for employers as in Variant 3a above and uses the increase in contributions to finance a more ambitious reduced rate system.

Variant 5a

16. Variant 5a gives the following structure: an allowance of **£41** a week for those earning between **£41 and £195** a week for both employees and employers. Employees and employers having marginal rates of **11.4 per cent** and **13.2 per cent** respectively. Above £195 a week, the present system would apply. (For illustration see Annex).

Approximate cost	1988-89	£315 million*
	1989-90	£900 million (includes £20 million for withdrawable allowance for optants earning between £41 and £70 a week as in original Option 5).

The advantage of this variant is that employers receive similar treatment to employees, at an additional long run cost of only £300 million p.a. The 13.2 marginal rate ensures that, like employees, employers will face no step at £195 although, unlike employees, there will be areas on the distribution where they will have to pay more NICs: £66 to £70, £88 to £105 and £130 to £155 a week.

17. The incentive effects are less than clear but appear to be in the right direction. Slightly higher marginal rates across the whole distribution between £41 and £195 a week are being substituted for very high marginal rates at four points on the distribution (£41, £70, £105 and £155). This should have a disincentive effect on the working of longer hours at everywhere between £41 and £195 except the steps. Average rates would generally be lower, which would reinforce the disincentive effect on employees to work longer hours but should encourage people to join the labour force and employers to recruit. As a result, the

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*Costings relate to contribution income, not to NIF income. Options involving an allowance or raising LEL will affect NHS allocation, and so effect on NIF will be smaller than overall cost (see Table 4).

ect on the unemployment trap is greater in the long run than in the short run (see Table 3) in contrast to Options 3a and 3b.

18. The disadvantage of the option is that there will be areas on the earning distribution, albeit very small ones, where the combined NIC burden will be higher than under the current system. These are between £69 and £70, £95 and £105 and £153 to £155 a week. The problem identified before with Option 5 persist, in particular the overall complexity and the weakening of the contributory principle.

Variant 5b

19. Variant 5b gives the following structure. An allowance of **£41** a week to all employees, with marginal rate of **10** per cent between **£41 and £305** a week (i.e the LEL and UEL). Employers' reduced rates abolished as in Variant 3a.

Approximate cost	1988-89	£300 million
	1989-90	£860 million(includes £50 million for allowance for optants with 4.4 per cent marginal NIC rate)

This variant would give increases in take home pay to all employees earning less than £316.66 a week, assuming UEL abolition and a 9 per cent marginal rate above £305 a week. The greatest gains would be at the lower end of the current bands, for example a gain of £2.05 at £41 a week, £2 at £70 a week and £3.05 a week at £105 a week. 60000 tax units would be taken out of the unemployment trap in the short run,

, although this falls to 20000 in the long run. It is the only option which reduces the tax burden at average earnings, while it also results in a reduction of around 1 per cent in the average tax burden at 50 per cent and 75 per cent of average earnings (see Table 5).

20. The main disadvantage is the return to the pre-1985 employers' NIC system with all the problems identified in Variant 3a.

However, this is necessary to finance the package, contributing a £1.1 billion offset against the £1.9 billion cost of the allowance in 1989-90. Another disadvantage relates to the 10 per cent marginal rate which will result in a small kink in marginal tax rates at £305 a week. However, at 1 per cent, it would be substantially less than the current kink of 9 per cent at the UEL, and anyway the solution, a marginal NIC rate of 9 per cent throughout, would add £1.7 billion to the cost of the option in 1989-90.

Option 6: Raising the LEL

21. Option 6 has been designed to have a broadly similar cost to the other options. The LEL is raised by £74 to £115 a week, giving the following structure:

£ per week	Employees % rate now	Employees % rate proposed	Employers % rate now	Employers % rate proposed
41-70	5	0	5	0
70-105	7	0	7	0
105-115	9	0	9	0
115-155	9	9	9	9
155-305	9	9	10.45	10.45

Approximate cost		
	1988-89	£190 million
	1989-90	£530 million

The attraction of this option is that it raises the LEL from a likely 16.8 per cent of average earnings to 47.1 per cent (see table attached) and takes over 4 million Class 1 contributors and 3/4 million optants out of the NIC system. The increase in take home pay for those earning between £41 and £115 a week would range from £1.58 for an optant earning £41 a week to £10.35 for a Class 1 contributor earning £115 a week. Employers would gain similar amounts to employees, and considerable labour market effects can be expected. The long run effect on the unemployment trap is greater than in any other option - 60000 being taken out

the average replacement rate being reduced by 2.8 per cent - making this option highly cost effective in trap terms.

22. The disadvantage is the reason for the option's lack of cost. Over 7½ million contracted out employees (including optants) earning over £115 a week would be losing £1.48 a week in the form of increased contributions, while employers would be losing £2.81 a week per contracted out employee. This is because the LEL determines the point at which the contracted out rate of NIC becomes payable; the higher the LEL the less earnings will be eligible for the 5.8 per cent rebate. Another problem would be the creation of a £10.35 step at £115 a week, a quite densely populated area on the earnings distribution; however, steps at £41, £70 and £105 a week would disappear.

23. More important would be the implications for the benefit system. As well as ceasing to pay NICs, 4 3/4 million people would be losing eligibility to contributory benefits. This would of course yield substantial public expenditure savings in the long run, but would be hard to defend. Those on low earnings during their working life are more likely to be dependent on the basic Retirement Pension for their income in retirement. They are also the people for whom the SERPs system was designed; 3.8 million of the 4.75 million taken out of NICs are contracted into SERPs. Theoretically SERPs could continue on earnings between £115 and £305 a week but the rebate would have to be recalculated and the start to personal pensions would be seriously undermined.

24. An alternative option (6a) would be to raise the LEL for NIC payment purposes say to £70 a week but to maintain the £41 LEL for benefit entitlement and rebate purposes . Those earning under the NIC LEL but over the benefit LEL would be given credits for benefit entitlement purposes, while the rebate for those low paid who are contracted out would cease to be a rebate and would become a subsidy. This would have a first year cost of around £550 million and would take around 2.1 million employees (including 0.4 million optants) out of NICs. The disadvantages of Option 6 are addressed; no benefit eligibility would be lost while the higher paid would not lose their contracted out rebate and

[illegible]s any take home pay. The disadvantage is that there would be no administrative savings for employers or DHSS, since notional contributions would still have to be scored. Moreover the contributory principle would be undermined more than in any of the other options. The low paid contracted out would be receiving a NIC subsidy of 2 per cent on earnings over £41 a week but would still be acquiring entitlement to benefits.

Health warning

25. It should be stressed that the above costings are based on the Treasury NIF model and given the radical nature of some of the options are therefore even more approximate than usual. To gain a more accurate estimate of any option, it would be necessary to run it through the GAD model.

ETS division

2 October 1987

TASK FORCE SECRET

Table 3

EFFECTS ON WORKING TAX-UNITS IN THE UNEMPLOYMENT TRAP[1]

Working heads of tax-units with replacement rates of 80 per cent or more

	Without wage adjustment		With wage adjustment	
	Number ('000s)	**Average replacement rate (%)**	**Number ('000s)**	**Average replacement rate (%)**
Present tax etc rates and post-Fowler benefits	430	89.7	430	89.7
Change from:				
Option 3	-25	-0.7	-25	-0.7
Option 3A	-25	-0.7	-	+0.2
Option 3B	-36	-1.1	-35	-1.0
Option 5	-25	-1.0	-25	-1.0
Option 5A	-25	-1.0	-35	-1.2
Option 5B	-60	-1.5	-20	-0.4
Option 6	-55	-1.8	-60	-2.8

1 Estimates based on 1985 FES projected forward to 1987-88 price and income levels.

TASK FORCE SECRET

Table 4

Effect of Options on National Insurance Fund; £ billion

1988-89

Option:	**Base***	**3a**	**3b**	**5a**	**5b**	**6**
Change in contributions	n.a.	+0.11	-0.4	-0.3	-0.31	-0.19
Change in NIF contributions	n.a.	+0.11	-0.4	-0.15	-0.15	-0.07
Surplus	1.55	1.7	1.1	1.4	1.4	1.5
Balance	8.3	8.5	7.9	8.2	8.2	8.3
- as % of outgo	31.1	31.5	29.6	30.6	30.6	30.9

1989-90

Option:	**Base***	**3a**	**3b**	**5a**	**5b**	**6**
Change in contributions	n.a.	+0.3	-1.16	-0.9	-0.86	-0.53
Change in NIF contributions	n.a.	+0.3	-1.16	-0.43	-0.46	-0.18
Surplus	2.2	2.5	1.0	1.7	1.7	2.0
Balance	10.5	10.9	8.9	9.9	9.9	10.2
- as % of outgo	37.0	38.8	31.8	35.2	35.1	36.4

* Base assumes Oct. 1988 Treasury Supplement and UEL/UPL abolition. Latter costed on Inland Revenue basis.

TASK FORCE SECRET

TABLE 5

Income tax and NIC as Percentage earnings
at multiples of adult MALE average earnings

Multiple average earnings	50%	75%	100%	150%	200%	500%
Single person						
1978-79	23.6	28.9	31.5	33.3	33.7	52.2
1987-88	24.9	28.6	30.5	31.1	32.1	45.8
1988-89:						
NIC option 3a	21.9	27.3	29.0	30.6	31.5	38.6
NIC option 3b	21.4	27.3	29.0	30.6	31.5	38.6
NIC option 5a	22.4	27.1	29.0	30.6	31.5	38.6
NIC option 5b	21.5	26.0	28.2	30.6	31.5	38.6
NIC option 6	23.9	27.3	29.0	30.6	31.5	38.6
Married couple, no children						
1978-79	16.0	23.8	27.8	30.8	31.4	50.5
1987-88	18.7	24.4	27.3	29.0	29.6	44.4
1988-89:						
NIC option 3a	16.2	23.5	26.1	28.7	30.1	37.8
NIC option 3b	15.7	23.5	26.1	28.7	30.1	37.8
NIC option 5a	16.7	23.3	26.1	28.7	30.1	37.8
NIC option 5b	15.8	22.2	25.4	28.7	30.1	37.8
NIC option 6	18.2	23.5	26.1	28.7	30.1	37.8
Married couple, 2 children under 11						
1978-79	2.5	14.6	20.9	26.2	27.9	48.8
1987-88	5.9	15.9	20.9	24.8	26.4	43.1
1988-89:						
NIC option 3a	4.2	15.5	20.1	24.7	27.0	36.6
NIC option 3b	3.7	15.5	20.1	24.7	27.0	36.6
NIC option 5a	4.7	15.3	20.1	24.7	27.0	36.6
NIC option 5b	3.8	14.2	19.4	24.7	27.0	36.6
NIC option 6	6.2	15.5	20.1	24.7	27.0	36.6

Note: All options for 1988-89 assume basic rate of 25p, higher rate 35p and 9 percent NIC above UEL.

TABLE 6: THE LOWER EARNINGS LIMIT AS A PERCENTAGE OF AVERAGE EARNINGS

	Lower Earnings Limit	Average Earnings	LEL as a percentage of average earnings
1975-76	11.00	65.5	16.79
1976-77	13.00	74.1	17.54
1977-78	15.00	80.7	18.59
1978-79	17.50	92.8	18.86
1979-80	19.50	109.3	17.84
1980-81	23.00	131.4	17.50
1981-82	27.00	145.9	18.51
1982-83	29.50	157.4	18.74
1983-84	32.50	171.0	19.01
1984-85	34.00	185.0	18.38
1985-86	35.50	198.5	17.88
1986-87	38.00	213.3	17.82
1987-88	39.00	229.3	17.01
1988-89	41.00 or 115.0	244.2	16.80 47.1

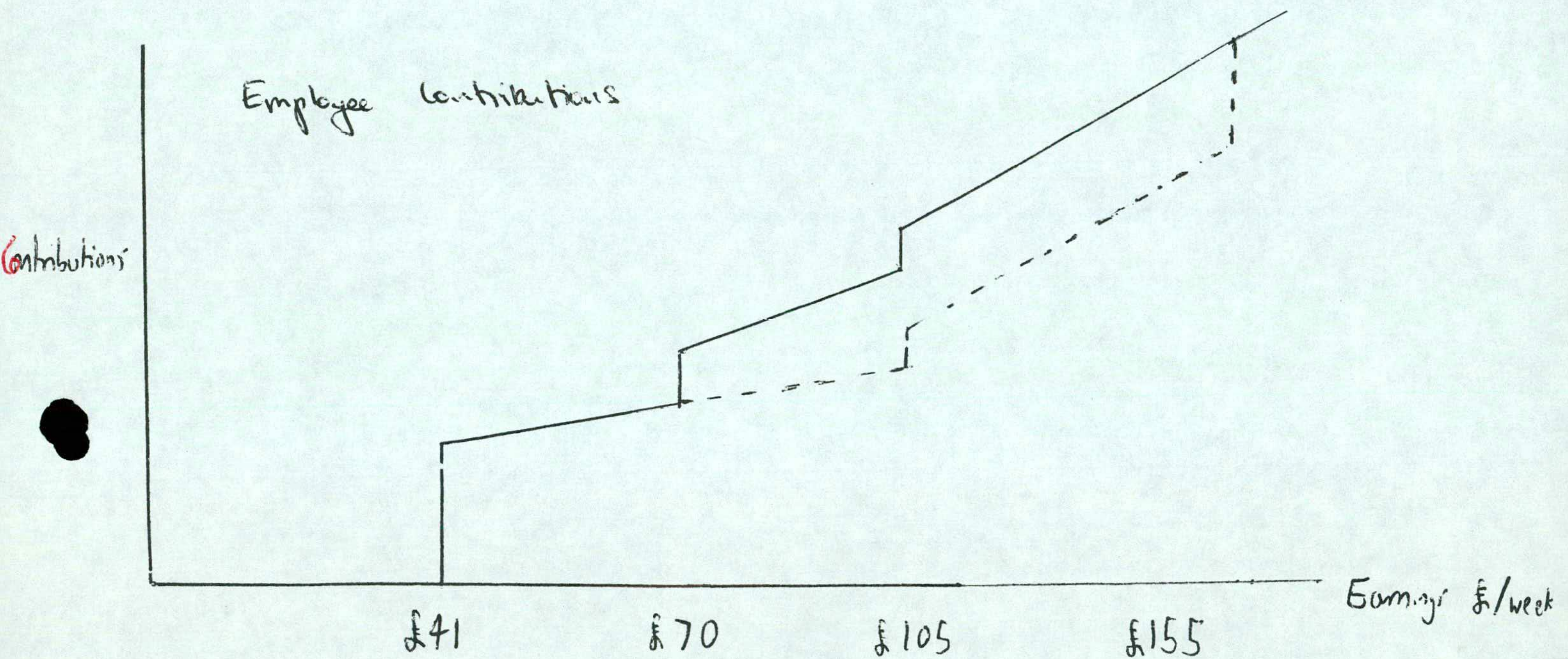
(1) of full-time men on adult rates in all occupations
(2) 1987-88 earnings figure assumes 7.5% growth on 1986-87
1988-89 earnings figure assumes 6.5% growth on 1987-88

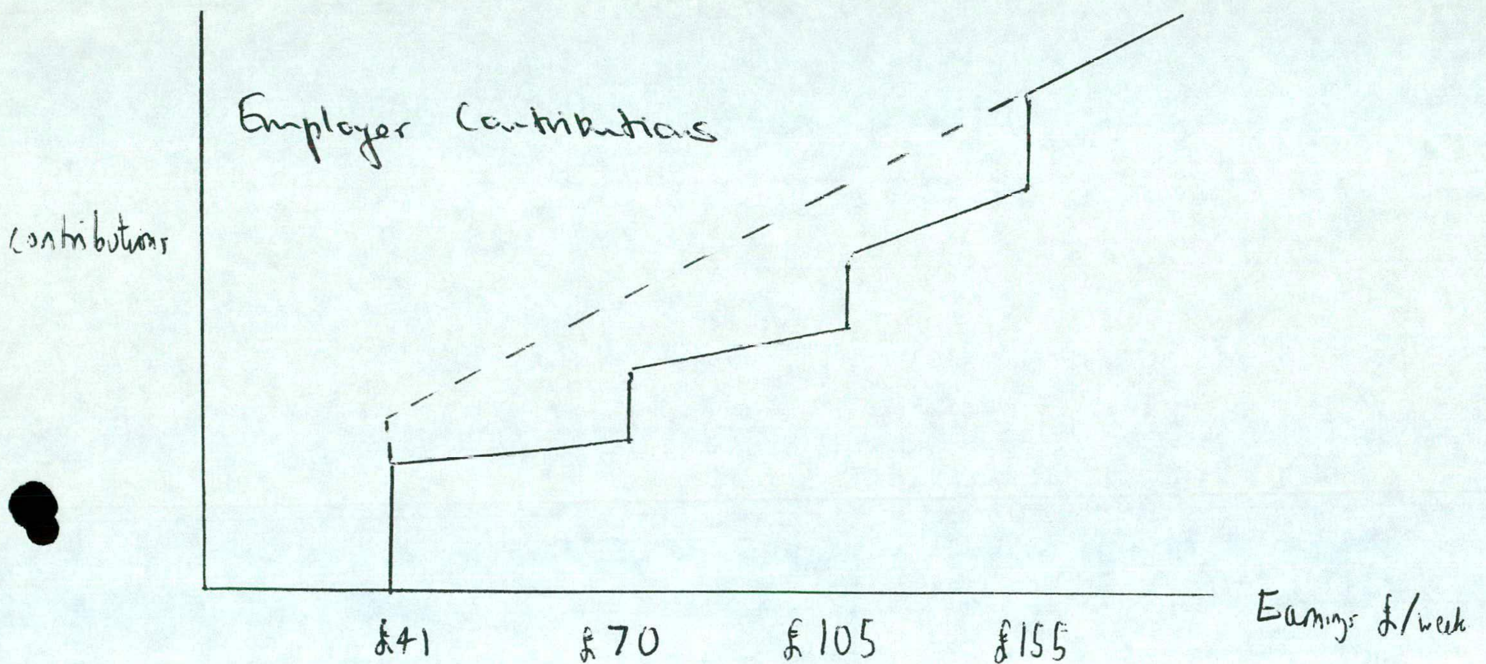
ANNEX: ILLUSTRATIONS OF OPTIONS **Task force SECRET**

Va[illegible]ant 3A

Variant A gives the following structure :

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	5	5	10.45
70-105	7	5	7	10.45
105-155	9	7	9	10.45
155-305	9	9	10.45	10.45

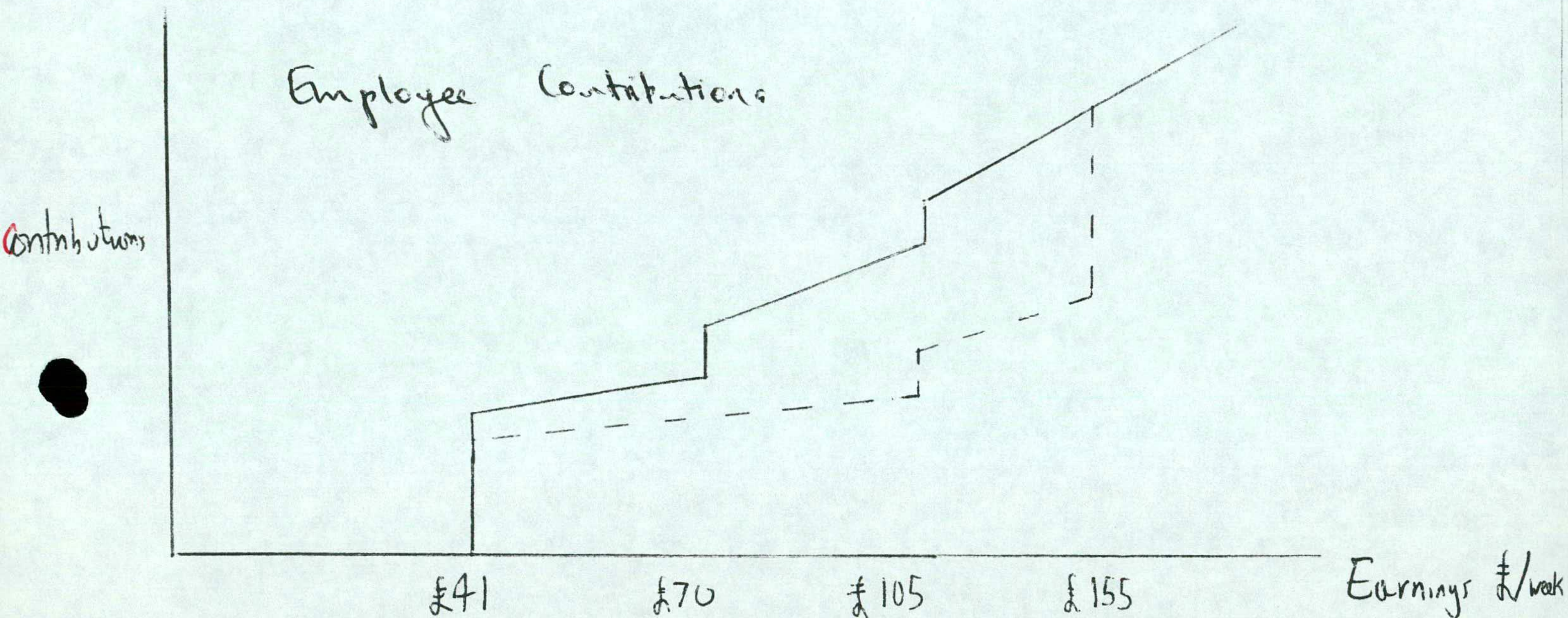


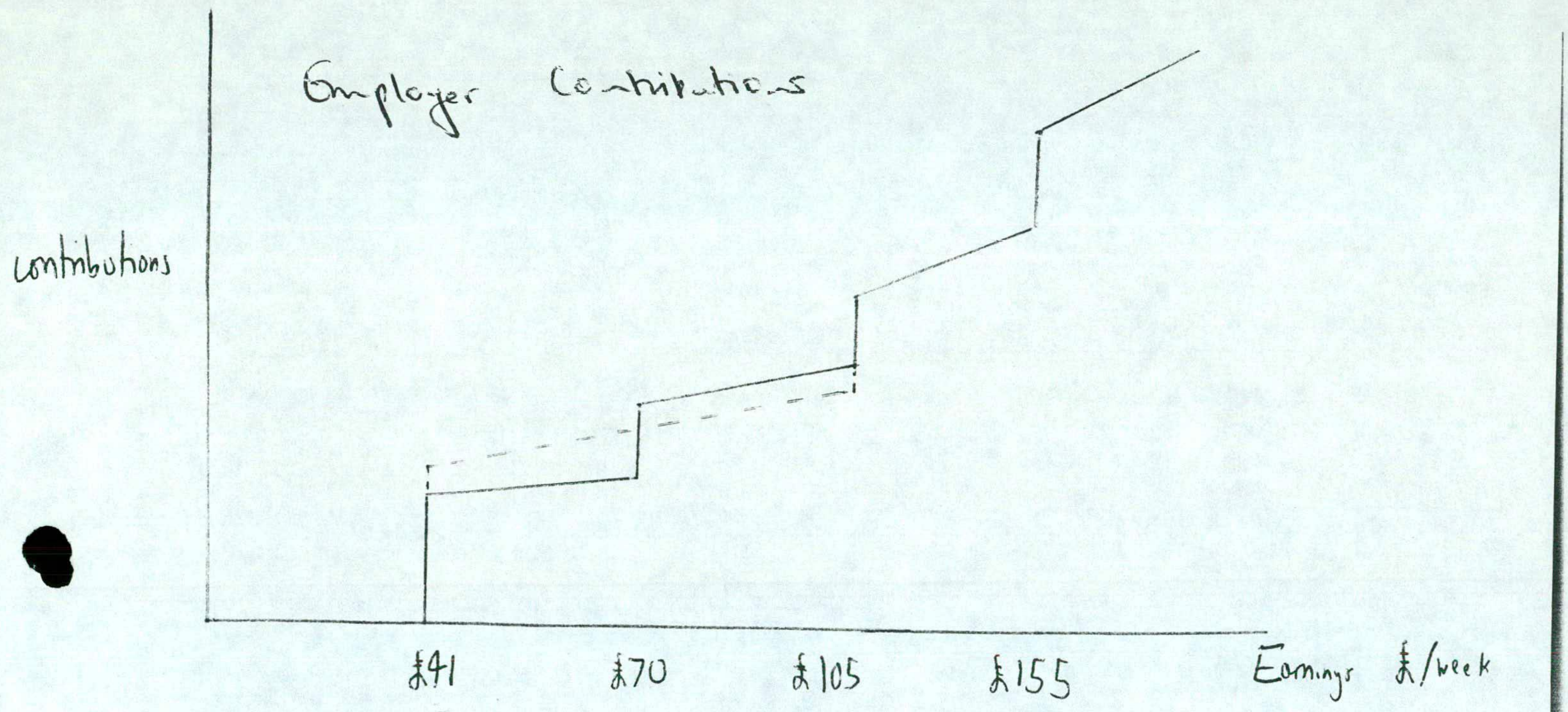


Variant 3B

Variant B gives the following structure :

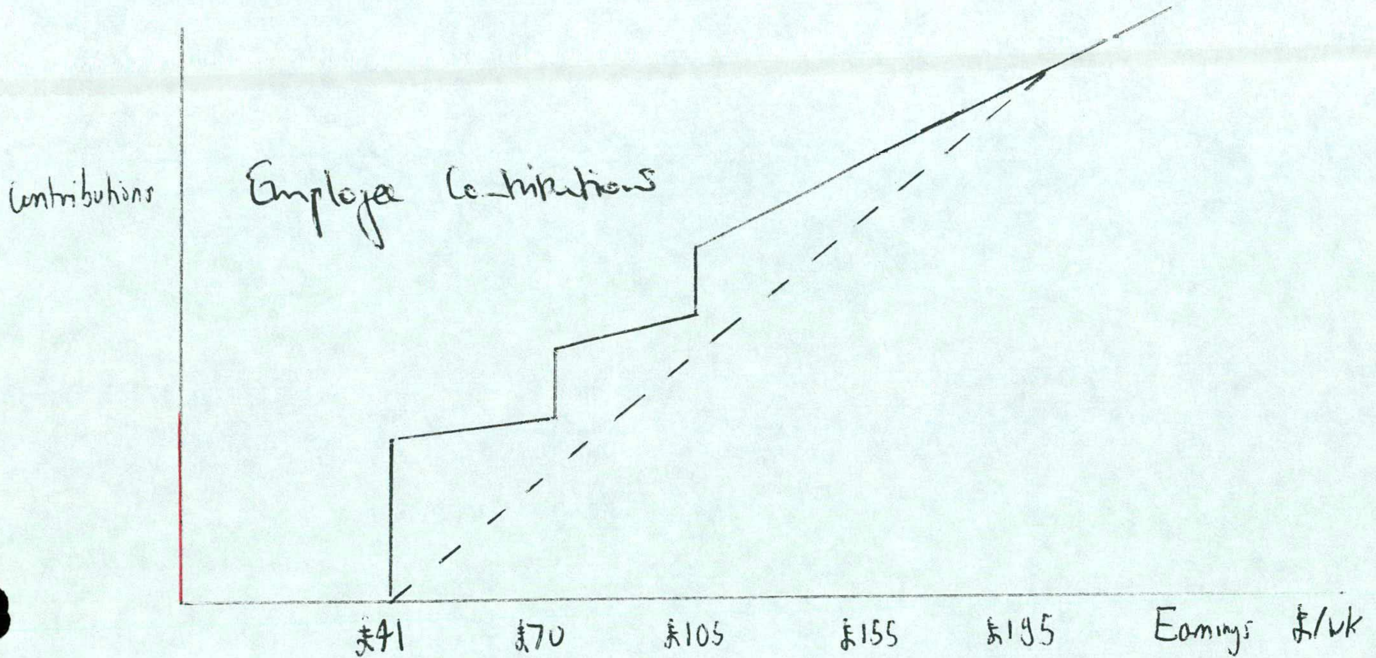
£ per week	Employees % rate now	Employees % rate proposed	Employers % rate now	Employers % rate proposed
41-70	5	4	5	6
70-105	7	4	7	6
105-155	9	6.5	9	9
155-305	9	9	10.45	10.45

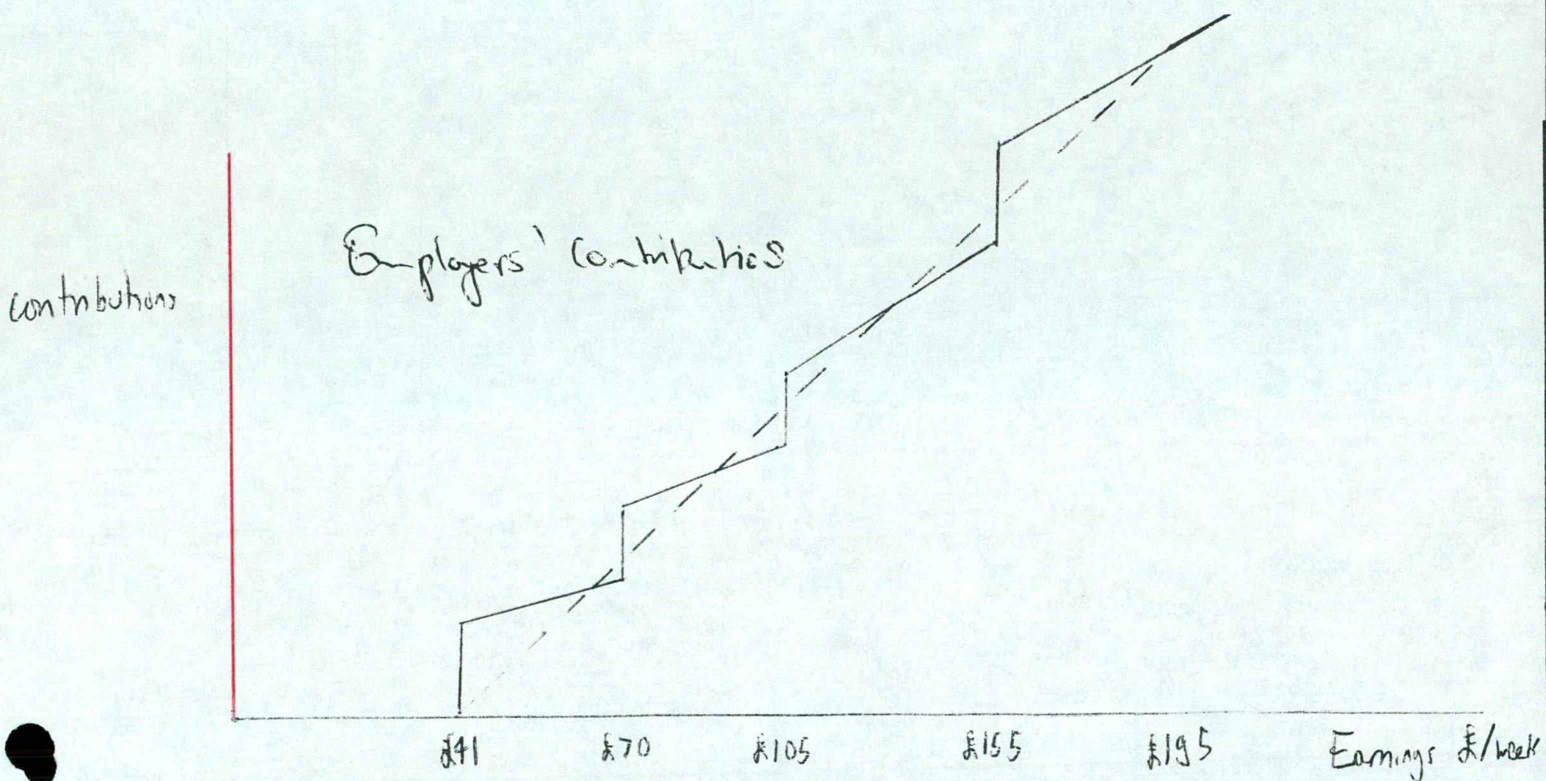




Variant 5a

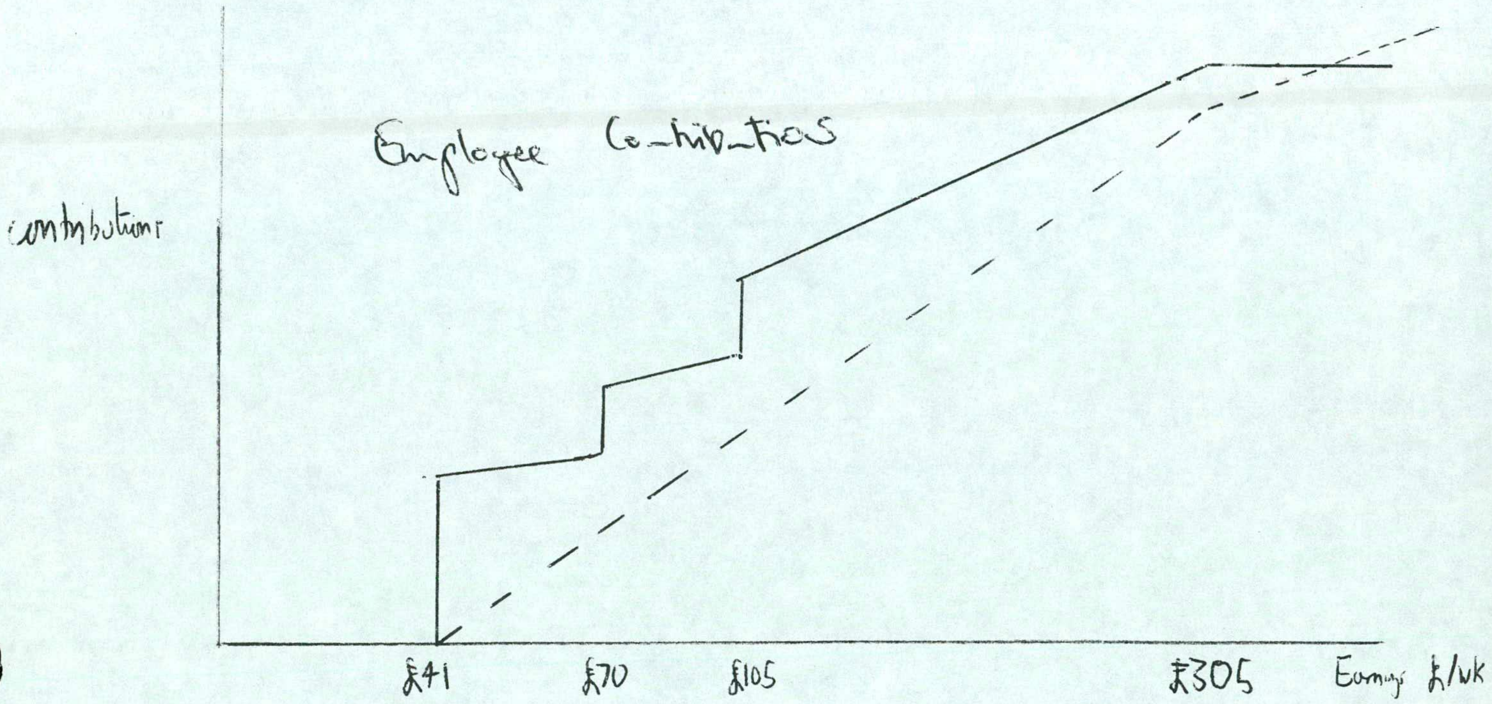
Variant 5a gives the following structure: an allowance of **£41** a week for those earning between **£41 and £195** a week for both employees and employers. Employees and employers having marginal rates of **11.4 per cent** and **13.2 per cent** respectively. Above £195 a week, the present system would apply.

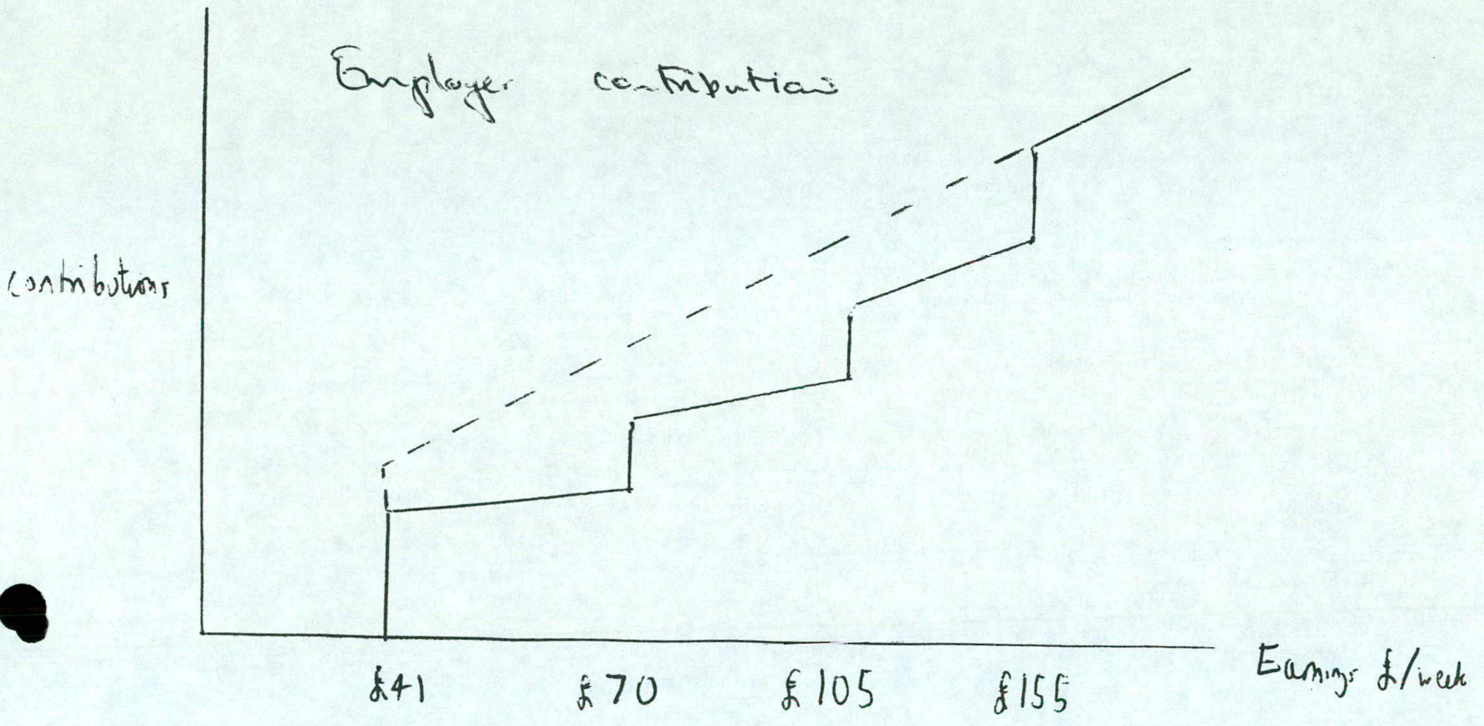




Variant 5b

Variant 5b gives the following structure. An allowance of **£41** a week to all employees, with marginal rate of **10** per cent between **£41 and £305** a week (i.e the LEL and UEL). Employers' reduced rates abolished as in Variant 3a.

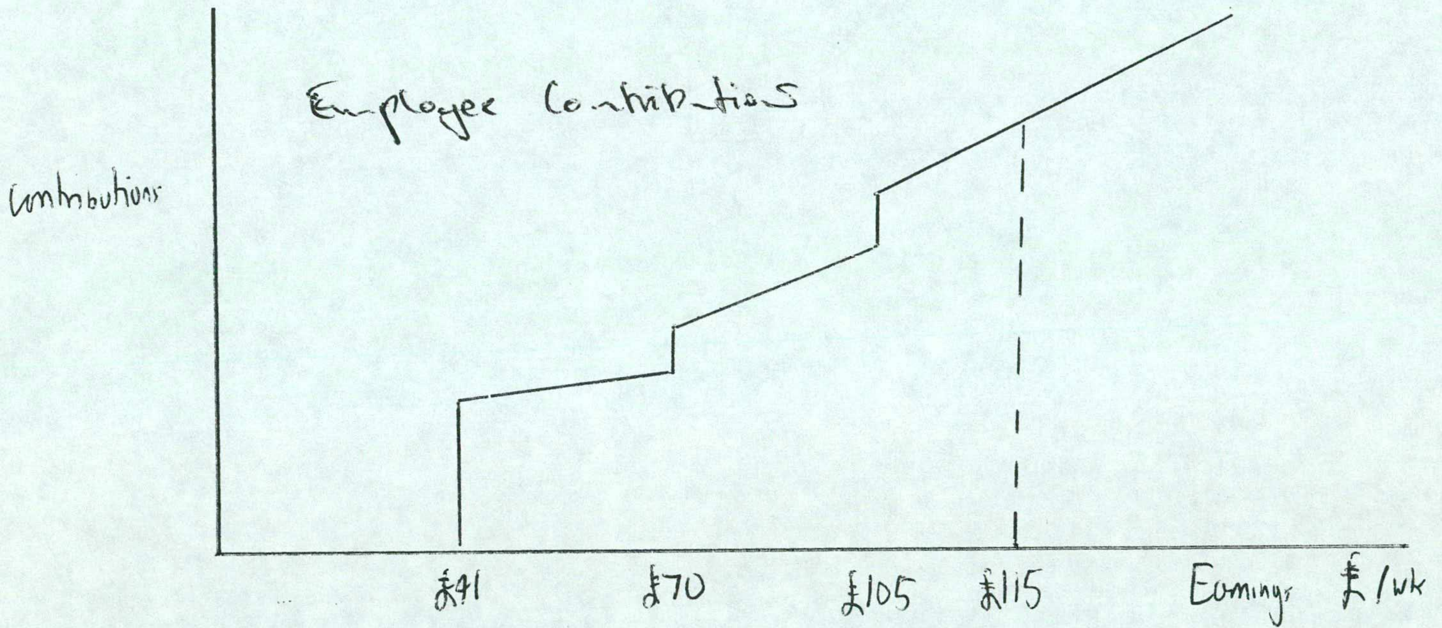


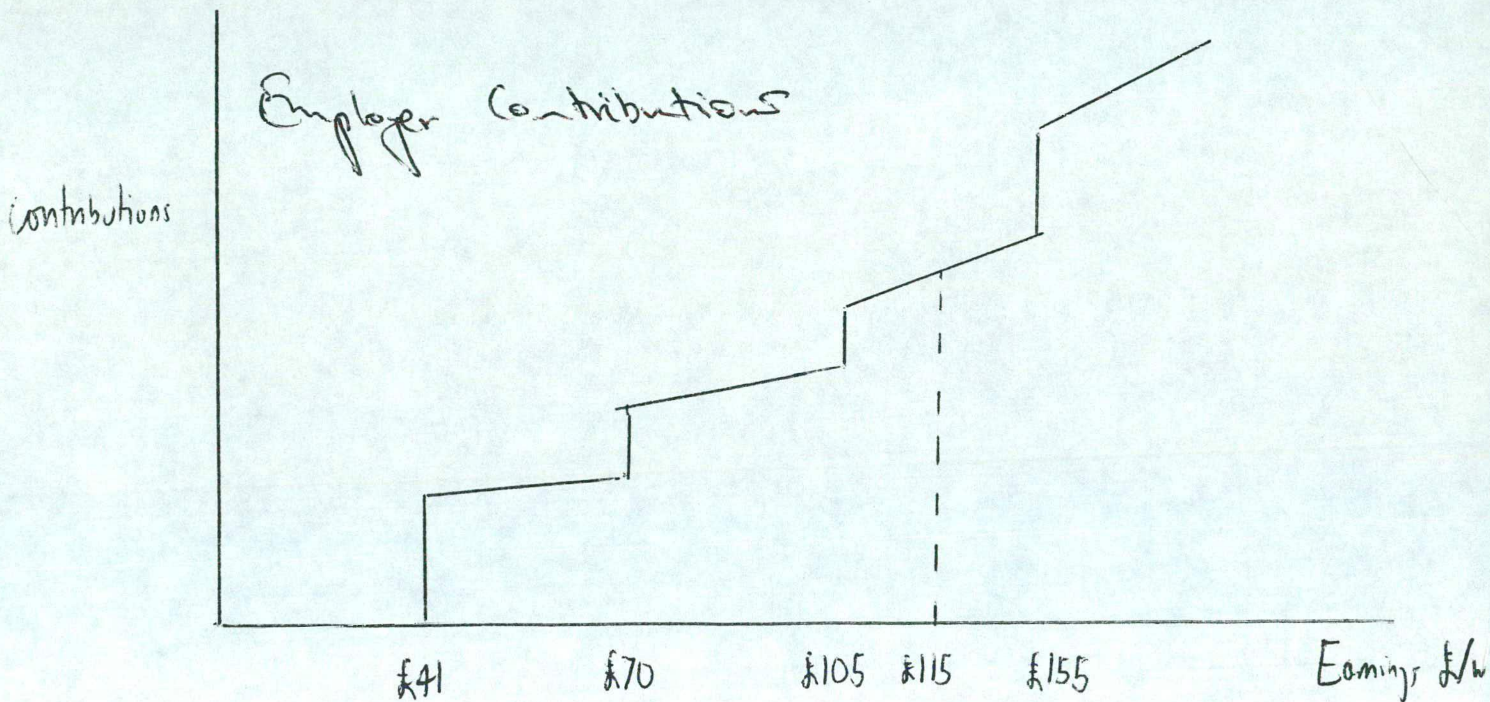


[hole-punch]tion 6: Raising the LEL

Option 6 gives the following structure:

£ per week	Employees % rate now	Employees % rate proposed	Employers % rate now	Employers % rate proposed
41-70	5	0	5	0
70-105	7	0	7	0
105-115	9	0	9	0
115-155	9	9	9	9
155-305	9	9	10.45	10.45





MR 1/13

FROM: A C S ALLAN

DATE: 2 October 1987

CHANCELLOR

TAX STRATEGY

A large wadge of tax papers in the bundle below:

(i) A new distributional analysis by Brian Mace.

(ii) A note by Michael Cayley on keeping CGT as a separate tax; and a brief response from Caroline Sinclair on the revenue effects of a 6 April start date (none).

(iii) Quite a warm note from John Isaac on Michael's proposals for switching the taxation of benefits in kind from employees to employers; and a note by the FST on taxation of subsidised loans for house purchase.

(iv) A note by Brian Mace on options for the married man's allowance under independent taxation; and a note by the FST on breadwinner wives etc who is clearly getting worried about how complicated this is all getting.

(v) A note on putting MIR onto a residence basis (again looking very complicated).

(vi) A note on the NICs proposals for the self-employed.

2. At the moment you have in the diary

(i) a meeting on 20 October on the overall costings, at which you could also take the papers being prepared on the economic effects and the economic rational.

(ii) a meeting on 26 October on benefits-in-kind (both the Scholar proposal, and what we would do if that does not run).

3. The other subjects on which it would be useful to have meetings soonish are

(i) Independent taxation (possibly taking MIR options at the same time

(ii) NICs at the bottom end (on which a submission should be coming soon)

(iii) Capital Gains Tax options

4. Now that ECOFIN has been cancelled, you have a pretty clear diary on Monday 12 October. I suggest that we slot in a bilateral with Michael Scholar to get an overall view of how it is all going; plus two of the meetings in para 3 above - probably the first two. OK?

A C S ALLAN

COPY NO 13 OF 14

FROM: J M G TAYLOR
DATE: 5 October 1987

JMGT TO PS/FST 5 OCT

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Miss Peirson
Mr Scholar
Miss Sinclair
Mr Macpherson
Mr McIntyre
Mr Cropper
Mr Tyrie
Mr Battishill - IR
Mr Isaac - IR
Mr Mace - IR

TAX REFORM: SELF EMPLOYED

The Chancellor has seen Mr McIntyre's minute of 30 September, and the enclosed paper prepared by Mr Macpherson.

2. The Chancellor has commented that he does not think that the "current proposal", as described in Mr Macpherson's paragraph 11, is acceptable. He has also said that (Mr Macpherson's paragraph 26) it is not an objective of the tax reform package to make any significant reduction in the NIF "subsidy" to the self-employed.

3. He has noted the "alternative" proposal (paragraph 15 of Mr Macpherson's paper), under which Ministers would introduce a 6.3 per cent rate above the UPL, with tax relief on half the contributions above (as well as below) the UPL. He has commented that, at first glance, this is the very least that should be done to produce a package that is tolerable to the self-employed.

J M G TAYLOR

TASK FORCE SECRET

Copy No. 16 of 17 Copies

FROM: J M G TAYLOR
DATE: 5 October 1987

JMGT TO MACE 5 OCT

MR MACE - IR

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

TAX REFORM: INCOME TAX AND NIC

The Chancellor was most grateful for your minute of 29 September.

2. He has noted the assumption (paragraph 6 (iv) of your minute) that there would be no income tax relief on the Class IV NIC charge above the UPL. He would be grateful for a note on the effect/cost of giving such relief.

3. He would also be grateful for two further tables. First, he would be grateful for a version of the table on page 5 in cash terms. Second, he would like a version of the table on page 8 in terms of percentage distribution.

J M G TAYLOR

PMP

FROM: J M G TAYLOR
DATE: 6 October 1987

MR SCHOLAR

TAX STRATEGY

You discussed with the Chancellor yesterday a number of points arising from the recent papers on tax reform.

(i) Analytical Paper on Budget Day

2. The Chancellor asked you to go ahead with planning for a separate paper to be published on Budget Day. The purpose of this was to present the tax reforms as a coherent whole. It would amplify the presentation in the Budget Speech and Chapter 4 of the FSBR.

(ii) Income Tax and NICs

3. The key papers here were Mr Mace's submission of 29 September, and the papers on mortgage interest relief. The Chancellor said the main problem with the income tax/NIC proposals was the number of basic rate losers. He was in two minds about reducing this number by raising the mortage ceiling. Was there any other way of reducing the number of losers or the extent of their losses? You said one possibility - which would solve some awkward independent taxation problems - might be to make the £30,000 ceiling available for each person (ie in effect double the ceiling for married couples in future) but remove higher rate relief and cut back on relief for improvements. The Chancellor noted the manifesto commitment that mortgage interest relief would continue" in its present form". Altering the relief on improvements might just be consistent with this; we could argue that the commitment was aimed at maintaining the support to home ownership. But abolishing relief for higher rates would go too far; and he could not contemplate increasing the ceiling for married couples on this scale for wider economic reasons.

TASK FORCE SECRET

4. The Chancellor said that putting relief on a residence basis, and going for full independent taxation would be very complicated. It was not, in any case, clear cut that the "tax penalty on marriage" had to be abolished; the cure seemed worse than the disease. The package as a whole gave considerable offsetting benefits to married people by extending existing reliefs, retaining the MMA, and introducing non-aggregation of investment income.

5. The Chancellor said it was clear that the NIC charge must be phased in. He noted that the overall costings for the package did not include an element for bringing down the small companies CT rate to 25 per cent. What would the cost of this be? He also asked for an analysis of Option A in Mr Mace's note in money-of-the-day terms.

(iii) Capital Gains Tax

6. Key paper: Mr Cayley's submission of 17 September. The Chancellor said there were two main options, apart from the status quo: a 40 per cent rate with rebasing, or a 35 per cent rate without rebasing. He was increasingly inclined to the 35 per cent option. The Revenue should be asked to provide proper costings for the option in Mr Cayley's submission, compared to the others. A summary table, showing the effects of all the options, was also needed.

(iv) Benefits-in-Kind

7. Key paper: Mr Isaac's minute and enclosure of 23 September. The Chancellor said this was a very interesting proposal indeed. His main concern was the additional burden on business, especially on small firms. It would be important to make any new procedure simple. The further work should set out more fully which benefits would be included in the new system, and which left out. The new system should also include a de minimis cut-off point. The proposal provided an opportunity for a substantial simplification of the tax system, and for a manpower saving in the Revenue. You noted that it might also provide some additional revenue, to offset

reductions elsewhere.

(v) Independent Taxation: Married Man's Allowance

8. Key papers: Mr Mace's minute and enclosures of 28 September. The Chancellor said he was prepared to rule out all the options except for (a) the "cosmetic" option; (b) the vanishing exemption based on the husband's income. Costings for (b), with a higher starting point (so as to avoid the 300,000 extra losers identified in Mr Mace's minutes) for the withdrawal of the married man's allowance and perhaps a 4 per cent additional marginal rate, should be worked up.

(vi) Subsidised Home Purchase Loans

9. Key paper: note by Financial Secretary of 28 September. The Chancellor said he entirely agreed with the Financial Secretary's views. These subsidies should be brought into tax. This should be included in the proposed benefits in kind reforms.

(vii) Self-employed and NICs

10. Key papers: Mr McIntyre's minute and enclosures of 30 September. The Chancellor said this was a very sensitive area. If the UEL were abolished, it was consistent also to abolish the UPL. But what should be done about income above the UPL? The self-employed already saw little correspondence between their contributions and benefits. A 6.3 per cent rate above the UPL might be possible (but difficult); a 9 per cent rate was not on.

11. The Chancellor asked for some supporting tables and figures to be prepared. We should need to look very carefully at the losers among the self-employed before deciding to go ahead in this area.

(viii) The Next Steps

12. It was agreed that:

(i) We should hold meetings on 12 October to consider particular problems eg the self-employed, mortgage interest relief, and covenants. You undertook to provide an annotated agenda.

(ii) A further meeting on 20 October would consider the whole package, including corporation tax (but excluding, at this stage, indirect tax options).

(iii) A further meeting on 26 October would consider benefits in kind.

J M G TAYLOR

CHANCELLOR

FROM: FINANCIAL SECRETARY
DATE: 6 October 1987

FST to CH.EX 6OCT

I do not see this 3-pt proposal being a runner! We have always seen the first 2 pts as alternative options, and I do not see how the addition of the 3rd pt – even if desirable – alters this. But I realise that the FST is v. keen on abolishing indexation, & I wd be content for a reassessment of this to be conducted in time for discussion, alongside the 25/35 option, at any forthcoming CGT mtg. NL.

cc Mr Scholar
Mr Cropper
Mr Tyrie
Mr Cayley IR

CAPITAL GAINS TAX: ANOTHER OPTION

You may be interested in another CGT reform option I have been thinking about with the help of officials.

Proposal

- Abolish indexation
- Gains taxed as the marginal slice of income on a rate scale of 25% and 35%; and
- Exemption of assets acquired post-Budget-Day, which have been held for more than 6 years.

2. Ignoring lock-in effects, officials have provided me with some broad brush estimates of the yield from this proposal accruing on 1988/89 disposals

Individuals and Trusts	£ 650m
Companies	£ 500m
	£1150m

3. Obviously, from the six year point (1994/5) a heavy cost to the Exchequer would tend to build up. This would be accompanied by a fall in Revenue manpower numbers. In the first few years there would, as a result of the abolition of indexation, be an increase in taxpayer numbers and little staff savings in the Revenue.

4. There would be a number of disadvantages with the proposed tax regime:

(i) Many people would lose from the abolition of indexation or the higher tax rate - unless they wanted to and could hold on for six years.

(ii) There would be substantial lock-in effects - although I often think that officials exaggerate the desirability of locking-in for tax purposes (particularly when investors are sitting on large gains from risky assets).

(iii) Share pools would no longer be possible.

(iv) Complex rules would be needed to reconcile the proposal with roll-over relief.

5. You may think that these are knock-down arguments against my proposal. I am not so sure. But this is another option to add to our burgeoning pile!

NORMAN LAMONT

CAPITAL GAINS TAX

RJ8.79 ~~TASK FORCE~~ SECRET COPY 14 OF 15

bf. 14/10

JMGT TO CAYLEY 7 OCT

FROM: J M G TAYLOR
DATE: 7 October 1987

MR CAYLEY - INLAND REVENUE

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

CAPITAL GAINS TAX

The Chancellor has seen and was grateful for your minute of 17 September. He would be grateful if you could prepare a full costing of the option set out in your note, and set this out on a table comparing it with the other options.

J M G TAYLOR

Bf 12/10

JMGT to Scholar 7 Oct

FROM: J M G TAYLOR
DATE: 7 October 1987

MR SCHOLAR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Monck
Miss Peirson
Mr Riley
Miss Sinclair
Mr G P Smith
Mr Macpherson
Mr Cropper
Mr Tyrie
Mr Isaac - IR
Mr Mace - IR
PS/IR

TAX REFORM AND NICs AT THE LOWER END

The Chancellor was grateful for your minute of 2 October, and for Mr Macpherson's enclosed paper. He will consider this further.

2. He would be grateful if, in the meantime, he could be provided with a costing for an option on the following lines:

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	0	5	0
70-105	7	5	7	5
105-155	9	9	9	9
155-305	9	9	10.45	10.45

(NB: Could be a higher start than £70 p.w.)

JT

J M G TAYLOR

TAX REFORM: SELF EMPLOYED

ps3/16T

TASK FORCE SECRET

JMGT TO PS/FST 7 OCT

COPY NO 14 OF 15 .

FROM: J M G TAYLOR
DATE: 7 October 1987

bf. 22/10

PS/FINANCIAL SECRETARY

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

TAX REFORM: SELF EMPLOYED

My minute of 5 October set out the Chancellor's reactions to Mr McIntyre's minute of 30 September and the enclosed paper by Mr Macpherson.

2. The Chancellor has been considering further the points in these papers. He has commented that we shall need to look very carefully at the losers among the self-employed before deciding to go ahead in this area. He would like some illustrative tables and costings to be prepared. I should be grateful if Mr McIntyre could take this forward.

J M G TAYLOR

RJ8.80 TASK FORCE SECRET COPY 16 OF 17.

JMGT TO MACE 7OCT

bf. 14/10

FROM: J M G Taylor
DATE: 7 October 1987

MR MACE - INLAND REVENUE

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

TAX REFORM: INCOME TAX AND NIC

The Chancellor has been considering further your minute of 29 September. In addition to the remits recorded in my note of 5 October, he would also be grateful for

- an analysis of option A in money-of-the-day terms;
- an estimate of the cost of bringing down the small companies CT rate to 25 per cent.

J M G TAYLOR

STUDENT LOANS + COVENANTS

TASK FORCE SECRET

Copy No 1 of 15.

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

ISAAC TO CH/EX 7 OCT

FROM: A J G ISAAC
7 October 1987

CHANCELLOR OF THE EXCHEQUER

STUDENT LOANS AND TAX RELIEF ON COVENANTED PARENTAL CONTRIBUTIONS

1. In his minute of 1 October the Financial [with Ch.] Secretary noted the Revenue's preference either for Mr Burr's Option 3 (paragraph 4(a)) or - perhaps better for our purposes - a staged approach (paragraph 6).

2. The common feature of these two options is that they do not imply a vertical redistribution of income - and above-average-income families do not lose more (from the loss of tax privileges for student covenants) than they gain (by a reduction in the parental contribution and/or increased student support).

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Cropper
Mr Tyrie

Mr Isaac
Mr Beighton
Mr Corlett
PS/IR

3. There is a particular point here, which I hesitated to raise outside a Task Force Secret circle. Under Mr Burr's other options there would be a loss for the above-average-income family which would reach its maximum (for a one-student family) as incomes approach £20,000 . This is, of course, precisely the income area likely to be affected by abolition of the UEL - where we may in any event be seeing a significant number of losers from the 1988 Budget changes.

A J G ISAAC

INDEP TAX'N 12 Oct

C, FST, PEM, TB, FC, MCS, CECS, PJC, AGT, MC

AMWB, JI, MAJ, BAM

C — Ans to 1st q'n is "yes".
Para 7(i).
Only thing in debate is 1st ½ of 2nd q'n. Thought JI inclined to cosmetic Opt A. ~~Quite~~ So was C. Quite straightfwd.
Cd be aborted at a late stage.

BAM — Some op'l complications. Makes BW wives harder to handle. Q'n, is it so robust as MMA as now. Wd have to legislate specif, wch wd bring into open fact that there are rules alloc'g allce automatically to H.

C — On balance prefer it.

FST — Me too

CECS — Marg. improvement. At least gets rid of name of MMA.

C — Agrees. Will be evidence of sensitivity.

MCS — Wd be lots of amdts.

C — Don't mind debate & won't give way.

Para 7(ii) <u>Vanishing exemptions</u>

C — Aim, on BAM of 9 Oct, is ~~to~~ not thinking of 40 ~~to~~ but 35. ~~So~~ Don't want any number above 50.
Can get <u>losers</u> to v. few. Cd even go higher than highest point in table. And who are losers? Surely they wd gain even more from disagg'n.
Got to look at this as a single package which for op reasons has to be spread. So need to look at losers in overall context.
Cd ∴ be constructed with no losers. Some gain less – but that's the point.
Does look odd to remove a kink & add a hump, though fewer humpers than kinkers.
Sensitive that combined effect will produce enormous loss for MCs in partic at top of Y range. This was only thing cd
→ think of. But it wd have that effect. Want to see worked examples of indiv couples.

FST — Objections in logic. Why on H's income – sits oddly on basis of treating sexes more equally.

C — But Indep Tax'n means can't ~~keep~~ work on agg. income

2

Been forced to retain MMA anomaly. Now seeking to reduce it.

JI. Is it proposition that MCA is withdrawn from whoever has it?

C Yes. Detach difference between MMA & AS, & call it MCA. Whoever has it, it fades away at high incomes.

BAM Does leave situ with 2 relatively high earners with £30000 between them, MC2E do better than MC1E.

C Yes. But exercised by excess bens at the top, & cd only think of this. Want to see examples. Cd look at it another way: MMA is anomaly; so more we can get rid of it, the better.

FST MST at the top?

C Yes, but beauty is, MST means high SS bens, with PX problems & targetting. Not a problem at the top.

BAM Cd get add'l losers if H's income is all earnings, ∵ of NIC charge.

Losers from basic package can go all the way up.

BAM Where shd run out start?

C Try some dif. options. Quite high. (prob. consid above HR threshold) Losers concerned about are those with normal reliefs, not shelterers.

FST Still think sits uneasily ≥ that works on H's income alone.

PEM But N.B. got sep. tax system for higher earners.

C But have that for elderly, age allce.

Basis of answer is to argue that it's a consequence of keeping MMA/MCA.

7 (iii) BWLWs

C Agreed with FST that shd transfer MMA.

FST Only problem is complexity.

JI But is in present system, & more absurd.

MCS What's complicated is transit. protection.

PEM V. odd: MST at the top; Ind. Tax'n in middle; TAs at the bottom! But decision right.

JI Got to do something for BWLW.

C Yes. Got to transfer MMA. Got to have transit protection. Package will be v. popular with articulate women.

7 (iv) Elderly

FST Follows from (iii). Answer definitely "yes".
C 2nd ½ is not complex at all.
JI Concept is simple, though some complic'ns in practice.
AB Only ∵ ~~cor~~ people's circumstances are simple.
MCS Can simplify a lot in the pres'n.

7 (v) CGT

FST Answer is "yes" – one exemption between them. Problem of cohab. couples with 2 residences, but can't do anything about it.
C So still a penalty on marriage of a sort.
FST But v. few people concerned, & have to get to point of sale.
C But v easy to ~~cs~~ claim. All cohabiting couples can do it.
This is something we're not touching & some will say we should.
PEM Prob right. But may attract disproportionate attention.
~~TB~~ C Only ~~problem~~ alternative is to give MMA 2. Leave untouched for now.

7 (vi) MIR ceiling

C Further q'n is shd MIR apply no longer for improvements – looks ~~strong~~ only practical way for whittling down MIR. Leicester Mercury article, & other adverts encouraging equity withdrawal. Suspect improvements relief is vehicle for abuse.
MAJ Yes – up to 20% of amount of relief on improvements may be an abuse.
~~C~~FC ~~R~~ Saw it as a strong runner.
MAJ Yes. But problems of eg. man with rundown house, man who wants to extend house.
C Have to accept unfairnesses. Think these are exaggerated. For most people, costs of moving are so great that over. extension bound to be cheaper. As for dilapidated houses, price wd drop. Hard cases ∴ those who've just bought a dilapidated house. Don't think cd have transit protection.
TB Conflict with inner cities policy?
FST No. Ps ↓ ∴, Fit v. well. Case for no relief v. strong of any of the mixed ~~cs~~ solutions.

C — And fiddle becoming more widespread.
Wd have to devise a package: increase ceiling, but apply only to house purchase. Wd have to apply to existing loans as well as new loans. Existing loans, incl. improvement, wd get new ceiling.

AGT — ~~Th~~ Wdn't raise ceiling. And package wd be a fillip for developers. New mkt for developers.

AB — Guess that most improvements are extensions.

FST/AGT — Not in London.

MAJ — And still advantages in doing it oneself.

C — Want more work.

<u>Residence basis.</u>

C — This was in GP; then feared complexity; then decided not so complex. But MAJ 8 Oct. ~~recent~~ note — want to explore further simplif'n in para 6.

MAJ — Seemed anomalous to retain also a ceiling for indiv tprs. But existing ceiling does 3 extra things
- DR
- divorce
- part of protection agst 2 residence problem.

Thought to d/w all those 3, wd safeguard cost, have £30000 to cover all residences. But if <u>either</u> got rid of DR, or ~~Be~~ allowed H & W to claim separately for DRs or sep residences, wd be one layer of complexity fewer.

C — Relief for DR & divorced spouses absurd.

MAJ — Don't know how many cases.

C — Not worried about getting rid of those. Problem is MC with 2 houses. That may be what forces to have ceiling. Clearly they can each own one. But can they show that they each have one? Cd be extremely difficult to determine. ~~MC wd be assumed to have one residence.~~

FST — Think there shd be a jt limit, subject to not being too complex.

MAJ — Wd parallel MCA — relief going to whoever cd make best use.

FST — Yes, admin as simple as pres system.

C — ~~With shares~~ Better to legislate that MC are assumed to have one residence.

MAJ — Better to do it that way ~~that~~ if not bothered about DR & divorce

C — Yes. // Sharers: proposing a different system. Not clear why. Don't say shares can shift according to best use, but split ~~down~~ evenly. Why?

MAJ — In case of shares, more change of circs, problems of confidentiality, more problems all round.

C — Take cohab'g couple, now have better treatment than MC. IR

are proposing worse.

FST But if 2 people live together – not man & wife, not perm – shd they be able to pool tax relief.

C Not pooling – agree amongst themselves.

MAJ Admin nightmare for lenders & IR if had to ~~share~~ have annual elections.

C Problem anyway when circs change.
But once house is bought, shares fixed.

MAJ Some worries re home improvement loans. Earlier dec'n helps.
Only problems comes when somebody moves out.

C What we're doing is much harsher than existing treatment, don't want to be unnecessarily harsh.

AB Don't want to be caught in middle of an argument.

C Yes – wd need fallback to equal shares if no clear ~~ag~~ agreement.

<u>MIR – level</u>

C Start with presumption agst ~~to~~ increasing level. But 2 special reasons for doing so this year.
(i) sharers, who are treated more harshly
(ii) in main package, embarrassing no. of losers, where cd help considerably with MIR ceiling.
An expensive business, so go only from 30 to 35.

MCS/BAM Reduces BAM losers from 300000 to 220000, and losers will lose less.

FC Confine relief to BR?

C No, that's out. One reason for shift from tax to NICs. PM had ruled out shift to BR only, but not res. basis.

AGT No pressure from Oppn parties. Priv. rented reforms in part ∵ of distortion of MIR. And no pressure from hsg lobby.

C Problem is losers in package as a whole. Problem is immed impact.

MCS Lobby will be affected by tot: cost of MIR. Rates will fall. Poss improvements out. So cost may ↓.

C Certainly cost of HR relief. Reason binkers lose is that tax increase is in form of NICs, & nothing can be set against it. ~~But~~ This helps ∵ sort of targetted.
Have to distinguish between ~~policy~~ strategy, & what may have a place in this package.

TB ~~Have~~ Alternative: £20,000 per person, ~~£?~~ no residence basis – so single 20, married or cohabiting 40.

C Lot to be said for that, exc. single going down.

TB But if you only do it ~~for th~~ when they move.

6

C Problem is 1st time buyer
MAJ And ~~...~~ newly separated spouses.
Over £20,000, 3~~2~~5000 (? check) each year single losers.
~~Yield~~ Cost of £20000 per indiv is £250m.

C So 2 options.

C If per person, wd have to allow transf'y between MCs, but not cohabiting.

→ Asked MAJ to ~~...~~ spot & compare & contrast
(a) residence on 35,000
(b) 20,000 per person.

NICs at the Lower End

C Attracted to raising LEL.

Trying to – reduce burden on low paid
– help U trap.

b.f. with advice or 19/10

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

CH/EXCHEQUER

REC.	08 OCT 1987 8/10
ACTION	PS / IR
COPIES TO	CST FST SIR P. MIDDLETON
	MR CASSELL MR SCHOLAR
	MR BONNEY

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Parliament Street
London
SW1P 3AG

8 October 1987

Dear Chancellor

I shall shortly be letting you have my suggestions on changes which I would like you to consider for next year's Finance Bill. But there is one issue which I think is worth sending to you early on so that it can be explored at an early stage as I am now convinced that the case for it is overwhelming.

This concerns the case for roll-over relief against CGT to be granted when the proceeds from the realisation of milk quota are re-invested in another business. The present position is anomalous and exposes us to the justifiable criticisms that the absence of roll-over relief stands in the way of enterprise and good commercial practice, restricts the ability of the industry to diversify, and runs counter to what we are trying to achieve in the dairy industry.

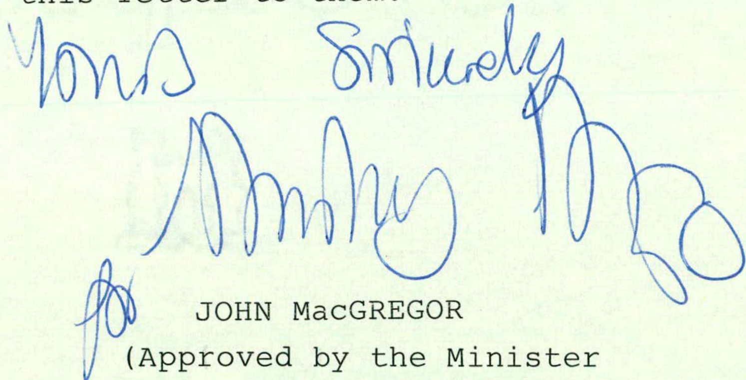
As you know, milk quotas are being steadily reduced and production is falling. Many dairy farmers are finding that their quotas are too small to allow their enterprise to be viable and are seeking to move to larger farms. Some are abandoning milk with the aim of diversifying on another, larger holding. When they move, and given that the value of the quota can amount to as much as half the value of their dairy farms, the CGT charge can be considerable. Of course, if a farmer sells his quota and retires then a capital gains charge will arise as it would for any other business, and that is fair. But the absence of roll-over relief for milk quotas means that a farmer must pay such a charge when he moves from one farm to another in order to develop his business. This inevitably inhibits sensible decision-taking and mobility, in a way that does not apply to the sale and re-use of any other business assets. I have a number of specific practical examples of the unjustified deleterious effects this is now having.

/ Another way of ...

Another way of looking at the matter is this. Milk quota is in effect a right to produce milk and seems tantamount to a measure of the goodwill attaching to the value of a dairy farm. The value of goodwill in any business now benefits from roll-over relief but milk quotas are not presently regarded as coming under this heading. Yet had milk quotas not been imposed, a farmer would have been able to move from his dairy farm to another holding and "rolled-over" gains arising on the sale of the dairy business. Treating quotas as goodwill, or by some other means you judge appropriate, so allowing them to attract roll-over relief, would be a return to the status quo ante.

In the correspondence on this matter between officials, the question of precedents has arisen, such as for potato, hops and fish quotas. I do not see that there should be any real difficulties of this kind. Hop quotas were abolished several years ago, fish quotas are not for re-sale and whilst potato quotas are traded, the individual area quotas sold are usually very small indeed.

Both Peter Walker, Malcolm Rifkind and Tom King have also received many representations on this and are convinced that the present position inhibits just the kind of diversification of farming that we are now exhorting upon farmers. They fully support the line I am taking. I am copying this letter to them.



JOHN MacGREGOR
(Approved by the Minister
and signed in his absence)

TASK FORCE SECRET

COPY NO 1 OF 1

Inland Revenue

Policy Division
Somerset House

FROM: B A MACE

DATE: 9 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

INDEPENDENT TAXATION: VARIANTS OF THE MARRIED MAN'S ALLOWANCE

1. Mr Taylor's minute of 7 October asked for costings of a vanishing exemption applied to the married man's allowance with withdrawal based on the husband's income.

2. I am afraid we cannot let you have a detailed costing of the vanishing exemption in time for your meeting on 12 October as this involves making a fairly complex computer analysis. In round terms, depending on the starting point for withdrawal, the additional yield from such a provision is likely to be of the order of no more than £50-100 million, possibly less if the starting point was pitched a very high level.

3. It is not possible to eliminate all the losers from the vanishing exemption by raising the starting point for withdrawal. At all income levels there would be some couples where the wife had no income of her own so that the couple would lose if the husband had part or all of the married man's allowance withdrawn. At the higher income levels, however, the likelihood is that the loss of the married man's allowance would be offset, at least in part, by the benefit from disaggregation of the wife's investment income under Independent Taxation.

---

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Jenkins (Parliamentary Counsel)

Mr Battishill
Mr Isaac
Mr Lewis
Mr Beighton
Mr Mace
Mr Eason
Miss Dyall
PS/IR

4. The table below provides a very rough estimate of the number of losers (at 1988-89 income levels) if a vanishing exemption was introduced at various starting points in 1990-91 at the same time as the change to Independent Taxation.

Starting point for withdrawal Husband's income in excess of £	Number of losers 000s
25,000	300
30,000	200
40,000	100
50,000	60
60,000	40

(1 be even higher

5. With indexation of allowances in 1988-89 and a rate of withdrawal of £1 of allowance for every £10 of additional income (implying a marginal rate over the withdrawal band of 44 per cent with a 40 per cent higher rate) the excess of the married man's allowance over the single allowance would be withdrawn over a band of income of some £14,300. Introducing the vanishing exemption would, of course, add a "hump" to the profile of marginal rates (for married men but no others) at the same time as the present "kink" in the marginal rate schedule between the UEL and the higher rate threshold is being eliminated. With the vanishing exemption in place the income tax rate schedule would effectively be 25 per cent, 40 per cent, 44 per cent, 40 per cent (34 per cent, 49 per cent, 53 per cent, 49 per cent, for the combined income tax and NIC schedule assuming the individual is contracted in and there is a 9 per cent NIC charge above the UEL.)

or 39 with 35

35 39 44 36 [illegible] 44 48

B A Mace.

B A MACE

Inland Revenue

Policy Division
Somerset House

Copy No. 1 of 20

FROM: M F CAYLEY
DATE: 9 OCTOBER 1987

1. MR ISAAC 9.10

2. CHANCELLOR OF THE EXCHEQUER

CAPITAL GAINS TAX

You asked for this at your discussion with Mr Scholar on 5/10

1. Mr Taylor's note to me of 7 October asked for a table comparing the cost of the options set out in my note of 17 September with other options.

2. I hope the attached table, which does little more than pull together the figures in my notes of 1 July, 10 September and 17 September, is largely self-explanatory. The figures relate to 1988/89 accruals - not receipts.

3. All the figures for the effect of reform now assume that the annual exemption will be frozen at £6,600, and this has involved marginal adjustments to the numbers cited in the earlier notes; the figures for the present system assume statutory revalorisation of the exemption.

---

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Battishill
Mr Isaac
Mr Beighton
Mr Houghton
Mr Cayley
Mr Hamilton
Mr Michael
Mr Gonzalez
Mr Mace
Mr Quinn
PS/IR

4. For the options involving the bringing together of gains and income, we have assumed a higher rate threshold of £20,400 - the present starting-point for the 45% band. Mr Mace's note of 29 September ("Tax reform: income tax and NIC") discuss schemes with a £25,000 starting-point for the higher rate. Making the higher rate threshold £25,000 rather than £20,400 would have only a small effect on the figures, reducing the yield by £m30 or less depending on the option concerned.

5. The table assumes no "sweeteners" for lumpy assets like land. It also ignores the effect of independent taxation in 1990 - this might reduce the tax take on gains by some £m80.

6. Finally, as you know we are conducting a survey to improve our statistics, and may well wish to revise the estimates in the light of the results of this: and the figures are of course likely to alter as the forecasting assumptions are changed.

M F CAYLEY

	YIELD Individuals and Trusts (£m)	TAXPAYER NUMBERS ('000)	YIELD Companies (£m)	TOTAL YIELD (£m)
PRESENT SYSTEM (Tax on 1988/89 disposals)	Shares etc 1330 Land 670 Total 2000	200	1600	3600
A. CHARGING GAINS AS MARGINAL SLICE OF INCOME				
(a) 35% higher rate and no rebasing	Shares etc +80 Land +60 Total +140	0	0	+140
(b) 35% higher rate and with rebasing	Shares etc -20 Land -530 Total -550	-60	-500	-1050
(c) 40% higher rate and no rebasing	Shares etc +160 Land +120 Total +280	-10	0	+280
(d) 40% higher rate and with rebasing	Shares etc +70 Land -510 Total -440	-60	-500	-940

	YIELD Individuals and trusts (£m)	TAXPAYER NUMBERS ('000)	YIELD Companies (£m)	TOTAL YIELD (£m)
B. KEEPING GAINS SEPARATE FROM INCOME WITH 25% RATE ON FIRST £5,000 ABOVE ANNUAL EXEMPTION				
(a) 35% higher rate and <u>no</u> rebasing	Shares etc +100 Land +70 Total +170	0	0	+170
(b) 35% higher rate and <u>with</u> rebasing	Shares etc 0 Land -530 Total -530	-60	-500	-1030
(c) 40% higher rate and <u>no</u> rebasing	Shares etc +180 Land +140 Total +320	-10	0	+320
(d) 40% higher rate and <u>with</u> rebasing	Shares etc +90 Land -530 Total -440	-70	-500	-940

TASK FORCE SECRET

Copy 1 out of

McPHERSON TO CH/EX 9/10

FROM: N I MACPHERSON
DATE: 9 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc. Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Monck
Mr Scholar
Miss Peirson
Mr McIntyre
Mr Riley
Miss Sinclair
Mr G P Smith
Mr Cropper
Mr Tyrie

Mr Isaac - IR
Mr Mace - IR
PS/IR

TAX REFORM AND NICs AT THE LOWER END

You asked for a costing of the following option:

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	0	5	0
70-105	7	5	7	5
105-155	9	9	9	9
155-305	9	9	10.45	10.45

2. If introduced in October 1988, this would cost around £80 million in 1988-89 and £120 million in 1989-90. However, the NIF surplus would be £20 million higher in 1988-89 and £40 million higher in 1989-90. The cause of the perverse effect on the NIF is reduced rebate expenditure, which more than offsets the effect of fewer people paying NICs. That the option has an overall cost reflects a lower NHS allocation.

3. 2.1 million employees would be taken out of NICs, while a further 2 million employees would experience a NIC reduction. Gains would range from 82p for those contracted out earning betwen £70 and £105 a week to £3.50 for someone contracted in earning £70 a week. Employers would gain similar amounts and considerable effects on the labour market at the lower end could be expected. 30,000 tax units would be taken out of the unemployment trap in the long run and the average replacement rate would be cut by 1.5 per cent.

4. The disadvantages are the same as those of Option 6 in Mr Scholar's submission of 2 October. Over 8½ million contracted out employees earning over £105 a week would be losing 58p a week in the form of increased contributions (the cause of the low cost of the option). This is because the LEL determines the point at which the contracted out rate of NIC becomes payable. Around 2 million of these losers will already be paying more NICs as a result of UEL abolition, and the effect will be to increase the number of losers from the overall tax package. Employers would be losing £1.10 a week on their contracted out employees earning over £105 a week, but this will be offset by having to fund for a lower Guaranteed Minimum Pension.

5. The problems with the benefit system identified in Option 6 remain, although clearly they are much less severe. 2.1 million people would lose their entitlement to contributory benefits, and again it can be argued that these are the people who depend most on Retirement Pension and for whom the SERPs system was designed; 2 million out of the 2.1 million are contracted into the state scheme. However, this argument carries slightly less weight here, because almost half of those earning between £41 and £70 a week are married women who will be entitled to some pension on their husband's account and a further 30 per cent are young people, who will be brought into NICs in due course. Only 20 per cent are adult single women or men.

Back again!

6. Some of these difficulties could be avoided by creating a dual LEL structure, one of £70 a week for NIC payment purposes and one of £41 for benefit entitlement and rebate purposes.

However, this in turn creates further problems identified in Option 6a (paragraph 24 of my earlier paper).

N I MACPHERSON

COPY NO 1 OF 16 COPIES

FROM: M C SCHOLAR
DATE: 9 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Gilmore (paragraphs 3-5 only: Confidential, not Task Force Secret)
Mr Burr (paragraphs 3-5 only: Confidential, not Task Force Secret)
Miss Sinclair
Mr McIntyre (paragraph 8 only)
Mr Macpherson (paragraph 8 only)
Miss Evans
Mr Cropper
Mr Tyrie
Mr Battishill - IR
Mr Isaac - IR
PS/IR

Ch/
Papers on covenants/student grants are on this folder. Papers on independent taxation, + NICs are on the separate red folder.
2. On covenants/student grants see also Mr Gilmore's minute (behind this one).
[initials] 9/10

TAX MEETINGS ON 12 OCTOBER: ANNOTATED AGENDA

You asked me to provide an annotated agenda for these meetings.

2. You have a meeting arranged for Tuesday 20 October to take stock of the tax reform package as a whole. We will before then let you have answers to the questions you have asked on the papers which have already been submitted - about the distributional effects of the present package on the self-employed with costings for alternatives, the costing of the non-integrated capital gains tax proposal and so on. But for Monday you wanted to take a prior look at some individual issues - independent taxation, covenants (including student convenants and loans) and national insurance contributions at the lower end. Sir Peter Middleton has also suggested that it might be useful to take stock briefly of where we have got to on benefits in kind.

SCHOLAR TO CH 9.10.87

3. The first item on the agenda is covenants. Here the papers are:

Mr Isaac/Stewart to Chancellor of 24 July: Covenants and Maintenance

Mr Taylor to Mr Isaac of 27 July: Convenants and Maintenance

Mr Barnes to PS/Chancellor of 30 July: Covenants and Maintenance

Mr Cropper to Chancellor of 31 July: Covenants and Maintenance

Financial Secrtary to Chancellor of 31 July: Covenants and Maintenance

Mr Tyrie to Chancellor of 4 August: Covenanting and Maintenance

Mr Kuczys to PS/Financial Secretary of 6 August: Covenants and Maintenance

Mr Taylor to Mr Burr of 13 August: Covenanting and Maintenance

Mr Burr to Chancellor of 18 September: Student Loans and Tax Relief on Covenanted Parental Contributions

Financial Secretary to Chancellor of 1 October: Student Loans and Tax Relief on Covenanted Parental Contributions

On folder - you have not seen before {

Mr Tyrie to Chancellor of 5 October: Student Loans

Mr Cropper to Chancellor of 6 October: Student Loans and Tax Relief on Covenanted Parental Contributions

Mr Isaac to Chancellor of 7 October: Student Loans and Tax relief on covenanted parental contributions.

4. The Financial Secretary has asked the Revenue to do more work on maintenance payments on divorce and separation, considering various options for limiting the tax relief which might be available on transfers from husband to former wife. The Financial Secretary's minute of 31 July (paragraph 5) lists the provisional decisions he has so far made in this area.

5. On covenants, it is agreed that legislation will be required to make ineffective for tax purposes convenants between spouses. But

(i) should this be achieved by general abolition of relief for individual-to-individual covenanting?

(ii) Which of the options in Mr Burr's paper do you wish to put to DES Ministers?

(iii) Should we go for a two-stage procedure (paragraph 6 of the Financial Secretary's minute of 1 October)?

6. Next, independent taxation. Here the most recent papers are:-

Mr Mace of 28 September: Independent Taxation: Variants of Married Man's Allowance

Mr Mace of 16 September: The Elderly and Breadwinner Wives

Mr O'Connor of 23 September: Mortgage Interest Relief: Residence Basis

Mr Johns of 8 October: Mortgage Interest Relief: Residence Basis

Mr Cayley of 23 September: Taxation of Husband and Wife: Capital Gains Tax Exemption of Private Residence

On folder - not seen before } Mr Mace's minute of 9 October: Independent taxation: Variants of Married Man's Allowance.

7. A number of decisions here have already been provisionally taken: but you may wish to run over this ground briefly. The main issues have been:-

(i) is the married man's allowance to go automatically to the husband except in strictly defined circumstances where he is unable to make full use of it? Is it to be split into a single allowance and a married couple's allowance (ie scheme A in Mr Mace's submission of 28 September), and are schemes B and C to be ruled out?

(ii) Is the married man's allowance to be withdrawn progressively above the higher rate threshold, on the basis of the husband's income alone?

(iii) Should part of the married man's allowance be transferable to breadwinner wives, with the transitional protection for existing breadwinner wives, as set out in paragraphs 9-13 of Miss Dyall's minute of 16 September?

(iv) Should the elderly be treated on the same basis as breadwinner wives, with cash protection for husbands under 65 who are already receiving the married age allowance when independent taxation is introduced (ie option 1 in Mr Mace's submission of 16 September)? For the future, under independent taxation, should men qualify for age allowance on the basis of their own age, not that of their wives?

(v) Should each married couple have only one capital gains tax exemption between them for the principal private residence?

(vi) Should the mortgage interest relief ceiling be limited to the residence from August 1988 and at what level; should the ceiling be divided equally between 'sharers' (the 'per capita' basis); and should a married couple be allowed to transfer between them entitlement to relief?

8. Finally, National Insurance contributions at the lower end. Here you will wish to assess the relative merits of the five options analysed in the paper attached to my minute of 2 October, together with the further option which you asked to be looked at (see Mr Macpherson's minute of 9 October).

On folder - you haven't seen before.

MCS

M C SCHOLAR

TASK FORCE SECRET

JMGT TO B/FST 12OCT

COPY NO. 6 OF 7 .

FROM: J M G TAYLOR
DATE: 12 October 1987

PS/FINANCIAL SECRETARY

cc Mr Scholar
Mr Cropper
Mr Tyrie
Mr Cayley - IR

CAPITAL GAINS TAX: ANOTHER OPTION

The Chancellor has seen the Financial Secretary's minute of 6 October.

2. He does not see this three-point proposal being a runner. We have always seen the first two points as alternative options, and he does not see how the addition of the third point - even if desirable - alters this. But he realises that the Financial Secretary is very keen to abolish indexation, and he would be content for a re-assessment of this to be conducted in time for discussion, alongside the 25/35 option, at any forthcoming CGT meeting.

J M G TAYLOR

Copy 1 of 19

FROM: N I MACPHERSON
DATE: 12 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc. Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Monck
Miss Peirson
Mr Scholar
Mr McIntyre
Mr Riley
Miss Sinclair
Mr Cropper
Mr Tyrie

Mr Isaac - IR
Mr Mace - IR
PS/IR

TAX REFORM AND NICs AT THE LOWER END

You asked for a costing of the following variant of the option discussed in my minute of 9 October:

£ per week	Employees % rate now	Employees % rate proposed	Employers % rate now	Employers % rate proposed
41-70	5	0	5	0
70-105	7	5	7	5
105-155	9	7	9	7/9
155-305	9	9	10.45	10.45

2. If introduced in October 1988, this would cost around £450 million in 1988-89 and £1.3 billion in 1989-90. The significant increase in cost reflects the 4.1 million employees who work between £105 and £155 a week, who will benefit by between £2.10 and £3.10 a week (less 58p if contracted out). Their employers will gain similar amounts (except their contracted out reduction is higher at £1.10).

3. This option would reduce the number of contracted out losing from the lower end package by 1.8 million to around 7 million. An additional attraction is that a further 10,000 ('high quality') tax units might be taken out of the unemployment trap, on top of the 30,000 taken out by the 9 October option. Unlike the latter option, the step at £105 a week would be no more than at present, although a step of £3.10 would be introduced at £155, a fairly densely populated area of the earnings distribution.

How many will be losers from USE package too?

4. However, the option would appear to be ruled out by its cost. Limiting the cut in aggregate NICs between £105 and £155 a week to 2 per cent would bring the cost down to a manageable level, £230 million in 1988-89 and £670 million in 1989-90. The 2 per cent cut might either be evenly distributed, giving a NIC rate of 8 per cent between £105 and £155 a week for both employees and employers, or be confined to employees, giving a 7 per cent rate for employees and an unchanged rate of 9 per cent for employers. The former variant has the attraction of keeping the treatment of employers and employees at the lower end the same. Its drawback is that the benefits are spread too widely; neither employers nor employees are likely to respond to a mere 1 per cent reduction. The latter variant is better targeted. Employees will keep the gains identified in paragraph 2, and the unemployment trap effect will be greater at least in the short run. The disadvantage is that employers will be paying a higher rate of NIC than employees; however they are already doing that between £155 and £305 a week.

N. I. Macpherson

N I MACPHERSON

TASK FORCE SECRET

Copy no 1 of 20

Inland Revenue

Policy Division
Somerset House

Ch/ Content to keep only the "alternative" option in play: i.e. to retain CGT as a separate tax and charge at the rates that would apply if gains were the marginal slice of income

CAYLEY To CH.EX 12OCT

FROM: M F CAYLEY
DATE: 12 OCTOBER 1987

1. MR ISAAC 12.10
2. CHANCELLOR OF THE EXCHEQUER

OK

13/10

REFORM OF CAPITAL GAINS TAX

1. Some of the options on the table involve adding capital gains to income and charging them at the rates that would apply if they were the marginal slice of income. I undertook to explore with Parliamentary Counsel the feasibility, if reform went ahead on these lines, of converting the charge from one to CGT to one to income tax.

2. An income tax charge would not make sense if capital gains were kept completely separate from income, as for instance in the options explored in my note of 17 September. And we doubt it would be appropriate if the higher rate of tax for gains differs from that for income - for instance if next year there was a single higher rate of 40% for income but for gains the higher rate was 35%. The idea of replacing CGT with a charge to income tax makes most sense if gains are added to income, the combined total being taxed at the same rate scale.

---

cc	Financial Secretary	Mr Battishill
	Sir P Middleton	Mr Isaac
	Sir T Burns	Mr Pitts
	Mr Cassell	Mr Beighton
	Mr Scholar	Mr Cleave
	Miss Sinclair	Mr Cayley
	Mr Cropper	Mr Hamilton
	Mr Tyrie	Mr Michael
	Mr Jenkins (Parliamentary C.)	Mr Lester
		PS/IR

3. Even then, the same substantive result could be achieved - and, Parliamentary Counsel has confirmed, much more simply achieved - while retaining CGT as a separate tax, but chargeable at the rate that would apply if gains were the marginal slice of income. The legislation for this (allowing for some special provisions to cover the interaction with income tax top-slicing reliefs and a few other technical consequentials) would be likely to be no more than a few pages - and possibly as little as two. (This and other references to length of legislation leave out the provisions required for rebasing, which could well, we think, run to twenty pages).

4. The difficulty with converting a CGT reformed on the lines envisaged into an income tax charge is that there is extremely little income tax legislation which one would wish to apply to gains. For example, the present CGT rules for determining who is liable to tax would continue: if they were replaced by those for income tax, among other things large numbers of non-residents would suddenly find themselves paying tax on gains made in the UK. Capital losses would not be available against income, nor income losses against capital gains. A lot of income tax anti-avoidance legislation - and many other income tax provisions - would be inappropriate for gains. There would be a separate threshold for capital gains. And so on. The one point at which we would need to apply the income tax rules would be in determining the rate of tax on gains.

5. One way to achieve an income tax charge would be to comb through all references to income and income tax in the Taxes Acts and decide which should apply to gains and to tax on gains, and which should not; and then make appropriate amendments to deal separately with each reference. We do not regard this as a practicable option: it would result in many pages of finicky amendments to the Taxes Acts, divert a large amount of our Head Office resources and Parliamentary Counsel's time from other tasks (including other Budget work), and lead to complaints from taxpayers and their advisers about

the need to come to terms with all the minor changes to the law.

6. The alternative would be to charge capital gains to income tax but to stipulate that, apart from the few provisions relating to tax rates, references in tax legislation to income tax excluded income tax on capital gains, and references to income similarly excluded capital gains. We would then need to replace references to CGT, and so on. All this could be done, though it would mean more legislation than keeping CGT as a separate tax and charging gains at the rates that would apply if they were income. But it would look odd. What the legislation would be saying - and in obvious terms - is that capital gains would be liable to income tax but (with the odd exception) existing statutory references to income tax would exclude tax on capital gains. It would be stating a proposition and then almost entirely negating it. Both we and Parliamentary Counsel think that there is a real risk of an approach on these lines attracting considerable criticism. Certainly it would be clear to everyone that the reform did not involve integration of CGT and income tax. And for some taxpayers and practitioners the result would be confusing.

7. Parliamentary Counsel has also expressed anxiety that this approach might lead to difficulty in the Courts: a taxpayer might argue that if the legislation was intended just to apply income tax rates to capital gains, it would have said so and retained CGT as a separate tax; and that therefore the presumption must be that the legislation does more than this. In Counsel's view, there is a risk that the Courts could sympathise with this line of argument and apply to capital gains some income tax provision which it was not intended to apply to them.

8. In short, Parliamentary Counsel's advice is that, while it would be possible to replace CGT with an income tax charge, the resulting legislation would look extremely odd, be likely to attract criticism, and add to the complexity of the Bill.

The alternative, which would achieve the same substantive result as regards tax liability, would be to retain CGT as a separate tax and charge gains at the rates that would apply if they were the marginal slice of income: this would be much simpler, and correspond much more closely to the reality of the reform.

Michael Cayley

M F CAYLEY

Copy 1 of 10

FROM: N I MACPHERSON
DATE: 12 OCTOBER 1987

CHANCELLOR OF EXCHEQUER

TAX REFORM AND NICs AT THE LOWER END

You asked for a costing of the following variant:

	Employees % rate		Employers % rate	
£ per week	now	proposed	now	proposed
41-70	5	0	5	0
70-105	7	5	7	6
105-155	9	7	9	8
155-305	9	9	10.45	10.45

2. If introduced in October 1988, this would cost:

1988-89 £310 million
1989-90 £890 million

3. You also asked what effect the 58p a week increase in contributions, experienced by the contracted out earning over £155 a week, would have on the numbers losing on the overall tax package. **Highly provisional** estimates suggest the number of losers might increase by around 80,000, assuming no phasing in (Mr Mace's Option A) and compared to indexation. If comparison is with 1987-88, the number would be in the region of 40,000.

N I Macpherson

N I MACPHERSON

NOTE OF MTG 12/10

ps4

TASK FORCE SECRET

COPY NO. 1 OF 21 .

NOTE OF A MEETING HELD IN HM TREASURY ON 12 OCTOBER 1987, AT 3.00 PM

Present

Chancellor
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr McIntyre)
Mr Macpherson) for discussion of NICs only
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
Mr Johns - IR
Mr Mace - IR

INDEPENDENT TAXATION; AND NATIONAL INSURANCE CONTRIBUTIONS

Paper: Mr Scholar of 9 October, and papers referred to within.

Independent taxation

- **Allocation of married man's allowance**

1. The Chancellor agreed that the married man's allowance should go automatically to the husband, except in strictly defined circumstances where he was unable to make full use of it. He was inclined to go for the "cosmetic" scheme A in Mr Mace's 28 September submission, which would split the allowance into a single allowance and a married couple's allowance. This looked quite straightforward, and could be aborted at a late stage if necessary.

2. Mr Mace said that there were some operational complications, and it would be harder to deal with breadwinner wives. But a bigger question was whether such an allowance would prove as robust as the present married man's allowance. It would have to be defined specifically in the legislation, which would draw more attention to the fact that there were rules allocating the allowance automatically to the husband.

3. The Chancellor concluded that, on balance, the married couple's allowance was preferable to the present married man's allowance.

4. Mr Scholar pointed out that there would no doubt be a large number of amendments put down, designed to take the change further. The Chancellor said that he had no objection to public debate on the issue, but confirmed that there would be no question of changing the proposal.

- **Progressive withdrawal of the married man's allowance**

5. The Chancellor explained that he was concerned that the overall effect of the reform package would be to produce enormous benefits for married couples at the top of the income range. His aim was to reduce those benefits, and the progressive withdrawal of the married man's allowance seemed to be the only device available. Before making a final decision, he asked to see worked examples of the effect of the measure on different couples.

6. On Mr Mace's 9 October minute, the Chancellor said that he was envisaging a higher rate of 35 per cent, rather than 40 per cent. This would bring down the withdrawal rates, which was important because he did not want any rate to be above 50 per cent. The starting point for withdrawal could be raised even higher than the top of the range in Mr Mace's minute. Gains and losses should be considered in terms of the package as a whole, rather than the

effect in any one year - it was a single package, which, for operational reasons, had to be spread over a period of years. On that basis, he thought a package could be constructed with no losers. The only oddity was that the package would remove the so-called "kink", but add a "hump", though at higher incomes and affecting fewer people.

7. The Financial Secretary thought there were objections to the proposal in logic. Operating on the husband's income alone sat uneasily with the move to treating the husband and wife equally. The Chancellor pointed out that the move to independent taxation meant that it would be impossible to operate on the joint income. The Government had been forced to retain the married man's allowance, which was now an anomaly, and which he was seeking to reduce at the top end. He said that the aim was to withdraw the married couple's allowance from whichever partner was using it.

8. Mr Mace said that that meant a couple with two similar incomes totalling, say, £30,000 would do better than a one-earner couple with the same income. The Chancellor accepted this, but could see no other way of reducing the benefit to couples at the top of the income range. He asked for a range of examples, with a fairly high starting point for withdrawal, probably considerably above the higher rate threshold. The only losers he was concerned about were those with the normal range of reliefs, rather than those exploiting tax shelters.

- **Breadwinner wives**

9. The Chancellor agreed with the Financial Secretary that part of the married man's allowance should be transferable to breadwinner wives, with transitional protection for existing breadwinner wives.

- **The elderly**

10. The Chancellor agreed that the elderly should be treated on the same basis as breadwinner wives, and that, under independent taxation, men should qualify for the age allowance on the basis of their own age, not that of their wives. It was agreed that the approach was simple in concept, and could be simplified in the presentation, though there would be some complications in practice.

- **Capital Gains Tax exemption**

11. The Financial Secretary thought that each married couple should have only one Capital Gains Tax exemption between them for the principal private residence. This meant that cohabiting couples with two residences would be treated more favourably, but he saw nothing that could be done about this. Very few people were affected, and in order to benefit, they would actually have to sell two houses. The Chancellor noted that this would still leave an - albeit modest - tax penalty on marriage, which would attract some attention. But the only alternative was to give married couples two exemptions. He decided not to make any changes at this stage.

Mortgage interest relief

- **Improvements**

12. The Chancellor thought that ending mortgage interest relief for improvements looked to be the only practical way of whittling down the relief. He thought that relief for improvements was the main vehicle for abuse.

13. Mr Johns said that up to 20 per cent of the relief given for improvements might be an abuse of the proper provisions. He said that the justification for the relief in the past had been to preserve equity between the person who bought a run-down house and the person with a new house, or between the person who wanted to extend a house and the person who bought a bigger house. The Chancellor said that some unfairnesses would have to be

accepted, but that these tended to be exaggerated. For example, the costs of purchase were so much greater than improvements, that withdrawing relief on the latter would have only a marginal effect. Also, the price of run-down houses would fall to reflect withdrawal of improvement relief.

14. The Chancellor thought a viable package could be devised, involving an increase in the mortgage interest relief ceiling, but restricting relief to house purchase. The higher ceiling would have to apply to existing loans, including those for improvements, as well as new loans.

15. Mr Tyrie thought it would be wrong to raise the ceiling for relief. He also thought that the package would be a fillip for property developers. The Chancellor asked for more work to be done on the likely effects of the proposals. There were special reasons for increasing the ceiling as part of the overall package (see paragraph 20 below)

- **Residence basis**

16. Turning to the proposed move to a residence basis, the Chancellor said that he had been attracted to the proposal in the Green Paper, but that its ramifications appeared complicated, particularly if an individual ceiling were retained alongside the ceiling for the residence. Two potential problems would be removed by abolishing relief for a dependent relative's house and a divorced spouse's house. The Chancellor said he was prepared to do this. This left the problem of married couples with two houses, who might be able to claim relief for both if there were no individual limit on relief. Clearly each partner could own a house. The question was whether they could show that they actually had separate main residences. That could be extremely difficult to determine.

17. After discussion, it was agreed that it was best to legislate that married couples were assumed to have the same residence, with a joint limit for relief, and the relief available to whichever partner could make best use of it.

18. The Chancellor said he was not clear why the Revenue were proposing a different approach for sharers. He did not see why sharers could not be allowed to split the available relief as they wished. Mr Johns explained that there were more changes of circumstances, and possibly problems of confidentiality, between sharers. Neither the Revenue nor the lenders could become embroiled in those, and it would be an administrative nightmare if an election for the split of the relief had to be made annually. But some of his worries had concerned loans for improvements, and if relief were no longer available for these, the position would be easier to handle.

19. The Chancellor asked for this issue to be reviewed. The proposal for sharers was much harsher than the existing treatment, and he did not want to be unnecessarily harsh. He recognised the potential administrative problems, and accepted that there would have to be a proviso that if there was no clear agreement among sharers, the relief would have to be split equally.

– **Mortgage interest relief ceiling**

20. The Chancellor said he started with a presumption against increasing the ceiling. But he saw two special reasons for doing so this year: to help sharers, who were treated more harshly under the proposed regime; and the embarrassing number of losers in the main package. Given the cost, he thought the increase should only be to £35,000. Confining the relief to the basic rate had to be ruled out.

21. Mr Mace said that increasing the ceiling to £35,000 reduced the potential losers from 300,000 to 220,000, and would reduce the size of the remaining losses.

22. Mr Tyrie argued against raising the ceiling. There was no pressure from the Opposition Parties. Part of the reason why reform of the private rented sector was necessary was the existing distortion caused by mortgage interest relief. And there was no pressure from the housing lobby. The Chancellor said that the problem lay with the number of losers in the package as a whole. There was no direct way of eliminating these, but this measure was reasonably well targetted.

23. Mr Scholar pointed out that some of the elements in the package would reduce the cost of mortgage interest relief, eg the reduction in the higher rates and the proposed removal of improvements relief.

24. Sir T Burns proposed an alternative of a £20,000 ceiling per person, without the residence basis, with protection for existing mortgages. The Chancellor thought this had a number of attractions, but saw problems with the reduction for single people, particularly first-time buyers. There would have to be transferability between married couples, but not between co-habiting couples. He asked Mr Johns to compare and contrast two options:

(a) the residence basis, with the ceiling at £35,000;

(b) the present regime, with a ceiling of £20,000 per person.

National Insurance Contributions at the lower end

Key papers: Mr Scholar's minute of 2 October; Mr Macpherson's minutes of 9 and 12 October.

25. The Chancellor said it was generally agreed that relief should be given at the bottom end of the earnings scale, and that NICs was the most suitable route. Any change should be simple. He also wished to avoid options in which there was little relationship

between contributions and benefits (given that the contributory principle was already stretched to its limit). He was attracted to raising the lower earnings limit. This was the best way of getting low earners out of the tax and contributions system. It also helped to redress the drift of the LEL down the earnings scale.

26. The Financial Secretary noted that raising the LEL removed entitlement to benefits as well as the requirement to pay contributions for those taken out of the field. They would need to rely on means tested benefits instead. The Chancellor said he envisaged taking 2 million people out of the field. Most would in fact become entitled to benefits at a later stage as their earnings increased. He noted that establishing a zero band would also benefit employers.

27. The Chancellor said that Mr Macpherson's minutes set out various options involving a zero rate band. There was little to choose between these on micro economic grounds; the aim should be for simplicity. Other constraints were that, for the employer, there must be no increase for any of the bands, and there should be no additional burden overall, compared to the present position.

28. The meeting considered the options set out in Mr Macpherson's second minute of 12 October. The Chancellor noted that, although this implied a large first step, this was less than had been the case in the past. Mr Macpherson noted that there would be around 80,000 additional losers, if this option were built into Mr Mace's option A. There would also be an effect on the actuarial basis of the NI Fund calculation; the Government Actuary would wish to recalculate this, and this would in turn affect firms calculations for the purpose of developing personal pension plans. Sir P Middleton noted that the switch to means tested benefits would also have a long term effect on DHSS running costs.

29. The Financial Secretary said he had considerable reservations about raising the LEL. This needed to be assessed in the context of the objectives of NIC reform. These included reducing the "unemployment trap", reducing the cost of labour, and relieving the tax burden. The Chancellor said the main objectives were to reduce the burden on the low paid, and the "unemployment trap". Raising the LEL particularly helped towards these objectives.

30. In further discussion, it was noted that raising the LEL had an inconclusive effect on the size of the "black economy". It was also noted that, under the reform, some single people would still pay income tax although they would no longer be liable for NICs.

31. The Chancellor noted that if the employers rates were set at the scale 0:7:9:10.45, the cost in the first full year would be reduced to around £½ billion. This option should be examined further. A fallback option with a 2 per cent lower rate band should also be considered. Other ways of juggling with the bands, at similar cost, should also be pursued. Mr Scholar undertook to take this forward. He would report back to the Chancellor in time for the opening of discussions with Mr Moore. This would be soon after the Autumn Statement.

Further work

32. The Chancellor noted that it was planned to hold further meetings to discuss capital gains tax, and benefits-in-kind. The more general proposal about switching taxation of benefits in kind to employers should be examined with the additional burden on businesses in mind. The Chancellor wished to hold further meetings on: the effect of the overall package on small businesses and the

self employed; on overall winners and losers; on NICs for the self employed. He also looked forward to the paper setting out the economic rationale behind the proposals.

A P HUDSON　　　　J M G TAYLOR

13 October 1987

Circulation

Those present*
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(*Mr McIntyre and Mr Macpherson: paragraphs 25-31 only)