

PO-CH/NL/0025

PART E

SECRET

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PO -CH /NL/0025



PART E

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

PO -CH /NL/0025

PART E

DD's 25 years NA33 410196

30-11-87

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TASK FORCE SECRET



COPY NO 15 OF 16 COPIES

FROM: J M G TAYLOR

DATE: 9 November 1987

MR MCINTYRE

cc Chief Secretary
 Financial Secretary
 Sir P Middleton
 Sir T Burns
 Mr Byatt
 Mr Scholar
 Miss Peirson
 Mr Gibson
 Mr Macpherson
 Mr Cropper
 Mr Tyrie
 Mr Call
 Mr Mace - IR

NATIONAL INSURANCE CONTRIBUTIONS, CONTRIBUTORY PRINCIPLE AND NIF SURPLUS

The Chancellor was grateful for your minute of 6 November, and for the two papers enclosed.

2. He agrees that the most promising way of reducing the surplus may be to increase the NHS allocation, and that we should consider whether to use the opportunity of next year's Social Security Bill to give ourselves more room for manoeuvre on this front.

3. He has commented that SERPS entitlement is difficult. There is obviously a case for changing the rules so that it depends on total NICs paid, and not just on those between the LEL and UEL (the latter having to be notionally retained just for the purpose). On the other hand, keeping SERPS entitlement rules as they are, while employee NICs are no longer bound by the UEL, would presumably encourage contracting-out by those on high earnings. He would be most grateful for a note on this point.

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

J M G TAYLOR

JMGT
 →
 MCINT-
 YRE
 9/11

PART E.



Inland Revenue

Policy Division
Somerset House

Ch
See also Mr Cayley's
minute of 29 October, behind, and his note of 3/11 in the enclosed red folder.
These pps. are for discussion
on 12 November.

Copy No ... of 30.

FROM: M F CAYLEY

DATE: 9 NOVEMBER 1987

df
9/11

1. MR ISAAC
2. CHANCELLOR OF THE EXCHEQUER

It is shifted
summary but not 100% genuine
a scheme wh. is not actually
5% less than that same for
proposed, & the same for
shares, but can be
extra 7.75%.
What will be
my good effect
indexation
bleekin
long
abolish?

CAPITAL GAINS REFORM

1. Mr Taylor's note of 22 October asked for a note on a scheme under which

- there would be rebasing to 1982 for all capital gains on shares and securities to which pooling applies and
- there would be full indexation back to 1965 for capital gains on land (and all other items apart from shares).

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

PS: And, available,
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was to only
rebas...
indexation
abolish?
be the difference
...

2. This note considers such a scheme. We have looked at this in the context of a system under which the gains of individuals and trusts would be charged to CGT at the rates that would apply if they were the top slice of income with a basic rate of 25% and a single higher rate of 35%. We have assumed a higher rate threshold of £25,000.

Feasibility and legislative implications

3. A scheme along these lines would be feasible technically, but would add a little to the length of the legislation. This is because the provisions required for rebasing would not be affected to any significant extent by confining them to shares alone. Our best guess is that rebasing could account for perhaps 20 pages of Finance Bill space. Indexing back to 1965 for land (and other assets except shares) might need an additional 2 or 3 pages.

Compliance burden and staff cost

4. Running two regimes side by side - one for shares and the other for land etc - would itself increase the compliance burden for both ourselves and taxpayers. Moreover, there would inevitably be problems in some cases involving land in unravelling past history. For example, if someone spent money on improving the value of property between 1965 and 1982 there was no need to keep records of the dates on which that capital expenditure was incurred. But that information would now be crucial for indexation purposes and although in many cases the sums at stake would be small there would by the same token be large amounts involved in others (eg in the field of property investment and development). Difficulties could also arise where an asset had been transferred at neither a gain nor a loss - for example from one spouse to another or between companies in the same group - especially where the original owner has died or was a now defunct company. For these reasons, therefore, we think it unlikely that this scheme would produce real staff savings and there might be a small

staff increase; and in practice we would have to adopt a board-brush approach where precise dates of acquisition or expenditure were hard to establish.

Indexation back to 1965 for land etc

5. Extending indexation to cover the period 1965-82 for all assets other than shares raises two important issues.

6. The first concerns the interaction with the existing indexation provisions. At present, someone who disposes of an asset acquired pre-1982 can elect to compute indexation on the March 1982 value. In most cases an election will be to the taxpayer's advantage because the 1982 value will usually be greater than actual cost. It would be necessary to decide whether in the new world this facility should continue so that people had the choice of computing indexation on either

- actual cost from the date of acquisition
- the March 1982 value from 1982.

If the election is abolished some people would be worse off given the way that prices and the RPI have moved since 1965. For example, if an asset was acquired in 1975 for £100 indexation relief for that figure from 1975 to the present time would amount to around £200. But if the same asset was worth, say, £1,000 in March 1982 then the relief available under the existing system would be around £300 (ie about 30% - the RPI increase since 1982 - of £1,000).

7. On the other hand there is a theoretical argument for abolishing the indexation election since it was introduced to provide an element of compensation for the lack of relief for pre-1982 inflationary gains. If these are taken out of charge, then the original justification for this provision goes with it.

8. The second issue concerns deferred charges, on which I commented in my note of 29 October in the context of a system under which 1982 rebasing applied to all assets. Briefly, the position there is that there is no difficulty where tax has been deferred pre-1982 but complications arise where someone acquired an asset before 1982, made a disposal after 1982, and claimed business assets or gifts relief. It would not be possible to unscramble these cases to confine the charge to post-1982 accruals and the only practicable solution we have been able to devise is to exclude an arbitrary proportion of the deferred gain. Even this option would involve considerable practical difficulty in some cases and would produce all sorts of anomalies.

9. For the scheme we are examining in this note there would still be precisely the same problem for shares (although it would be confined to gifts since the business assets relief does not run for investments of any kind). For other assets - which would qualify for indexation from 1965 rather than rebasing - it would be a hopeless task to unravel the labyrinth of deferred charges going back over 20 years to the start of CGT in order to adjust the deferred charge to give full relief for inflation. So where tax on gains has been deferred, there could be no practical possibility of recomputing the deferred charge on the new basis. As I said in my note of 29 October it is arguable that there is no reason in principle to give an uncovenanted benefit to those who opted to defer tax over those who paid it at the time.

Key statistics

10. The following table (which takes into account the results of our recent survey) summarises the effect on yield and taxpayer numbers on an accruals basis. It is confined to individuals and trusts. In addition there would be a loss to the Exchequer of a further £m250 to £m400 in tax receipts from the corporate sector. For present purposes we have assumed the continuance of the indexation election for 1982 values (paragraphs 6 and 7 above). The usual caveats apply to the

figures. In addition it is important to note that they ignore the effect of the recent stock market fall (we are covering the implications of this for the main CGT reform options in a separate paper).

11. As compared with the scheme under which rebasing applied to all assets and the gains of individuals and trusts were cumulated with income and charged to CGT at income tax rates (a basic rate of 25% and a higher rate of 35%), the present scheme works out at some £m175 more expensive.

	Yield (£m)	Taxpayer Numbers ('000)
PRESENT SYSTEM (Tax on 1988/89 disposals)	- shares 1,250 etc - land <u>680</u> Total 1,930	190
EFFECT OF REFORM WITH 35% HIGHER RATE, REBASING FOR SHARES AND INDEXATION BACK BACK TO 1965 FOR OTHER ASSETS	- shares 0 to 40 - land -300 to -350 <hr/> Total -300 to -390	- 30 to 40 -40

Distributional effects

12. For shares the position remains much the same as set out in paragraphs 8-12 of my note dated 10 September.

13. For land, indexation from 1965 is generally more generous than rebasing, though in the nature of things this will not be true in every case. This reflects the fact that our recent survey suggests that we have in the past overestimated the extent to which gains on land occurred before 1982 - and hence the benefit of rebasing. I am reporting separately on our revised costings.

Pros and Cons

14. This scheme has various attractions.

- i. Most significantly it avoids exempting substantial real gains on land which accrued between 1965 and 1982. (With rebasing most agricultural landowners would see real gains on pre1982 acquisition converted into indexed losses).
- ii. Given the existence of indexation, indexing back to 1965 has a greater theoretical justification when it is practicable (which is not the case for shares).

15. But there are drawbacks as well.

- i. It would result in a sharp demarcation between shares and land with the ^{Latter}~~former~~ being afforded much more generous treatment. And although share price indices in the 1965-82 period moved broadly in line with the RPI, large real gains will have accrued on many ~~more~~ shareholdings.
- ii. It may often be a matter of history whether someone holds shares or another type of asset. Thus land which was securitised before 1982 would tend to be at a disadvantage compared with land owned

This is true for the 17 years taken as a whole. There are an very big divergences within the period.
 CAC

directly; for example where investment properties acquired before 1982 were held via a company so as to obtain deductions for management expenses the CGT bill would often be higher than if they had been held direct by the individual. This would be bound to lead to complaints.

- iii. Businesses may start as unincorporated and then move into the corporate sector. If legislation at some point goes ahead on disincorporation, they may also move out of the corporate sector. Having a different regime for shares is bound, in such circumstances, to involve complications (both practical and legislative) and to result in sizeable anomalies.
- iv. It would be more costly to the Exchequer than rebasing across the board.

Market implications

16. These would be for the Treasury and the Bank to comment upon.

Michael Cayley

M F CAYLEY

I can see the intellectual attractions of "partial rebasing".

However, you have identified it as one of your objectives that reform should not leave CGT more complex than it is now. And experience suggests that it would be unwise to underestimate the practical complexities involved in this approach: both reopening files going back over 20 years and differentiating between shares and the underlying assets.

If you judge that "rebasing" is a necessary part of the reform package, my advice would be strongly for a clean solution across the board.

A J G ISAAC

A J G ISAAC

TASK FORCE SECRET

COPY NO 1 OF 18 COPIES

FROM: M C SCHOLAR
DATE: 9 NOVEMBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Riley
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
Mr Mace - IR
Mr Cayley - IR
Mr Calder - IR
Mr Gonzalez - IR

Chy You have the papers at X below
You have not seen before Mr
Riley at Y below.

2. All other papers mentioned in para 2, below are
flagged (by author) in red, above.

JK
11/11

- CGT REFORM: MEETING ON 12 NOVEMBER

Your office asked me to provide an agenda for your meeting on 12 November.

2. The papers for the meeting are:

Mr Cayley of 10 September	: CGT reform
Mr Cayley of 17 September	: Capital Gains reform
Mr Calder of 16 October	: Capital Gains Tax Data
Mr Taylor of 19 October	: Capital Gains Tax Data
Mr Cayley of 19 October	: CGT: Abolishing Tax Deferral on Gifts
Mr Taylor of 22 October	: Capital Gains Tax
Mr Cayley of 29 October	: CGT: Deferred charges and rebasing
Mr Cayley of 3 November	: Reform of CGT: abolishing tax deferral on gifts
Mr Cayley of 9 November	: Capital Gains: Reforms
Mr Cayley of 9 November	: CGT reform: revised costings
Mr Taylor of 10 November	: CGT reform
Mr Cayley of 10 November	: CGT reform
Mr Riley of 11 November	: Reform of CGT: Costings and the 'Surge' Effect

(Decisions have already been taken on a number of subsidiary issues - see Annex attached)

I suggest that you address the following main questions:-

- (i) Should gains be taxed as marginal slice of income or should gains and income be taxed separately (see Mr Cayley of 17 September - retain £6,600 exemption followed by slice (say £5,000) at 25 per cent and rest at 35 per cent)?
- (ii) Should indexation be abolished (see Financial Secretary's minute of 6 October)?
- (iii) Should values be rebased to 1982? If so, is it confirmed that rebasing should extend to companies?
- (iv) Should shares only be rebased, and other assets indexed to 1965?
- (v) Is it confirmed that 6 April 1988 should be commencement date of new regime?
- (vi) Is it confirmed that the annual exemption be frozen at £6,600 pending independent taxation?
- (vii) Should rate changes be phased in, in line with phased reduction in IT rates?
- (viii) Should tax deferral for gifts be abolished? Including business assets? Including inter-spouse gifts?.
- (ix) If rebasing is part of the package should concession be made for assets transferred pre-1982, disposed post-1982 and gains rolled/held over?

(Further discussion)

no

yes

Yes but not me

yes

yes

yes

(under state of 1982)

Any other points? but how 50% concession or rest?

W. J. H. J. H.



Prof. S. J. H.

11 M C SCHOLAR

Memorandum: decisions already provisionally reachedHusband and wife

Relevant papers : Cayley to C/Ex 6 August
 Taylor to Cayley 10 August
 Heywood to PPS 9 September

Decision: freeze annual exemption at current level (£6,600) until 1990. Under independent taxation give husband and wife individual exemptions; do not attempt to prevent asset switching

Principal private residence

Relevant papers : Allan to Cayley 4 September
 Heywood to PPS 9 September
 Cayley to C/Ex 11 September
 Taylor to Cayley 14 September

Decision: maintain current CGT exemption for principal private residence

Commencement

Relevant papers : Cayley to C/Ex 26 August
 Allan to Cayley 1 September
 Heywood to PPS 9 September
 Sinclair to C/Ex 18 September

Decision: CGT reforms to take effect from 6 April 1988

Convert CGT charge to IT charge (technical change)

Relevant papers : Cayley to C/Ex 12 October
 Taylor to Cayley 14 October

Decision: leave CGT as (technically) separate tax but leave open possibility of charging gains as marginal slice of income

"Another option" proposed by FST

Tax gains at 25/35 per cent
 Abolish indexation
 Exempt from CGT gains on assets held for longer than 6 years

Relevant papers : Heywood to Cayley 24 September
 Cayley to FST 30 September
 FST to C/Ex 6 October
 Taylor to PS/FST 12 October

Decision: Option not a runner but abolition of indexation to be considered as part of main 25/35 per cent option

CGT: DEFERRED
CHARGES + REBASING

ps3/23T

TASK FORCE SECRET



COPY NO. 2 OF 3 .

FROM: J M G TAYLOR

DATE: 10 November 1987

PS/FINANCIAL SECRETARY

CGT: DEFERRED CHARGES AND REBASING

The Chancellor has seen Mr Cayley's submission of 29 October. He would be grateful for the Financial Secretary's views.

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

J M G TAYLOR



Inland Revenue

Policy Division
Somerset House

FROM: P A MICHAEL

DATE: 10 NOVEMBER 1987

COPY NO 1 OF 30.

PS/CHANCELLOR OF THE EXCHEQUER

CORRIGENDUM

I am afraid that there is an error in line two of paragraph 15.i. of Mr Cayley's note to the Chancellor dated 9 November ("Capital Gains Reform"): the word "former" should, in fact, be "latter". I would be grateful if you and copy recipients could make the appropriate amendment to your respective copies.

PAM
P A MICHAEL

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



COPY NO. 18 OF 19 .

FROM: J M G TAYLOR

DATE: 10 November 1987

MR CAYLEY - Inland Revenue

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

CAPITAL GAINS REFORM

The Chancellor was grateful for your submission of 9 November.

2. He has commented that it is slightly surprising to see that a scheme which is less generous to land than that originally proposed, and the same for shares, should cost an extra £175 million. What would be the yield effect if the indexation election were abolished? And, incidentally, was the original rebasing proposal costed on the basis of indexation election retained or abolished? What would be the difference in cost?

3. I should be most grateful for advice.

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

J M G TAYLOR



Inland Revenue

PPA: P1
Policy Division
Somerset House

Copy No 1 of 30

FROM: M F CAYLEY

DATE: 10 NOVEMBER 1987

1. MR ISAAC ^{10/11}
2. CHANCELLOR OF THE EXCHEQUER

CAPITAL GAINS REFORM

1. Mr ^{Taylor} Tyrie's minute to me of 10 November raises some questions on my note of 9 November on a scheme with rebasing for shares and indexation back to 1965 for other assets.

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

2. For assets other than shares, indexation back to 1965 is, as my submission explained, generally more generous than rebasing. (Mr Michael's corrigendum of 10 November put right an error that crept into the summary at the end of the submission.) This is, because, typically (and subject to the inevitable exceptions), such assets appreciated over the period to 1982 by less than the rate of inflation. So typically indexation exceeds pre-82 gains and effectively therefore gives some offset against post-82 gains.

3. It follows that, although we have assumed that people would be able to elect for a 1982 base for indexation this makes ~~initially~~ ^{virtually} no difference to the overall costings. But, as explained in the Annex to my 9 November note on revised costings, our estimates are based on the assumption that asset prices have moved over time in line with the indices we have now devised. In practice, there may be considerable dispersion of movement, and some assets will have appreciated by more, and others by less, than the indices. So for some people an election for a 1982 indexation base would be very advantageous. Against this, the dispersion probably - as the Annex explained - means that we have overestimated the cost of rebasing for shares. We cannot say whether these two effects cancel out, but they certainly offset each other.

4. The original rebasing proposal - rebasing across the board - assumed that generally indexation - like the gains themselves - would be computed on 1982 values except where ^{the} acquisition cost was higher. The election would disappear. This is part and parcel of what rebasing means.

Michael Cayley

M F CAYLEY

REFORM OF CGT:
TAX DEFERRAL ON
GIFTS

~~TOP SECRET~~ SECRET



COPY NO. 18 OF 19.

FROM: J M G TAYLOR
DATE: 10 November 1987

MR M F CAYLEY - Inland Revenue

- cc PS/Chief Secretary
- PS/Financial Secretary
- PS/Paymaster General
- PS/Economic Secretary
- Sir P Middleton
- Sir T Burns
- Mr Byatt
- Mr Cassell
- Mr Scholar
- Miss Sinclair
- Mr Cropper
- Mr Tyrie
- Mr Jenkins (Parly Counsel)
- Mr Battishill - IR
- Mr Isaac - IR
- PS/IR

**REFORM OF CGT:
ABOLISHING TAX DEFERRAL ON GIFTS**

The Chancellor has seen your submission of 3 November. He has commented that your impression that the relief is increasingly used as a tax planning device is correct, and important.

J M G TAYLOR

TASK FORCE SECRET



Copy No. 1 of 18

FROM: FINANCIAL SECRETARY

DATE: 11 November 1987

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Riley
Miss Sinclair
Mr Scotter
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Cayley - IR
Mr Calder - IR
Mr Mace - IR
Mr Gonzalez - IR

CAPITAL GAINS TAX REFORM

I have considered the following papers in advance of your meeting tomorrow:

Mr Cayley (29 October): Deferred Charges and Rebasing

Mr Cayley (3 November): Tax Deferral on Gifts

Mr Cayley (9 November): Revised Costings

Deferred Charges and Rebasing

2. You asked for my view on this issue. The complications arise only in a narrow set of circumstances, namely, where someone acquired an asset before 1982, made a disposal after 1982 and claimed rollover or holdover relief. Of course, if rebasing is not introduced there is no issue to consider.

3. I had lunch with the County Landowners' Association today and they volunteered the view that the difficulties caused by rollover/holdover relief were so acute that they had considered rebasing and then rejected it. They actually said that some of their members would lose from rebasing because of the rollover/holdover relief problem. I think this is a difficult argument to sustain, but nevertheless, I do accept that there would be some hard cases if rough and ready relief were not introduced. This would certainly take the glitter off the ginger-bread.

4. Although I can see the argument in principle against making a concession, I do think that the political argument for introducing the "50% option" is stronger. I therefore recommend the rough justice of this option.

Tax Deferral on Gifts

5. I recognise that gifts relief is increasingly being used as a tax planning device. I also recognise that once independent taxation comes in the no gain/no loss treatment of gifts between husband and wife will become more valuable. Nevertheless I am not in favour of changing the rules in this area, either for gifts generally or for husband and wife. I think abolition of relief would be bitterly resisted and would be criticised as being counter to the Government's desire to encourage lifetime giving. The key point is that when assets are given away no cash is received with which to meet any possible tax liability. To the extent we are moving towards treating realised capital gains as income, to tax gains accruing on assets given away would seem inconsistent.

General Package

6. Although I have been opposed to rebasing, which is an unwarranted and legislatively complex (20 pages) compensation for gains made in the past, I do recognise that the revised costings in Mr Cayley's minute of 9 November weaken the argument against rebasing. I would still only favour spending perhaps £500m (depending on behavioural effects) in this way if you thought it to be an essential compensation

for raising the tax rate (for some) by 5%.

7. On the assumption that rebasing is introduced, I think that the only two options worth considering are numbers 2 and 4 in Mr Cayley's minute (paragraph 8).

Option 2: provides a much greater degree of "integration", but is slightly more complex;

Option 4: is simpler, but would be harder to present as integration.

8. I imagine that you will be more inclined to Option 2 than 4. I myself do not think that 4 can be dismissed. Although it would leave a demonstrable distinction between CGT and income tax and would result in some people facing different marginal rates on capital gains and income, there would be an alignment of the rates. Probably for the large majority of people the marginal rates would be the same for gains and income.

9. In addition, option 4 would produce fewer losers and would reduce the chances of a single large realisation in one year pushing a taxpayer into the 35% bracket.

10. I think, however, that the strongest argument for Option 4 comes when we consider the possible phasing of the higher rate reductions. If we went for Option 4 we could simply have a 25%/35% structure from the outset. If, however, we went for Option 2, we would face a choice between:

(i) going for 25%/35% straight away, with the 35% being out of line for several years with the highest income tax rate - requiring complicated legislative provisions for the transitional period and making the presentation more awkward; or

(ii) going for a pattern of higher CGT rates of:

1987/88	30%
1988/89	37%
1989/90	36%
1990/91	35%

In my view, this pattern looks very odd. Indeed, I think that a rate of 37% even if just for one year looks too high in present circumstances.

11. If we go for phasing of the income tax changes, I think we should definitely go for Option 4. If we do not I marginally prefer Option 4 although I think 2 is closer to what you want.

9.4

|| NORMAN LAMONT

TASK FORCE SECRET

COPY NO 1 OF 9

FROM: A G TYRIE

DATE: 11 NOVEMBER 1987

CHANCELLOR

cc Financial Secretary
Sir P Middleton
Mr Scholar
Ms C Sinclair
Mr Cropper
Mr Isaac

CAPITAL GAINS TAX

1. The Options. As you know I start from the prejudice that capital gains should be taxed and that the tax on them should, as far as possible, be integrated with income. On these grounds I favour options 1 or 2. Options 3 and 4 have little to offer: the creation of a two tier system and a new, messy, £5000 threshold for the lower rate. Options 3 and 4 retain a virtually separate CGT, but one in which it happens that the two rates are the same as income tax. Rather than adopt either of these options I think we would be better off sticking with the CGT we have got (we claim it is on a 'sustainable basis'). We could rebase anyway.

2. If we decide we need phasing because of kink losers I don't think we should allow that decision to influence the choice between options on CGT reform.

3. Tax deferral on Gifts. I think we should do nothing. A gift, for example of shares, is not a gift of disposable income. Assuming that you want to move towards integration on the grounds that capital gains are in most instances similar

to disposable income it would be perverse to tax a gift until it had been converted into income.

4. I acknowledge the point that the relief is used as a vehicle for tax avoidance but this is largely between spouses and to some extent to children, often of stakes in small businesses. I think action on gifts to spouses is out of the question. Action on transfers to children would sit uneasily with your views on intergenerational wealth, reform of IHT etc.

5. Deferred tax charges. On these I would also do nothing. I don't think we should worry ourselves sick that these people would benefit less from rebasing than others. It is a small problem affecting only those who will have obtained a CGT deferral on an asset between 1982 and 1988, on assets acquired before 1982. The rough and ready proposal to halve the liability as a *douceur* looks an unnecessary complication. At the very most I suggest we keep the 50% proposal up our sleeve until Committee Stage.

6. Alternatively, if you feel we need to do something I suggest that we provide the 50% sweetener for, say, three years.

7. Rebasing. Now that we are told (Riley, 11 November) that rebasing costs hardly anything at all, as opposed to £1 billion, my objection to it falls. How confident are we that the £100 million figure is more accurate than the £1 billion?

Aut -

A G TYRIE



NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM,
HM TREASURY AT 3.00PM ON THURSDAY, 12 NOVEMBER 1987

Present: Chancellor
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Riley
Mr Scotter
Mr Cropper
Mr Tyrie

Mr Battishill - IR
Mr Isaac - IR
Mr Mace - IR
Mr Cayley - IR
Mr Calder - IR
Mr Gonzales - IR

CAPITAL GAINS TAX REFORM

Papers: Mr Scholar's annotated agenda of 9 November, and previous papers.

The Chancellor thanked officials for the papers prepared for the meeting. He proposed that the meeting should address the main questions listed in paragraph 2 of Mr Scholar's agenda.

2. In preliminary discussion, it was noted that the US system had the following characteristics: no distinction between long and short term gains; tax levied at the rate of the marginal slice of income; no offset for losses; and no exemptions. The current proposal for our system similarly envisaged taxing capital gains at the same rates as income, but above the high, separate threshold for CGT. Given the characteristics of our tax system there was



very considerable administrative advantage in retaining a high CGT threshold which took a large number of taxpayers out of the CGT system altogether.

3. The meeting considered the questions in paragraph 2 of Mr Scholar's minute.

Should gains be taxed as the marginal slice of income or should gains and income be taxed separately?

4. The Chancellor said that, on the assumption that the new higher rate of income tax was phased in, the question arose whether these transitional rates were prohibitive for the taxation of gains. He himself did not think the markets would find them so (Mr Cassell agreed and said that the Bank of England's view confirmed this) nor that they would much distort the rate of disposals. He favoured taking gains as the marginal slice of income, which Mr Isaac confirmed would be more complex to administer but not insuperably so. Nor should the maximum combined rate (44 per cent, including NICs) act in practice as a disincentive to work since it would be difficult for an individual to identify his capital gain as the reason why income tax liability at a higher rate was triggered.

5. The Chancellor, continuing, said that a change of this sort was made possible by the substantial reduction in higher rates. It was more equitable than a flat rate on gains, and made a better package with rebasing. It was agreed to go ahead on the basis of taxing gains as the marginal slice of income.

Should indexation be abolished?

6. It was agreed to retain indexation.



Should values be rebased to 1982?

If so, is it confirmed that rebasing should extend to companies?

7. It was noted that the cost estimates in Mr Riley's paper were lower than earlier estimates for a number of reasons, including the fall in share values. The Table in the Red Book would show receipts figures. These would be nil in 1988-89; and a low figure in 1989-90. The Red Book would also show a considerably higher figure on an accruals basis. It was agreed to rebase to 1982, and to extend rebasing to companies.

Should shares only be rebased, and other assets indexed to 1965?

8. It was agreed not to pursue this option.

Is it confirmed that 6 April 1988 should be the commencement date of the new regime?

9. This was confirmed. (Mr Cassell noted that the Bank of England had agreed with the Treasury's view of the market implications of a 6 April start.)

Is it confirmed that the annual exemption be frozen at £6600 pending independent taxation?

10. It was agreed to freeze the exemption at £6600. However, it was noted that in presenting this it would be preferable to link this to rebasing, rather than independent taxation. This was agreed.

Should rate changes be phased in, in line with phased reduction in IT rates?

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Should tax deferral for gifts be abolished?

Including business assets?

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If rebasing is part of the package should a concession be made for assets transferred for 1982, disposed post-1982 and gains rolled/held over?

13. The Chancellor said there were three possibilities: no concession; this proposal; and a 50 per cent concession. These could be combined by beginning with no concession, but considering making one at Committee stage. The Financial Secretary noted that the Country Landowners Association had said that they did not want rebasing, because of the hold over problem.

14. In discussion, it was noted that only a small number of people would be 'losers' if the concession were not made. They would be losers in the sense that they would not benefit from rebasing. They would be in the same position as those whose gains had all been made since 1982. It was agreed, therefore, that there should be no intention to make the concession from the outset, but that the Revenue should work up the technical details needed to make such a concession, if it proved necessary, during the course of the legislation.

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Mr Byatt

25
..
J M G TAYLOR
17 November 1987

TASK FORCE SECRET

Copy No. 1 of 5 Copies

FROM: P J CROPPER
DATE: 12 November 1987

CHANCELLOR

cc Financial Secretary
Mr TyrieCAPITAL GAINS: TAX REFORM

I shall not make a great song and dance at this afternoon's meeting, but I should register that I am unrepentant on this issue. I do not see any justification for treating realised capital gains as income, in theory or in practice.

2. Even Options 1 and 2 do not achieve total integration between CGT and Income Tax. Capital losses are still not to be offset against earned income; the tax on gains is still levied arbitrarily on realisations rather than on accruals; there is still a separate tax-free tranche for gains. We could hardly claim to have abolished a fifth tax, which would at least have been a good reason for doing something on this front.

3. Options 3 and 4 seem to me hardly worth the disruption they would cause. All they do is to introduce an element of progression and a new high rate that would be keenly resented by all the most vocal lobbies. Part of the trouble about CGT has been the frequent changes in the rules - particularly after the false start to indexation in 1982. There is an awful lot to be said for no change.

4. Above all, and I know this is an unfashionable argument, either of these schemes would pave the way for a future government of a different complexion to remove the separate tax-free tranche of gains and integrate gains tax almost completely into what would, without doubt, become a more steeply progressive income tax.

TASK FORCE SECRET

5. The motive of wanting to simplify the administration of CGT will be partly met by re-basing. The trend of thinking seems to be away from abolition of indexation. Indexation, in any case, never struck me as more than an extra layer on top of an already inherently difficult tax. If we insist on taxing long term gains (as opposed to speculative short term gains) I believe we have to accept complexity as inescapable.



P J CROPPER

CGT, 12 Nov.

C Stick to US model, with exempt slice - that is big difference. Interaction with IT & incentives: N.B. only 10 percentage pts difference; and optical illusion - nobody will realise marginal rate will be 44%, not 34%.

Cost/Yield

Have to give accruals figs where different.

Full yr fig is basically first yr accruals fig.

Legislate for as much as possible, incl. CGT annual exemption.

Justification for freezing exemption, ~~is~~ in public, is that rebasing is generous. Present it as part of CGT package, not IT package.

And draw contrast between threshold for CGs and threshold for inv. income (which for most is nil).

~~10 acres at £2,500 acre⁻¹ in 1980~~

by 1982 £2000

Now

MFC

July: with rebasing, if actual gain less than 1982 gain, wd tax only ~~the~~ actual gain.

+ Where bought pre 82, sold or gave it away post 82, & claimed deferral. In many cases, won't be able to establish 1982 value. So cannot reduce deferred gain by rebasing, tho' in a few cases info will be available. IR^v ∴ suggest arbitrary reduction of gain.

C

Rather do nothing since only "disadvantage" is not being able to take new advantage of new rebasing. But work out how to give concession if need be.

~~IF~~ I receive a dividend

~~IF~~ taxpayer receives a dividend

37-36-35



NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM,
HM TREASURY AT 3.00PM ON THURSDAY, 12 NOVEMBER 1987

Present: Chancellor
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Riley
Mr Scotter
Mr Cropper
Mr Tyrie

Mr Battishill - IR
Mr Isaac - IR
Mr Mace - IR
Mr Cayley - IR
Mr Calder - IR
Mr Gonzales - IR

CAPITAL GAINS TAX REFORM

Papers: Mr Scholar's annotated agenda of 9 November, and previous papers.

The Chancellor thanked officials for the papers prepared for the meeting. He proposed that the meeting should address the main questions listed in paragraph 2 of Mr Scholar's agenda.

2. In preliminary discussion, it was noted that the US system had the following characteristics: no distinction between long and short term gains; tax levied at the rate of the marginal slice of income; no offset for losses; and no exemptions. The current proposal for our system similarly envisaged taxing capital gains at the same rates as income, but above the high, separate threshold for CGT. Given the characteristics of our tax system there was



very considerable administrative advantage in retaining a high CGT threshold which took a large number of taxpayers out of the CGT system altogether.

3. The meeting considered the questions in paragraph 2 of Mr Scholar's minute.

Should gains be taxed as the marginal slice of income or should gains and income be taxed separately?

4. The Chancellor said that, on the assumption that the new higher rate of income tax was phased in, the question arose whether these transitional rates were prohibitive for the taxation of gains. He himself did not think the markets would find them so (Mr Cassell agreed and said that the Bank of England's view confirmed this) nor that they would much distort the rate of disposals. He favoured taking gains as the marginal slice of income, which Mr Isaac confirmed would be more complex to administer but not insuperably so. Nor should the maximum combined rate (44 per cent, including NICs) act in practice as a disincentive to work since it would be difficult for an individual to identify his capital gain as the reason why income tax liability at a higher rate was triggered.

5. The Chancellor, continuing, said that a change of this sort was made possible by the substantial reduction in higher rates. It was more equitable than a flat rate on gains, and made a better package with rebasing. It was agreed to go ahead on the basis of taxing gains as the marginal slice of income.

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14. In discussion, it was noted that only a small number of people would be 'losers' if the concession were not made. They would be losers in the sense that they would not benefit from rebasing. They would be in the same position as those whose gains had all been made since 1982. It was agreed, therefore, that there should be no intention to make the concession from the outset, but that the Revenue should work up the technical details needed to make such a concession, if it proved necessary, during the course of the legislation.

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Mr Byatt

JF

J M G TAYLOR
17 November 1987

SCOTT
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SELF
EMPLOYED
NICs
16 NOV

js/4652p

CONFIDENTIAL

P/PTV/5



DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Minister of State for Social Security and the Disabled

*Under I have
answer
a his*

The Rt Hon Norman Lamont MP
Financial Secretary to the Treasury
HM Treasury
Parliament Street
LONDON
SW1P 3AG

FINANCIAL SECRETARY	
REC.	17 NOV 1987
ACTION	MR McIntyre
COPIES TO	Ps/chancellor Ps/CST Sir P. Middleton Sir T. Burns MR Cassell MR Munnick Miss Pearson MR Scholer Miss Sinclair MR Gibson MR Cropper MR Tyrre MR Mace IR Ps/IR

16 NOV 1987

Dear Norman,

THE STRUCTURE OF SELF-EMPLOYED NATIONAL INSURANCE CONTRIBUTIONS

Officials of DHSS and Inland Revenue have recently been in touch about the possibility of simplifying the structure of National Insurance contributions (NICs) for the self-employed. I would like your agreement to their working up detailed and costed proposals on the basis of which we could decide whether this change was worth implementing.

As you know, self-employed people now pay two sorts of NICs: a flat-rate contribution of £3.85 a week which is paid to DHSS either by direct debit or by stamping a card; and a profits-related Class 4 contribution which Inland Revenue collect for us alongside Schedule D Tax. The present NIC structure for the self-employed is universally disliked. Self-employed people resent having to pay two separate types of contribution, particularly when only the flat-rate Class 2 contribution gives them benefit rights. From a Government standpoint, it is clearly inefficient to have two Departments involved in collection and would make more sense if the NIC structure were changed to enable one to take full responsibility. Cutting down the number of Departments with whom self-employed people have to deal and whose paperwork they have to complete would also be a plus for deregulation.

The most obvious simplification would be to levy a single profits-related NIC from self-employed people collected by Inland Revenue. This might operate between lower and upper profits limits in the same way as employed earners NICs do. A great deal of detail would need filling in - eg on what the rate or rates of contribution should be - but the main point is that it would be collected twice yearly alongside Schedule D tax as is the present Class 4.

E.R.

Although the idea of such a rearrangement is simple, there would be many points to be resolved. eg:

BENEFIT ENTITLEMENTS

Contributions would be collected later than Class 2 are now and this would mean some change for DHSS benefit year rules, which govern the year for which NICs give rise to benefit rights.

GAINERS AND LOSERS

Changing the structure of self-employed NICs would inevitably create gainers and losers and the new structure would need to be designed to keep them to a minimum.

STAFFING AND ORGANISATION

We believe that the potential staff savings in DHSS may be up to 1,270. We understand from Inland Revenue officials that there would be a large off-setting staff cost for Inland Revenue but in order to assess the proposal properly this needs to be quantified. The DHSS savings would have major implications for the organisation of contributions work in our local offices and those also would need to be assessed.

COSTS

Other costs would need to be estimated, especially a possible one-off cost involved from moving to the new timescale for collection.

LEGISLATION

Changes in both primary and secondary legislation would be needed. A further deregulation advantage would be that we could get rid of some offences from the statute book.

And there are other points, including several raised by your officials. I do not wish to underestimate the size or complexity of the issues which would be thrown up in the kind of fundamental streamlining we are contemplating. But given the undoubted advantages both to the self-employed and to Government which are possible, I think we must look at the proposal in greater depth to see how large the problems are and how they could be surmounted. Only then will we be on firm ground in deciding whether to proceed or not.

I should be grateful therefore for your agreement that our officials should look into this and report back to us by, say, the middle of next year.

I am copying this to David Young.

Yours wv,

Nick.

NICHOLAS SCOTT



Inland Revenue

Policy Division
Somerset House

FROM: B A MACE
DATE: 17 NOVEMBER 1987

Pass on to Mrs

for 2 packages

- 1. MR ISAAC *note over of CE 17.11*
- 2. CHAIRMAN *17/11*
- 3. CHANCELLOR OF THE EXCHEQUER

**
 pss let me
 have an update
 for Mr Scholar
 on the
 development of
 UPL admin
 since April 1989*

MACE
 →
 CHIEF
 17/11

TAX REFORM 1988: OPERATIONAL IMPLICATIONS

1. In the light of the emerging shape of the tax reform package for 1988 we have been looking at the operational implications of the various components of the reform and assessing the effect of accommodating the changes within our computer systems. This note describes the results of that work, focusing in particular on the impact of the immediate computer development work which would need to be undertaken over the next 6 months. It looks first at the background to the changes which would be required and gives some examples of the items for which

- cc Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir T Burns
- Mr Byatt
- Mr Scholar
- Mr Culpin
- Miss Peirson
- Miss Sinclair
- Mr McIntyre
- Mr Macpherson
- Mr Riley
- Mr Cropper
- Mr Tyrie
- Mr Call

- Chairman
- Mr Isaac
- Mr Painter
- Mr Beighton
- Mr Lewis
- Mr Calder
- Mr Matheson
- Mr Mace
- Mr Cayley
- Mr Yard
- Mr Allen
- Mr Glassberg
- Mr Pinder
- PS/IR

we need to make contingency plans. It then looks at the software development costs of the various components of the package and assesses the impact that accommodating this work might have on our other computer development plans. Finally the note responds to your request at the meeting on 20 October for further advice on implementing changes to NIC for the self-employed (in particular abolition of the Upper Profits Limit) from October 1988. You may therefore like to have the note available for your meeting on 19 November.

Background: Computer Development Work

2. Our skilled computer manpower at Telford, who will have to bear the brunt of the additional development work to implement the reform package, are, as you know, very tightly stretched at present. Major tasks currently on hand include, in particular, the completion of various essential (for staffing reasons) enhancements to COP, the implementation of the CODA system nationally, assuming the present pilot is successful, and the development of the initial stages of the BROCS project. Any new work adds to the existing pressure but we have undertaken not to seek any additional resources for 1988-89 to carry out the work needed to implement the Budget package. The purpose of this note is to identify some of the risks which might in due course have to be faced because of the need to give priority to work on the Budget package ahead of work on our other plans. The note is specifically concerned with those aspects of the reform which have to be implemented in 1988-89 (or 1989-90). It does not look at the operational implications of Independent Taxation.

The Budget Changes: Operational Implications

3. On the income tax/NIC side the present reform package contains a number of individually complex components which interlock in a number of places. Although the ultimate effect of the package will be a simplification of the overall structure of the income tax allowances and rates this does not mean that the transition to the new system, in terms of the changes needed to the underlying computer

systems, is simple. The reform will be considerably more complex to implement than any of the Budget changes we have had to undertake since 1979, and certainly the most complex since the COP system was introduced into local tax offices. Although computer systems generally offer the opportunity of being able to handle options which would be impossible or very costly under a manual system they inevitably impose the constraint that it takes longer to amend computer procedures than for staff to make alterations in a manual system. We simply cannot afford to make mistakes when the computer system applies the changes throughout every office in the country. Another point is that while it may be possible to get the computer to carry out automatically some of the changes needed to implement a new system (in order to save staff time and effort), programming the machine to deliver that help requires early preparation.

PAYE

4. So that we can implement the changes under PAYE as quickly as possible after they have been announced we have already had to begin, centrally, the task of identifying the necessary computer software changes. Although none of the proposed changes individually requires a very substantial amount of computer programming or other work the total package will be more difficult to achieve than the individual parts might suggest, particularly if we are to keep all of our other projects to their existing timetables. Accordingly, to minimise the risks that a particular component of the Budget proposals might give rise to operational difficulties, at a late stage, we have had to put in hand now, on a contingency basis (and with all proper security), the work required to implement the changes you might want to make. This is not something which can be left until the final shape of the package is clear. There remains a risk, however, that some interactions between the various components of the package may not come to light until a late stage.

5. Because the scope of the Budget changes is not yet determined we shall have to provide flexibility in the system to

cope with a range of possible options. We can then select the particular facilities which are needed once the package is settled. However, undertaking work now, on a contingency basis, in order to keep the various options open means that some of the work we are carrying out may be wasted. We think this is unavoidable, but the result is that resources available to carry forward work on our other computer projects are that much smaller.

PAYE: Budget Implementation Timetable

6. Although we are making much earlier contingency plans for implementation of the Budget package this year, we anticipate that it is nevertheless likely to take tax offices a few weeks longer than usual to put the changes into effect. For the vast majority of PAYE taxpayers, Budget proposals are implemented automatically by employers (by uprating codes and bringing new tax tables into operation). Normally only about 1 million PAYE codes have to be recalculated in tax offices but, on the basis of the current reform package, we estimate that that figure could be more than doubled this year. This would tentatively point to implementing the changes under PAYE with payments of wages and salaries made after mid to late June (rather than after mid May as in the last few years). We shall not, however, be able to set a firm timetable until the final shape of the package is determined a few weeks before Budget Day.

7. We have ruled out any extension of employer action where this would mean changes in computer payroll programs since this would lead to much greater delay in implementation.

8. Annex 1 gives some illustrations of the practical problems which will have to be faced in implementing the Budget proposals under PAYE.

Computer Development Work: Staff Costs

9. The software development work required in the 6 months to March 1988 (including the work needed for abolition of the UPL from October 1988) represents only a small proportion of the total software development resources available during this period. But the staff involved already have a very full programme of work in developing our existing and planned systems so that any new tasks have to be fitted in either by overtime (which in some cases is already being worked to clear the existing workload) or by displacing part of the work programme to a later date. This creates a "bow wave" effect: we shall start development work for 1988-89 already behind, so further increasing the pressure on resources through 1988-89 and subsequent years with a possible eventual impact on projects with implementation dates several years ahead. This could put back valuable staff savings if later projects get delayed.

10. The attached table (Annex 2) shows how software development work to implement particular components of the reform package is spread over the next 18 months with a concentration in the period up to March 1988. These costs represent only a small part of the total work involved in building the changes into our systems. Further work is required to test and document the changes so that we can be sure the new system will operate satisfactorily. In addition there is further work, for example to prepare the necessary working procedures in tax offices and to train the staff involved.

Assessment of risks

11. Looking at the work involved in implementing the package our assessment is that we shall be able to implement the Budget changes so far proposed without unacceptable risk provided that the abolition of the UPL for the self-employed can be deferred until 1989-90. Even with this suggested postponement (the reasons for which are discussed below) some risks will remain, however.

12. In particular a major assumption in meeting the timetable for implementing the Budget changes is that we do not run into any unforeseen problems. After accommodating the work needed for the Budget changes there is little or no resilience left in our plans so that the risk, if we run into difficulties, is that we might have to consider deferring the delivery date either of major projects and their staff savings (or of enhancements to existing projects and their associated staff savings) in order to keep all of the Budget work on course.

13. A delay in implementation of our major projects (or enhancements to existing projects) and their staff savings would be very embarrassing since we shall be seen not to have met published timetables (and the associated manpower targets.) More important, any postponement of staff savings will increase our running costs, and hold up our efficiency savings, until the staff reductions can be achieved.

And these savings are already counted in our budget.

Self-employed NIC: Implementation

14. As requested at your meeting on 20 October we have looked further at the possibilities for abolishing the Upper Profits Limit effectively from October 1988. As I explained in my note of 19 October taken in isolation there are fairly severe risks in seeking to implement the abolition of the UPL during 1988-89 because of the burden it imposes on the specialist computer staff involved and because of the potential consequential effects on the work of tax offices. As the attached table shows the software development work required in the next 6 months to implement the Budget changes is more than doubled if we have to provide for the abolition of the UPL during 1988-89. (This is because the abolition involves very complex changes to the structure of the CODA system). Deferring the change so that it takes effect from April 1989 would enable us to spread the work over the 12 months from March 1988 to March 1989 when it can be accommodated more easily, not least because it would no longer be

under conditions of Budget secrecy. Deferral would also reduce the risks of disruption in local tax offices at the time when CODA is going live nationally in May/June next year.

15. We have now looked at the changes needed to implement the abolition of the UPL from October 1988 in conjunction with the other amendments which have to be made to the computer system over the next few months to implement Budget changes. In the light of this our view is that 1988-89 implementation carries high risks either of serious disruption to the Schedule D assessing programme in tax offices during the summer of next year and/or of the need to defer new projects or system enhancements and their resulting staff savings in order to ensure implementation of the Budget measures on time. In the circumstances our advice has to be that on operational grounds this change should be deferred until April 1989.

Conclusion

16. To sum up, the main points which emerge from this note are

- X |
- (i) Abolition of the UPL from October 1988 carries unacceptably high risks of breakdown. Our strong recommendation would therefore be to defer this change until April 1989.
 - (ii) If abolition of the UPL is deferred until April 1989 our view, on the information we have available at present, is that we should just be able to implement the remainder of the Budget package without affecting the implementation dates for other computer projects or enhancements to existing systems. However, because of the complexity of the changes it is likely to take a few weeks longer than in previous years to put the Budget measures into effect under PAYE.
 - (iii) We shall have no margin whatsoever for contingencies. If we come up against unforeseen difficulties either in

implementing the Budget changes themselves or in completing computer projects (or enhancements for existing systems) the need to give priority to Budget work could mean that we would have to postpone the implementation of a major project or system enhancement and its staff savings.

B A Mace

B A MACE

I think the main points, underlying Mr Mace's note above, are:

- It is truism that there is a risk in changing the tax structure in the middle of major computer developments. But a degree of risk must be accepted, if administrative costs are not unacceptably to constrain policy reforms.
- Subject to the NIC/UPL point, we think that the risks or costs entailed in implementing the 1988 Budget reforms are of an order which you can reasonably accept.
- So far as we can judge at this stage, it should also be possible to achieve your objectives without adverse financial or operational consequences for existing projects in 1989-90 and subsequent years. But it is a large and complex operation and will leave us with no margin for contingencies on the computer front. Though we think you will feel the risks to be reasonable - measured against the benefits of the reform - you will wish to note that the costs in deferred staff savings and potentially higher running costs could be significant, if problems emerge.
- Our advice has to be that, if you add the UPL option in mid-year 1988, the risks grow to a level which we cannot advise you to accept.

CFE

A J ISAAC

I very much agree. We are gearing ourselves up for the changes, but there will be no margin to spare. *EMJ* 17/11

BUDGET PROPOSALS: PRACTICAL EFFECTS FOR PAYE

1. This annex gives examples of the particular consequences which the current Budget proposals may have for PAYE.
2. First, if there is only a single higher rate of income tax for 1988-89, and a substantial increase in the higher rate threshold, tax offices will have to review a significant proportion of the PAYE codes of existing higher rate taxpayers before the changes can be put into effect under PAYE. To be ready for this, we need to prepare the COP system to identify those cases requiring review and, where possible, make any necessary coding adjustments automatically.
3. In some cases (for example higher rate adjustments for mortgage interest relief) an automatic adjustment by the computer will not be possible. For those we shall want the machine to list the taxpayers affected so that the review can be undertaken individually.
4. Second because of the complexity of the changes it may not be possible, in a small number of cases, to make adjustments under PAYE to give taxpayers immediately the full benefit of tax reductions for the whole of the tax year.
5. An example of this arises for some higher rate taxpayers who have a second job (or a number of directorships). In these cases a special PAYE code is applied which deducts tax non-cumulatively from the pay in the second employment or office at the taxpayer's expected marginal rate. We would propose to amend these codes to reflect the new higher rate structure so that any deductions made after the Budget package has been implemented under PAYE would be at the appropriate marginal rate. But because these special codes are non-cumulative it would not be possible to adjust any tax which has been overpaid in the second

employment between 6 April 1988 and the date the package is implemented except by asking employers to make complicated amendments to their payroll programs. These could take several months to carry out and we think the effort involved is likely to be disproportionate to the resulting benefits. We will, instead, aim to sort matters out for these taxpayers at the end of the tax year. In most cases those affected are likely to benefit considerably in their main employment when the Budget changes are put into effect under PAYE.

TASK FORCE SECRET

ANNEX 2

SOFTWARE DEVELOPMENT COSTS: MAN DAYS (1)

	<u>6 months</u> <u>to</u> <u>March 88</u>	<u>6 months</u> <u>to</u> <u>Sept 88</u>	<u>6 months</u> <u>to</u> <u>March 89</u>	
Rate Changes & Minor Personal Allowances	225	50	100	
NIC - Self employed	250(2)			
Capital Gains	-	100	100	
Covenants	-	-	-	
Maintenance	No impact - swept up in other changes			
Benefits in Kind	Under consideration			
Independent Taxation	-	100	525	
	<hr/>	<hr/>	<hr/>	
Total	475	+ 250	+ 725	Total 1450

ANK
2
SOFTWARE
DEVELOPMENT
COSTS

Notes

1. The costs represent the Software Development costs only expressed in man days. There will be substantial further costs in other areas (see paragraph 10). The costs are based on our present perception of the work needed to make the changes and may well change as more detailed work is undertaken.
2. Work required for UPL abolition assuming implementation from October 1988. If implementation was deferred until April 1989 the development costs would be spread over the 12 months to March 1989.

FROM: M C SCHOLAR
DATE: 18 NOVEMBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Culpin
Miss Peirson
Miss Sinclair
Mr McIntyre
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

Mr Isaac - IR
Mr Mace - IR
PS/IR

SCHOLAR
CH/EX
18/11

**TAX REFORM: INCOME TAX & NICs - EFFECT OF POSTPONING ABOLITION
OF UPL FOR SELF EMPLOYED UNTIL APRIL 1989**

Mr Mace's submission of 17 November ^{on operational implications. There is another Mace note, on costings, also behind.} said that abolishing the UPL for self-employed NIC contributions in October 1988 would put at risk the major computer developments in the Revenue on which you are counting, both for the implementation of policy changes such as independent taxation, and for further staff savings. He advised you to make the change in April 1989. You asked us for a quick note considering the implications of this for the tax reform package.

2. At present you are considering a phased package as follows:

	1988-89	1989-90	1990-91
Higher rate	37	36	35
NIC charge above UEL for employees	7	8	9
NIC charge above UPL for self-employed	6.3 per cent (plus tax relief)	6.3 per cent (plus tax relief)	6.3 per cent (plus tax relief)

The higher rate of tax on capital gains would, in any year, be the income tax higher rate.

3. The main rationale for phasing is not cost (less significant anyway now that the CGT reform looks much cheaper in 1988-89 and 1989-90 than originally foreseen) so much as the desire to reduce both the number of losers, and the average size of losses, from the abolition of the UEL.

4. Postponing abolition of the UPL is likely to mean an addition of some £70 million to the score-card arithmetic in 1988-89.

5. We have known all along that the timing of different elements in the package involves some awkwardness for employees - gains from June onwards from the cuts in income tax, then reductions in those gains and in some cases their conversion into losses from October onwards. We have so far taken the view that this kind of unevenness does not too much matter - partly because the uneroded gains from lower tax rates do not exist for long enough for people to become habituated to them and partly because employees are up to a point used anyway to their tax codes swinging around.

6. Delaying the abolition of the UPL to April 1989 adds a further complexity to this for the self-employed. For 1988-89 (tax payable 1 January 1989 and 1 July 1989) the self-employed above the UPL will get the full benefit of the income tax cut but pay no additional NICs. For 1989-90 (tax payable 1 January 1990 and 1 July 1990) they will then face the full NIC charge above the UPL. So for those above the UPL there will be a sharp drop in liabilities between 1987-88 and 1988-89 and a sharp rise between 1988-89 and 1989-90. Abolition from October 1988 would have meant a smaller drop between 1987-88 and 1988-89 and a smaller rise between 1988-89 and 1989-90.

7. So delaying abolition of the UPL means greater unevenness than we have so far contemplated. It means, too, that there will be a longer period of time for the opposition to the abolition of UPL to crystallise. And, perhaps less important, the employed will have a further ground for complaint about the favourable treatment of the self-employed: not only is their top Class IV rate only 6.3 per cent

rather than 9 per cent, but those above the UPL are let off their extra NICs altogether for half a year.

8. This final point may, to a degree, help us to deal with the opposition to the abolition of the UPL: we will be able to point out to the self-employed how favourable their treatment is compared to that of the employed. But since the self-employed reckon to get no benefit from Class IV contributions at present they may be expected to be unimpressed by this.

9. The longer the period of time between announcement (in the Budget) that the UPL is to be abolished and the date of abolition, the greater the risk may be that a campaign will build-up against the abolition of the UPL (and perhaps, by extension, also against the abolition of the UEL). But this may be a pessimistic conclusion, since the period at which we would be most at risk would be between Budget Day and Royal Assent of the necessary Social Security Bill: once that was on the statute book opposition to the abolition of the UEL and UPL would be harder to sustain.

10. If you think these risks are considerable you may wish to consider alternative options. One which occurs to us is to delay abolition of the UEL, too, to April 1989. If this were done, we imagine that you might want to make a small immediate reduction in the higher rate viz:

	1988-89	1989-90	1990-91
Higher rate	45 (44)(40)	37	35
NIC charge above UEL for employees	-	7	9[8]*
NIC charge above UEL for employers	-	6.3 per cent (plus tax relief)	6.3 per cent (plus tax relief)

* Option E2 in Mr Mace's minute of 17 November.

11. The drawbacks with this approach are that it would somewhat increase the cost of the package in year one - the extra yield from the 45 per cent higher rate would be outweighed by the loss of yield from delaying the abolition of the UEL/UPL; that it would extend the

period during which employees became habituated to higher net pay, and so build up opposition to the removal of the UEL; and that it might mean taxing gains at 45 per cent, which looks very unattractive.

12. All in all, it looks better to say that for technical reasons, it will not be possible to abolish the UPL in October 1988, when the UEL is abolished. The change will therefore take place in April 1989. This means that for 6 months the self-employed will continue to enjoy a cut-off point for NICs, whereas the employed will not. After 6 months both groups will have had to pay NICs on all their earnings.

Mus

M C SCHOLAR



COPY NO 15 OF 16 COPIES

FROM: J M G TAYLOR

DATE: 18 November 1987

JMGT
→
Scholar
18/11

MR SCHOLAR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Miss Sinclair
Mr Cropper

Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Mace - IR
PS/IR

TAX REFORM 1988: OPERATIONAL IMPLICATIONS

The Chancellor has seen Mr Mace's submission of 17 November. He would be grateful for a note of the consequences for the package of deferring UPL abolition until April 1989.

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

J M G TAYLOR

FROM: J P MCINTYRE
DATE: 18 November 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Miss Peirson
Mr Scholar
Mr Riley
Miss Sinclair
Mr Gibson
Mr Macpherson
Mr Cropper
Mr Tyrie
Mr Call
Mr Isaac (IR)
Mr Mace (IR)

NATIONAL INSURANCE CONTRIBUTIONS: OUTSTANDING ISSUES

This submission responds to your requests for further work in three areas of the NICs package. We are sending you separately a brief for your meeting next week with Mr Moore. Both can be discussed at your meeting on the reform package tomorrow.

behind

2. The points on which you asked for further work are:

- i. NICs at the lower end: further analysis of Options C and F (para 16 of the record of your 20 October meeting);
- ii. Effect on contracting out of abolishing the UEL (Mr Taylor's minute of 9 November).
- iii. Self employed: assessment of abolishing tax relief in return for cutting Class II contributions (Mr Allan's minute of 2 November).

MEASURES AT THE LOWER END

3. You wanted Options C and F kept in play; you have also asked us to cost variants of these options which would involve matching employers rates with those already envisaged for employees. More generally, we have been looking at the interaction of NIC changes at the lower end with the new social security benefit system.

Comparison of Options C and F

4. Before considering the variants, it may help to summarise the main differences between C and F. The table below shows how Options C and F compare with the present position:

<u>Bands (£)</u>	<u>EMPLOYEES RATES (%)</u>			<u>EMPLOYERS RATES (%)</u>		
	<u>Now</u>	<u>C</u>	<u>F</u>	<u>Now</u>	<u>C</u>	<u>F</u>
41-70	5	0	5	5	0	5
70-105	7	5	5	7	7	7
105-130	9	5	5	9	7	9
130-155	9	7	7	9	9	9
155-305	9	9	9	10.45	10.45	10.45

5. The differences are:

- a. Option C involves a substantial increase in the LEL to £70; F leaves the position of those in the £41-70 bracket unchanged.
- b. Option C cuts the employers rate in the £105-130 bracket by 2 per cent, so that the combined NIC rate for this group falls by 6 per cent. F Makes no changes in employers rates.

6. Options C and F are identical in their effect on employees rates above £70. They are each particularly helpful to those in the £105-130 bracket, with a 4 per cent cut in the rate.

7. In weighing the respective merits of these options, these are among the key considerations:

- i. Option C would take 2 million employees out of NICs but, as a consequence, around 400,000 of these could end up relying entirely on means tested benefits in their old age. A further 500,000 may not establish a long enough contributions record for a full pension and may therefore be partly reliant on means tested benefits.
- ii. In raising the LEL to £70, Option C would also reduce SERPS entitlements in the long run of those earning over £70 by £5.80 a week.
- iii. Option C would benefit 8.5 million tax units against F's 6.8 million. But average gains would be higher with F (£3.05) than C (£2.70). Targetting on families with children is similar: C helps 1 million heads of tax units with children, F 0.9 million. Although C helps more families with children in total (2.1 million versus 1.5 million), half the beneficiaries are not heads of household, that is mainly working wives. An analysis of gainers is in the Table 1 attached to Annex B.
- iv. Option C costs £590 million in 1989-90; F costs £730 million. (Each costing assumes no change in bands for 18 months from October 1988, except for the LEL and UEL in Option F which are uprated in line with the retirement pension in April 1989.) The reason why you would be able to achieve more with Option C at lower cost is that raising the LEL would reduce the band of earnings to which the contracted out rebate applies; thus contribution income from the contracted out would rise.

- v. By increasing contributions from the contracted out, Option C would have a wider distributional impact on the whole package. The 7 million contracted out on over £155 a week would have to pay an extra 58p a week, their employers an extra £1.10.
- vi. Option C would not have the effect of taking many people out of tax and NICs. There could be pressure to increase the single person's allowance (around £48 a week in 1988-89) in line with the new LEL of £70.
- vii. At present, employers pay the same reduced rates as employees. This will remain true only up to £70 under Options C and F. Thereafter, Option C has employers paying 2 per cent more in each band. Option F widens the disparity to 4 per cent in the £105-130 band and also involves three reduced rate bands for employers compared to two for employees; this might add to employers' pressure for equal treatment.
- viii. Option C would reduce the required minimum contributions from employers to personal pensions: these (and the 2 per cent bonus) would be calculated on earnings above the new LEL. The cuts in contributions would bear most harshly on the low paid, making personal pensions much less attractive for them. Personal pensions generally would be less attractive, and the plans of personal pension providers (gearing up for a 1 July start) would be upset by a Budget time announcement; they will have already been promoting schemes on the basis of the current LEL.

8. The big attraction of Option C is that it would take 2 million people out of NICs. But the balance of the other considerations points pretty firmly to Option F, or a variant of it. If you go for Option C (or leave the choice open for the time being), DHSS may oppose it because of the consequent switch away from contributory to means tested benefits for a large number of people.

Variants of C and F

9. The variants of C and F with matching employers rates would cost considerably more than the £750 million or so we have so far assumed for this part of the package (£1340 million in a full year for C and £1700 million for F). The extra cost would avoid employers' complaints about lower employees' rates and would reduce employment costs. But it would not help with the unemployment trap in the short run, one of the major aims of the reform (though in the long run employer NIC cuts can be as effective as employee NIC cuts in relation to the trap).

10. You may nonetheless want to consider changes in C and F. To assist with this, there is a ready reckoner at Annex A, prepared by Mr Macpherson, which shows the cost of marginal changes to each of the options.

11. It shows, for example, that if you wanted to extend the 7 per cent band for both employees and employers a little further you could increase the upper limit by £5 to £160 at a cost of £125 million. This would increase the cost of Option C to £715 million and of F to £855 million.

Interaction with Benefits

12. The problem here is that, from next April, the income-related benefits (income support, family credit and housing benefit) will be assessed on net rather than gross income. This means that a cut in NICs (which increases net income) for benefit claimants will be partly (in some cases largely) offset by reductions in benefit. The income taper applying to income support and family credit will result in withdrawal of 70 per cent of marginal net income; the housing benefit taper for rents will be 65 per cent next year and 70 per cent from 1989-90; for rates it will be 20 per cent.

13. As the analysis at Annex B shows, the result would be to leave some families on both family credit and housing benefit with as little as 4½ per cent of any gains from NIC reductions. But this effect of the poverty trap by no means destroys the case for NIC reductions, because:

- i. Relatively few of the gainers from the NIC changes are benefit claimants (eg ½ million out of 8½ million under Option C).
- ii. Very few families on benefit will face a combined taper as high as 95½ per cent, and for those affected the change would be consistent with the government's aim of reducing dependence on benefits and allowing people to keep more of their earnings.
- iii. For the average household on benefits, withdrawal of benefit would still leave a net gain of £1.23 a week under Option C and £1.32 under Option F.
- iv. 75,000 heads of tax units would be taken out of the poverty trap (defined as marginal tax rate over 70 per cent). Most of these would be floated off benefits completely as a result of the increase in net incomes from the tax and NIC cuts.

UEL ABOLITION: EFFECT ON CONTRACTING OUT

14. Mr Taylor's minute of 9 November reported your comment that there is obviously a case for changing the rules so that SERPS entitlement depends on total NICs paid, not just on contributions between the LEL and UEL. On the other hand, you wondered whether keeping SERPS entitlement rules as they are (with employee NICs no longer bound by the UEL) would encourage contracting out by those on high earnings.

15. The answer to your question is that, assuming we do not allow a contracted-out rebate on NICs above the UEL, keeping the existing SERPS entitlement rules should not encourage more contracting out. The NIC rate above the UEL would then be the same (9 per cent) for contracted in and contracted out employees. Those earning more than the UEL would have no more incentive than they do now to contract out.

but not advised

16. If we were to allow a contracted out rebate on NICs above the UEL, this would blow a large hole in our package arithmetic. It would roughly cut in half the extra income (£1½ billion) to the NIF from UEL abolition.

17. The note at Annex C goes into this question in more detail and also considers the implications of changing the SERPS entitlement rules. As the note says, the great disadvantage would be the additional public expenditure cost: the state would be taking on an open-ended liability to pay an earnings-related pension equal to 20 per cent of average lifetime earnings above the LEL. This would seem at odds with the main thrust of pension reform which is to encourage private provision.

18. The note indicates one way in which you might consider softening the blow of abolishing the UEL for contributions but not for SERPS purposes. This would be to raise the notional UEL, retained for SERPS, which would generate a limited amount of additional SERPS entitlement. In the event of your choosing Option C for the lower end measures (raising the LEL to £70), it would also help the contracted out whose rebates are squeezed by Option C in that they would apply to a narrower band of earnings.

19. The difficulty would be cost. Raising the UEL by roughly as much as the LEL under Option C (£30) would cost around £150 million.

SELF EMPLOYED: TAX RELIEF

20. If we were to use the existing tax relief to finance a Class II reduction (ie relief on 50 per cent of contributions below the UPL), £85 million would be available, permitting a 75p cut in Class II to £3.30 (Option 1).

21. The full year cost of tax relief on 50 per cent of all Class IV contributions, above and below the UPL, would be £150 million (assuming Option D in Mr Mace's minute of 17 November were adopted). If we were to regard this larger amount as available from the ending of tax relief, the savings could be used to reduce the Class II rate by one third, from £4.05 to £2.70 (Option 2).

22. Abolition would eventually save 80 Revenue staff in a full year. *~ 2 what was?*

23. As Mr Macpherson's note at Annex D explains, both Options 1 and 2 would increase the number of self employed gainers from the package; these would include the 500,000 self employed who pay Class II but not Class IV. But there would also be an additional 30,000 losers under Option 1 and 15,000 under Option 2. This is because their gains from a lower Class II would be more than offset by loss of tax relief. *✓*

24. If you wanted to avoid additional losers, an alternative would be to keep tax relief for contributions between the LPL and UPL but not to allow it above the UPL. This would save £65 million in relief and allow a 60p cut in Class II to £3.55 (Option 3).

25. If you wanted to go still further and to reduce the number of losers from the overall package, this might be done by retaining tax relief (above and below the UPL) and cutting Class II. But this would be expensive. For example, a cut in Class II of £2.50 (costing £280 million) would be required to reduce the number of self employed losers in the package from 25,000 to 6,000. This would totally offset the increase in revenue from abolishing the UPL.

Conclusions

26. These are all questions on which DHSS would no doubt have views if we were to consult them, especially on the choice between options C and F for low paid employees. You will therefore want to consider whether it would be preferable to firm up your proposals in these areas before seeing Mr Moore next week rather than leaving them open. *Yr ✓*

Jm

J P MCINTYRE

READY RECKONERS

At the meeting on 20 October, the Chancellor narrowed the lower end NIC options down to Options C and F. Costings of these are restated below, along with ready reckoners of the cost of introducing small changes to the options.

Option C

<u>£ per week</u>	<u>Employees % rate</u>		<u>Employers % rate</u>	
	<u>now</u>	<u>proposed</u>	<u>now</u>	<u>proposed</u>
41-70	5	0	5	0
70-105	7	5	7	7
105-130	9	5	9	7
130-155	9	7	9	9
155-305	9	9	10.45	10.45

The bands (including the UEL) are not uprated in April 1989.

If introduced in October 1988, this would cost:

1988-89	£340 million
1989-90	£590 million

Ready reckoner: Cost (£million) of changes to Option C

	1988-89	1989-90
LEL £5 higher	(10)	(20)
Extend £70-£130 band by £5	45	110
Extend £130-£155 band by £5	50	125
Uprate LEL and UEL only in April 1989	-	40
[S		
Uprate all limits in April 1989	-	360
1% change in employee rate		
- in £70-£130 band	80	200
- in £130-£155 band	60	150
1% change in employer rate		
- in £70-£130 band	85	210
- in £130-£155 band	65	160

Option F

<u>£ per week</u>	<u>Employees % rate</u>		<u>Employers % rate</u>	
	<u>now</u>	<u>proposed</u>	<u>now</u>	<u>proposed</u>
41-70	5	5	5	5
70-105	7	5	7	7
105-130	9	5	9	9
130-155	9	7	9	9
155-305	9	9	10.45	10.45

LEL and UEL are uprated in April 1989. Reduced rate limits are not.

If introduced in October 1988, this would cost:

1988-89 £370 million

1989-90 £730 million

Ready reckoner: Cost (£ million) of changes to Option F

	1988-89	1989-90
Extend Employee £41-£130 (5%) band by £5	20	60
Extend Employee £130-£155 and Employer £105-£155 bands by £5	50	125
Extend Employer £41-£70 band by £5	10	20
Extend Employer £70-105 band by £5	15	40
Uprate reduced rate limits in April 1989	-	320
UEL not uprated April 1989	-	(60)
1% change in employee rate		
- in £41-£130 band	100	240
- in £130-£155 band	60	150
1% change in employer rate		
- in £41-£70 band	20	40
- in £70-£105 band	40	90
- in £105-£155 band	110	280

TASK FORCE SECRET

The Chancellor has also asked for costings of variants of Options C and E, where employer reduced rates and bands are the same as for employees.

Option C(i)

<u>£ per week</u>	<u>Employees % rate</u>		<u>Employers % rate</u>	
	<u>now</u>	<u>proposed</u>	<u>now</u>	<u>proposed</u>
41-70	5	0	5	0
70-105	7	5	7	5
105-130	9	5	9	5
130-155	9	7	9	7
155-305	9	9	10.45	10.45

The bands (including the UEL) are not uprated in April 1989.

If introduced in October 1988, this would cost:

1988-89 £650 million
 1989-90 £1340 million

Option F(i)

<u>£ per week</u>	<u>Employees % rate</u>		<u>Employers % rate</u>	
	<u>now</u>	<u>proposed</u>	<u>now</u>	<u>proposed</u>
41-70	5	5	5	5
70-105	7	5	7	5
105-130	9	5	9	5
130-155	9	7	9	7
155-305	9	9	10.45	10.45

LEL and UEL are uprated in April 1989. Reduced rate limits are not.

If introduced in October 1988, this would cost:

1988-89 £770 million
 1989-90 £1700 million

Annex B

Handwritten notes:
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MEASURES AT THE LOWER END: DISTRIBUTIONAL EFFECTS AND THE POVERTY TRAP

This note looks at the distributional effects of the lower end NIC proposals (Options C and F), and the extent employees in the poverty trap will benefit from the tax reform package.

ANX
 B
 MEASURES
 AT THE
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Distributional effects

2. Since single people and married women dominate the lower end of the earnings distribution, they are unavoidably the main beneficiaries of the lower end measures.

3. Disaggregated information on the gainers (by tax unit) from the lower end NIC package is shown in the table attached. 8.5 million tax units gain from Option C and 6.8 million from Option F. When income tax cuts and benefit offsets are taken into account the average net gain will be £4.21 per week in Option C and £4.57 in Option F. Over half the gainers in both Option C and D will be single and of those who are married most will be women. Less than half the 2.1 million gainers with children who benefit from Option C are head of households, while although the proportion rises to 60 per cent in Option F the number of gainers with children is lower at 1.9 million.

4. Despite the NIC reductions in both Option C and F going only to employees earning less than £155 a week, 3.3 million gainers in Option C and 2.4 million gainers in Option F are in tax units with incomes over £155 a week. These gainers will generally be women married to working husbands.

Poverty Trap

5. Although only a small proportion of those gaining from the NIC changes receive benefits (0.5 million out of 8.5 million under Option C), conversely, a large proportion of families

TASK FORCE SECRET

receiving benefits gain from the NIC changes. Out of our estimated 470,000 families receiving family credit, 330,000 gain from the NIC changes.

6. But for those families receiving benefits, benefit withdrawal may work to offset their gains from NIC changes and the cut in basic rate of income tax. The appendix gives some stylised examples of how withdrawal might work. Example (iv) shows the effect on a one earner married couple with two children on gross earnings of £150 a week and in receipt of both housing benefit and family credit. The lower end package results in a reduction in tax and NICs of £4.45 a week but because benefit entitlement declines as a result take home pay only increases by 20p a week. This reflects a combined family credit and housing benefit taper of 95.5% in 1988-89. As a result of this year's PES savings, the taper will rise to 97% in 1989-90.

7. Although the examples suggest that the withdrawal of benefits may be a major obstacle to the objective of helping low earning families, many of these families do not take up their entitlement (possibly as few as 30 per cent of working families take up housing benefit and only 60 per cent are expected to take up family credit). Amongst those who are expected to take up benefits, the average benefit loss under Option C is £1.96 against a tax and NIC gain of £3.19. The proportionate loss (62%) is lower than the examples might suggest because some families are floated right off benefit. (In Option F a £2.28 benefit loss offsets a £3.60 gain). But over three quarters of families with children who would gain from the low end proposals are not entitled to, or do not claim, benefits.

8. The lower end measures would also alleviate the poverty trap. 75,000 head of tax units would be taken out of the trap (membership requiring a marginal tax rate of over 70 per cent), nearly all of these being taken out of benefits altogether.

TASK FORCE SECRET

Analysis of those gaining under NIC changes at the lower end
=====

	-----NIC option C-----			-----NIC option F-----		
	Tax units	Tax units in which head gains from NIC	Tax units receiving benefits	Tax units	Tax units in which head gains from NIC	Tax units receiving benefits
Number of gainers (m)	8.5	6.4	0.5	6.8	5.6	0.4
Average NIC gain (£pw)	2.68	2.70	2.72	3.04	2.95	2.99
Average tax & NIC gain (£pw)	4.33	4.01	3.19	4.71	4.40	3.60
Average benefit offset (£pw)	0.12	0.15	1.96	0.14	0.16	2.28
Net gain (£pw)	4.21	3.86	1.23	4.57	4.24	1.32
Breakdown of gainers from NIC by tax unit type						
Single (m)	4.7	4.7	-	4.0	4.0	-
Married, no children (m)	1.7	0.7	0.25	1.3	0.7	0.2
Married with children (m)	1.8	0.7	0.15	1.3	0.7	0.1
Lone parents (m)	0.3	0.3	-	0.2	0.2	-
Breakdown of NIC gainers by tax unit gross income (before income tax, NIC or benefits)						
Under £70 pw	0.6	0.6	-			
£70-£130 pw	3.2	3.1	0.3	3.0	3.0	0.3
£130-£155 pw	1.4	1.4	0.1	1.4	1.3	0.1
Over £155 pw	3.3	1.3	-	2.4	1.3	-

APPENDIX

LOWER END PACKAGE AND THE POVERTY TRAP: SOME STYLISTED EXAMPLES

Base case is base rate of 27%, NIC rates as in Autumn Statement.

'Budget' case is base rate of 25%, NIC rates as in Option C or F.

Married man's tax allowance is assumed at £3955.

In tables T+NI is tax and National Insurance

NE is net earnings

FC is Family Credit

HB is Housing Benefit

DY is disposable income (includes child benefit but net of rent)

(i) Couple, 2 children aged 6 and 12, rent £30 p.w., gross earnings £100 p.w., claiming FC and HB.

	T+NI	NE	FC	HB	DY
Base	£13.45	£86.55	£24.95	£9.15	£105.15
Budget	£11.00	£89.00	£23.25	£8.65	£105.40

There will also be a further loss on rate rebate of 15p

Gross gain from changes: £2.45

Net gain from changes : £0.10

(ii) Couple, 2 children aged 6 and 12, rent £30 p.w., gross earnings £100 p.w., claiming HB but not FC.

	T+NI	NE	HB	DY
Base	£13.45	£86.55	£25.70	£96.75
Budget	£11.00	£89.00	£24.10	£97.60

There will also be a further loss on rate rebate of 50p

Gross gain from changes: £2.45

Net gain from changes : £0.35

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DIX

(iii) Couple, 2 children aged 6 and 12, rent £30 p.w., gross earnings £150 p.w., claiming FC and HB.

	T+NI	NE	FC	HB	DY
Base	£33.45	£116.55	£3.95	£3.65	£108.65
Budget	£29.00	£121.00	£0.80	£2.80	£109.10

There will also be a further loss on rate rebate of 25p

Gross gain from changes: £4.45

Net gain from changes : £0.20

(iv) Couple, 2 children aged 6 and 12, rent £30 p.w., gross earnings £150 p.w., claiming HB but not FC.

	T+NI	NE	HB	DY
Base	£33.45	£116.55	£15.65	£116.70
Budget	£29.00	£121.00	£12.75	£118.25

There will also be a further loss on rate rebate of 90p

Gross gain from changes: £4.45

Net gain from changes : £0.65

Summary

Benefits claimed	Percentage clawback
FC and HB	95.5%
HB only	85%
FC only	70%
none	-

(assuming HB recipients also entitled to rate rebate)

SERPS: IMPLICATIONS OF UEL ABOLITION

1. In this note we consider the implications of not retaining a notional UEL to restrict SERPS entitlement and the implications of this for the contracted-out rebate. The note is written on the assumption that the notional UEL would be about the 1988-89 level of £305 a week.

(i) UEL abolition for SERPS purposes

2. Abolition of the UEL for SERPS purposes would have a considerable effect on long term public expenditure. The state's pension liability at present is strictly limited; for those retiring next century, an additional pension will be paid equal to 20 per cent of average lifetime earnings between the LEL and UEL. The accrual of this liability is currently being controlled by not uprating the UEL in line with earnings. Were the UEL abolished for SERPS purposes, the state would be taking on an open-ended liability to pay an additional component equal to 20 per cent of average lifetime earnings above the LEL.

3. Were the scheme funded, this might not matter. Employees would be paying NICS of 9 per cent on earnings above the UEL for around 40 years, in exchange for a pension of 20 per cent on the same earnings for an average retirement period of 20 years. The additional SERPS liability would be roughly equal to the additional contribution income.

4. However, SERPS is not a funded scheme. The 9 per cent contribution income is in effect being used to finance other parts of the tax reform package. When the higher pensions start being paid in the next century, they will have to be financed out of current revenue, at a time when the number of pensioners is increasing and the number of workers is declining.

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5. This problem would be partly mitigated by the majority of those earning above the UEL being contracted out, 1.7 million out of 2.5 million employees. In these cases, and assuming the rebate also applied above the UEL, occupational pension schemes will assume most of the SERPS liability (up to inflation of 3%). However, the state would still be responsible for ensuring that the individual receives the inflation-proofed additional component which would have been available had they remained contracted into the state scheme.

6. For those contracted out, the problem then arises as to whether they should receive the contracted-out rebate on their earnings above the old UEL. There are two options:

a) Giving rebate above old UEL

The combined rebate, at 5.8%, would eliminate about half the extra income arising from UEL abolition. This would seem unattractive. It would also tend to encourage contracting-out by high earners, since the rebate is higher than the actuarially calculated rate. Since this also means that contracted-out employees cost the NIF more than contracted-in ones, this would increase the cost to the NIF of extending SERPS entitlement.

b) No rebate above old UEL

In this case it would be necessary to retain a notional UEL anyway. Those contracted-out would complain, correctly, that there was no actuarial justification for thus limiting their rebates, and the attractiveness of contracted-out schemes would be severely reduced.

7. In addition to the public expenditure cost, there is a problem of principle. The Fowler reforms were based on the view that the role of the state should be reduced. Abolishing the UEL for SERPS purposes would run counter to this principle, the role of the state being dramatically increased. At a time when the Government is attempting to encourage more private pension provision, it might be seen as inconsistent to provide state earnings-related pensions to the better off.

(ii) UEL retained to limit SERPS entitlement

8. This would avoid the problems above of funding and principle above. If NICs above the UEL brought no SERPS entitlement, then clearly there would be no case for a rebate (why should contracted-in employees pay more than contracted-out ones when neither payment brings any extra benefit entitlement?). NICs above the UEL would be payable at the standard rate. There would also be no extra incentive to contract out because the NIC rate above the UEL would be the same for contracted-in and contracted-out employees. The disadvantage is that discussed in our paper on the contributory principle, that the extra NIC payments above the UEL would bring no extra benefit entitlement.

9. This disadvantage could be mitigated somewhat by raising the notional UEL from its present level; clearly not all those earning above the UEL are millionaires. If Option C were chosen this would help to offset part of the adverse effect on the contracted out of raising the LEL, as well as benefitting a group that would otherwise lose from the tax package overall. A rough estimate is that the cost would be about £150 million a year to raise the notional UEL by £30 to £335 (assuming the higher rebate applies to employers contributions).

CONCLUSIONS

10. Not retaining the UEL for SERPS purposes would lead to a large future burden on public expenditure. Under such a scenario, there are drawbacks both in allowing those on higher earnings to receive a rebate (loss of revenue from abolition) and in not doing so (complaints of unfair treatment from occupational schemes). If a notional UEL is retained for SERPS purposes, there is no case for allowing a rebate above the UEL for the contracted-out.

SELF EMPLOYED NICS*Class 4
no further*

The Chancellor asked for work on an option where the self employed would lose their tax relief on Class 4 contributions and the resulting savings would be used to cut Class 2 contributions (Mr Allan's minute of 2 November).

2. The extent Class 2 contributions can be cut depends on how the relief, which is being abolished, is defined. If it is relief which is currently available, this is likely to have a full year cost of £85 million in 1988-89 (tax rates as in Option D of Mr Mace's submission of 17 November). This is slightly higher than previous estimates, a reflection of the Inland Revenue's latest self employed profit projections for next year. Given a Class 2 rate of £4.05 and projected Class 2 accruals of £450 million in 1988-89, abolition of Class 4 relief could finance a 75p cut in the Class 2 rate to £3.30 a week (Option 1). However, under Mr Mace's Option D relief would also be available on Class 4 paid at a rate of 6.3 per cent on profits above the abolished UPL. If this further relief, which would have a full year cost of around £60 million, is also taken into account a further 60p could be taken off Class 2 giving a rate of £2.70 (Option 2).

*(now 74.05)**? 72.50*

3. The reduction in Class 2 might be presented as the first step along the road to integrating Class 2 and 4, along the lines of the medium term options of Mr McIntyre's submission of 30 September. This could not, of course, be fully implemented until the mid 1990s when the computerisation of Schedule D income tax (CODA) and the new computerised collection system (BROCS) will be in place.

Distributional Effects

4. Both these options would result in a greater number of self employed losers from the overall tax package than the current proposal. Option 1 would result in 55,000 losers (compared with 1987-88), while Option 2 would result in 40,000 losers. This compares with about 25,000 losers from Option D. The cause of

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this increase is that losers from the current package are most likely to be among the 200,000 self employed earning between £20,000 and £30,000 a year (see Table attached). Both Option 1 and Option 2 would increase the likelihood of people in this range losing, their gain in Class 2 of £39 a year (Option 1) or £70.20 (Option 2) being offset by loss of tax relief of at least £160 a year (assuming they are paying income tax).

5. Of course there would be a large number of gainers from both Options 1 and 2. The biggest gainers would be the 500,000 self employed who pay Class 2 but not Class 4. Of those paying Class 4 all those with profits under £9700 a year would gain compared to Option D under Option 1, while all those with profits under £13,660 would gain under Option 2. In both Options, there will be gainers higher up the income distribution among non-tax payers.

6. Ministers will want to bear in mind that cutting Class 2 in isolation could put pressure on low earning employees to 'become' self employed (paragraph 13 of the minutes of the meeting on 20 October).

Manpower and Operational Implications

7. Inland Revenue advise that if tax relief on Class 4 were abolished, staff savings of 80 units could be achieved in a full year when the computerised Schedule D system (CODA) is in operation. Taken in isolation cutting Class 2 and abolishing Class 4 relief from October 1988 should not cause problems. But Ministers may want to make these changes at the same time of abolition of the UPL. Mr Mace's note of 17 November on the operational implications of the Budget proposals advises deferring abolition of the UPL until April 1989 because of the risks of a mid year start.

A compromise option

8. Options 1 and 2 may be criticised not only for the number of losers but also for the abolition of tax relief. The latter may give rise to charges of inconsistency, with the self employed

TASK FORCE SECRET

asking what has changed since 1985 when the principle was conceded that for NIC relief purposes the self employed were half employer and half employee. A compromise option might involve maintaining tax relief between the LPL and UPL but not granting relief above the UPL. The resulting savings relative to Option D could be used to cut Class 2 by 60p a week (Option 3).

9. The advantage of this option is that it would result in broadly the same amount of losers as under Option D. All those earning under the UPL, £15860 p.a, would gain £31.20 a year compared to Option D. However, high earners would still do badly, especially those earning between £25,000 and £30,000 (see Table attached). It might also give rise to even greater charges of inconsistency than Options 1 and 2, since it would imply that contributions above the UPL are somehow different than those below. No such distinction is made for employers' Class 1 contributions.

Summary

The table below summarises the costs of the options in this note (compared with Option D) and the number of losers under each Option from the overall reform.

<u>Option</u>	<u>Full year cost/ yield compared with Option D (1988-89 income levels) £ million</u>	<u>No. of losers</u>
Option D (Tax relief above and below UPL)	-	26,000
Option 1 (No tax relief; 75p off Class 2)	+65	55,000
Option 2 (No tax relief; 135p off Class 2)	-	41,000
Option 3 (Tax relief between LPL and UPL; 60p off Class 2)	-	27,000

TAX REFORM: SELF EMPLOYED (6.3 PER CENT NIC)

Comparison with 1987-88

	Option D Class IV tax relief above and below UPL		Option 1 No Class IV tax relief; Class 2 cut by 75p		Option 2 No Class IV tax relief; Class 2 cut by 135p		Option 3 No Class IV tax relief above UPL; Class 2 cut by 60p	
Total income (lower limit) £000	No. losers (000)	Am.t loss (£m)	No. losers (000)	Am.t loss (£m)	No. losers (000)	Am.t loss (£m)	No.losers (000)	Am.t loss (£m)
0	0	0	0	0	0	0	0	0
18	0	0	1	0	0	0	0	0
20	10	1	28	3	19	2	9	1
25	9	2	17	3	16	2	13	2
30	4	1	7	1	6	1	5	1
40	1	0	1	0	0	0	0	0
50	0	0	0	0	0	0	0	0
Total*	26	4	55	7	41	6	27	4
Amount of loss (lower limit) £								
0	6	0	19	0.5	15	0.5	7	0.5
50	4	0.5	12	1	5	0.5	6	0.5
100	6	1	12	2	12	2	9	0.5
200	4	1	7	2	5	1	3	1
300	3	1	4	1	3	1	1	1
500	1	0.5	1	1	1	1	1	0.5
Total*	26	4	55	7	41	6	27	4

*Totals not identical due to rounding

FROM: J P MCINTYRE
DATE: 18 November 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Miss Peirson
Mr Scholar
Mr Riley
Miss Sinclair
Mr Gibson
Mr Macpherson
Mr Cropper
Mr Tyrie
Mr Call
Mr Isaac (IR)
Mr Mace (IR)

NATIONAL INSURANCE CONTRIBUTIONS: MEETING WITH MR MOORE ON
TUESDAY, 24 NOVEMBER

You have already outlined your thinking to Mr Moore, when you saw him on 10 September. You may now want to take him through your NICs proposals as they currently stand. I attach at Annex A an aide-memoire for this purpose listing the measures and their estimated effects. (This can be amended as necessary after your meeting on Thursday of this week to reflect any changes).

2. In addition to getting Mr Moore's agreement to the main thrust of your proposals, you will also want to agree that we and DHSS officials should now examine them to resolve any administrative problems and to work out what provisions will be needed in the Social Security Bill. We know that abolition of the UEL and Treasury Supplement will require primary legislation; there may be other points to be picked up, including the possibility of allowing larger increases in the NHS allocation in order to cut the NIF surplus.

MCINTYRE
→
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MTR
LITH
MOORE

The Measures

3. You may get no more than a guarded and provisional reaction to your proposals from Mr Moore, until he has been briefed by his officials. But in briefing him for the meeting, his officials are likely to emphasise the need for action to contain the NIF surplus. (The GAD report, out on 23 November, is likely to project a £1.8 billion surplus in 1988-89 on present assumptions, increasing the balance in the NIF to 34 per cent of outgo.) On this point, you can say that the likely net impact of your measures in the first and probably second years will be to reduce the surplus but that in the longer term they will add to it. For this reason, you will want to consider with him putting a provision in the Bill to enable larger NHS allocations.

4. On your proposals to help low paid employees, the DHSS reaction will be strongly influenced by whether you go for Option C (raising the LEL to £70) or Option F (reduced rates between £70 and £155 only). DHSS may well resist Option C because of its impact in removing or reducing benefit entitlements. Therefore, if you were to keep open both Options C and F for discussion with DHSS, we could expect them to back Option F or come up with their own proposals.

5. As far as the self employed are concerned, the timing of implementation will depend on your decision in the light of the Revenue's latest advice on the operational difficulties of an October 1988 start. (See Mr Mace's minute of 17 November).

The Bill

6. We will first want to establish with DHSS the likely size of the Bill and the main provisions needed. Having done that, we (formally DHSS) will have to seek the Lord President's consent for it, so that Parliamentary Counsel can start work on it and so that it can be given a slot in the legislative programme.

Is there a new Bill?
an Act?

7. You might prefer to avoid any consultation with the Lord President at this stage. But if we leave this to nearer Budget time, he may react badly, given the busy programme he is already managing. As it is, another Bill will be unwelcome news to him. Some advance notice, on a confidential basis and without consulting other colleagues, may help to smooth the path. There is also the point that, without the Lord President's consent, Parliamentary Counsel cannot be instructed by DHSS to prepare the Bill.

Self Employed NICs

8. Mr Scott has written to the FST (16 November) proposing further work by officials on simplification of self employed NICs. Mr Moore might refer to this. At present, the Revenue collect Class IV contributions and DHSS Class II. The main proposal to be examined would be a single profits-related NIC collected by the Revenue. If Mr Moore raises this, you can say that you are content for further work to be done: your Budget proposals affecting the self employed would not preclude a more radical change to a single NIC rate in the longer term, when the Revenue's computerisation programme allows.

Consulting DHSS

9. Following your meeting with Mr Moore, we would propose to include a small number of DHSS officials in the Task Force arrangements. They would of course be consulted only on the NICs changes. If you agree, you might like to tell Mr Moore that we will be in touch with his officials very shortly to go into the detail of the proposals.

Jm

J P MCINTYRE

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taken at
this stage

ANNEX A**NICS: PROPOSED CHANGES**Class I

(i) Abolish Upper Earnings Limit (UEL) for employees. Means 9 per cent charge on total gross earnings for all those earning £155 a week or more.

[(ii) C. Increase Lower Earnings Limit (LEL) from £41 to £70 for both employees and employers. Takes 2 million people out of NICs. Introduce additional reduced rate band between £105-130: employee rate would be 5 per cent (down 4 per cent) and employer rate 7 per cent (down 2 per cent). Other employee rates at lower end reduced by 2 per cent.

New structure would be:

£ per week	EMPLOYEE RATE (%)		EMPLOYER RATE (%)	
	<u>Now</u>	<u>Proposed</u>	<u>Now</u>	<u>Proposed</u>
41-70	5	0	5	0
70-105	7	5	7	7
105-130	9	5	9	7
130-155	9	7	9	9
155-305	9	9	10.45	10.45]

OR

[(ii)F. Introduce additional reduced rate band between £105-130: employee rate would be 5 per cent (down 4 per cent). Other employees rates above £70 reduced by 2 per cent. Employers rates unchanged. New structure would be:

£ per week	EMPLOYEES RATE (%)		EMPLOYERS RATE (%)	
	<u>Now</u>	<u>Proposed</u>	<u>Now</u>	<u>Proposed</u>
41-70	5	5	5	5
70-105	7	5	7	7
105-130	9	5	9	9
130-155	9	7	9	9
155-305	9	9	10.45	10.45]

Self Employed

(iii) Abolish Upper Profits Limit (UPL). Propose 6.3 per cent charge on all profits above Lower Profits Limit (LPL) ie same percentage charge to apply to those with profits above UPL as now applies below UPL. [Tax relief on 50 per cent of Class IV contributions would apply as now/would be abolished to pay for reduction in Class II.]

Treasury Supplement

(iv) Abolish (will be down to 5 per cent from next April)

Timing

(v) All measures would be announced at Budget time. Hope Class 1 changes can be implemented October 1988; no Inland Revenue problems with that timetable. Would also abolish Treasury Supplement in October. But measures affecting self employed [would have to wait till April 1989 because UPL abolition will require significant changes to Revenue's Schedule D computer system which need more time to complete.]

(vi) Effect on NIF

£ billion

	1988-89	1989-90
UEL/UPL abolition	+0.4	+1.5
Treasury Supplement abolition	-0.8	-1.0
Measures to help employees at lower end	-0.4	-0.7
	—	—
Net effect	-0.8	-0.2
Resulting NIF surplus for the year	1.1	0.6
Balance of NIF	8.0	8.6
Surplus at end-year as percentage of outgo	29.9	30.3

TASK FORCE SECRET

COPY NO 1 OF 14
 FROM: MISS C E C SINCLAIR
 DATE: 18 November 1987

CHANCELLOR

cc Chief Secretary
 Financial Secretary
 Economic Secretary
 Paymaster General
 Sir P Middleton
 Sir T Burns
 Mr Scholar
 Miss Peirson
 Mr Culpin
 Mr McIntyre
 Miss Hay

Mr Mace - IR

**MEETING WITH MR MOORE ON TUESDAY, 24 NOVEMBER: CONVERTING
 ADDITIONAL PERSONAL ALLOWANCE INTO SOCIAL SECURITY PROVISION**

i.e. further to the points in the note immediately behind.
 There is a further point which you may want to raise with Mr Moore when you see him on 24 November to outline your thinking on NICs.

2. You have already suggested to Mr Moore that the Additional Personal Allowance should be converted into benefit. You subsequently wrote on 16 October giving him the assurance he had been seeking on the public expenditure consequences of such a change. The position now is that DHSS are working on possible options, but to date we have had nothing from them.

3. The original timetable which you proposed to Mr Moore envisaged a report to Treasury/DHSS Ministers by the end of November. If this slips substantially, it could be difficult to get the measure into place in time for the Budget.

4. Mr McIntyre is checking with DHSS officials on the latest state of play. Depending on what he reports at tomorrow's meeting, you might want to re-emphasise to Mr Moore the importance you attach to this exercise.

Carolyn Sinclair

CAROLYN SINCLAIR

SINCLAIR
 →
 CHIEF
 18/11
 MTC
 WITH
 MOORE

*One or two
useful points
are possible.*

COPY NO. 11 OF 15 COPIES

FROM: I SCOTTER
DATE: 18 NOVEMBER 1987

MEETING ON CGT REFORM ON 11 NOVEMBER 1987

Present:	Mr Cassell	Mr Isaac)	Inland
	Mr Scholar	Mr Cayley)	Revenue
	Mrs Lomax			
	Miss Sinclair	Mr E A J George	-	B of E
	Mr Riley			
	Mr Scotter			

1. The meeting was to seek the Bank's views on the CGT reforms set out in the papers which Mr Cassell had sent to the Bank in September.
2. Mr Cassell said that the basic shape of the package was to move the base for the calculation of capital gains from 1965 to 1982 (rebasings), to retain indexation relief for gains since 1982 and to tax those gains as the marginal slice of income. The commencement date for the reform would be 6 April 1988 but it would be announced in the Budget two or three weeks before that. The details of the scheme were still fluid but the Bank's comments on that core scheme would be valued.
3. Mr George said that he was in favour of integration of CGT into income tax. It would mean less distortion as artificial arrangements to convert income into gains and avoid higher rate tax would be less worthwhile (although integration was not complete as the annual exemption, indexation and deferral were retained).

Integration into income tax would have some effect on the relative attractiveness of different assets - equities (or other assets offering long-term capital appreciation) would become less attractive relative to gilts; and low coupon stocks would become less attractive. But these changes would be fairly marginal and should not lead to a significant switch in terms of the whole market.

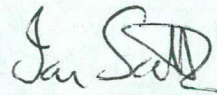
He had no strong views on rebasing which he saw mainly as a political sweetener to counteract putting up the CGT rate for

TASK FORCE SECRET

higher rate taxpayers. Some in the Bank would see rebasing as having an unlocking effect, particularly for agricultural land. There would be grumbles, but not market disruption, if rebasing were not included.

He thought that announcing the changes in advance would lead to large scale bed and breakfasting to avoid paying CGT at higher rates in later years. Although there would be extra work involved for Stock Exchange firms, it should not create any great difficulties. It was sensible to give investors this chance to take gains under the old tax regime; it should avoid claims of retrospection. Rebasing would reduce the extent of forestalling on older assets. Some investors might switch between assets at this stage if they saw income-yielding assets as being more attractive in future.

4. In discussion it was pointed out that rebasing was more than a sweetener. It would mean that only real gains would be taxed. There was no practical way of extending indexation back to 1965 because of the complication of share pools, and recent work by the Revenue had demonstrated that there was no advantage in indexing land, but not shares, back to 1965.
5. It was noted that the costs of the reform had been substantially revised since the papers which the Bank had seen. Once the details of the scheme had settled down, papers with revised costings would be sent to the Bank. At a later stage it might be useful for the Bank to repeat its more detailed analysis of the probable effects of the changes - but there was general agreement at this meeting that this would be unlikely to alter the broad conclusions already arrived at.



IAN SCOTTER

Circulation:

PS/Chancellor

Financial Secretary

Sir P Middleton

Sir T Burns

Those present.



Inland Revenue

Policy Division
Somerset House

copy no 1 of 24

Ch / A useful note, which confirms the provisional view that the disincentive effect of the reform is likely to be minimal.

FROM: M F CAYLEY
DATE: 19 NOVEMBER 1987

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20/11

- 1. MR ISAAC *file 19.11*
- 2. CHANCELLOR OF THE EXCHEQUER

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Monday.

CGT REFORM : PERCEPTION OF MARGINAL RATES

1. At your meeting on 12 November, the situation was raised of someone who anticipated making a large gain which, when added to their income, would push them into the higher rates. It was suggested that such a person might see this as making the marginal rate on their income 44% (35% tax plus 9% NIC) instead of 34% (25% plus 9%); and that this could have a significant disincentive effect, and serve as a deterrent to eg working overtime.

cc

- Chief Secretary
- Sir P Middleton
- Sir T Burns
- Mr Byatt
- Mr Scholar
- Mr Culpin
- Miss Sinclair
- Mr Riley
- Mr Cropper
- Mr Tyrie

- Mr Battishill
- Mr Isaac
- Mr Beighton
- Mr Calder
- Mr Pitts
- Mr Cayley
- Mr Hamilton
- Mr Gonzalez
- Mr Mace
- Mr Weeden
- Mr Michael
- Mr Lester
- PS/IR

2. It is of course inherent in the proposed reform that marginal rates will be affected by both gains and income, and that where capital gains have been realised the marginal rate may be higher than it would otherwise be. It follows that if a block of income is regarded as the marginal element, then gains may push the marginal rate on income up to 44% (35% tax + 9% NIC); whereas the marginal rate on gains can never exceed 35% because gains do not attract NIC.

3. A simplified example may help. Take the case of a taxpayer with gross earnings of £24,000, and assume that reform goes ahead next year with a 35% higher rate starting at taxable income of £25,000 and NIC at 9% on employment earnings above the UEL. The taxpayer has personal allowances and reliefs of £5,000 so his taxable income is £20,000. If he makes no capital gains, his tax and NIC position would be:-

Tax	£20,000	x	25%	=	£5,000
NIC	£24,000	x	9%	=	<u>£2,160</u>
					<u>£7,160</u>

If he earns another £1,000, his combined tax plus NIC rate would be 34%, and his total extra liability therefore £340.

4. Now assume that he makes a capital gain (after indexation) of £26,600 (£20,000 above the annual exemption).

The position then becomes:-

Tax on earnings	£20,000	x	25%	=	£5,000
NIC	£24,000	x	9%	=	£2,160
Tax on gain:-					
(a)	£5,000	x	25%	=	£1,250
(b)	£15,000	x	35%	=	<u>£5,250</u>
					<u>£13,660</u>

If he earns another £1,000, his tax bill would go up by £350 and his NIC by £90, giving a total of £440, so his marginal extra liability would be at 44%.

5. It is possible that some economists and commentators (eg. the IFS) will present things this way, and that there may be a few newspaper articles advising people whose income is below the higher rate threshold to think carefully about the tax position before they do things which generate extra earnings in a year when they anticipate large gains - and to consider whether it would be possible to defer some of those earnings to another tax year.

✓ 6 Nevertheless, we doubt that many people would see things in those terms. First, even with help from newspaper articles not all those involved would have the sophistication to understand the point and sit down and do the sums. Second, If he is within PAYE, what ^{the taxpayer} he will see is the extra £1,000 pay being taxed when it is paid at 25%, with 9% NIC, followed months later by a CGT assessment on the gain in which the amount of gain taxed at 35% will be £1,000 more than it would have been if he had not worked the overtime: so he is likely to perceive (if he thinks at all about it) the effect of the extra earnings as being to increase the amount of gain liable at 35% rather than the gain increasing the marginal rate on income to 35% tax plus 9% NIC. Third, the NIC will not appear in the tax computations when we issue the assessment.

This can be illustrated by the following simplified version of the tax computations with which he might be presented.

TASK FORCE SECRET

(i) He does not earn the extra £1,000

Taxable income	£20,000	
Tax at 25%		£5,000
Gain	£26,600	
<u>less exemption</u>	<u>£6,600</u>	
	£20,000	

of which	£5,000 at 25%	£1,250
	£15,000 at 35%	<u>£5,250</u>
		<u>£11,500</u>

(ii) He earns the extra £1,000

Taxable income	£21,000	
Tax at 25%		£5,250
Gain	£26,600	
<u>less exemption</u>	<u>£6,600</u>	
	£20,000	

of which	£4,000 at 25%	£1,000
	£16,000 at 35%	<u>£5,600</u>
		<u>£11,850</u>

7. The issue needs to be put in perspective. The number of people in this situation is likely to be pretty small. Our present CGT population is approaching 200,000. (How this will be affected by reform will depend critically on what happens to stockmarket values, on behavioural responses, and on the size of any "surge" effect). About a sixth of these taxpayers are trusts. Of the remaining five-sixths, we think that less than half are in employment or self-employed. Of those who are currently employees or self-employed, we think that:-

- i. over a third will be people who remain within the basic rate;
- ii. about half will be liable at the higher rate irrespective of their gains;

This means that the number pushed by gains into the higher rate may well be less than a tenth of all individuals liable to CGT - possibly 15,000 or less. Of this group:-

- many will not be able to judge the likely level of their gains until it is too late to influence their decisions on whether to earn more income.
- many will not be able to add to their pay by working more (because e.g. they are not in an overtime grade or are already working to the maximum possible.)
- following independent taxation those who are married may be able to avoid the higher rate charge by transferring assets to their spouses before they are sold.
- most are more likely to be able to vary the timing of their gains than the level of their income.

So the numbers potentially involved are small.

8. Finally, we are talking about only a 10% tax differential: there might be rather more risk of a disincentive effect if higher rate liability could be at up to 60%. And, if the present income tax rate structure were to continue, some of the relatively small number of people

concerned would be facing a marginal rate of 45% on their income alone (the 45% rate would start, with revalorisation, at a little over £21,000), and for those ^{people} on any basis and on any perception, the combined marginal tax/NIC rate on income would be lower than under the current system.

Michael Cayley

M F CAYLEY

bf. 25/11



FROM: J M G TAYLOR
DATE: 19 November 1987

MR CAYLEY - Inland Revenue

cc PS/Financial Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Isaac - IR
Mr Houghton - IR
PS/IR

CAPITAL GAINS TAX: ROLLOVER RELIEF

A farmer has complained to the Chancellor that, if it proves necessary for him to sell a small packet of land in order to offset the costs of his business, he will not get rollover relief on the gain. The Chancellor would like to know the circumstances in which a farmer would be entitled to rollover relief on gains from sales of land. I should be most grateful for a short note.

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

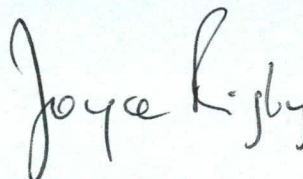
J M G TAYLOR

FROM: Miss J E Rigby
20 November 1987

PS/CHANCELLOR
PS/CHIEF SECRETARY
PS/FINANCIAL SECRETARY
PS/PAYMASTER GENERAL
PS/ECONOMIC SECRETARY
PS/PERMANENT SECRETARY
MR BYATT
MR SCHOLAR
MR CULPIN
MISS SINCLAIR
MISS HAY
MR CROPPER
MR TYRIE
MR CALL
MR PAINTER, IR
PS/IR

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

You should know a copy of Mr Cassell's submission of 19 November on this subject has also been sent to the Paymaster General.



Miss J E Rigby

TASK FORCE SECRET

3. **Perception.** Because the PAYE system clearly works so painlessly for the employee, removal of P11Ds would not necessarily result in hats being thrown in the air. Nevertheless individual taxpayers would be relieved of paying personal income tax on their benefits, so some political advantage could be expected to accrue to Government. Companies do not have votes. **Advantage**

EBT.

4. **Universality.** It would be easier to get rid of the £8,500 limit altogether if one were at the same time switching to an EBT. On the other hand the EBT would be less straightforward to operate if it were desired to maintain the £8,500 limit or raise it to, say, £20,000. Then the employer would still have to take into account the "who" of each benefit, as well as the "what" and "how much". **Advantage dependent on detail of scheme.**

EBT is amount paid in kind w/ approx 1/3 to 1/2 anti-avoidance

5. **Politics of Envy.** If one is looking for a system of benefit taxation which is clearly equitable as between those in jobs which carry benefits, and those in jobs which do not, then one would stick with the P11D. As between benefit-receivers the P11D is also the more even-handed: the EBT would leave employers with more incentive to give benefits in kind to their highly paid employees than to their basic rate people. **Advantage**

P11D.

6. **Simplicity.** For conceptual and regulatory simplicity there is little to choose. Much would be gained by cutting out all the niggling benefits and concentrating on a limited tariff of big taxable benefits. If this were possible, it would be equally possible with P11D or with EBT. **Advantage even.**

7. **Return to Cash Payments.** If one's main aim is to discourage the use of benefits in kind right through the economy, the EBT is to be preferred. A tax falling

TASK FORCE SECRET

on the employer is more likely to curb the use of benefits than one falling on the employee. The employer is the "active partner" in the benefit relationship.
Advantage EBT.

PROBLEMS OF TRANSITION

1. Burdens on Industry. A considerable tax burden would be transferred from employees (Pl1D) to employers (EBT). It would be difficult for the employers to recoup much of this added liability by cutting the salaries of their employees (or holding back their increments). So there would be a permanent addition to industry's costs.
2. Employers' Compliance. Employers' accounts offices would have to learn new tricks. In the case of big computerised companies this would present little problem: small companies and unincorporated businesses would be a lot less easy to placate - particularly if Pl1Ds continued to run alongside the new EBT.
3. Managing Change. If it is the intention to raise car benefit scales substantially, it would probably be easier to do this behind the smoke-screen of a comprehensive reform of the whole system.
4. Motor Sales. One way or another, a switch to EBT would lead to the withdrawal of some company cars, and a downgrading in the size and quality of others. The motor industry is bound to complain, especially the Rover and Jaguar companies.

ADDITIONAL POINTS

The special advisers remain uncertain about two points that are central to this debate:

1. The Need for an Ongoing Pl1D. Would it really be necessary to keep the Pl1D system going for the

miscellaneous benefits, alongside an EBT system covering the big specified benefits - cars, education, health, holidays, accommodation? If the PlLD could be scrapped entirely, the balance of advantage would be more in favour of change.

yr | 2. The Scope for Raising Car Scales. Would it be as difficult as we think to raise the car scales to realistic levels, within the PlLD framework? If income tax rates are coming down, then the scales could surely be raised at least pari passu, in order to maintain the yield. And possibly by more. If the income tax rate reductions were more noticeable at the upper levels, maybe the scales should be raised steeply on the bigger/more expensive cars. Or the PlLD benefit tax could be surcharged in the case of higher rate payers. It may not be necessary to change the whole system for the sake of bringing in more realistic car scales.

PRESENTATION

Assuming it were decided to switch to an EBT system, but that the PlLD had to continue in parallel, political presentation would have to concentrate on Relief to employees, who would no longer be personally charged to tax on their budgets. This would go against consideration of equity.

Not much could be made presentationally of the raising of car scales to more realistic levels, or of the encouragement to employers to switch back from benefits to cash. Some people would like to be free to buy a VW rather than be obliged to accept their employer's Maestro; there is a freedom of choice argument to deploy. But against that, they will soon realise what they are losing in terms of group insurance, the pleasure of having a new car every three years, and the peace of mind of knowing that there will be a replacement vehicle at the front door the day after the old one has been crashed. Meanwhile, it is unlikely that many points could be scored for simplification or reduced compliance costs under an EBT.

P J CROPPER

A G TYRIE

TASK FORCE SECRET

Copy No 1 Of 4

*Mark
Thanks. Will be
PJC's pup: Bar*

CHANCELLOR

FROM: A G TYRIE
DATE: 20 NOVEMBER 1987
cc Mr P Cropper

AN EMPLOYER BENEFITS TAX: FOR AND AGAINST

I have seen Peter's note ^{behind} and discussed it with him in the drafting. Neither he nor I can find any really good reasons for the proposal, even after much head scratching.

An EBT would be well worth trying either if it took much of the political hassle of benefits in kind off our backs (getting rid of Plls could do that) or (even better) if it severely curtailed/eradicated them and we got back to cash. These proposals do neither.

So my conclusion is still that, maddening though it is, it's not worth the candle. My recommendation remains: increase the threshold, exempt absurdities, increase the car scales this year as much as we dare.

*X to not write
its problems, which show
the necessity to push threshold.*

AGT.

A G TYRIE

X

TASK FORCE SECRET

EBT: FOR AND AGAINST

Arguments For

- A 45 per cent EBT would ensure neutrality between cash and benefits in kind for all basic rate taxpayers.
- The fact that this tax would bear on employers rather than employees might make it easier to increase car scales to realistic levels.

Arguments Against

- An EBT would be seen as an increased burden on employers, a new, high and politically unattractive tax. The retention of P11Ds would severely weaken any claims we made on grounds of simplification.
- An EBT would retain the same NIC advantage for higher rate taxpayers that at present pertains (in fact, a decrease in the advantage from 10.45 per cent to 10 per cent).
- The inevitable lobbying during transition to an EBT might cost us dear. We might, for example, be forced to commit ourselves not to increase car scales for the time being.
- It is not clear that neutrality would get us 'back to cash', even for basic rate taxpayers. Benefits in kind would remain attractive for other reasons: status, less hassle etc. Benefits in kind were rife before 1985 when we had neutrality, through the P11D system, for those earning above £15,000.

Copy No. 1 of 22

FROM: J P MCINTYRE
DATE: 23 November 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Miss Peirson
Mr Scholar
Mr Riley
Miss Sinclair
Mr Gibson
Mr Macpherson
Mr Cropper
Mr Tyrie
Mr Call
Mr Isaac (IR)
Mr Mace (IR)**NATIONAL INSURANCE CONTRIBUTIONS: MEETING WITH MR MOORE ON TUESDAY, 24 NOVEMBER**

At your meeting on Thursday, you decided to tell Mr Moore tomorrow about your plans (Option F) for reducing NICs at the lower end. I attach a note at Annex A for this purpose. You also want to remind Mr Moore about the conversion of the Additional Personal Allowance (APA) into benefit. Mr Moore might mention Self Employed NICs; he may also express concern about the NIF surplus.

2. You said on Thursday that you would prefer not to consult DHSS about the other NIC changes until just before Christmas. But you asked us to give further thought to this.

3. There are conflicting considerations here. First, to minimise the risk of leaks, we want to consult DHSS as late as possible. Second, to make sure that any operational or policy considerations we have not identified are picked up in time, so they can be resolved to allow an October 1988 start, we want to consult DHSS as soon as possible.

4. There is a third consideration: the need for a Social Security Bill to be prepared for early introduction after the Budget. Work cannot start on the Bill until the Lord President has agreed it should be included in the legislative programme; DHSS can then instruct Parliamentary Counsel. The Bill may be relatively simple. But until DHSS and Parliamentary Counsel have considered what is involved, we cannot be certain of that.

5. One way of reconciling these objectives might be for Mr Mace and I to speak privately to two senior officials in the DHSS to sound them out on the changes. (The officials we have in mind are Mrs Bowtell and Mr Fanning.) We would not give them any papers at this stage. The aim would be simply to establish that the October timetable is feasible and how soon preparations on the Bill would need to begin. They would of course be consulted on the practicalities not the policy. We would then report back to you before any further steps were taken.

6. Consulting now instead of just before Christmas would give us an extra few weeks to sort out any problems that DHSS identify. This time could be valuable in making sure that the October timetable can be delivered. For this reason, we think the additional risk of a leak (as a result of the limited consultation exercise envisaged in paragraph 5) is worth taking. I have discussed this with Mr Scholar who agrees with this advice.

7. It may be that Mrs Bowtell and Mr Fanning would tell us that one or two others in DHSS would need to be consulted before they could be reasonably sure of the operational and legal consequences of what you propose. But it would still be useful to get their provisional views, and we would consult you again before any of their colleagues were brought in.

8. If you are persuaded by this, you will want to consider revealing the rest of your NIC measures to Mr Moore tomorrow. I attach a list of the other changes at Annex B.

Self Employed NICs

9. Mr Scott has written to the Financial Secretary (16 November) proposing further work by officials on simplification of self employed NICs. Mr Moore might refer to this. At present, the Revenue collect Class IV contributions and DHSS Class II. The main proposal to be examined would be a single profits-related NIC collected by the Revenue. The idea is that officials should prepare a report for Ministers by the middle of next year. | behind

10. If Mr Moore raises this, you can say that you welcome the idea of a study and are content for further work to be done, though Budget preparations are bound to be a heavy drain on Revenue time in the next few months so you would prefer to leave the work until after the Budget. As any change to a single NIC rate could not be achieved in the short term (because of the Revenue's computerisation programme), this delay would not have any practical consequences. The Financial Secretary will be replying shortly.

11. If you have revealed your plans for self employed NICs, Mr Moore should readily see the difficulty for the Revenue (and his own Department) in taking on other work in the short term. And even if you have not disclosed your plans, it would be reasonable to say that those in the Revenue who would be closely involved in the work on a merger of Class II and Class IV would also be engaged in Budget preparations on tax.

APA

12. You wrote to Mr Moore on 16 October giving him the assurance he had sought on the public expenditure consequences of converting APA into benefit. Mr Moore has been given a draft letter by his officials, confirming that he is content for the work on conversion options to proceed but saying that, because of other pressures, it will not be possible to meet the end-November timetable for a report to Ministers which you had proposed. Instead, Mr Moore is likely to envisage a report by Christmas. | behind

13. In response, you will want to stress the importance of meeting this revised deadline in view of the need for decisions to be reflected in the Budget statement. (Even though implementation would not be until April 1989, abolition of the APA would need to be included in the 1988 Finance Bill.)

Jm.

J P MCINTYRE

ANNEX A**NICS: PROPOSED CHANGES TO CLASS I AT THE LOWER END**

Introduce additional reduced rate band between £105-130: employee rate would be 5 per cent (down 4 per cent). Other employees rates above £70 reduced by 2 per cent. Employers rates unchanged. New structure would be:

£ per week	EMPLOYEES RATE (%)		EMPLOYERS RATE (%)	
	Now	Proposed	Now	Proposed
41-70	5	5	5	5
70-105	7	5	7	7
105-130	9	5	9	9
130-155	9	7	9	9
155-305	9	9	10.45	10.45

Timing

Announcement at Budget time, with implementation from October 1988.

Effect on NIF

	<u>£ million</u>	
Reduction in contributions	400	700
Resultant NIF surplus*	1400	100

* Assuming no other changes in contribution rates and other current assumptions. To contain the first full year cost, reduced rate bands would not be uprated in April 1989, though LEL and UEL would be uprated as usual.

Gainers

Around 6.8 million tax units will gain an average of £3 a week. 3 million of these gainers will ^{be} in tax units with gross incomes of less than £130 a week. 35,000 will be taken out of the

unemployment trap (out of 400,000 working heads of household estimated to be in the trap).

Interaction with Benefits

Some claimants will lose a large part of their benefits, because the NIC reduction will increase their net incomes - the basis for assessing income-related benefits under the reformed scheme coming in next April. But the number affected in this way will be relatively small. Only 400,000 of the 6.8 million gainers are benefit claimants, and the average gain for those on benefits will still be over £1 a week. There will be some modest public expenditure savings as a result of these benefit reductions.

ANNEX
B

NICS: OTHER PROPOSED CHANGES

Class I

(i) Abolish Upper Earnings Limit (UEL) for employees. Would mean 9 per cent charge on total gross earnings for all those earnings £155 a week or more. (Though the 9 per cent figure might be reached by phasing over 3 years, starting at 7 per cent.)

Self Employed

(ii) Abolish Upper Profits Limit (UPL). Propose 6.3 per cent charge on all profits above Lower Profits Limit (LPL) ie same percentage charge to apply to those with profits above UPL as now applies below UPL. [Tax relief on 50 per cent of Class IV contributions would be abolished to pay for reduction in Class II increase in LPL.]

Treasury Supplement

(iii) Abolish (will be down to 5 per cent from next April)

Timing

(iv) All measures would be announced at Budget time. Hope Class I changes can be implemented October 1988; no Inland Revenue problems with that timetable. Would also abolish Treasury Supplement in October. But measures affecting self employed would have to wait till April 1989 because UPL abolition will require significant changes to Revenue's Schedule D computer system which need more time to complete.

(v) Effect on NIF

£ billion

	1988-89	1989-90
UEL/UPL abolition	+0.4	+1.5
Treasury Supplement abolition	-0.8	-1.0
Measures to help employees at lower end	-0.4	-0.7
	_____	_____
Net effect	-0.8	-0.2
Resulting NIF surplus for the year	1.1	0.6
Balance of NIF	8.0	8.6
Surplus at end-year as percentage of outgo	29.9	30.3



COPY NO. 17 OF 18 .

FROM: J M G TAYLOR

DATE: 23 November 1987

MR MACE - Inland Revenue

- cc PS/Chief Secretary
- PS/Financial Secretary
- PS/Paymaster General
- PS/Economic Secretary
- Sir P Middleton
- Sir T Burns
- Mr Cassell
- Mr Scholar
- Mr Culpin
- Miss Sinclair
- Mr Cropper
- Mr Tyrie
- Mr Battishill - IR
- Mr Isaac - IR
- PS/IR

JMG
TO
MACE
23.11.87

TAX RATES

The Chancellor would be grateful if you could cost out two further packages for income/capital gains tax.

2. These are:
 - (a) a higher rate of 30 per cent, and a standard rate of 25 per cent;
 - (b) a higher rate of 30 per cent and a standard rate of 24 per cent.

3. The Chancellor would be grateful if, in your note on these, you could set out the position on gainers/losers.

J M G TAYLOR



COPY NO 15 OF 16 COPIES + (Culpin)

FROM: J M G TAYLOR

DATE: 23 November 1987

*Part in folder for
Economist's only (not for
Culpin) ✓
(for L work with Scholar
+ Culpin)*

MR CAYLEY - INLAND REVENUE

cc PS/Chief Secretary

Sir P Middleton

Sir T Burns

Mr Byatt

Mr Scholar

Mr Culpin

Miss Sinclair

Mr Riley

Mr Cropper

Mr Tyrie

Mr Battishill - IR

Mr Isaac - IR

PS/IR

CGT REFORM: PERCEPTION OF MARGINAL RATES

The Chancellor was most grateful for your minute of 19 November. He has commented that clearly there is no real problem with disincentive effects.

JMGT

J M G TAYLOR



COPY NO 3 OF 4 COPIES

FROM: J M G TAYLOR

DATE: 23 November 1987

MR CROPPER

cc Mr Tyrie

BENEFIT TAXATION

The Chancellor was most grateful for your note of 20 November.

2. He has commented that your question whether it would be necessary to keep the P11D system going is an important one. The answer is that, in his proposed scheme, where there is no catch-all EBT but only one for the big specified benefits, there would be an incentive for employers to reward employees with benefits in kind simply because they were not on the EBT list. The P11D system would therefore need to be kept for the residue. But the P11D limit could be pitched very high, so very few people would be affected and for the vast bulk of employees life would be very simple indeed.

3. He thinks that the main problem is that the transfer from employees to employers would, as you suggest, be a permanent addition to industries' costs, unless we decide to relieve business taxation in some other way, which would be expensive. On universality, he has commented that the EBT is universal, while the P11D limit would apply only to anti-avoidance.

4. The Chancellor has also seen and was grateful for Mr Tyrie's note of the same date. He has commented that increasing ^{the} threshold etc is not without its problems.

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

J M G TAYLOR



Inland Revenue

Policy Division
Somerset House

copy no 1 of 10

FROM: M F CAYLEY

DATE: 24 NOVEMBER 1987

PS/CHANCELLOR OF THE EXCHEQUER

*Thanks.***CAPITAL GAINS TAX : ROLLOVER RELIEF**

1. Your minute of 19 November asked for a note covering the circumstances in which a farmer would be entitled to rollover relief on gains from sales of land. This response has a task force classification because decisions on task force issues affect the farmer's position.

2. There are in fact two reliefs which might allow tax to be deferred - rollover relief and the small part disposals relief.

Rollover relief

3. The capital gains tax rollover relief itself enables a trader who sells business assets to defer some or all of any capital gains tax liability if he uses (all or part of) the proceeds to acquire fresh business assets within certain time limits - running from one year before to three years after the disposal. Only certain classes of asset can qualify including land and buildings, fixed plant and machinery and (a very recent addition) milk quota. Both the old and the new asset must fall within the qualifying test.

cc	PS/Financial Secretary	Mr Isaac
	Sir P Middleton	Mr Pitts
	Mr Scholar	Mr Cayley
	Mr Culpin	Mr Michael
		PS/IR

4. In some cases a trader - and in particular a farmer - may not wish to acquire a new asset. He may instead want to use the proceeds to meet other business expenses or perhaps pay off part of an overdraft. Because in those circumstances no new asset is acquired there is nothing for the gain to be rolled into and so no rollover relief is available. Where the gain is on land there is a special relief - the small part-disposals relief - specifically designed to assist in these circumstances.

Small part disposal relief

5. The small part disposal relief is primarily intended to assist the small and medium sized farmer faced with a potential tax charge in this situation. The relief enables a small portion of land to be sold without incurring an immediate tax charge, by reducing the cost for capital gains purposes of the remaining land held. So the tax charge is deferred until that land is sold. The end result is similar to rollover - but the mechanism is different.

6. The relief is available provided that the piece of land sold does not realise more than £20,000 and does not constitute more than 20% of the entire holding. The financial limit was increased in 1984 from £10,000 to its present level and the percentage limit was increased in 1986 from 5% to 20%. A further increase in the financial limit has been regularly included in our list of possible sweeteners as part of any wider package of reform.

7. In addition rebasing to 1982 would substantially remove any difficulties faced by farmers in this situation. This is because, as the Chancellor is aware, accrued gains on agricultural land arose largely between 1965 and 1982; and in some cases the value of land has dropped relative to inflation since then. So ~~if~~ with rebasing to 1982, with the annual exempt amount standing at £6,600, many farmers would face no liability at all on a sale of part of their land and indeed some may realise indexed losses. Where

gains remain after rebasing (for example because land has acquired development value since 1982), rebasing is likely to reduce them substantially.

Summary

8. Even under the present system there is already some considerable scope for farmers selling part of their land to defer any capital gains liability: where a new qualifying asset is acquired, by claiming the normal rollover relief; or where the parcel of land disposed of is fairly small, by claiming the small part disposal relief. The effect of rebasing to 1982 would generally be to reduce substantially any gains that may arise on disposals of small parcels of farmland - and frequently to eliminate the gains altogether.

Michael Cayley

M F CAYLEY



COPY NO. 8 OF 9 .

FROM: J M G TAYLOR

DATE: 25 November 1987

MR CAYLEY - Inland Revenue

cc PS/Financial Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Isaac
PS/IR

CAPITAL GAINS TAX: ROLLOVER RELIEF

The Chancellor was grateful for your note of 24 November.

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

J M G TAYLOR



NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM,
HM TREASURY AT 4.15PM ON WEDNESDAY, 25 NOVEMBER 1987

Present: Chancellor
Chief Secretary
Financial Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Burr
Mr Cropper
Mr Tyrie

Mr Battishill - IR
Mr Isaac - IR
Mr Corlett - IR
Mr Stewart

MAINTENANCE AND COVENANTS

Papers: Mr Stewart's annotated agenda of 24 November; Financial Secretary's minute to the Chancellor of 24 November; Mr Isaac's submissions to the Chancellor of 20 November; Mr Stewart's submissions to the Chancellor of 20 November; Mr Stewart's submission to the Financial Secretary of 20 November.

The Chancellor thanked Mr Stewart for his most helpful annotated agenda. He invited the meeting to consider the questions listed in it.

(i) Maintenance

Where should the limit be set?

2. The Chancellor said there were only two practicable possibilities: at the level of the single allowance, or at the level of the married allowance. There was a strong case for



setting the limit at the level of the single allowance. The case for setting it at the level of the married allowance - which would cost an additional £10 million - would be to reduce the number of losers. Following a brief discussion, it was agreed to set the limit at the level of the single allowance at the outset. The higher limit should be kept in reserve, in case difficulties were encountered at Committee Stage. It was also agreed that the limit should not be doubled for someone who had two ex-spouses (and so on).

Should relief for all maintenance payments to children be stopped? If not, where could or should the line be drawn between qualifying and non-qualifying payments to children?

3. The Chancellor said his initial view was that there should be no relief for maintenance payments to children. It might, however, be sensible to work out an uncomplicated fallback, in case Ministers came under great pressure during the passage of the Bill. The Financial Secretary said it was difficult to envisage any defensible fallback on the tax side; wherever the line was drawn there would be a problem with hard cases. It might be more appropriate to tackle this problem through an increase in benefits.

4. Mr Scholar said the major difficulty related to the children of deserted unmarried mothers. It would seem very harsh to withdraw tax relief from these children, and odd generally to withdraw relief from children but perpetuate it for women in a Budget which introduced independent taxation. Mr Isaac drew attention to the sensitive problems in this area set out in his minute of 20 November. Following decisions at the meeting on 17 October, it was currently planned only to provide tax relief in respect of payments to separated wives. Maintenance payments to deserted deserted unmarried mothers, and for children living with guardians, would attract no relief.



5. The Chancellor asked whether it would be possible to replicate the proposed arrangements for divorced mothers for unmarried mothers. Mr Isaac thought this might be possible. The Financial Secretary noted that one of the objects of the reform was to stop covenants for cohabittees. This would necessarily hit those with children who were not cohabiting. It was difficult to see how tax relief for payments to ^{deserted} unmarried mothers could be protected if the proposed reforms were to go ahead. Mr Battishill noted that any protection of this sort would also require the Revenue to establish whether or not cohabitation had taken place; this would add considerably to the Revenue's administrative difficulties.

6. Mr Scholar said that a reform of the sort envisaged would almost certainly attract complaints from the one parent family lobby. But it was difficult to see any fallback on the tax side. The Chancellor, summing up this part of the discussion, said that the only offset seemed to be to increase benefits to one parent families. This would carry a huge deadweight cost. But it ought to be examined as a fallback. He invited the Chief Secretary to examine further the possibilities.

Should there continue to be no relief for (a) voluntary payments and (b) payments under foreign Court orders or agreements?

7. The Chancellor agreed with the Financial Secretary that there should be no relief for these payments.

Other points

8. It was agreed that:

- the new rules should apply to Orders/Agreements made on as well as after Budget day;
- relief should continue to run without time limit to pre-Budget Orders/Agreements;



- the possibility of allowing the old rules to apply where an application was made to the Court before Budget day and the Order made within three months after Budget day should be pursued (if necessary in discussion with the Lord Chancellor's Office);
- where a pre-Budget day Order/Agreement is superseded or varied by a new Order/Agreement after Budget day, the new rules should apply to the new Order;
- couples with pre-Budget Orders should be allowed to elect to switch immediately to the new rules, provided both partners wished to do so;
- pre-Budget agreements should be submitted to the Revenue by 30 June '988 in order to get the benefit of the old rules.

(ii) Covenants

9. It was agreed that the new rules should apply to covenants made on as well as after Budget day. It was also agreed that relief for pre-Budget covenants should continue indefinitely, and should apply to increased payments resulting from the automatic application of a formula already built into the covenant.

10. On students, the Chancellor said that the revised estimates of the cost of covenant relief, and the subsequent work on the implications of this for the provision of direct support, should be proceeded with as quickly as possible. Transitional problems should be discussed in the light of that work.

11. Mr Isaac suggested an alternative transitional system to those mentioned in the annotated agenda. Under this alternative, anyone on a course at the time the new system was introduced would remain covered by the old system, and anyone else would be covered by the new system. This would not provide perfect symmetry with holders



of covenants (because students did not necessarily start to receive covenant payments at the same time that they began their course). But it was simpler than the two grant/contribution scale option mentioned in paragraph 6 of the annotated agenda. The Chancellor agreed that that option was too complicated to pursue; Mr Isaac's variant should be examined further.

12. The Chancellor said that the Paymaster General had asked whether the new system would not be more regressive than the present arrangements (Paymaster General's minute of 25 November). Mr Burr said the new system would involve the reintroduction of a minimum grant. In a sense it would be slightly more regressive than the present arrangements, since people at the top of the income scale would receive some maintenance grant. But low income parents would not be worse off.

13. The Chancellor invited those present to be guided by the points made in the discussion. He asked the Revenue also to work up a paper setting out how the proposals would simplify matters both for the taxpayer and for the tax administration. Manpower savings at the Revenue should also be identified. The paper should also set out the key presentational advantages of the new system. More generally, thought should be given to how best these changes could be presented to the public. Mr Scholar and Mr Isaac undertook to take this work forward.

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

J M G TAYLOR

26 November 1987

Circulation

Those present
PS/PMG
Sir T Burns
PS/IR



COPY NO 17 OF 18

FROM: J M G TAYLOR

DATE: 26 November 1987

 JMG
 TO
 PS/EST
 26.11.87

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
 PS/Paymaster General
 PS/Economic Secretary
 Sir P Middleton
 Mr Scholar
 Mr Culpin
 Miss Sinclair
 Mr Cropper
 Mr Tyrie
 Mr Jenkins - OPC
 Mr Battishill - IR
 Mr Isaac - IR
 Mr Painter - IR
 Mr Beighton - IR
 Mr Mace - IR

INDEPENDENT TAXATION - STAFF COSTINGS

The Chancellor has seen Mr Isaac's and Mr Mace's notes of 23 November. He has also seen Mr Beighton's note of the same date on cutting the cost of handling claims.

2. On Mr Isaac's note, the Chancellor has commented that changes to eg. maintenance and covenants should give rise to some staff savings. On Mr Mace's note, he has commented that this would seem to strengthen the case for a straightforward flat rate withholding tax on dividends etc.

A handwritten signature, likely 'JMG', in dark ink.

J M G TAYLOR

FROM: N I MACPHERSON
 DATE: 27 NOVEMBER 1987

CHANCELLOR OF THE EXCHEQUER

- cc. Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir T Burns
- Mr Byatt
- Mr Cassell
- Mr Scholar
- Mr Culpin
- Miss Peirson
- Mr McIntyre
- Mr Riley
- Miss Sinclair
- Mr Cropper
- Mr Tyrie
- Mr Call
- Mr Isaac - IR
- Mr Mace - IR

Thanks. There are a quite some ways here, but subject to the views of CS & others on mm. The LPL option looks better to edge by virtue of price. It is also argued, more logical & comprehensive for a class 4 contribution. It is also a class 4 (under plan class 2) advantage - a number of known that the self-employed have paid Class 4. Mr.

NATIONAL INSURANCE CONTRIBUTIONS: FURTHER WORK

You asked for further work on raising the LPL, as an alternative to lowering Class 2, as part of the self employed package. You also asked what social security flowbacks would result from the lower end package for employees (Option F).

Raising the Lower Profits Limit

2. At the meeting on 19 November, ^{behind} you decided that a Class 2 reduction of £1.55 to £2.50 a week could be a suitable quid pro quo for withdrawing tax relief on Class 4 contributions. The Class 2 reduction would have a full year cost of £170 million, enough to finance a £1650 rise in the LPL to £6400 p.a.

3. Raising the LPL would have the advantage of taking 360,000 self employed out of Class 4 NICs. Of these 320,000 would be men or single women, while 40,000 would be married women. It would result in 33,000 losers from the self employed package, making it more effective than the Class 2 option, which would result in 38,000 losers (see Table attached). This compares to 26,000 losers ^{behind} under Mr Mace's Option D, which involved tax relief on all Class 4 contributions but left Class 2 and the LPL unchanged.

4. The main disadvantage of the LPL option is that it reduces the number of gainers. By targeting on the 1.65 million Class 4 contributors, it does nothing for the 500,000 Class 2 contributors who earn below the current LPL (£4750). Most of these will not be paying income tax and so would gain nothing from the overall reform package. In this respect, the LPL option is similar to the lower end employee package, where those earning less than £70 a week also stand to gain little or nothing. However, unlike low earning employees, who are predominately married women, the vast majority of low earning self employed are adult men.

5. Another consideration is the effect on average NIC rates. The Class 2 option would remove the anomaly, caused both by Class 2's flat rate nature and current level, whereby the lowest earners face the highest average NIC rate (see Table below). However, it would increase the discrepancy between self employed rates and the combined employer/employee Class 1 rate at the lower end. These have been actuarially linked, Class 2 (£4.05 a week) bringing broadly the same entitlement to flat rate benefits as NICs paid on earnings up to the LEL (10 per cent of £41, i.e. £4.10 a week).

Average NIC rates (Class 2 and 4 contributions as % of profits)

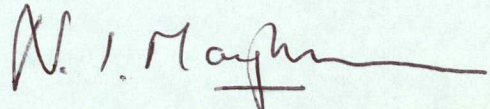
	Profits £p.a:	2250	6400	60000
Unchanged policies		9.4	4.7	1.2
Abolish UPL & Tax relief				
- Lower Class 2		5.8	3.7	6.0
- Raise LPL		9.4	3.3	5.9
<u>Memo item</u>				
Class 1 rate		10	14	19.45
(Option F: employer plus employee)				

Flow-backs from Option F

6. The full year social security flow-backs from the lower end employee package (Option F plus a 2p cut in income tax) are estimated to be £50 million. These break down roughly as follows: £40 million off Family Credit expenditure, £7 million off Rent Rebates/Allowance and £3 million off Rate Rebates, the latter being revenue foregone rather than public expenditure.

7. Entitlement to family credit is reassessed every six months and housing benefit only once a year. Although recipients of housing benefit are supposed to advise their local authorities of changes in financial circumstances between assessments, they do so only very rarely. This, together with the lags before the tax/NIC package becomes effective, will result in the flow-backs in 1988-89 being little more than £10 million. Flow-backs in 1989-90 should be around £50 million, the uprating of the needs allowance and the freezing of the reduced rate bands broadly offsetting the effect of rising earnings.

8. Flow-backs were not taken into account in the original costings nor are they included in the current score card.



N I MACPHERSON

TAX REFORM: SELF EMPLOYED (Class 4: 6.3 PER CENT NIC and no tax relief)

Comparison with 1987-88

	Lower Class 2 to £2.50		Raise LPL to £6400	
Total income (lower limit) £000	No. losers (000)	Am.t loss (£m)	No. losers (000)	Am.t loss (£m)
0	0	0	0	0
20	17	2	13	1
25	15	2	13	2
30	6	1	5	1
40	0	0	0	0
50	0	0	0	0
Total*	38	5	33	4
Amount of loss (lower limit) £				
0	13		10	
50	7		7	
100	11		9	
200	4		4	
300	2		2	
500	1		1	
Total*	38		33	

*Totals may not sum due to rounding.

Note

Estimates are at 1988-89 income levels to permit comparison with Option D (Mr Mace's submission of 17 November) and previous analyses though the Class 4 changes will not now be made in 1988-89.



Inland Revenue

TASK FORCE SECRET

Policy Division
Somerset House

FROM: B A MACE

DATE: 27 NOVEMBER 1987

Copy No. 1 of 28.

MACE
To
CH.
27.11.87

- 1. MR ISAAC *27.11.*
- 2. CHANCELLOR OF THE EXCHEQUER

Thanks. Information for us is gone. Sub it doesn't really answer my question since (a) it completely ignores the 30% with tax part gone (b) it leaves out the crucial option F2A. Ask lot to have the full copy, etc. ASAP.

TAX REFORM: INCOME TAX AND NIC

1. Mr Taylor's note of 23 November asked for the costs and distributional effects of two further options:

- (a) higher rate of 30 per cent; basic rate of 25 per cent (Option F1);
- (b) higher rate of 30 per cent; basic rate of 24 per cent (Option F2).

2. Your office asked if we could let you have a note on these options before the weekend.

3. In the time available we have only been able to look quickly at the effects of these options for both income tax and CGT. (The CGT implications are discussed in the attached Annex by Mr Cayley.) If you would like further information on these options or variants of them we will produce more refined costings later.

- cc Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir T Burns
- Mr Byatt
- Mr Cassell
- Mr Scholar
- Mr Culpin
- Miss Sinclair
- Mr Riley
- Mr Cropper
- Mr Tyrie
- Mr Call

- Chairman
- Mr Isaac
- Mr Painter
- Mr Beighton
- Mr Lewis
- Mr Pitts
- Mr Calder
- Mr Cayley
- Mr Mace
- Mr Eason
- Mr Allen
- PS/IR

24
30
1.4
0.25
1.65
1.5
2.0

BM's note of 17/11
is in the NICs
folder.

Costs

4. On the income tax side the full year cost of Option F1 compared with Option D of my note of 17 November would be about £530 million at 1988-89 income levels, of which about half would come through in 1988-89. The full year cost of Option F2 (again at 1988-89 income levels) would be about £2 billion on top of Option D, of which around £1.65 billion would come through in 1988-89. Both these options assume that the higher rate threshold remains at £25,000 of taxable income. On the CGT side, assuming the stock market stabilises at around the levels reached at the end of October the extra cost compared with the previous 25 per cent/35 per cent rate structure could be in the region of £50-£100 million in a full year.

but see below (para 7)

Income tax gainers and losers

5. Compared with Option D, Option F1 has only a very small effect on the number of losers from the overall tax and NIC package (since very few of the losers are liable at the higher rate under Option D). Excluding the self employed (who would not be affected by the abolition of the UPL until 1989-90) the total number of losers under Option F1 in 1988-89 (at 1988-89 income levels) would be around 505,000, roughly the same as under Option D. The further reduction in the higher rate would, however, have a significant effect on the size of the gains of those with large incomes. Average gains compared with 1987-88 for the just under 1/4 million tax units with incomes in excess of £50,000 would rise from around £7,300 under Option D (see Table 3 of my note of 17 November) to around £10,000 under Option F1.

6. Option F2 would lead to a substantial reduction in the number of losers compared with Option D. The picture is very similar to Option E1 of my note of 17 November (which had a 24 per cent basic rate and 35 per cent higher rate.) Under both Options E1 and F2 the total number of losers would be just over 200,000 in

1988-89. Average gains under Option F2 for those with incomes in excess of £50,000 would still be around £10,000, (as for Option F1) since the basic rate cut is worth only up to an additional £250 per individual.

Further variants

7. We understand you were also interested in variants of Options F1 and F2 in which the higher rate threshold might be set at a lower level than £25,000 of taxable income.

8. We have looked quickly at a variant of Option F1 (Option F1A) in which the higher rate threshold would be set at £20,000 of taxable income. Compared with Option F1, Option F1A would yield an additional £230 million in a full year at 1988-89 income levels so that the additional cost of Option F1A on top of Option D would be about £300 million (about half of which would come through in 1988-89).

9. Option F1A would increase the total number of losers under the package by about 30,000 to around 535,000 in 1988-89 (excluding the self employed). Of these around 83,000 would be liable at the higher rate (compared with around 10,000 under Option D).

10. Compared with Option D therefore the overall effect of reducing the higher rate threshold from £25,000 to £20,000 combined with a reduction in the higher rate from 35 per cent to 30 per cent is to

- (a) increase the full year cost at 1988-89 income levels by about £300 million;
- (b) increase very substantially the number of losers who are liable at the higher rate, but
- (c) increase the total number of losers by only about 6 per cent.

11. There would also be a major increase in the total number of higher rate taxpayers from around 700,000 under Option D to about 1.2 million under Option F1A. These 1/2 million additional higher rate taxpayers would have a significant extra staff cost. But because the differential between the basic rate and the higher rate would be only 5 percentage points each would pay at most only an additional £250 in tax.

12. Tables 1 and 2 attached show the distribution of gainers and losers under Option F1A. The table of losers (Table 2) excludes the self-employed (none of whom can be losers in 1988-89 if the UPL is not abolished until April 1989) and so is not directly comparable with Table 4 of my note of 17 November.

B A Mace

B A MACE

These illustrate the familiar pattern etc, compared
and option D
- reductions in the HQ threshold add to both 'losers' and
HQ staff costs;
- reductions in the basic rate reduce 'losers', but are costly.

C. J. E. 27. 11.

Option FIA: 1988-89 Gainers Compared with 1987-88

Gainers by range of income and amount of gain

Income range (lower limit) £000s	Amount of gain (£ per year)							TOTAL
	0-50	50-100	100-200	200-300	300-400	400-500	>500	
0	1692	4344	7656	1710	0	0	0	15401
15	66	116	624	1872	249	0	0	2928
20	47	54	80	290	528	47	51	1097
25	21	14	39	44	85	78	252	532
30	12	9	28	29	30	33	183	324
35	8	8	12	11	13	8	130	191
40	1	1	2	3	7	5	105	123
45	0	0	1	1	1	1	66	69
50	0	0	0	0	1	0	218	220
TOTAL	1846	4547	8441	3961	914	172	1004	20885

Gainers ranged by total income (lower limit)

Range of total income £000s	Amount of gain £million	Number of gainers 000s	Average gain £
0	1877	15401	122
15	662	2928	226
20	332	1097	302
25	298	532	560
30	242	324	748
35	226	191	1185
40	229	123	1854
45	191	69	2765
50	2144	220	9754
TOTAL	6201	20885	297

Note: ACT etc effects excluded.

Option FIA: 1988-89 Losers compared with 1987-88

Losers by range of income and amount of loss

Income range (lower limit) £000s	Amount of loss (£ per year)							TOTAL
	0-50	50-100	100-200	200-300	300-400	400-500	>500	
0	0	0	0	0	0	0	0	0
15	38	11	1	0	0	0	0	50
20	60	60	106	48	19	3	0	296
25	10	15	33	22	19	15	8	121
30	7	5	11	7	10	2	3	45
35	4	4	3	1	1	1	1	13
40	1	0	1	0	0	0	0	5
45	0	0	0	0	0	0	0	1
50	0	0	0	0	0	0	1	2
TOTAL	121	95	155	79	49	20	14	533

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
15	2	50	34
20	41	296	137
25	30	121	244
30	10	45	229
35	3	13	190
40	1	5	226
45	0	1	250
50	2	2	1048
TOTAL	88	533	165

Note: ACT etc effects excluded.

Capital Gains Tax

1. On the capital gains side, we have assumed the package that emerged from the meeting on 12 November, that is

- rebasing to 1982 and
- taxing gains as the marginal slice of income.
- the annual exemption is frozen.

However the arguments for rebasing would look slightly different with a maximum tax rate of 30%: it would not be needed to offset the impact of an increase in tax rates on gains for higher rate people, and would therefore have to be justified entirely on its own merits.

2. The postulated changes in rates would have no effect on the cost of rebasing for companies, which was very provisionally put at £m300 in my note of 9 November. We are doing more work on this.

3. The following table, using the alternative stock market assumption as my 9 November note, gives estimates of the effect of reform with the new rate assumptions. For comparison, I include figures for option 2 - the same structural regime but with 35%/25% higher rates. Two levels of behavioural response are illustrated - the 2%/1% and 6%/3% assumptions of the 9 November note. As ever, the figures are likely to alter in the light of further work and changes in the forecasting assumptions. The figures relate to individuals and trusts only, so £m300 should be added to the costs to take account of the loss in corporation tax. They are on a 1988/1989 accruals basis. It will be seen that if, in the medium term, the stock market stabilises at around the level of end October, the extra CGT cost compared with having rates of 25% and 35% might be around £m50 to £m100 in a full year.

4. Looking at gains alone, the only losers would be from the freezing of the annual exemption. These would constitute a minority, which would include some who would be kept out of tax by statutory revalorisation. Their maximum extra tax (compared with revalorisation) on gains realised in 1988/89 would, on current inflation projections, be to about £90, and in some cases this would be more than offset by income tax reductions. Almost everyone else would pay less tax than now - in some cases substantially less.

5. Finally the figures are based on a higher rate threshold of £25,000: the request to look at a lower figure came through too late to be included in the costings. But our previous work suggests that if the higher rate threshold were £20,000 this would pull down the cost by under £m20.



Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

COPY NO 1 of 3

FROM: A J G ISAAC
27 November 1987

Handwritten red scribbles

*Chy
ACSA spoke to Mr Isaac +
explained your thinking on this,*

26/11

ISAAC
To
CCT
27.11.87

CHANCELLOR OF THE EXCHEQUER

*See also
urgent note
on paper
sent on*

1. Mr Mace's note today responds to your question about a 24/25% basic rate, and 30% higher rate.

2. The Chairman and I have had a word about this - and allowed ourselves to wonder whether, if it is possible to get the higher rate down so close to the basic rate, it is completely unthinkable to unify the income tax on a single rate. We have not commissioned any substantive work on this. On the face of it, however, it ought to offer some big prizes, both in simplification and in Revenue staff savings.

3. It would also, obviously, sit very happily with current ideas for taxing benefits in kind and, possibly, investment income.

4. Is this, as we have previously rather assumed, outside the bounds of practical possibility? Or would you like us to have some work done on the implications, keeping the thing within a very close circle of people?

5. I have not copied this note, except to the Chairman. May I leave it to your Private Office, if you want anyone else in the Treasury to have copies?

C.J.C.

A J G ISAAC

**
ACSA
You have explained to
Mr Isaac why that is not on.
However, does Mr Isaac believe that more
of the pages referred to in para 2 could be
secured with unification for a vast major
of tax payers - ie with a higher rate than
£50,000 tax (ie for all) on dividends
etc, or a flat rate of 30% on dividends
with a higher rate (ie as now)?
I would be happy to have urgent
work done on this, with no
near-universal IT rate (or universal
with the higher rate @ 25%,
& a flat rate @ 30%
etc) @ 30%.*

cc Mr Battishill
Mr Isaac



Inland Revenue

TASK FORCE SECRET

copy no 1 of 22

Policy Division
Somerset House

Noted. The X is wrong. The 'point' is right.

FROM: M F CAYLEY

DATE: 27 NOVEMBER 1987

1. MR PITTS

Under CGT reform, some gains will be taxed at a higher rate than now. Some will be wife's gains

2. MR ISAAC

taxed at the husband's marginal rate. Not a major point, but it will attract criticism; and Mr Cayley rightly draws it to your attention.

3. CHANCELLOR OF THE EXCHEQUER

At the same time, you will be announcing plans under which, in due course, a wife's gains will be taxed at her own rate (whether lower or higher).

CGT REFORM : HUSBAND AND WIFE

27/11

1. You may wish to be aware of one of the consequences of charging gains next year as the marginal slice of income at income tax rates prior to independent taxation in 1990.

Present position

2. At present, the gains of a husband and wife are computed separately and the single annual exemption which they share is divided between them in proportion to their respective taxable amounts. The wife's gains are assessed on the husband but since CGT is charged at a flat rate this can never affect the total tax payable. A married couple may elect for separate assessment but again the overall tax bill will be the same.

- cc Chief Secretary
- Financial Secretary
- Sir P Middleton
- Sir T Burns
- Mr Byatt
- Mr Scholar
- Mr Culpin
- Miss Sinclair
- Mr Riley
- Mr Cropper
- Mr Tyrie

- Mr Battishill
- Mr Isaac
- Mr Beighton
- Mr Pitts
- Mr Cayley
- Mr Hamilton
- Mr Mace
- Mr Michael
- Mr Lester
- PS/IR

Independent taxation

3. From 1990/91 onwards a husband and wife will be treated for most capital gains purposes as two separate individuals. Accordingly, they will each qualify for a separate annual exemption and the rate of tax on gains will be determined by the level of their own earned and/or investment income. The legislation to achieve independent taxation of both income and gains will be contained in next year's Finance Bill.

The transitional years - 1988/89 and 1989/90

4. A principal aim of the CGT reform is to align the taxation of capital gains with that of investment income.

5. Prior to 1990, the investment income of a wife will continue to be assessed on the husband at his marginal rate. The same rule will follow for capital gains purposes so that the rate of tax on the gains of a wife will be determined by aggregating them with the income and gains of the husband together with the wife's investment income (and earned income except where there is a wife's earnings election). What this means therefore is that for the transitional years there are bound to be cases where the gains of a wife will be taxed more heavily than under either the present regime or independent taxation - because aggregation can either push the wife's gains into the higher rate or increase the proportion of her gains liable at that rate. This will unquestionably be perceived by some as a step in the wrong direction given the prospect of independent taxation. We are advised by Parliamentary Counsel that for technical reasons we shall need an additional clause - running to about a third of a page - to align the taxation of gains with investment income for the next two years, so the change will be obvious in the legislation.

6. Compared with 1987/88 it will be for only a minority of CGT payers that the aggregation rules for married couples in

4. There is a third consideration: the need for a Social Security Bill to be prepared for early introduction after the Budget. Work cannot start on the Bill until the Lord President has agreed it should be included in the legislative programme; DHSS can then instruct Parliamentary Counsel. The Bill may be relatively simple. But until DHSS and Parliamentary Counsel have considered what is involved, we cannot be certain of that.

5. One way of reconciling these objectives might be for Mr Mace and I to speak privately to two senior officials in the DHSS to sound them out on the changes. (The officials we have in mind are Mrs Bowtell and Mr Fanning.) We would not give them any papers at this stage. The aim would be simply to establish that the October timetable is feasible and how soon preparations on the Bill would need to begin. They would of course be consulted on the practicalities not the policy. We would then report back to you before any further steps were taken.

6. Consulting now instead of just before Christmas would give us an extra few weeks to sort out any problems that DHSS identify. This time could be valuable in making sure that the October timetable can be delivered. For this reason, we think the additional risk of a leak (as a result of the limited consultation exercise envisaged in paragraph 5) is worth taking. I have discussed this with Mr Scholar who agrees with this advice.

7. It may be that Mrs Bowtell and Mr Fanning would tell us that one or two others in DHSS would need to be consulted before they could be reasonably sure of the operational and legal consequences of what you propose. But it would still be useful to get their provisional views, and we would consult you again before any of their colleagues were brought in.

8. If you are persuaded by this, you will want to consider revealing the rest of your NIC measures to Mr Moore tomorrow. I attach a list of the other changes at Annex B.

1988/89 and 1989/90 will increase the tax on the wife's gains. In many cases where the wife has gains (for example where the gains ~~are taxed. Indeed the aggregation of gains~~ would be chargeable at either the basic or higher rate in any event) aggregation will have no effect. And even where aggregation does result in a greater tax charge on the gains of a wife it may well be that the married couple's overall tax bill on income and gains combined will be less due to the reductions in tax rates on income. X

7. The effect of aggregation in the transitional years will mean that for the first time the wife's gains will enter into the calculation whether or not to make a wife's earnings election. An earnings election - by reducing the husband's marginal rate - could reduce the rate at which the wife's gains are taxed. Indeed the aggregation of gains may increase slightly the number of earnings elections - for precisely the same reason that it works to some couple's advantage with investment income.

8. It would not be possible to ensure that no couple was worse off on gains during the interregnum period without either anticipating for the purposes only of determining the tax on gains, much of the independent taxation package (this would look extremely odd, the legislation necessary would be highly complex and taxpayers would find the end product hard to understand) or alternatively cutting across the integration principle by, for example, restricting the charge on a wife's gains to the basic rate only. Again this would be extremely unattractive.

Conclusion

9. Prior to independent taxation, the gains of a wife under will be assessed in the same way as her investment income. The natural corollary, therefore, is that until 1990 they will be charged at the husband's marginal rate. This may well attract comment, but there is no practicable alternative which is compatible with the reforms coming into force next year.

Michael Giff



FROM: A C S Allan

DATE: 30 November 1987

MR ISAAC - IR

cc: Mr Battishill - IR

A SINGLE RATE OF INCOME TAX

The Chancellor was grateful for your minute of 27 November. As I explained to you on the 'phone, the Chancellor feels that there are some serious difficulties over moving to a single rate, for example because of the effect it would have on ossifying the tax system: once we had a single rate, it would be very difficult to reintroduce a basic/higher rate structure, and that would make it harder to continue to get tax rates down further.

2. However, he would be grateful to know whether you believe that most of the prizes you referred to in your paragraph 2 could be secured with unification for the vast majority of tax payers: ie with a higher rate threshold of, say, £50,000, a flat rate withholding tax (ie for all) on dividends etc, and a flat rate CGT (ie as now). If so, he would be happy to have urgent work done on this, with the near universal IT rate (and universal withholding tax rate) at 25 per cent, the higher rate at 40 per cent, and the flat CGT rate (as now) at 30 per cent.

ACSA

A C S ALLAN

ACSA
To
ISAAC
30-11-87



FROM: J M G TAYLOR

DATE: 30 November 1987

MR MACE

JMG
TO
MACE
30-11-87

cc: CST
FST
PMG
EST
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Scholar
Mr Culpn
Miss Sinclair
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill
Mr Isaac
Mr Painter
PS/IR

TAX REFORM: INCOME TAX AND NIC

The Chancellor was grateful for your note of 27 November, and Mr Cayley's annex.

2. He would be grateful if the options could be reworked to take account of the 30 per cent withholding tax part of the package. He would also be grateful if a further option, F2A, could be examined (i.e. *Option F2 with a £20,000 higher rate threshold*).

Handwritten initials 'JMG' in dark ink.

J M G TAYLOR