

PO-CH/NL/0025

PART F



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PO -CH /NL/0025



PART F

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

PO -CH /NL/0025

PART F

DD's 25 years NA33 410196

24-12-87

**CLOSED**

CLOSED ON:-

PART 6



17  
Tax  
CGT  
Starts: - 1-12-87  
Tax Reform



FROM: J P McINTYRE

DATE: 1 December 1987

CHANCELLOR —

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 Riley  
 Miss Sinclair  
 Mr Macpherson  
 Mr Cropper  
 Mr Tyrie  
 Mr Call  
 Mr Isaac IR  
 Mr Mace IR

**NATIONAL INSURANCE CONTRIBUTIONS : SELF-EMPLOYED**

Mr Taylor's minute of yesterday reported your views on Mr Macpherson's submission of 27 November on the self-employed. You commented that the option of raising the Lower Profits Limit (LPL) to £6400 looked to have the edge over the alternative of reducing Class II contributions to £2.50. (One of these measures would be the quid pro quo for abolition of tax relief on self-employed contributions.)

2. This was subject to the views of the Chief Secretary and other Ministers.

3. There is one further consideration which probably ought to be taken into account and which would support a cut in Class II. This is the possibility that, in the 1990's, we will be able to abolish Class II and merge it with Class IV in a single contribution by the self-employed. Neither of the options in Mr Macpherson's paper would preclude that development. However, a cut in Class II would pave the way for it rather more smoothly, in that



- (i) It would be a step towards abolition of Class II;
  
- (ii) A substantial increase in the LPL would (in the absence of a Class II) take some 750,000 self-employed out of NICs. In this sense, it would be rather like Option C for employees, which would have taken 2 million out of NICs by substantially raising the Lower Earnings Limit. Unless, at the point of merger, we were to reduce the LPL, the threshold above which people pay NICs would be very much higher for the self-employed than for employees (£6400 v £2132 in 1988-89 terms).

*Jm*

J P McINTYRE





COPY NO. 21 OF 22 .

FROM: J M G TAYLOR

DATE: 3 December 1987

MR McINTYRE

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 Riley  
Miss Sinclair  
Mr Macpherson  
Mr Cropper  
Mr Tyrie  
Mr Call  
  
Mr Isaac - IR  
Mr Mace - IR

**NATIONAL INSURANCE CONTRIBUTIONS: SELF-EMPLOYED**

The Chancellor has seen your minute of 1 December. He awaits the views of the Chief Secretary. He has commented, however, that the merger of Classes II and IV is some way off: we must do what is best in the context of the 1988 package.

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

J M G TAYLOR





Ch.

M.i.r. on home improvements.

I spoke to Mr Johns.

2. On the basis of the assumptions in the 27 November paper, abolishing the home improvement relief yields:

£ 80 million in 1988-89

£ 200 million in 1989-90.

3. These figures do not allow for behavioural changes.

JF  
30/11



CONFIDENTIAL

FROM: ROBERT CULPIN  
DATE: 4 December 1987

CHANCELLOR

cc Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Sir T Burns  
Mr Byatt  
Mr Scholar  
Miss Sinclair  
Mr Riley  
Miss Evans  
Miss Hay  
Mr Hudson  
Mr Cropper  
Mr Tyrie  
PS/Inland RevenueCULPIN  
To  
CH  
4-12-87

## INDEPENDENT TAXATION

We are meeting on Tuesday to take stock on Independent Taxation. The main objective is to make sure you are happy with the package as a whole. The Revenue are producing a helpful factual account of what it is. FP will offer an annotated agenda.

2. Coming new to the subject, I am struck by how far you have moved from the Green Paper. It might be sensible, at Tuesday's meeting, to take stock not just of what you have decided but also of what you have rejected - and why. That could, at the least, help us to get the presentation right.

3. To anyone who has followed the Government's propaganda over the last three years, the decisions at which you have arrived are likely, at first sight, to look pretty rum. In 1985 and 1986, you put a lot of effort into selling transferable allowances. You then said, in 1987, that you would look at half-way houses. Most of my former customers assume that to mean some sort of partially transferable allowances. Critics have moved towards transferability; and the IFS now describes two partially transferable variants as "the new middle way". Yet, after all this, you plump for mandatory separate taxation (which everyone thinks you loathe) plus the married man's allowance (which everyone agrees in principle should be scrapped).



4. This combination does nothing whatever for the one-earner couples whom you have said you want to help: families where the wife (say) stops work to look after children or elderly relatives. And far from eroding the married man's allowance, it entrenches it: couples who currently forfeit the allowance by exercising the wife's earnings election will suddenly find themselves given it back.

5. I doubt if I shall be alone in wondering how you got to this position. I have therefore had a go at answering the question.

6. To help clarify the options, without a lot of prose, the following table by Mr Sparkes compares the present pattern of the main personal allowances with:

- your proposal
- partially transferable allowances, and
- fully transferable allowances.

Under partially transferable allowances, it shows the two variants in the latest IFS Report, and one analysed by the Revenue in Mr Mace's paper of 18 December 1986. The costings are only very rough and ready, and should not be taken as more than broad orders of magnitude.

**1.0 = Present Single Allowance**

Household Type	Now	Proposed	PTAs			FTAs
			IFS.1	IFS.2	IR	
Single	1.0	1.0	1.3	1.0	1.3	1.3
Transferable element	-	0.6*	0.3	0.6	0.65	1.3
Male 1 earner	1.6	1.6	1.6	1.6	1.95	2.6
Female 1 earner	2.6	1.6	1.6	1.6	1.95	2.6
2 earner	2.6	2.6	2.6	2.0	2.6	2.6
Approximate cost (£ billion)	-	½	2	-2½**	4	6

\* Allowance for married couples, **not** transferable element of single allowance.

\*\* Spent on higher child benefit.



7. First, then, why have you rejected partially transferable allowances? I think the short answer is that they are not, unfortunately, fully transferable allowances in miniature. They have several of the main costs of fully transferable allowances, but lack one of the key benefits.

8. The main costs are these:

- They would be complicated for the Revenue: you couldn't introduce them until well into the 1990s.

- They would be complicated for taxpayers: they require a choice.

- And they would be expensive (unless we imposed losses).

9. The key missing benefit is that partially transferable allowances do little or nothing for one-earner couples.

- The IFS versions do nothing directly. IFS 1 only benefits single people. IFS 2 could help one-earner couples with children - though only at the expense of higher public expenditure - but not those where (say) the wife stops work to look after elderly relatives.

- The Revenue option does help one-earner couples, but only at the (considerable) expense of bumping up the personal allowance and so benefiting all single people. The one-earner couple still gets the same multiple of the single allowance as before.

10. In short, our propaganda was true: only fully transferable allowances can meet all our objectives. Partially transferable allowances are not a scaled down substitute.

11. If, then, you rule them out, why don't you do the simple thing and just convert the wife's earnings election into a wife's income election? I think the answer is that this would only help



those with lots of investment income, not those with a bit. The reason is that anyone who elects to be taxed separately loses the married man's allowance: so if you only have a bit of investment income, it wouldn't be worth making the election.

12. And a wife's income election would look a mouse.

13. So why, finally, bother to change things at all, only to replicate the present structure of the main personal allowances, with no change of substance? You only have to glance at the table in paragraph 6 to see, in one sense, how little is achieved. Yet the Revenue paper makes it clear that, in detail, the change will look far from simple. There are an awful lot of complications which will affect people in one position or another; and it will take a lot of Revenue staff to manage the change.

14. I assume the answer is:

*MS*

- The new system sweeps away a nonsense which has lasted 180 years - the rule that a married woman's income is her husband's. It gives privacy and independence, and eliminates aggregation.

- Compared with other options, it's simpler, cheaper, less disruptive, and better for privacy and incentives.

- It leaves options open.

15. How is this a half-way house? Well, it gives you independence and a fair deal for marriage - half way there - without helping one-earner couples or junking the anomalous married man's allowance.

*of course*

16. That leaves one presentational tease which is probably quite irresponsible: can we claim a significant element of transferability? If you look at the second line of the table in paragraph 6, and ignore the rather important footnote, it is possible to argue that your proposal offers at least as large a transferable element as the IFS; and - I rather like this joke - that it is a half-way house because it has broadly half as large a transferable element as fully transferable allowances.

*Rc*  
ROBERT CULPIN







well with the proposed move to a progressive capital gains tax. They have none of the administrative advantages of the flat tax proposal discussed below -indeed they introduce additional complexity. But by the same token they avoid some of the adverse distributional consequences of a flat tax, and involve a less pronounced distinction between investment and earned income.

3. The two options are discussed in detail in Annex 1, and total tax rates for different forms of company finance and different categories of taxpayer are shown in panels 3 and 4 of the attached table. Both options put dividends and interest on an equal footing for tax purposes; limiting interest deductibility achieves this at a higher tax rate, somewhat closer to the total rate on retentions, than raising the imputation rate.

4. Both options would give rise to considerable difficulties which are discussed in more detail in Annex 1.

Limiting interest deductibility would:

- cause grave difficulties for the taxation of financial companies, and groups of companies with a financial component, which we can see no realistic way of overcoming;
- run a risk of inducing large-scale switching between interest and other forms of compensation for the use of money, which could not be countered by any known administrative or legal device;
- give rise to adverse effects on investment, and considerable complaints from companies who would face a higher tax burden.
- prompt accountants and businessmen to complain that interest is a legitimate business expense like any other, and should thus not be taxed on a par with dividends.



Raising the imputation rate would:

- in principle require part of the tax credit to be paid to basic rate taxpayers, which would be a major administrative burden for the Revenue;
- increase the advantage enjoyed by pension and other exempt bodies compared with taxpayers;
- no doubt cause companies to complain about the temporary adverse effect of higher ACT on their cash flow;
- cost money, perhaps around £½ billion in 1988-89 on a full year basis in addition to the cost of the main scorecard package.

5. The objections to these options, particularly the practical ones, are formidable. Given the relatively slight improvements in neutrality which they would produce, over and above those already achieved by other elements of the package, we do not consider them worth pursuing any further.

A flat rate withholding tax on investment income

6. Mervyn King has proposed a flat rate withholding tax on investment income, with the rate set at 25%. The ACT rate would be one third (ie 25/75), and tax at 25% would be withheld from interest. Bill Robinson (IFS) has suggested that the withholding rate should be 35%, which would involve raising the ACT rate to 35/65ths. The King proposal has been discussed in a Revenue submission (by Michael Johns) on 23 July.

7. The Revenue have commented that the flat tax proposal raises complex and fundamental issues across the whole tax system. It affects each one of the Revenue's Policy Divisions and a wide range of their technical specialists. Many of these are already heavily committed on existing Budget work. Time would in any case now be dangerously short for working up and drafting a change of this scope and complexity for 1988 even if adequate resources were available, though at least some of the work now envisaged on CGT might be



avoided. There would also probably be implications for their computerisation programme. If a flat rate tax were to be a starter for this year it would be necessary to lay down rigorous priorities, but it would inevitably remain a high risk undertaking.

8. In considering the proposals it is helpful to distinguish three separate dimensions:

- setting a flat rate of tax on all investment income;
- setting the rate of the flat tax above the basic rate;
- extending the coverage of withholding arrangements beyond the existing limits.

**(i) Setting a flat rate**

9. Setting a flat rate tax has three implications:

- (a) the tax would not be graduated, though income tax still would be;
- (b) any withholding tax deducted would not be repayable to individuals, nor would any tax credit be payable to individuals;
- (c) where the tax was not deducted at source (eg National Savings, War Loan, interest from abroad) the flat rate tax would have to be assessed separately, as income tax is now.

10. Mervyn King regarded erosion of the special privileges of exempt bodies such as pension funds as a considerable attraction of his scheme. However given what was said in the 1985 Budget speech, we assume there could be no question of removing these privileges in the 1988 Budget, so that payment of tax credit would - for the time being at any rate - continue to be made to exempt bodies. A considerable source of non-neutrality would thus remain.



11. Even with no change in the existing coverage of withholding arrangements there would be considerable practical advantages from moving to a flat rate tax, whatever the rate. This is the major advantage of the flat tax proposal. It would simplify administration for the Revenue and reduce taxpayer compliance costs. Where tax was withheld at the flat rate, taxpayers' liabilities would be met in full: there would be no need to recover tax at the higher rate. Equally there would be no need to pay tax credit on dividends paid to non-taxpayers.

12. For individuals there would be no need to keep and return dividend slips to the Revenue. Indeed, it would be possible to say that much of the investment income received by individuals from UK sources could be ignored for tax purposes (the kind of claim we have been able to make about investment in Personal Equity Plans). The more widely the withholding arrangements could be applied to investment income not currently taxed at source, the greater the simplification for both Revenue and taxpayers.

13. For those forms of investment income where tax cannot be deducted at source, the flat tax liability would have to be assessed separately as income tax is now. It would be for decision whether it should be charged with or without attracting allowances - currently these run against gross income. If it were not to attract allowances this would mean charging the tax to those who would otherwise be non-taxpayers. This would somewhat reduce the administrative savings, and would deny non-tax payers any means of saving without paying tax. There is thus a good case for letting the tax attract allowances though, as discussed below, this would distort somewhat the choices faced by non-taxpayers, encouraging them to invest in media such as INVAC and overseas assets.

14. Before the introduction of independent taxation, the staff savings to the Revenue would come from not having to pay tax credit to individuals or to repay tax deducted at source, and from not having to collect additional tax on investment income from higher rate taxpayers. The savings from this would be worthwhile. The staff costs of running a system of independent taxation would also be substantially reduced. If this change were not made, married



women below the tax threshold would be able to claim payment of tax credits on dividends. The Revenue estimate that such claim/repayment work could account for between 30 to 50 per cent of the staff cost of introducing independent taxation, which is now put at between 1850 and 2000 staff.

15. Although the Revenue have not put the flat tax proposal to their staff costing people, Michael Johns' earlier submission noted that the overall staff savings could run into four figures.

16. A flat rate tax would simplify the rules required under independent taxation to deal with the attributions of income from joint accounts/assets. It would also reduce the need for complex avoidance provisions designed to limit income splitting through capital settlements (although under any system which retained the CGT threshold there would remain an incentive for the transfer of assets between spouses). On the other hand there would need to be a thorough review of the basic structure of income tax to take account of the various changes needed for the flat rate tax.

17. Moving to a flat rate tax would effectively decouple the taxation of investment and earned income, just when the distinction might otherwise have become redundant for tax purposes with the introduction of independent taxation. Of course in practice, and using a broad definition of tax, the two sources of income are not taxed at the same rate at present because employee NICs are payable on earned income only. And a further decoupling could be defended as a hybrid of an income tax and an expenditure tax which avoids some of the distortions on savings and investment of the former, while not involving the major transitional and international problems of the latter. Note however that at 35% the overall rates (including NIC) on investment and earned income would be virtually identical for basic rate taxpayers.

18. One possible objection to the flat rate tax might be that investment income would no longer be taxed on a progressive basis. But this type of equity argument is now much weaker than envisaged in July, because the gap between basic and higher rates is likely to be no more than 10 percentage points.



19. There will be one or two boundaries between earned and investment income which would need further consideration. If the flat rate tax were to be extended to all investment income then rents and royalties would have to be included. There are some cases where it is not clear how far these are savings and how far they are investments, and some individuals receive interest as part of a trade (eg moneylenders). At the very least their interest expenses would have to be deductible from their receipts for flat rate tax but they might need to be kept within the ambit of the tax on earnings (with consequential definitional and leakage problems).

*discuss  
brief*

20. Whatever the rate, a flat tax would not fit well with the current proposals for reforming CGT. It would look very odd indeed to move to a system which taxed gains at differential rates while at the same time moving to a flat rate for interest and dividends. And there would be market implications - eg for the attractions of different sorts of instruments. The provisional decisions taken at your meeting on 12 November would thus need to be reconsidered if you wished to pursue the idea of a flat tax further.

*discuss  
(can  
para 22)*

21. The distributional consequences of a flat rate tax would clearly depend on the rate. But even with a 25% rate, basic rate taxpayers would lose from the rise in the composite rate (from 23½% in 1988-89, eventually nearer 22%, to 25%). And whatever the rate, there would be losers as a result of the abolition of refunds and tax credit payments to non-taxpayers. Among those affected would be individuals, including the self-employed, with only small retirement annuities or similar provision, and married women who would otherwise benefit from independent taxation. Their losses would be in addition to those arising under the present composite rate arrangements for bank and building society interest. This might be difficult to defend, especially if at the same time higher rate taxpayers gained.

22. Abolition of tax credit payments on dividends could prove particularly difficult to defend. It would appear to conflict with the Government's aim of achieving wider share ownership. And it



would hit the new army of small shareholders created by the privatisation programme.

23. At present, some National Savings media - INVAC, income and deposit bonds - pay interest gross. This provides non-taxpayers with a place to put their savings without paying tax. Even with a 25% rate for the flat tax there would be an inflow into these media, subject of course to the holdings limits, as non-taxpaying investors reacted to the abolition of refunds on other instruments. There could also be significant inflows into overseas assets paying interest gross.

24. Finally, it would be necessary to consider a number of issues on company taxation which would arise with a flat rate tax. Although we are not aware of any major difficulties, the Revenue would need to look into this further. Annex 2 sets out some of the issues which would need to be considered.

**(ii) Setting the rate above the basic rate**

25. Total tax rates for a flat tax set at 35%, 30% and 25% are shown in panels 5-7 of the table. A 35% rate would mean complete neutrality between different types of investment income and, if CGT is not paid, between different forms of company finance, for both basic and higher rate taxpayers. Exempt bodies would be able to claim payment of the tax credit at 35%, so that both dividends and interest would for them be free of tax. The 30% and 25% rates would not produce complete neutrality between dividends and interest, and exempt bodies would still bear some tax on profits paid out to them as dividends because the CT rate would exceed the ACT rate.

26. Setting the rate much above 25% would give rise to a number of problems. As regards the distributional consequences, there would be many basic rate losers, and non-taxpayers would lose more. For these groups the change would involve a rise in both ACT and the composite rate on bank and building society interest - a rise of nearly a half in the case of a 35% rate. The table below shows the effect of 25% and 35% withholding tax rates on different taxpayers receiving £100 gross investment income from various sources.



Gain(+) or Loss(-) to taxpayers receiving £100 of (gross) investment income\*

	Withholding rate 25%			Withholding rate 35%		
	Bank or building Society**	Interest paid gross	Dividend or gilt etc	Bank or building Society**	Interest paid gross	Dividend or gilt etc
Non-taxpayers	- 3	- 25***	- 25	- 13	- 35***	- 35
Basic rate	- 3	0	0	- 13	- 10	- 10
Higher rate	+ 10	+ 10	+ 10	0	0	0

30%  
 -8 0 -30  
 -8 -5 -5  
 +5 +5 +5  
 it must

~~30%~~

- \* change relative to main scorecard package
- \*\* assuming an illustrative composite rate of 22%, consistent with a basic rate of 25%.
- \*\*\* loss occurs only if allowances do not run against the flat tax.

27. The Revenue have made a very preliminary assessment of the likely gainers and losers, though information available on non-taxpayers is incomplete. At 25%, there would be perhaps around 1 million gainers; virtually all the 700 thousand higher rate taxpayers under the main package would gain (average £500 per annum), as would around 300 thousand relatively well-off aged who are in the taper where age allowance is withdrawn (marginal rate nearly 42%) or who now become eligible for age allowance. There would be many more losers; all those with building society or bank deposits would lose a little, and non-tax payers would lose.

28. At 35% there would be far fewer gainers - only perhaps 20 thousand in the age allowance taper. Around 10 million taxpayers would probably be losers; for 8 million the loss would be less than £200 per annum. In addition there would be many non-taxpayer losers. Losers among the aged could number around 3 million, and the average loss at any given level of income would be higher than



for the non-aged because of greater reliance by the aged on investment income.

29. A higher rate would increase the tax subsidy to pension funds and other exempt bodies, assuming they are to remain exempt. This could be politically difficult when there are a significant number of losers, though many basic rate losers would experience gains via their pensions. A possible solution might be to restrict the tax credits paid to exempt bodies to 25%.

30. With a higher rate, say 35%, the inflow into National Savings could be much greater than with a 25% rate. To the extent that tax had to be recovered on some of these instruments - eg INVAC - administrative costs would rise in step with the inflows into them. One way of dealing with this would be to reduce holdings limits; another would be to place a withholding tax on more of them.

31. A higher rate for the flat tax would also have significant international implications. It would provide basic rate taxpayers with an increased incentive to invest overseas in media paying interest gross. Although in principle investment income from overseas would also be subject to the flat rate of tax, policing would be difficult and in any event the tax payment would be delayed.

32. The effect on inward investment would depend on whether overseas investors continued to be entitled to any tax credit under existing treaties. If the credit were given, the overseas investor would be in an unduly favoured position compared with his United Kingdom counterpart and consideration would have to be given to overriding the treaties concerned. Denying the tax credit would reduce the rate of return of the overseas investor and this could reduce levels of inward investment.\*

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\* This would be contrary to the stand taken by the United Kingdom in association with other European Governments. The United Kingdom's opposition was expressed most recently by the Chancellor in a letter to Secretary Baker in connection with the treatment in the United States of Lloyds (letter of 16 November 1987).



33. Abolition of the UEL in the present package provides some additional incentive for directors and higher paid employees to convert earnings into investment income. By doing so they avoid paying NICs. Setting the flat rate on investment income below 35% would exacerbate this problem, and at 25% the overall incentive to make this conversion for higher rate employees would widen from around 15% under the package\* to around 25%, compared to 7% under the present tax system.

34. A rate significantly above 25% would have some features in common with the investment income surcharge - at least for basic rate taxpayers. We would need to look carefully at what has been said publicly about IIS abolition, and how it could be squared with the flat tax.

35. The higher the flat rate the more likely it would be to bring in additional revenue compared with the present package. At 35% the extra tax on basic rate and non-taxpayers, and amounts of stranded ACT not ultimately offset against CT liability, might mean a net gain of perhaps £1.5 billion in a full year.\*\* In the first year the increased yield might be about £3.5 billion; the increased ACT would arrive before offsets against companies' CT liabilities were made.

36. A 25% rate would not yield additional revenue; provisionally we estimate that the net effect compared with the present package would be negligible. The concession to higher rate taxpayers would offset the extra revenue from non-taxpayers and from the rise in the composite rate.

37. One final point on the rate. If it were set at 30%, you might consider it fairly natural to leave the present CGT regime - or at least the rate - unchanged. Even with a 25% rate you might consider this, given that deferral of CGT implies a lower rate on accruals.

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\* Employee NICS at 9% plus employer NICS AT 10½% less CT offset worth 3½%.

\*\* Assumes no behavioural effects and no change in the arrangements for mortgage interest relief.



The cost of the proposed CGT changes, and the greater complexity of a dual rate system, might thereby be avoided.

(iii) Extending the coverage of withholding

38. The boundaries of withholding were last considered in detail in the run up to the 1984 budget, when the composite rate was extended to banks. The bulk of interest payments on retail savings media are now subject to withholding tax (either basic or composite rate), including:

- gilts except for FOTRA, and institutions can make arrangements for automatic refunds;
- individuals' bank and building society deposits under £50,000;
- UK corporate bonds, except eurobonds;

39. The main domestic instruments on which interest is now paid gross are:

- wholesale deposits, including interbank deposits and short term money market instruments;
- deposits by companies, non-residents and exempt bodies;
- eurobonds
- certain National Savings media, including INVAC (individual holdings limit £100,000) income and deposit bonds, and gilts held on the stock register.

40. There would be considerable problems in extending the boundaries of withholding further. Extending withholding to internationally mobile funds runs a real risk of driving business offshore. Reaction in Germany to their 10% withholding tax proposal is a reminder of the sort of rumpus that any major extension of



current arrangements could cause, and the significant damage which could be done to London's standing as an international centre.

41. Non-residents are a major problem: as we found out in 1984, there are no administrative arrangements which would allow us to satisfactorily identify non-residents that would not also act as a deterrent. What non-residents want is payment of interest gross, not elaborate bureaucratic arrangements that allow them to claim back tax already withheld. Nor do financial institutions like running certification procedures. That was a major reason why we adopted a £50,000 cut-off in 1984: it has the effect of excluding automatically most non-resident sterling balances.

42. Removing the £50,000 limit would catch large UK investors and depositors, including corporate treasurers, as well as non-residents. They would almost certainly respond by routing funds offshore.

43. Since 1984 UK companies have been able to pay interest gross on eurobonds. Before then larger companies were able effectively to do so through foreign affiliates. We do not see any way that a withholding tax could be imposed on eurobonds of foreign affiliates, and any attempts to impose one on UK company eurobonds might put up the cost of finance to smaller companies which cannot use foreign affiliates as intermediaries, while having no effect on larger ones.

44. It would in principle be possible to extend withholding to all National Savings media such as INVAC where income is paid gross. But, if allowances do run against the flat rate tax, this would exacerbate the losses suffered by non-taxpayers, and would provide further encouragement for them to invest overseas as the only way of avoiding tax. These are serious disadvantages.

45. So, in short, we believe it would be necessary to retain essentially the present (1984) boundaries for withholding. Flat rate tax on UK resident holdings of overseas assets and the domestic instruments in paragraph 39 would thus have to be collected separately. If there were significant switching into these assets, perhaps because the rate were set significantly above the basic rate, this would limit the administrative gains from the flat rate



proposal. However withholding of refunds to non-taxpayers would still yield significant administrative gains, as would removal of the need to assess liability to higher rate tax on investment income.

### Conclusion

46. The rationale paper noted that we have very little hard evidence on the scale of distortions to company financing decisions caused by non-neutralities in the present tax system; or on the effects of such distortions. However the presumption is that we should aim for greater neutrality, though if there are significant costs in doing so we would need to be clearer than we are now about the likely benefits.

47. We also need to remember that measures which reduce distortions to company financing may increase distortions elsewhere - eg in the treatment of capital and labour, or between different forms of remuneration or saving. And it may be that the main advantages are in other areas - eg administration in the case of the flat tax.

48. Bearing these points in mind we see relatively little advantage in limiting interest deductibility or raising the imputation rate. And in both cases there would be serious disadvantages and difficulties. We would advise against pursuing these options further.

49. The flat rate withholding tax, even with the current boundaries of withholding, is a more serious candidate. It would reduce compliance costs and yield considerable administrative savings for the Revenue, not least in the context of independent taxation. It would be a significant simplification of the system. At 35% it would contribute to greater neutrality in company financing, though at 25% or 30% it would do little by comparison with the present package. At 25% it would be broadly revenue neutral; at 30% or 35% it would raise substantial additional revenue. It would be natural, especially if the rate were set at 30%, to leave the present CGT rate alone rather than introduce a more complex two rate structure.



50. But a flat tax would have awkward distributional consequences. Non-taxpayers would be losers, though there could still be some scope for small savers to invest in exempt National Savings media and other assets on which interest is paid gross. Even if the rate were set at 25%, basic rate taxpayers would lose from a rise in the composite rate, while there would be large gains for the more wealthy. If the rate were set above the basic rate, with no refunds made, there would be considerably more losers, and larger losses for non-taxpayers. A higher rate would also probably mean considerably more funds invested overseas and in other exempt media; and the administrative gains would be somewhat reduced. In any event, a flat rate tax would detract from wider share ownership and limit the gains from independent taxation.

51. The case for a flat rate tax thus rests mainly on gains in simplicity and administration, and these would have to be weighed against the distributional effects and the various distortions which would be likely to occur. Setting the rate above 25% would be somewhat difficult to defend in the context of a tax cutting Budget, and there would be many losers. Setting the rate at 25% would probably minimise the disadvantages; and the financial cost would be negligible.

*CJR*

C J RILEY



**ANNEX 1: INTEREST DEDUCTIBILITY AND THE IMPUTATION RATE**

This annex considers in more detail the options discussed briefly in paragraphs 2-5.

**Limiting Interest Deductibility to 25p**

2. Under this proposal, relief for interest payments against companies' CT liability would be restricted to 25p in the £, rather than 35p (the full CT rate) at present. In other words, twentyfive thirtyfifths of interest payments would be deducted from gross income when computing CT liability, rather than all interest as now. The change would not apply to the self employed, nor to small companies subject to tax at the basic rate.

3. The implications for total tax rates on different forms of company finance and different categories of taxpayer are illustrated in panel 3 of the table. The tax rates on interest and dividends are brought into line for all taxpayers by raising the tax rate on interest. In the absence of CGT - eg when gains remain below the threshold - this yields complete neutrality for basic rate taxpayers. For higher rate taxpayers, who are more likely to be above the CGT threshold, the tax rate on interest and dividends (44p) lies between the rates on retentions with and without CGT. For exempt taxpayers the tax rate on both interest and dividends is 13p, still somewhat below the rate on retentions (35p).

4. At a theoretical level this looks an attractive option. To the extent that most retentions are not in practice subject to CGT, it leads to almost complete neutrality between different forms of company finance for non-exempt bodies. It would also alleviate somewhat the problem of 'thin capitalisation', because debt finance by overseas parents would become less attractive relative to equity finance than it is at present. It retains a progressive system of income taxation, and treats all forms of income the same for tax (but not NIC) purposes. And it would raise additional revenue from CT, perhaps £1 billion on 1988-89 accruals.



5. But even at a theoretical level there are a number of disadvantages:

(i) Raising the effective tax rate on interest would raise the cost of capital. This would tend to reduce investment.\*

(ii) The overall tax burden on companies would be increased at a time when the tax burden on individuals is being brought down. This would be strongly opposed by the CBI - see for example their recent paper to NEDO which argued that companies are already taxed relatively heavily in the UK.

(iii) As a corollary of (ii) the cost of any future reduction in the CT rate - perhaps to 25 per cent in line with the basic rate - would be increased.

(iv) It would undoubtedly be necessary to treat interest receipts by companies on the same basis as interest payments. This would mean taxing them at 25 per cent. Special arrangements would therefore probably be necessary for the taxation of banks and other financial institutions, since otherwise they would benefit from a reduced rate of tax on their profits. If so there would be problems with groups of companies containing both industrial/commercial and financial concerns, and when industrial/commercial concerns deal with financial companies.

6. It would not be too difficult to deal with the problem posed by the rise in the company tax burden under this option. One possibility might be to bring down the main CT rate somewhat at the same time. If special arrangements were put in place to offset the loss of revenue from financial companies, a reduction to 33% would probably be possible while at the same time maintaining broad revenue neutrality (in terms of 1988-89 accruals).

---

\* To the extent that tax cuts allow some easing of gross interest rates (because net of tax rates would otherwise be increased), there may be an offset. But arguably in the longer term gross rates are determined essentially in world markets for an open economy such as the UK.



7. But the practical problems are much more severe. A separate arrangement would presumably be necessary for financial institutions for whom interest is no more than a current payment or receipt in its trading account. But we can see no realistic means along these lines of dealing with such institutions, whether operating independently, in groups or offshore, which would not be wide open to abuse by way of round tripping or such like.

8. There is also no clear way of defining interest in a manner in which it can be distinguished from other sorts of ways in which people can be paid for the use of money over time - eg the cost may be discounted, capitalised in prices, subsumed in service charges, commitment fees or whatever. There is obvious scope for avoidance here: tax paying companies will try to arrange transactions with tax exhausted or overseas companies so as to minimise their tax liability. No administration in any country has yet found a workable solution to this problem.

9. A final point on this proposal is that accountants and businessmen would not accept the case for taxing interest and dividends on an equal basis. They would argue that interest is to be regarded as a cost, whereas dividends are a distribution out of profits. The consequences of not paying interest are quite different from not paying a dividend. While this does not provide a convincing case for taxing them unequally, thus distorting the choice between debt and equity finance, it does indicate the nature of some of the objections which would probably be raised against this proposal.

#### Raising the Imputation Rate to 35 per cent

10. This option would mean raising the rate of ACT to 35% and deeming income tax to have been paid at this rate on dividends. In general, total corporate tax liability would be unchanged, though a higher proportion would be in the form of ACT.\* The main effect

---

\* Tax exhausted companies would pay more, however, because higher ACT would not be offset by lower MCT.



would be to reduce the additional tax on dividends payable by individuals and increase the rebate given to pension funds and other exempt bodies. Non-residents investing in the UK who are currently entitled to payment of tax credit (in whole or in part) would receive a higher payment. And in principle, rebates would have to be given to basic rate taxpayers.

11. Total tax rates are given in panel 4 of the table. Effectively, the level of tax on company finance would be levelled downwards, with tax rates on interest and dividends reduced to 35p for higher rate taxpayers - the same as on retentions as long as CGT liability can be avoided. Complete neutrality would thus be achieved for higher rate taxpayers under this option. For basic rate taxpayers neutrality would be achieved between dividends and interest as long as they receive a tax rebate on dividends.

12. This option also has a number of serious disadvantages:

(i) It would be necessary in principle to pay part of the tax credit to basic rate taxpayers, because their marginal rate would be below the imputation rate. This would be a major administrative burden for the Revenue, since tax returns would be required from many more basic rate taxpayers than at present.

(ii) There would be a net revenue cost, of perhaps £½ billion on 1988-89 accruals.

(iii) There would be an adverse timing effect on company cash flow, undoubtedly giving rise to complaints from the CBI and others. However, the cost of equity capital would be reduced.

(iv) The tax treatment of pension funds and other non-taxpayers would become even more favourable relative to that of tax payers: payments of tax credit would rise.

13. This option scores rather less well in terms of neutrality than limiting interest deductibility; it brings total tax rates down on interest and dividends which makes the differential with the rate of tax on retentions wider, especially for basic rate taxpayers. But



the main problem is an administrative one: it would not be feasible in practice to implement this option if rebates had to be given to basic rate taxpayers. The only way forward in practice would be not to give the rebates.



**ANNEX 2: COMPANY TAX ISSUES**

The Revenue would need to do a considerable amount of further work to identify the legislative and administrative changes necessary to adapt the present CT system to a flat rate withholding tax (including ACT). A quick review has not identified any insuperable problems although a number of important, but at this stage second order, questions will need to be addressed, eg:

- to what extent are trading losses (and other business reliefs) to be set against tax deducted at source on company investment income;
- if set off is to be allowed will special rules be necessary in the case of small companies (otherwise trading profits would be taxed at 25% but trading losses potentially relieviable at 35%);
- if set off is allowed, will it also be available for unincorporated businesses, eg those in the financial sector and others outside that sector receiving interest on bank and possibly other deposits. (The point is particularly relevant to Lloyd's Underwriters for whom the Revenue are considering a new assessment and collection regime);
- is the flat rate tax to be a non-refundable tax in the case of small closely controlled investment companies, (if not, there would be an increased incentive to create such companies - liable at 25% - to hold and manage personal portfolios);
- what would be the implications for the present system of life insurance taxation and the review which is currently in hand?

It would be necessary to look at these and other issues in more detail if the proposal is to be pursued.

A flat rate above the basic rate would have additional implications. For small companies there would be a disincentive to distribute profits, because the ACT rate (say 35%) would exceed the small companies CT rate (of 25%) so that in respect of distributions



companies would effectively lose the benefit of the lower CT rate. Just how great that disincentive would be would need to be explored. Strictly it should apply to any distribution, however small, but arguably it could be limited to the point at which the ACT exceeded the CT due on the profits. In practice small companies tend to be low distributors anyway, but for those who are not there would be an incentive to retain profits. This would provide companies a lower benefit from dressing up earnings as dividends; the NIC benefits would however remain.



TOTAL TAX RATES ON COMPANY FINANCE

	<u>Basic rate tax payers</u>	<u>Higher rate tax payers</u>	<u>Exempt tax payers</u>
<b>1. <u>Present tax rates</u></b>			
Interest	27p	40-60p	-
Dividends	35p	47-64p	11p
Retentions*	55p(35p)	55p(35p)	35p
<b>2. <u>Main Package</u></b>			
Interest	25p	35p	-
Dividends	35p	44p	13p
Retentions*	51p(35p)	58p(35p)	35p
<b>3. <u>Limit interest deductibility to the basic rate (25p)</u></b>			
Interest	35p	44p	13p
Dividends	35p	44p	13p
Retentions*	51p(35p)	58p(35p)	35p
<b>4. <u>Raise the imputation rate to 35%</u></b>			
Interest	25p	35p	-
Dividends	25p(35p)**	35p	-
Retentions*	51p(35p)	58p(35p)	35p
<b>5. <u>Flat rate withholding tax on investment income*** - 35%</u></b>			
Interest	35p	35p	-
Dividends	35p	35p	-
Retentions*	51p(35p)	58p(35p)	35p
<b>6. <u>Flat rate withholding tax on investment income*** - 30%</u></b>			
Interest	30p	30p	-
Dividends	35p	35p	7p
Retentions*	51p(35p)	58p(35p)	35p
<b>7. <u>Flat rate withholding tax on investment income*** - 25%</u></b>			
Interest	25p	25p	-
Dividends	35p	35p	13p
Retentions*	51p(35p)	58p(35p)	35p

\* The figures in brackets apply for those whose gains are below the CGT threshold.

\*\* The figure in brackets for basic rate tax payers applies if the difference between the imputation rate and the basic rate is not rebated.

\*\*\* Assumes that rebates are given to the exempt sector, but not to basic rate tax payers.



COPY NO *18* OF *19*  
 FROM: MISS C E C SINCLAIR  
 DATE: 4 December 1987

CHANCELLOR

cc PS/Chief Secretary  
 PS/Financial Secretary  
 PS/Paymaster General  
 PS/Economic Secretary  
 Sir P Middleton  
 Sir T Burns  
 Mr Scholar  
 Mr Culpin  
 Mr Riley  
 Miss Hay  
 Mr Cropper  
 Mr Tyrie

Mr Isaac  
 Mr Beighton - IR  
 Mr Mace

**TAX REFORM - INDEPENDENT TAXATION, COMPANY FINANCE AND WITHHOLDING  
 TAX: MEETING 8 DECEMBER**

1. Here is an annotated agenda for this meeting.

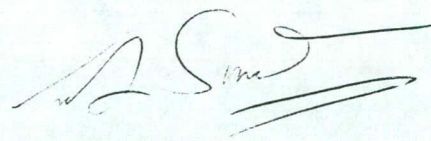
2. The papers for the meeting are:

Mr Mace of 4 December: Independent Taxation

Mr Culpin of 4 December: Independent Taxation

Mr Riley of 4 December: Tax reform: Company Finance and  
 Withholding Tax

3. You may like to address the following main questions.



CAROLYN SINCLAIR



Independent Taxation

1. Having read Mr Culpin's note of 4 December, which describes how your proposals will look to outsiders in relation to the Green Paper, are you content to go ahead with independent taxation on the basis now proposed?

Yes -

2. Assuming the answer is yes, are you content with the shape of the package set out in Mr Mace's note of 4 December? Are there any detailed proposals on which you have doubts or second thoughts?

2 (a) *Vanishing MCA.*

3. Mr Mace's note is a quarry for publicity material on independent taxation on, or after, Budget Day. It would be helpful to know now whether you want

(a) a booklet explaining clearly and in detail the changes which will happen 1990-91, (like the booklet which you have commissioned on covenants and maintenance);

Yes -

?

(b) a general press release justifying the approach proposed for the taxation of married couples; summarising the main features of independent taxation in 1990-91; and listing the tax penalties on marriage which will be removed by the Budget (in some cases, before 1990-91);

(c) two more detailed press releases:

(i) on the 1990-91 proposals (less detailed than (a) but more detailed than (b) - aimed at the journalists interested in the subject);

(ii) on the tax penalties which will be removed by the Budget, together with any changes in benefits proposed by way of compensation.



TASK FORCE SECRET

4. Do you want all this material ready for publication on Budget Day?
5. Would you like to make a major speech (on the lines of the one you gave in the summer of 1986) justifying <sup>the</sup> "halfway house" you have chosen, drawing on the arguments in Mr Culpin's note?



Company Finance and Withholding Tax

1. Do you agree that the options described in paragraphs 2-5 of Mr Riley's note (limiting interest deductibility/raising the imputation rate) can be ruled out?
2. Are you interested in a flat-rate withholding tax on investment income for the 1988 Budget (despite the pressure<sup>ca</sup>time)?
3. If so, which rate would you regard as the front runner - 25 per cent, 30 per cent, 35 per cent?
4. Do you agree that it would not be worth proceeding with this proposal unless you abolish refunds of tax<sup>and</sup> payments of tax credits (for ACT) to non-taxpaying individuals (the main source of administrative savings)?
5. Do you agree that the flat rate tax should be repayable to pension funds and other exempt institutions?
6. Do you think that personal allowances should cease to run against tax liability for all investment income - or should there be any exceptions eg for National Savings, or for other income from which tax cannot be withheld, such as income from abroad?
7. How would you defend the proposal against criticism that it hurts all basic rate taxpayers with investment income subject to composite rate, as well as non-taxpayers who would (presumably) cease to get payments of tax credits (for ACT)? Both effects would be worse with a rate above 25 per cent. Measure could be seen as unfavourable to wider share ownership.
8. Do you agree that in practice it looks difficult, if not impossible, to extend the present coverage of withholding (see paragraphs 38-45 of Mr Riley's note)?

N.B. problem with  
10M unit trusts etc.



TASK FORCE SECRET

9. If you went ahead, this year or next, with a flat-rate withholding tax on investment income, do you agree that it would make no sense to introduce a two-rate structure for CGT?
  
10. If we keep a single rate for CGT, does this point to leaving the CGT regime as it is (rebasings was a way of balancing the higher rate of 35 per cent on gains)? Or keeping the regime, but reducing the rate to 25 per cent if that is the rate chosen for the flat rate tax on investment income (likely cost, in terms of 1988-89 accruals, would be £200 million. A rate of 25 per cent plus rebasing would cost between £250-£450 million.)





FROM: A P HUDSON

DATE: 7 December 1987

CHANCELLOR

cc Mr Culpin

Mr Mace - IR

**INDEPENDENT TAXATION**

A quick thought on Independent Taxation.

2. We shall be trying to reach (at least) three audiences.

- (a) The general public. They never understood transferable allowances - that was part of the problem. So the priority is to stress the benefits of Independent Taxation as a measure in its own right.
- (b) The initiates, who will ask, critically or otherwise, why we have changed our mind.
- (c) The tax professional, who need to know the details.

3. The key group is the first one. So we have to start from the best positive presentation of Independent Taxation. I agree broadly with Robert Culpin's ideas (his paragraph 14). The line could be something like:

- Everybody agrees aggregation etc. is a nonsense.
- Almost everybody agrees that the tax system should nonetheless recognise marriage.
- And everybody agrees that the new system should be simple and introduced quickly.
- Independent Taxation meets all those criteria.

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

A P HUDSON



## TASK FORCE SECRET

COPY NO 1 OF 19  
 FROM: MISS C E C SINCLAIR  
 DATE: 4 December 1987

CHANCELLOR

cc PS/Chief Secretary  
 PS/Financial Secretary  
 PS/Paymaster General  
 PS/Economic Secretary  
 Sir P Middleton  
 Sir T Burns  
 Mr Scholar  
 Mr Culpin  
 Mr Riley  
 Miss Hay  
 Mr Cropper  
 Mr Tyrie  
  
 Mr Isaac  
 Mr Beighton - IR  
 Mr Mace

Ch.  
 Apart from the pps. below, see  
 also the following pps. behind:  
 (i) FST's minute to you of today;  
 (ii) Mr Mace's three submissions  
 to you of today.  
 See also Mr Hudson's note, opposite.

7/12

**TAX REFORM - INDEPENDENT TAXATION, COMPANY FINANCE AND WITHHOLDING  
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CAROLYN SINCLAIR



## TASK FORCE SECRET

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  - (b) a general press release justifying the approach proposed for the taxation of married couples; summarising the main features of independent taxation in 1990-91; and listing the tax penalties on marriage which will be removed by the Budget (in some cases, before 1990-91);
  - (c) two more detailed press releases:
    - (i) on the 1990-91 proposals (less detailed than (a) but more detailed than (b) - aimed at the journalists interested in the subject);
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TASK FORCE SECRET

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TASK FORCE SECRET

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10. If we keep a single rate for CGT, does this point to leaving the CGT regime as it is (rebasings was a way of balancing the higher rate of 35 per cent on gains)? Or keeping the regime, but reducing the rate to 25 per cent if that is the rate chosen for the flat rate tax on investment income (likely cost, in terms of 1988-89 accruals, would be £200 million. A rate of 25 per cent plus rebasing would cost between £250-£450 million.)

*30%  
+ rebasing*



Copy No. 1 of 49  
FROM: ROBERT CULPIN  
DATE: 7 December 1987

CHANCELLOR

cc Sir P Middleton  
Sir T Burns  
Mr Scholar  
Miss Sinclair  
Mr Riley  
Mr Scotter

TAX BURDEN

It has come to my attention (below) that you have proposals to increase the tax burden. Some mistake, surely?

ROBERT CULPIN

a  
(not all that surprising)

Thanks for EV.  
but have compared for  
the 1989-90 vs 1990-91  
on basis of current package  
& last year's MTFP.



COPY NO / OF 4 COPIES  
 From: I SCOTTER  
 Date: 7 December 1987

MR CULPIN

cc: Miss Sinclair  
 Mr Riley

## TAX BURDEN

You asked what would happen to the tax burden with the current package. The figures, such as they are, are in the table. Two limitations are that there is no allowance made for any increase in GDP as a result of the tax cuts and I have costed the package at £4.9 billion which is a receipts figure, while the other figures are on an accruals basis.

## Taxes and GDP (£ million)

	1987-88	-----1988-89-----	
		Excluding fiscal adjustment	With package
Including North Sea			
Taxes	160312	177430	172530
GDP	419388	450597	450597
Tax as % GDP	38.2%	39.4%	38.3%
Excluding North Sea			
Taxes	155779	173210	168310
GDP	410036	442252	442252
Tax as % GDP	38.0%	39.2%	38.1%

2. These figures show a small increase in tax burden, but given the limitations, I would expect that there will in fact be a modest fall in the burden.



IAN SCOTTER





Copy 1 of 8

Inland Revenue

Policy Division  
Somerset House

*Ch*  
*What this doesn't say*  
*is whether it delivers*  
*the value*  
*AA*

FROM: B A MACE  
DATE: 7 DECEMBER 1987

*withhold tax*  
*2 1/2 hrs*

MACE  
7.12.87  
INCOME  
TAX.

CHANCELLOR OF THE EXCHEQUER

INCOME TAX

*is related to*  
*option D*  
*(but when*  
*is*  
*related*  
*to*  
*statutory*  
*quo)*

1. Mr Allan asked if we could let you have a brief note about the costs of the Option described in his minute of 30 November which involved:

- Basic rate of 25 per cent
- Higher rate of 40 per cent
- High rate threshold at £50,000 of taxable income
- flat rate of CGT at 30 per cent
- withholding tax rate of 25 per cent.

2. We have looked first at the option (Option G) without the withholding tax (but assuming abolition of the UEL/UPL as before.) On the income tax side this would have

- a full year cost of about £4.7 billion (about £540 million more than Option D of my note of 17 November);
- a first year cost of about £3.9 billion (about £300 million more than Option D);
- about 500,000 losers in cash terms in 1988-89 (compared with about 505,000 under Option D (self-employed excluded throughout);
- about 120,000 higher rate taxpayers <sup>in 1988-89</sup> (compared with 700,000 under Option D);

- cc
- Chairman
  - Mr Isaac
  - Mr Lewis
  - Mr Calder
  - Mr Beighton
  - Mr Eason
  - Mr Mace



- gainers at income levels above £50,000 gaining on average around £8,600 (compared with £7,300 under Option D.)
3. Superimposing the withholding tax
- yields an additional £600 million or so compared with Option G;
  - reduces the overall cost of the package in a full year to about £4.1 billion;
  - increases the number of losers compared with 1987-88 to at least 4 million of whom about 2 1/2 million would be non-taxpayers;\*
  - increases the average gains of those with incomes above £50,000 to about £9,400.
4. In addition to these income tax effects there would be an additional yield of between £150 and 240 million from CGT (compared with the Option D (rate structure) on the assumption that the stock market stabilises at around the end October levels. (No change, of course, compared with existing structure).

B.A. Mace.

B A MACE

\* Paragraphs 27-28 of Mr Riley's note of 4 December gives figures for gainers and losers from the withholding tax relative to Option D.





Ch.

We are still awaiting  
advice in response to these two  
minutes. We shall chase on  
Monday. Other pps. below.

JS  
4/12



Yours



---

\*\* The Macer paper Unaccountably  
overlooks one of the important aspects  
of the Indep. Tax package: viz No  
~~Disappnt~~ MCA (à la app allowance).  
THIS MUST BE COVERED FOR MTG. M.





**FROM: FINANCIAL SECRETARY**  
**DATE: 7 December 1987**

**CHANCELLOR**

cc Chief 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

*1 still answer  
 CST's VTHMS. X.  
 Chy  
 Mr Mace's minute of 17/11  
 (behind) is also a key  
 background ppr. for tomorrow's box  
 meeting. 25/11*

**NATIONAL INSURANCE CONTRIBUTIONS: OUTSTANDING ISSUES**

You asked for comment on the issue of whether to:

- (i) Reduce Class II contributions to £2.50 per week;  
or
- (ii) Raise the LPL to £6400.

*X/* 2. I think the prior question is whether it is right to abolish tax relief on Class IV contributions. I oppose abolition because:

- (i) It was only in 1985 that the principle was conceded that for NIC relief purposes the self-employed were half employer and half employee. Employer NICs will continue to attract tax relief, so the self-employed will argue vigorously that they should continue to get 50% relief.
- (ii) Retaining tax relief minimises the number of losers.

*(7,000 jobs)*

TASK FORCE SECRET



TASK FORCE SECRET

3. If, however, you do want to abolish tax relief, then it must be right to compensate Class IV losers with an increase in the LPL. I am told that taking 360,000 self-employed out of Class IV NICs would not yield any manpower savings for either the Revenue or for DHSS. That surprises me, but there will be a useful easing of the compliance burden for those taken out.

4. There is an argument that in addition to compensating Class IV losers for the abolition of tax relief we should help the lower paid self-employed who will not benefit from the cuts in income tax. I think we can hold the line on this since non-taxpaying NIC-paying employees are not going to be helped either.



NORMAN LAMONT

TASK FORCE SECRET





FROM: CHIEF SECRETARY  
DATE: 7 December 1987

CHANCELLOR

cc 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 MacPherson  
Mr Cropper  
Mr Tyrie  
Mr Call  
Mr Isaac IR  
Mr Mace IR

*I agree. This  
means we have to  
get the 10 only  
revised we need to  
check us & think @  
the FST's note below.*

**NATIONAL INSURANCE CONTRIBUTIONS: SELF-EMPLOYED**

You asked for my comments on Mr MacPherson's minute of 27 November on the options for reimbursing the self-employed for the loss of tax relief on their Class IV contributions and the abolition of the upper profits limit. Essentially the choice lies between raising the lower profits limit on a Class IV contributions by £1,650 to £6,400 per annum and reducing Class II contributions by £1.55 a week to £2.50. The arguments are rehearsed in Mr MacPherson's minute.

2. I have considered both options and on balance am inclined to prefer the increase in the lower profits limit. Since the changes that we are introducing affect Class IV and not Class II contributions it seems appropriate to take action to relieve the burden of Class IV contributions. Making the change on Class IV is also better targetted on those who lose out from the proposed changes. It produces a slightly larger reduction



TASK FORCE SECRET

- 2 -

in losers than the alternative (38,000 against 33,000). Moreover, crucially, it takes 360,000 people out of Class IV contributions altogether.

3. Class II contributions give an obvious return to the contributor in terms of entitlement to benefit. Class IV contributions give no such entitlement and are much more unpopular among the self-employed. Given, also, that the merger of Class II and Class IV is still some way off, I think there is advantage in maintaining the Class II contribution at a credible rate, since it does bring an entitlement to benefit.

4. I, therefore, believe we should reimburse the £170 million raised from the self-employed by the package through an increase in the lower profits limit.

A handwritten signature in blue ink, appearing to read "John M.", is positioned above the typed name.

JOHN MAJOR





Inland Revenue

Policy Division  
Somerset House

COPY NO 1 OF 26.

FROM: B A MACE

DATE: 7 DECEMBER 1987

CHANCELLOR OF THE EXCHEQUER

**TAX REFORM: INCOME TAX AND NIC**

1. Mr Taylor's note of 30 November asked for further costings based on the options considered in my note of 27 November (Options F1, F2, and F1A). We are still analysing the detailed costs and distributional effects of a withholding tax on investment income and these will be examined in a separate submission. This note concerns Option F2A in which:-

MACE  
7.12.87  
INC. TAX  
+ NIC

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 Calder  
Mr Macc  
Mr Eason  
Mr Allen  
PS/IR



- the basic rate is 24 per cent
- the higher rate is 30 per cent
- the threshold for the higher rate is £20,000.

Option F2A is therefore Option F2 with the threshold for the higher rate reduced from £25,000 to £20,000.

### COSTS

2. In a full year at 1988-89 income levels, Option F2A would yield £280 million compared with Option F2 and the overall cost of the option would be almost £6 billion compared with indexation of the 1987-88 regime. Costs of options leading up to Option F2A are summarised in the attached Table 1.

### INCOME TAX GAINERS AND LOSERS

3. Compared with Option F2, Option F2A increases the number of cash losers\* in 1988-89 by 10,000 from 202,000 to 212,000. The rise in the number of losers results from the reduction in the higher rate threshold by £5,000, thus increasing tax liability by up to £300 (6% of £5,000) per individual. The number of higher rate losers increases by over 20,000 to about 25,000 because some losers who were basic rate taxpayers under Option F2 (with taxable incomes between £20,000 and £25,000) become higher rate losers under Option F2A and some higher rate gainers at higher incomes will also become losers. Losers are summarised in Table 2.

\*compared with retaining the 1987-88 tax regime.



4. The impact on the majority of the 21 million gainers is nil since they are basic rate taxpayers, but for those gainers with taxable incomes above £25,000 their gain will be reduced by £300 per individual. Nonetheless average gains, compared with retaining the 1987-88 regime, for those with incomes over £50,000 would still be almost £10,000; and £3,000 for those with incomes between £45,000 and £50,000.

5. Compared with Option D (which had a 25 per cent basic rate and a 35 per cent higher rate starting at taxable income of £25,000) Option F2A would:-

- (a) cost an extra £1.8 billion in a full year;
- (b) reduce the number of cash losers from over 500,000 under Option D to about 210,000 under F2A (excluding the self-employed who cannot lose until 1989-90 at the earliest);
- (c) increase the number of higher rate taxpayers to about 1.2 million, compared with 700,000 under Option D, of these 25,000 would be losers compared with 10,000 under Option D;
- (d) leave about 185,000 cash losers at the basic rate (below £20,000 taxable income).

*200,000  
loss ops  
for 2*

*BAM*

B A MACE



**Income Tax Costs of Packages  
against 1987-88 Regime Indexed to 1988-89  
at 1988-89 Income Levels**

	£ billions	
<u>Option D</u>	1988-89	Full Year
Reduce basic rate from 27p to 25p	- 2.50	- 2.80
Increase higher rate threshold to £25,000	- 0.78	- 1.35
Reduce higher rates to 35p	- 0.93	- 1.76
Class IV NIC relief above UPL	-	- 0.06
Total Income Tax	<u>- 4.22</u>	<u>- 5.97</u>
NIC : Charge 9% above UEL	+ 0.63	+ 1.45
: Charge 6.3% above UPL	-	+ 0.40
Total NIC	+ 0.63	+ 1.85
Total Option D	<u>- 3.59</u>	<u>- 4.12</u>
<u>Option E1</u>		
Reduce basic rate to 24p	- 1.36	- 1.53
Total Option E1	- 4.95	- 5.65
<u>Option F2</u>		
Reduce higher rate from 35p to 30p	<u>- 0.27</u>	<u>- 0.53</u>
Total Option F2 over Option D	- 1.63	- 2.06
Total Option F2 over 1987-88 Indexed	- 5.22	- 6.18
<u>Option F2A</u>		
Reduce higher rate threshold to £20,000	+ 0.16	+ 0.28
Total Option F2A over Option D	- 1.47	- 1.78
Total Option F2A over 1987-88 Indexed	- 5.06	- 5.90

Note All costs assume changes listed above are made first.

TABLES



## LOSERS COMPARED WITH 1987-88 REGIME

Range of Total Income Lower limit £000	Option D		Option F2		Option F2A	
	No. 000's	Average loss (£)	No. 000's	Average loss (£)	No. 000's	Average loss (£)
0	0	0	0	0	0	0
15	50	35	1	74	1	74
20	295	140	111	87	111	87
25	116	250	70	167	72	166
30	33	240	17	186	22	176
35	4	280	1	513	3	331
40	4	240	1	342	1	331
45	1	250	0	0	0	0
50	1	1,300	1	1,859	1	1,586
<b>Total</b>	505	160	202	133	212	135





# Inland Revenue

TASK FORCE SECRET

Copy 1 of 26  
Policy Division  
Somerset House

FROM: B A MACE

DATE: 7 DECEMBER 1987

CHANCELLOR OF THE EXCHEQUER

INDEPENDENT TAXATION: WITHDRAWAL OF THE MARRIED COUPLE'S ALLOWANCE

1. At your meeting on 12 October you asked for a further note on the option of withdrawing the married couple's allowance under Independent Taxation at high income levels with some worked examples of how the option would affect different couples. I am sorry that we have not been able to let you have a note on this before now.

Worked Examples

2. The Tables attached show the effect of the various stages of the reform package on couples in different circumstances, with different incomes and different starting points for the withdrawal of the married couple's allowance.

3. The main points which emerge from the examples are:

---

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 Calder  
Mr Mace  
Mr Eason  
Mr Allen  
PS/IR

MACE  
7.12.87  
IND.TAX.



- (i) The maximum increase in the tax bill as a result of the vanishing exemption with 1988-89 indexed allowances is £500.50;
- (ii) The amount of the clawback is relatively small compared with gains to the couples affected from the package overall;
- (iii) Couples most likely to be affected are, of course, those where the husband has the bulk of the income, who are unlikely to gain substantially from Independent Taxation.

#### Couples affected

4. To set the worked examples in context we have looked at the distribution of incomes of couples who might be affected by a measure to withdraw the married couple's allowance at high income levels.

5. The attached table <sup>\*</sup> shows the number of couples at 1990-91 income levels with total incomes in excess of £40,000. There are just under 1/2 million of these, of whom, even at these income levels, nearly half, are couples where the wife has income below the tax threshold (£2,755 on an indexed basis in 1990-91). The table can be used to estimate how many couples would be affected by a vanishing exemption set at different levels. Thus a vanishing exemption starting where the husband's net income exceeded £40,000 would affect some 330,000 of the just over 490,000 couples with combined net incomes in excess of £40,000. Of these around 220,000 (two-thirds) would be couples where the wife has total income below the tax threshold. (As the table shows there are very few couples where the husband has income below the tax threshold (£4315 on an indexed basis in 1990-91) but the wife has net income in excess of £40,000 (and so would suffer a withdrawal of the married couple's allowance if it were transferred <sup>to</sup> by her <sup>to</sup> her husband). The impact of



the vanishing exemption on couples where the wife has little or no income would not be easy to defend, given the justification for the married couple's allowance as a recognition of the situation where one partner is dependent on the other.

Costs

6. At 1990/91 income levels and compared with Option D of my submission of 17 November (which had a 25 per cent basic rate and a 35 per cent higher rate) a vanishing exemption to withdraw the married couple's allowance above certain income levels would have the following yield in a full year:

Allowance withdrawn if husband's net income exceeds:	Yield
£	£m
40,000	95
50,000	55
60,000	35

Other aspects

7. We would need to examine in more detail the interaction of the vanishing exemption with a number of the other features of the present package. The operational implications would also need further scrutiny though our preliminary view is that these should be manageable.



8. You would also want to consider whether adding capital gains to the husband's taxable income should trigger the operation of withdrawal. This would be an additional complication in integrating the capital gains and income tax and might not be easy to defend, bearing in mind that income tax allowances and reliefs will not be available to set against capital gains. It would also increase the number of losers from the capital gains tax reform.

*B A Mace.*

B A MACE



Specimen Income Calculations

1. The attached tables show the effect of various stages of the current tax reform proposals on married couples with substantial incomes.

2. Five types of couple are considered at three different income levels:

Couple A: Income all earned by husband.

Couple B: Income all earned, 90 per cent by husband, 10 per cent by wife.

Couple C: Income all earned, 10 per cent by husband, 90 per cent by wife.

Couple D: Income all earned, 50 per cent by husband, 50 per cent by wife.

Couple E: 20 per cent of income is wife's investment income, remainder is husband's earned income.

3. The tax position of each couple is considered where their joint annual income is

- (a) £50,000
- (b) £75,000
- (c) £100,000.

4. In all cases it is assumed that the husband claims mortgage interest relief at £3,000 and that the partners pay 5 per cent of their gross earnings in superannuation contributions.

5. In each of the tables the first column (Column 1) shows the total tax liability of the couple under the 1987-88 tax regime.



TASK FORCE SECRET

Column 2 shows the change in tax and NIC liability on the same income in 1988-89 assuming

- (i) indexation of personal allowances
- (ii) reduction in basic rate to 25 per cent
- (iii) increase in higher rate threshold to £25,000
- (iv) a single higher rate of 35%
- (v) abolition of the UEL.

Column 3 shows the change in tax liability on the introduction of Independent Taxation (assuming the same allowances, rates and thresholds as for Column 2). Column 4 shows the further change in liability if a vanishing exemption was introduced which reduced the married couple's allowance by £1 for every £10\* of additional income where the husband's net income (that is, after deductions but before setting off personal allowances) exceeds

- (i) £40,000
- (ii) £50,000
- (iii) £60,000.

Thus, for Couple A where the husband has earned income of £50,000 his 1987-88 tax liability is £16,105.75. This falls by £1,342.40 under the proposed regime for 1988-89. There is no change in tax liability for this couple on the move to Independent Taxation but introducing a vanishing exemption starting at net income of £40,000 would increase the liability by £157.50. Vanishing exemptions starting at net income of £50,000 or £60,000 would not, of course, affect this couple.

---

\* With a 35 per cent higher rate this implies an effective marginal rate over the withdrawal band of 38.5 per cent.



Comment

6. As the tables show, the vanishing exemption bites most quickly on Couples A and B where the income is all or mostly earned by the husband. (We have not done calculations for a couple where all the income is all earned by the wife: the results would be very similar to those for Couple A). For Couple B (who are mainly wife's earnings election cases under the present system) the vanishing exemption recovers part or all of the married couple's allowance returned to the husband on the change to Independent Taxation. By contrast, Couples C and D (where the wife has the larger or an equal share of the earned income) escape the effect of the vanishing exemption altogether except in the case of the couple (Couple D) earning £50,000 each, where a vanishing exemption starting at £40,000 recovers about one-third of the benefit the husband gets from regaining the married couple's allowance under Independent Taxation. Only one couple in these examples is a loser from the changes in 1988-89: Couple D, where both partners are earning £25,000. They gain from the change to Independent Taxation because the husband recovers the married couple's allowance but are not affected by the vanishing exemption.

7. Compared with the overall gains for couples at this level from the package, the effect of the vanishing exemption is modest. The maximum additional tax taken from a couple by the vanishing exemption is £500.50. This compares with gains in excess of £5,000 from the changes in 1988-89 in most of the examples where the vanishing exemption bites.



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Table 1

Couple: Income level £50,000

	1	2	3	4
Couple	1987-88	1988-89	Independent Taxation	Vanishing Exemption
	£	£	£	£
A	16,105.75	-1342.40	-	(i)+157.5 (ii) - (iii) -
B	14,772.00	-1342.40	-222.50	(i) - (ii) - (iii) -
C	14,772.00	-1342.40	- *	(i) - (ii) - (iii) -
D	11,252.25	+255.45	-357.50	(i) - (ii) - (iii) -
E	16,381.00	-2342.65	-1631.25	(i) - (ii) - (iii) -

\* Assuming Transitional Protection so that husband can transfer unused balance of his basic allowance to his wife.

TABLES



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Table 2

Couple: Income level £75,000

	1	2	3	4
Couple	1987-88	1988-89	Independent Taxation	Vanishing Exemption
	£	£	£	£
A	30,331.00	-5005.15	-	(i) +500.50 (ii)+500.50 (iii)+288.75
B	28,147.00	-4379.90	-460.00	(i) +500.50 (ii)+389.37 (iii)+39.37
C	28,876.00	-5108.90	-17.00	(i) - (ii) - (iii) -
D	27,466.00	-1450.80	-500.50	(i) - (ii) - (iii) -
E	30,781.00	-6542.65	-2131.25	(i) +490.00 (ii)+140.00 (iii) -



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Table 3

Couple: Income level £100,000

	1	2	3	4
Couple	1987-88	1988-89	Independent Taxation	Vanishing Exemption
	£	£	£	£
A	44,581.00	-8692.65	-	(i) + 500.50 (ii)+500.50 (iii)-500.50
B	41,613.25	-7705.65	-500.50	(i) + 500.50 (ii)+500.50 (iii)-500.50
C	42,603.25	-8498.65	-254.50	(i) - (ii) - (iii) -
D	35,606.00	-4028.30	-500.50	(i) +157.50 (ii) - (iii) -
E	45,181.00	-10,742.65	-2631.25	(i) + 500.50 (ii)+500.50 (iii)-455.00



SHPL11

Page 2

Table: Format(F) Name(PIT90)

VANISHING EXEMPTIONS UNDER INDEPENDENT TAXATION  
1990-91

COUNT OF CASES (JOINT TNI > £40000)

HUSBAND'S TOTAL NET INCOME (LOWER LIMIT)

WIFE'S TOTAL NET INCOME	0	4,315	20,000	30,000	40,000	50,000	60,000	TOTAL	
0	0	0	0	0	0	60,254	30,513	54,244	145,011
1	0	0	0	0	* 5,555	32,881	13,341	23,152	74,929
2,755	0	0	0	0	11,405	16,598	11,927	8,675	48,606
5,000	0	0	0	0	26,266	13,099	5,072	6,924	51,361
10,000	0	0	10,048	27,757	10,027	2,470	7,098	57,401	
15,000	0	0	16,305	12,527	4,810	1,141	3,517	38,300	
20,000	0	6,788	19,239	9,014	4,670	2,224	3,032	44,967	
30,000	0	2,191	3,111	4,738	3,868	1,295	2,332	17,536	
40,000	48	529	486	960	1,637	694	1,791	6,144	
50,000	3	376	56	207	360	555	1,057	2,614	
60,000	6	317	414	159	236	219	2,139	3,489	
TOTAL	57	10,201	49,658	98,589	148,442	69,450	113,962	490,358	

330,000

\* total in these cells: 220,000

TASK FORCE SECRET

ANNEX 2.





FROM: J J HEYWOOD  
DATE: 7 December 1987

MR SCHOLAR

*I agree with the FST  
or this (i), (ii) & (v).  
I am doubtful you see  
conceder (vi). Whether (ii) is  
more progress than (i) is  
whether we have a watershed  
tax or not - but take it into  
account. Where we are still  
Rt (iii), chaps, (no);  
answer is that  
but cuts both  
ways.*

- cc PS/Chancellor
- Sir P Middleton
- Mr Culpin
- Mr Riley
- Mr Battishill IR
- Mr Isaac IR
- Mr Cropper
- Mr Tyrie
- Mr Call
- PS/IR

**RATIONALE OF TAX REFORM PROPOSALS**

You asked for comments on the Rationale Paper. The Financial Secretary has made the following observations:

- (i) There should be much more discussion of independent taxation which will be perhaps the major talking point post-Budget.
- (ii) The package does not score well against the objective of simplification.
- (iii) Are we sure that the overall tax burden (as a proportion of GDP) will fall?
- (iv) There should be a fuller discussion of the kink.
- (v) There should be a section on the self-employed and possibly also on the employed/self-employed interface and the personal tax/company tax interface.
- (vi) On paragraph 40, there will be a further dent in the contributory principle.

*Depends on whether we have withdrawal tax or not  
no - a deposit  
straight method*

*9.7/2*

JEREMY HEYWOOD  
Private Secretary



CONFIDENTIAL

8/12



CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	INDEPENDENT TAXATION + TAX OVERVIEW
DATE AND TIME	TUESDAY 8 DECEMBER 3.45 PM
VENUE	Chancellor's Room, Treasury/No.11/ <del>Conference Room/House of Commons</del>
PAPERS	PAPERS TO FOLLOW.
THOSE ATTENDING	CST FST PMG EST SR P.MIDDLETON SIR T.BURNS MR CASSELL MR SCHOLAR MISS SINCLAIR MR CROPPER MR CULPIN MR TYRIE MR BATTISHILL + IIR TEAM







# CHANCELLORS MEETING

~~March 3rd~~

1. SUBJECT

Independent Taxation

2. LOCATION.

HMT.

Plasering round

confirmed



CAST LIST	'PHONE NO'	DATE - TIME		
		3/12 3.00pm	2/12 10.30	4/12 10-11.30
CST	5088 ✓	✓	✓	✓
FST	5103 ✓	✓	Nat Fed of Nurses X Resident Fringe	X PRIVATE.
PMG	✓	Council of Charitable Support	CCO mtg 9.30	X CCO
EST	<del>5158</del> ✓	✓	X opening X office	✓
PEM	5158 ✓	x	✓	✓
TB	5202 ✓	✓	✓	✓
Cassell	5181 x	<del>5181</del>	✓	✓
Scholar	4380 ✓	✓	✓	✓
Ms Sinclair	4914 ✓	✓	✓	✓
Cropper	5027 ✓	✓	✓	✓
Tyre	5025 ✓	✓	✓	✓
Mr Culpin	5264 ✓	✓	✓	✓
Battisell	25416386 ✓	In Edinburgh	✓	LETTERS FROM SECT. - NAT MARSHALL.
+ team				
Psalc / Mace / Peter Lewis (?)				

Please add Andrew to right hand side of meeting notice.

PAPERS

MTG NOTICE SENT :



Tax meetings.

① Indep tax<sup>n</sup> (including mortgage interest relief)

② Covenants

All Ministers next week.  
 =  
 PEM  
 TB  
 Cassell  
 Scholar  
 Sinclair  
 Cropper  
 Tyne  
 Battisill  
 Isaac  
 Mace  
 Lewis  
 Johns

All Ministers  
 =  
 PB  
 All Ministers + Tay  
 to before  
 2.4/25.

Battisill  
 Isaac  
 Corlett  
 C Stewart

John Moore, <sup>after</sup> next week NI Contributions.  
 Bilateral 29157666.

23

30 Nov. Benefits in kind.



## MINOR STARTERS

<u>NO.</u>	<u>TITLE</u>	<u>STATUS</u>	<u>DATE OF LATEST SUBMISSION</u>	<u>COMMENT</u>
2	Duty differential for unleaded petrol	NSM		Consultation ends 30/11/87 ?
3	Def. of process of rendering wine or made-wine "sparkling"	I	4/11	EST agreed to include 20/11/87
4	Restructuring of wine and made-wine duties	I	4/11	EST agreed to include 20/11/87 Didn't we consult last year?
5	Pool betting duty structure	NSM		<del>Submission expected at end of month</del> EST wd drop ✓
6	Phased abolition of matches and mechanical lighters duties	NSM		IMC report awaited
7	Abolition of minimum duty charge for beer	I	4/11	EST agreed to include 20/11/87
8	Power to assess beer, wine and cider duties	D	4/11	EST agreed to drop 20/11/87
9	Remission of duty on spirits for medical or scientific use	I	4/11	EST agreed to include 20/11/87
10	Oil duties relief	UCM	20/11	EST would drop.
11	Relief from duty of goods testing	I	4/11	EST agreed to include 20/11/87 Regularises an ESC
30	Keith	I		Favourable - good news.

I - definitely included; I\* - provisionally included; D - definitely dropped; D\* - provisionally dropped;  
 UCM - under consideration (at least one submission received by Ministers); NSM - a first submission to go to Ministers.



31	Revalorisation of registration and deregistration thresholds	NSM		Preliminary leg. not required
32	Motor expenses	D	9/11	EST agreed to drop 20/11/87
33	Value of used goods	D		EST considers should be dropped 19/11/87
34	Tax on supply to be liability of person completing tax invoice	I		EST agreed <sup>to include</sup> inclusion <del>16</del> 16/11/87. Closes loophole.
35	Amend. to VAT Act 1983 Sch. 1	I		EST agreed to <sup>include</sup> drop 17/11/87. Bring UK practice into line with 6th Directive.
36	Computer evidence (Scotland)	D		EST agreed to drop 17/11/87
60	Disclosure of importers' details	NSM		Consultation with DTI progress unlikely until December CX rather keen.
61	Search of persons	I	12/11	CX agreed inclusion
62	Penalty for Customs fraud	UCM	17/9	} Related to COCOM. Smooth relations with Americans. Do we get something in return?
63	Prosecution time limits	UCM	17/9	
64	CAP warehouses approval and controls	UCM	20/11	
110	Amend. to PRP leg	UCM/NSM	3/9	1 item drafted further sub. when reaction to new leg + IR Guidance Notes available
111	Review of S79 unapproved employee share scheme	I	22/7	Draft clauses published with consultative document
112	Employee priority shares in a public offer	I	5/11	Drafting completed. Announced in press notice on 23 September. But new proposal to widen exemption



116	FA 1984 Employee Share Option Schemes - restricted shares	I	5/10	Drafting completed
151	Personal pensions - delay in commencement date	I	13/11	Instructions sent to Counsel 21/10/87 but proposal to include some other minor changes
200	Close companies apportionment of interest	D*	5/11	FST does not regard this as essential for 88
203	Business Expansion Scheme	NSM		CX wished considered. <i>remains attracted.</i> Awaiting results of review submission expected at end of month
204	Capital Allowances: pre-consolidation amendments	NSM		Submission expected next week
205	Capital Allowances: transfers by exempt bodies	I	12/10	<i>Water authorities, have to do.</i>
206	Capital Allowances: fire safety etc	NSM		<i>Consequential on HO leg'n.</i>
208	Capital Allowances: enterprise zones	D	21/10	CX recommended dropping, 11/11
209	Capital Allowances: assured tenancies	NSM		Depends on outcome of review of tax. of private renting <i>Cassell review with FST.</i>
210	Exchange gains and losses	NSM		
211	Abolition of relief for business entertaining of overseas customers	I	11/11	FST recommends inclusion <i>import agents benefiting too.</i>
212	Small advertising gifts	D	11/11	FST recommends dropping
213	In-year assessment on Schedule D income	UCM	12/11	



214	Lloyds RIC Leavers	UCM	19/11	Don't commit ourselves now.
215	Lloyds special Reserve Fund	UCM	17/11	CX agot increasing exemption. Leavers, on merit, a case for doing something.
216	Lloyds: <sup>reform</sup> <del>return</del> of assessment and collection system	NSM		
217	Pension Scheme repayments	NSM		Awaiting ABL reps. Need case for putting insurance coys on all fours with pension funds!
251	IHT exemption for +T/Fs to political parties	I	30/10	FST agrees inst to Counsel
255	CGT: definition of investment trust	I	17/7	Drafting completed change announced in PQ 23/7/87 Consequential of FA 1987 II
256	CGT: extension of roll-over relief to satellites and spacecraft	I		Drafting completed announced 27/7/87
257	CGT: Capital losses on building society and co-op shares	I	18/6	Drafting completed announced 3/7/87 Had to do.
258	CGT: indexation and groups	I*	12/10	Inst to Counsel 4/11/87 <u>Anti-avoidance,</u> FST provisionally approv. inclusion 23/9/87 Inst to Counsel 29/10/87
259	CGT: intra-group share exchanges	I*	21/9	
260	CGT: extensions of roll-over relief to milk and potato	I	23/9	FST approved inclusion 23/10/87 ? extend scope. Relief announced 29/10/87
301	Stamp duty on shares	NSM		Submission by end November Drop.
302	Stamp duty: Channel Tunnel	I	21/9	FST approved inclusion 13/10/87 Inst. to Counsel 22/10/87
303	Abolition of Unit-Trust Instrument Duty	NSM		Submission by end November Euro angle important?



350	PRT: Expenditure claims during safeguard periods	D	13/11	EST agreed to drop 30/11
351	PRT: Variations in assessments or determinations	D*	20/11	EST inclined to drop 19/11 ✓
352	PRT: Expenditure relief - tariffing arrangements	D	21/10	EST agreed to drop 26/10
353	Oil licence gains: work programme farm cuts	I*	20/8	EST agreed to provisional inclusion 2/11. <i>Extend rollover relief to work programme farm cuts. Cd be done neatly.</i>
400	Company residence and migration	USM	19/11	Case unlikely to come before European Court of Justice before Budget. Chance of success not good so pre-emptive leg. recommended
450	Tax appeals: General Commissioners for N.Ireland	I*	14/7	Views of consultative doc. requested by 20/11/87 Final decisions late December
451	Tax appeals: place of hearing by Gen. Commissioners	UCM	20/10	Consultative document issued 5/11/87 comments requested by 31/12/87
452	Keith, Ctee: administrative improvements	I	15/7	
650	Public Accts + Charges Act 1891: tech amend to Sect 2(3)	UCM	17/11	
651	Gilts: redemption procedure	UCM	20/11	} EST's wd include
652	Gilts: Small Estates	UCM	20/11	





MINUTES OF A MEETING HELD IN THE CHANCELLOR'S OFFICE,  
HM TREASURY, AT 3.45PM ON TUESDAY, 8 DECEMBER 1987

Present

Chancellor  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Sir T Burns  
Mr Scholar  
Miss Sinclair  
Mr Riley  
Mr Culpin  
Mr Cropper  
Mr Tyrie  
  
Mr Battishill - IR  
Mr Isaac - IR  
Mr Beighton - IR  
Mr Calder - IR  
Mr Mace - IR

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**INDEPENDENT TAXATION, COMPANY FINANCE AND WITHHOLDING TAX**

Papers: Miss Sinclair's annotated agenda of 4 December; Financial Secretary's note of 7 December; Mr Mace's submissions of 7 December and 4 December; Mr Culpin's submission of 4 December; Mr Riley's submission of 4 December.

Independent taxation

The Chancellor invited the meeting to consider the questions in Miss Sinclair's annotated agenda.

2. The Chancellor confirmed that he was content to go ahead with independent taxation on the basis now proposed. He noted the points made in the Financial Secretary's minute. The proposals were a "halfway house" only in that they were distinct from fully transferable allowances. But they should not be presented in this





way. They gave privacy and independence to married women. They recognised marriage. They could be afforded and brought in in this Parliament. These were positive virtues, which should be stressed.

3. He agreed that we would need defensive answers to the question why we were not proceeding with any form of transferable allowances. He thought the analysis of the present system in the 1986 Green Paper stood up well, since it was clear that there was insufficient support for the option of transferable allowances canvassed there. In any case, transferable allowances could not be introduced in this Parliament.

4. The Chancellor said the second question related to the shape of the package set out in Mr Mace's note of 4 December. A key point to consider, here, was the vanishing married couple's allowance (MCA). He saw attractions in this. The only losers would be those who would gain from the rest of the package. It would offset the degree to which the package could be criticised as benefiting the rich. It would be a complication compared to the present system, and could possibly enhance the difficulties of moving to mandatory separate taxation. But these difficulties were outweighed by the advantages of the exemption. He concluded that we should plan on the assumption that the vanishing exemption would be introduced, starting at an income of £40,000. It should not flow through capital gains tax as well. He invited the Revenue to instruct Counsel on this basis.

5. The Chancellor said that he otherwise generally agreed with the presentation in Mr Mace's note of 4 December. He had a number of small points:

- (a) the note placed too much emphasis on who gained what from the package. More emphasis should be placed instead on the promotion of privacy and independence in taxation as a result of the package;





- (b) he agreed with the Financial Secretary that it would be bizarre to abolish limits on pre-1984 life assurance policies. But he did not favour a joint system. Instead, he would prefer that the existing limit should apply to individuals on a basis of £1,500  $\frac{1}{6}$ th of income. But the precise terms of previous Government commitments should be examined;
- (c) something on mortgage interest relief should be included, on the lines suggested in Mr Mace's draft;
- (d) the "covenants" section should state clearly that all covenants to charities, and all existing covenants to individuals, would continue;
- (e) officials should continue to pursue at their level the proposals for Additional Personal Allowances (APA). He would discuss this with Mr Moore at an early date;
- (f) Minor Personal Allowances were not part of the independent tax package.

6. It was agreed that a booklet should be prepared on independent taxation, particularly as it affected women. The Revenue was asked to draft this in consultation with FP. More generally, there should be a range of publications from short press releases up to fully-fledged documents. The documents should be ready for publication on Budget Day. The Chancellor would also wish to make a major speech on the proposed changes. The Chancellor otherwise agreed with the Financial Secretary's advice, as set out in his minute of 7 December.

#### Company finance and withholding tax

7. The Chancellor said that a withholding tax would be a tremendous prize in terms of simplification. But there were two big problems: it would be seen as a further handout to the rich; and, as envisaged, would give rise to a fair number of losers.





Mr Isaac said that the viability of the tax would also depend on equivalence of treatment between investment sources (which would need to take account of, eg Isle of Man investments).

8. The Chancellor invited comments on whether the reform was worthwhile, bearing in mind the two major difficulties. Mr Culpin said that the attractions of the tax seemed less than they had done at the outset. First, because withholding could not be universal. Second, because the tax would not achieve as much neutrality as might have been hoped. It would be difficult to explain to the many losers, many of whom would be people with such savings or small shareholders. He was therefore against the proposal. The Financial Secretary agreed. Sir P Middleton also agreed: a 35 per cent rate would be best as far as the objectives of the tax were concerned, but would involve an unacceptable number of losers. But the lower the rate of tax, the smaller the benefit from its introduction.

9. The Chancellor, summing up, said that a rate of 25 per cent would be most consistent with other proposed tax changes, and would overcome the losers problem. But it would be attacked as too generous to the rich. He concluded, therefore, that the withholding tax should not be a starter for this Budget. It might be examined further, however, in the context of the proposed consultative document on the taxation of savings.

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

J M G TAYLOR

14 December 1987

Distribution

Those present  
Chief Secretary





COPY NO 8 OF 9

FROM: J M G TAYLOR

DATE: 8 December 1987

MR CULPIN

cc Sir P Middleton  
Sir T Burns  
Mr Scholar  
Miss Sinclair  
Mr Riley  
Mr Scotter**TAX BURDEN**

The Chancellor was grateful for your minute of 7 December, covering Mr Scotter's minute of the same date.

2. He would be grateful for comparable figures for 1989-90 and 1990-91 on the basis of the current package and last year's MTFS.

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

J M G TAYLOR





COPY NO. 12 OF 13.

FROM: J M G TAYLOR

DATE: 8 December 1987

MR SCHOLAR

cc Financial Secretary  
Sir P Middleton  
Mr Culpin  
Mr Riley  
Mr Cropper  
Mr Tyrie  
Mr Call  
  
Mr Battishill - IR  
Mr Isaac - IR  
PS/IR

**RATIONALE OF TAX REFORM PROPOSALS**

The Chancellor has seen PS/Financial Secretary's minute to you of 7 December.

2. He agrees with the Financial Secretary that there should be much more discussion of independent taxation; that there should be a fuller discussion of the kink; and that there should be a section on the self-employed and possibly also on the employed/self-employed interface and the personal tax/company tax interface.

3. He is doubtful if we should concede that there will be a further dent in the contributory principle.

4. He has commented, further, that whether it is right to say that the package does not score well against the objective of simplification depends largely on whether we have a withholding tax or not - but even if not, we need to stress those places where we are simplifying. He has also commented that, clearly, the overall tax burden as a proportion of GDP will not fall; but that this cuts both ways.

A handwritten signature in dark ink, appearing to be 'J M T'.

J M T TAYLOR



FROM: FINANCIAL SECRETARY  
DATE: 9 December 1987



CHANCELLOR

*Age letters  
have - uncl -  
Virus of Mr. Schuler, FP  
& Mr. Wopple  
Ms.*

**VANISHING EXEMPTION**

Could I just return to one point I raised at yesterday's meeting?

2. I suggested that if we introduced the "vanishing exemption" then it would make it much more difficult to move subsequently to transferable allowances, because the married man's allowance would have to be "reinvented" for higher earners. You disagreed on the grounds that transferable allowances meant one single allowance for everyone.

3. Perhaps I could just clarify with the use of a simple example what I meant. Taking the position of the one earner couple with income too high to benefit from the MCA under independent taxation:

Present Position:	£3795	allowance
Independent Taxation:	£2425	allowance
Transferable Allowances:	either £4850	(2 x £2425)
	or	£6220 (£3795 + £2425)

4. The example shows that if we moved from independent taxation to transferable allowances there would be a huge gain for wealthy married couples - an increase in allowances of £2425 if one set the single transferable allowance at the current single personal allowance; an increase of £3795 if we set the transferable allowance at the level necessary to avoid two-earner couple losers.

5. It might be argued that these increased allowances are not a reintroduction of the "married man's allowance" - the latter would certainly be abolished in name. But these allowances would be given to the married man only because he is married and in recognition of the fact he is married.



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6. Whether or not this represents the reinvention for high-income couples of the married man's allowance is in a sense a matter of semantics. What is clear is that the pattern of allowances in my example is a bizarre one. I am sure that most commentators will see the natural next step as being the phasing out of the MCA for all couples and not the reintroduction of a higher allowance for wealthy couples.

7. We are agreed, however, that independent taxation must be presented on its own terms and not as a half-way house on the road to a different system.

8. In this context too I think the vanishing exemption will create presentational difficulties. I can foresee the following train of questioning:

(i) Why retain the married couple's allowance?

Answer: because we believe that the extra responsibilities and expenditures that come with marriage should be recognised by the tax system.

(ii) Then why not keep it for high-income couples too?

Answer: because the higher-income couples have sufficient net income to meet their special responsibilities and they will benefit greatly, in any case, from the overall Budget package.

(iii) What about high-income couples where the wife has the large income?

Answer: ?

(iv) Will not this vanishing exemption create a huge incentive for husbands to transfer all their investment income to their wives?

Answer: ?

9. These last two questions are decidedly tricky. The vanishing exemption will create a new anomaly and unfairness. We might well argue that the high-earning wife is a very rare case. But will it



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always be a rare case under present proposals? High-earning husbands will have an incentive to give all their assets to their wives to keep their own incomes below the vanishing exemption threshold, safe in the knowledge that the wife's income will not trigger a loss of allowances.

10. I do wonder whether all this is worth it when the maximum clawback is £500 compared with gains of £5000 and more from the main package for the same couples.



NORMAN LAMONT





MINUTES OF A MEETING HELD IN THE CHANCELLOR'S OFFICE,  
HM TREASURY, AT 3.45PM ON TUESDAY, 8 DECEMBER 1987

Present

Chancellor  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Sir T Burns  
Mr Scholar  
Miss Sinclair  
Mr Riley  
Mr Culpin  
Mr Cropper  
Mr Tyrie  
  
Mr Battishill - IR  
Mr Isaac - IR  
Mr Beighton - IR  
Mr Calder - IR  
Mr Mace - IR

NOTE  
OF  
MEETING  
8/12

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INDEPENDENT TAXATION, COMPANY FINANCE AND WITHHOLDING TAX

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2. The Chancellor confirmed that he was content to go ahead with independent taxation on the basis now proposed. He noted the points made in the Financial Secretary's minute. The proposals were a "halfway house" only in that they were distinct from fully transferable allowances. But they should not be presented in this





way. They gave privacy and independence to married women. They recognised marriage. They could be afforded and brought in in this Parliament. These were positive virtues, which should be stressed.

3. He agreed that we would need defensive answers to the question why we were not proceeding with any form of transferable allowances. He thought the analysis of the present system in the 1986 Green Paper stood up well, since it was clear that there was insufficient support for the option of transferable allowances canvassed there. In any case, transferable allowances could not be introduced in this Parliament.

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8. The Chancellor invited comments on whether the reform was worthwhile, bearing in mind the two major difficulties. Mr Culpin said that the attractions of the tax seemed less than they had done at the outset. First, because withholding could not be universal. Second, because the tax would not achieve as much neutrality as might have been hoped. It would be difficult to explain to the many losers, many of whom would be people with such savings or small shareholders. He was therefore against the proposal. The Financial Secretary agreed. Sir P Middleton also agreed: a 35 per cent rate would be best as far as the objectives of the tax were concerned, but would involve an unacceptable number of losers. But the lower the rate of tax, the smaller the benefit from its introduction.

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

J M G TAYLOR

14 December 1987

Distribution

Those present  
Chief Secretary



COPY 1 OF 14

FROM: J J HEYWOOD

DATE: 9 September 1987

PPS

cc

Sir P Middleton  
 Sir T Burns  
 Mr Byatt  
 Mr Cassell  
 Mr Scholar  
 Miss Sinclair  
 Mr Cropper  
 Mr Tyrie  
 Mr Battishill - IR  
 Mr Isaac - IR  
 Mr Houghton - IR  
 Mr Cayley - IR

**CAPITAL GAINS REFORM**

The Chancellor asked for the Financial Secretary's views on a couple of outstanding issues.

*below*

(i) Commencement Arrangements (Mr Cayley's minute of 26 August): the Financial Secretary would strongly favour the much simpler option of a 6 April start unless the forthcoming Treasury analysis of the market implications points strongly against this.

*below*

(ii) Husband and Wife (Mr Cayley's minute of 6 August): the Financial Secretary thinks that a reduction in the annual exemption level would be very unfair to single people and therefore he sees no alternative to freezing the annual exemption at its current level of £6,600.



2. The Financial Secretary has also seen your note of 4 September on the possibility of withdrawing the CGT exemption from the sale of the principal residence. The Financial Secretary thinks that the political problems are obvious. He understands the motive behind trying to deal with these with roll-over relief. But he thinks that for some people, including many with inadequate pensions, the family home is the only asset, which is then used to finance retirement. For these people the problem will not be solved by roll-over relief and the Financial Secretary believes that their reaction to the proposal would be fierce.

*Separate  
files*



**JEREMY HEYWOOD**  
**PRIVATE SECRETARY**



TASK FORCE SECRET

COPY NO 1 OF 10

FROM: A G TYRIE

DATE: 9 DECEMBER 1987

CHANCELLOR

cc Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir T Burns  
Mr Scholar  
Mr Culpin  
Mr Cropper

**INDEPENDENT TAXATION: THE VANISHING MARRIED COUPLE'S ALLOWANCE**

I didn't have a chance to read Brian Mace's paper of 7 December properly before the meeting yesterday. It looks a bit of a mess to me.

The drawbacks are substantial:

i. Complexity. Wealthy wives, 'tax novices', would have their work cut out understanding this. Their first introduction to the tax system would be grappling with the need to switch investment income from their husbands to their own name to prevent the loss of the husband's MCA. How could we possibly reconcile the encouragement of income splitting wheezes with claims that we are simplifying tax?

ii. A three rate system. We would not be able to take full credit for having amalgamated all the higher rates into a single rate. There would be a new 'increased

TYRIE  
CHX  
9/12



rate band' at 38.5% (assuming a 35% top rate) between £40,000 and £53,000.

iii. 'A hump for a kink'. Once we had a kink, now we have a hump. The marginal rates would look like Annex 1. As I say, not a pretty sight in our presentation tables for budget day. If we don't publish it the IFS will.

iv. What's the motive? We can't claim we're doing it for the money. The yield would be derisory compared to the Revenue losses in the cause of the wealthy elsewhere. Nor could we use it to defend our flank from those who would accuse us of being over generous to the wealthy, the equity lobby. It takes only £500 at the most from those earning over £40,000.

v. The presentation of independent taxation. This blows a hole in the presentation of independent taxation. How can we reconcile the vanishing allowance with our line on the presentation of the MCA? I thought our line was that we thought the tax system should confer some benefit to the institution of marriage. With a vanishing allowance we recognise marriage, that is, unless you're wealthy. We want to help one earner couples, but not if they're well-heeled! I suppose that's just about wearable as a line.

The biggest problem is that the MCA does not vanish if the wife is the main breadwinner. It vanishes only if



the man brings home most of the bacon. So we are happy to hit wealthy husbands but not wealthy wives! Compare Annexes 1 and 2. They may want change but I haven't heard many calls for this particular gesture from the ladies.

*M. May*

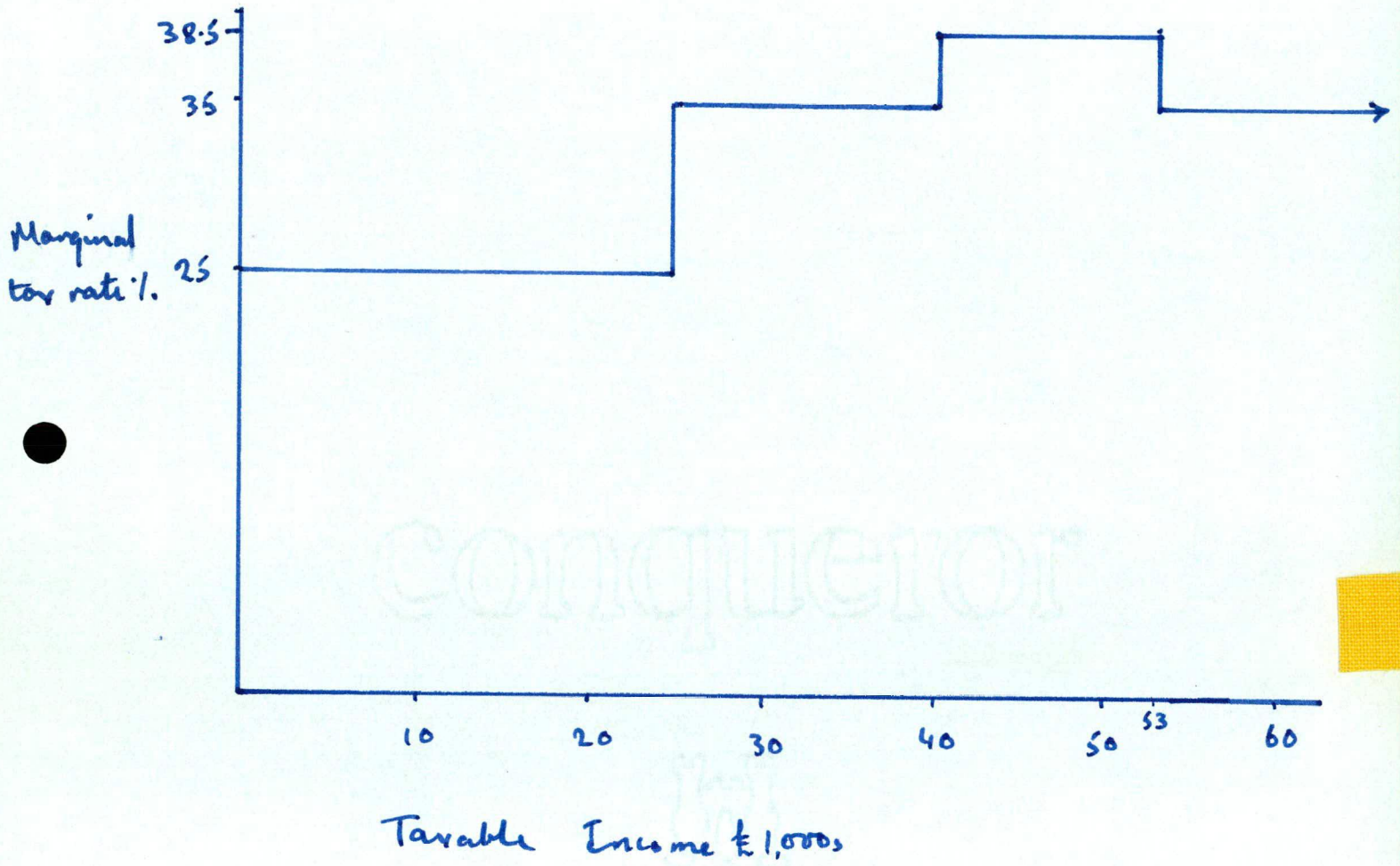
*pp*

A G TYRIE



Annex 1

Marginal Tax Rate: Married Men

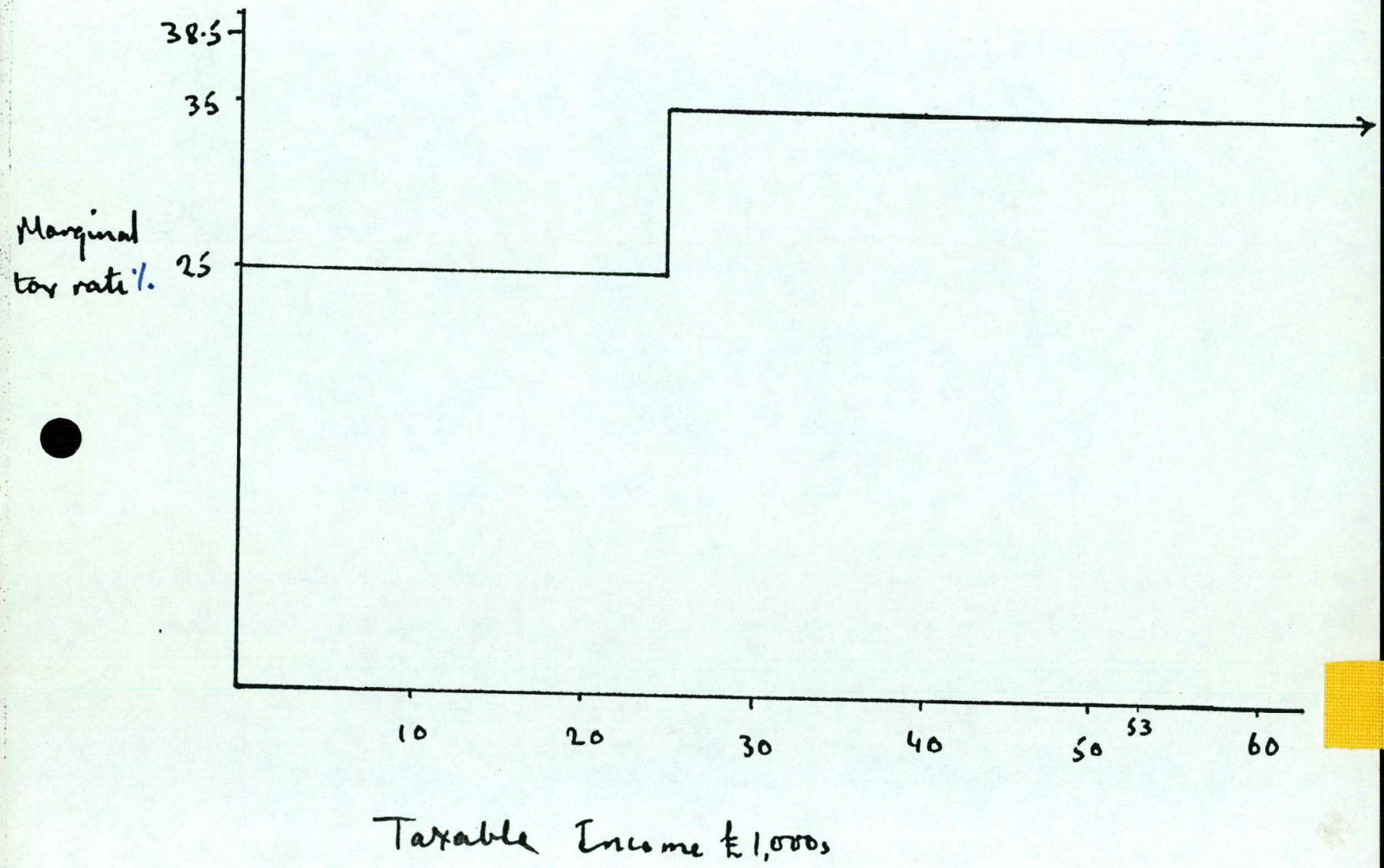


ANNEX  
1



Annex 2

Marginal Tax Rate: Virtually all Married Women



ANNEX 2



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FROM: P J CROPPER  
DATE: 10 December 1987

CHANCELLOR

cc Financial Secretary  
Mr Scholar  
Mr Culpin

VANISHING EXEMPTION

I see the vanishing exemption entirely as a cosmetic concession to those who might think the budget package as a whole goes too far in favouring the "rich". Taken by itself, it messes up the diagram of marginal tax rate versus income so clearly illustrated in Andrew Tyrie's note. The IFS would undoubtedly make fun of it.

behind -

2. Would I do it? No, not if I could help it. Much depends on the final form of the package itself. Even as a cosmetic it might back-fire. Might people not say "He must be really worried about the distributional consequences of the budget if he thinks he has to conceal them behind that"?

CROPPER  
CHK  
10/12

P J CROPPER

Handwritten notes in red ink:

WD Why?  
The ~~US~~ US tax system - about 15% on 2000 -  
more - about 15% on 2000 -  
But when if they got 15-28-33-28.  
WE can discuss further  
@ Charles  
m..



CONFIDENTIAL



Inland Revenue

Policy Division  
Somerset House

*mp*

*I agree on both points. While in principle other taxpayers swapping assets could object that you were singling out oil licences for favourable treatment, in practice complaints are likely to be muted because it will be recognised that oil is generally more severely taxed. (e.g. no rollover relief on post Annex B disposals of licences)*

From: M A HILL  
Date: 10 December 1987

*MSJ 10/12*

1. Mr. Johns
2. Economic Secretary

**BS353: CAPITAL GAINS AND FARM OUTS**

1. Last month you decided legislation should be prepared providing a capital gains exemption for work programme farm outs before Annex B (Mr Barnes' minute of 2 November, responding to ours of 27 October). This note is about two matters which have arisen during subsequent discussions with the industry, both of which could affect the detail of the legislation. The first is licence swaps; and the second the capital allowance treatment of any consideration passing which is to be given a nil value for capital gains purposes.

Licence Swaps

2. In our original advice the possibility of extending the relief to pre-Annex B licence swaps was considered but rejected. At that stage we had gained the impression that licence swaps were the concern of a handful of larger companies. But the

- 
- cc. Chancellor of the Exchequer  
Financial Secretary  
Mr Scholar  
Mr Culpin  
Mr C J Riley  
Mr M L Williams  
Miss Sinclair  
Mr Jenkins - Parliamentary Counsel

- Mr Painter  
Mr Pollard  
Mr Beighton  
Mr Johns  
Mr Elliss  
Mr Beauchamp  
Mr Ridd  
Mr Cayley  
Miss Hill  
PS/IR



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industry have since come back on this issue, and it now seems that there is an industry-wide consensus that licence swaps should be relieved from any immediate CG charge. Following a discussion arranged at their initiative, UKOOA wrote to us on 20 November (copy of UKOOA's letter attached). At the meeting to discuss their Budget representations, Brindex expressed their support for UKOOA's representations on licence swaps. And Graham Hearne of Enterprise wrote direct to you on 23 November, making very similar points. *You commented on his letter (Mr Westhead's note of 27 November) that you hoped we were not ruling out this possibility.*

3. The burden of the industry's case is that licence swaps have more in common with work programmes than with cash disposals. This is true up to a point. Most obviously neither a work programme nor a swap results in the person who makes the disposal receiving cash with which he can fund an immediate CG bill. Equally both pose similar valuation problems, with swaps highlighting the difficulty that the two parties to the transaction might have quite different perceptions of the value of the licence interests transferred.

4. Rather more difficult to assess is the extent to which pre-Annex B licence swaps will lead to more exploration activity. They have become more common only in the last year or two, so there is no past experience to go by. It is true that Department of Energy are unlikely to agree to the exchange unless they feel it is in the interests of UKCS exploration and development generally. But there is no obligation analogous to the work programme which will, by definition, result in new exploration activity.

5. Work programmes are a very special kind of asset, which have no real parallels outside the oil industry. By contrast all sorts of assets can be swapped, with asset swaps in general being chargeable occasions for CGT purposes. Although it may be possible to distinguish interests in oil licences from the generality of chargeable assets eg on the grounds that no ready market exists, a more favourable regime for exchanges of these



assets could lead to pressure for relaxations elsewhere in the CG code.

6. In the light of the industry's new initiative, we have tried to estimate more precisely the revenue effects of extending relief to licence swaps. At present swap deals are relatively uncommon, and extending relief to those which have already taken place would probably do no more than turn an immediate cost of £m2 to £m3 a year into one of £m5. If, as Mr Hearne's letter claims, extending relief results in additional exploration wells being drilled, there could be a further short-term revenue loss. This is because such wells would qualify for immediate PRT exploration and appraisal relief - and the Section 5A cost of drilling just one extra well could be around £m5. In the longer term there might of course be an Exchequer yield if any of these wells lead to extra discoveries.

#### Capital Allowances

7. Hitherto we had been working on the assumption that any legislation on farm outs would be confined to their capital gains treatment, with the other aspects of the transaction being sorted out under the existing provisions. But continuing discussions with the industry of the "nil value" approach now agreed suggests this would not be a sensible option, as it would still leave farm outs requiring valuation for capital allowance purposes.

8. The obvious way to circumvent this valuation problem would be to provide that any consideration which is deemed to have a nil value for CG purposes should likewise be treated as nil for capital allowance purposes. Indeed such a provision could be seen as the logical consequence of what is being done on the capital gains front. As with the capital gains provision, such a rule would in general benefit the farmer out at the expense of the farmer in.

9. The revenue effects of such a provision are likely to be minimal, and the additional legislation could, we think, be made



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quite short. You should be aware, however, that this solution may displease certain farmers-in, who may have hoped to have some benefit from the capital allowances relating to the costs incurred or work carried out by the farmer-out in these circumstances. But the quantum of any individual loss on this account is likely to be small; and the farmer-in would still be entitled to claim PRT exploration and appraisal relief and CT scientific research allowances in respect of his own drilling costs.

### Conclusion

10. Whether or not to legislate on either of the issues covered by this note must be a matter for political judgment. Licence swaps, although they could lead to greater exploration activity and ultimately more revenue, do not have all the same special characteristics as work programmes. To provide for swapped interests to have nil value would run counter to the CG treatment of asset swaps generally and might lead to complaints from less-favoured tax payers. On the other hand including licence swaps is likely to involve an Exchequer cost which is quite small in oil industry terms, and probably not too much in the way of additional legislation. And it would represent a very positive response to a representation which seems to have wide support within the oil industry. We would, on balance, see this as a worthwhile sweetener.

11. Legislation to cover the capital allowance point, though not essential, is the logical consequence of what is to be done for capital gains, and would remove the remaining need for work programmes still to be valued on this account. There could be some complaints from disgruntled farmers-in, but on the whole the industry seem unlikely to quarrel with a provision along the lines of that outlined in paragraph 8. We would therefore recommend its inclusion.



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12. In order that we may finalise our instructions to Parliamentary Counsel on BS 353, we would welcome your decisions on both the matters considered in this note. But, whatever your decision on the licence swaps issue, we suggest you send simply a brief acknowledgement to Graham Hearne's 23 November letter on the lines of the attached draft.

MAH

M A HILL



# UK OFFSHORE OPERATORS ASSOCIATION LIMITED

3 Hans Crescent, London SW1X 0LN  
Telephone: 01-589 5255  
Telex: 938291

CDCW/SLP

cc Miss Hill  
Mr Ellis  
Mr Keegan ✓  
Hunt / file

20th November 1987

M A Johns Esq  
Under Secretary  
Inland Revenue  
Policy Division 7  
Somerset House  
Strand  
London WC2

Dear Michael

At our November 11 meeting with your colleagues to discuss Capital Gains Taxation of licence rearrangements, UKOOA, UKOITC and Brindex were asked for 'evidence' that the CGT treatment of acreage swaps was inhibiting such transactions from going ahead. We have discussed this matter with Brindex, and they join us in this submission.

It appears to be common ground between us that swaps during the pre-development phase are worthwhile, and should not be artificially restricted. Nonetheless, it is worth reiterating why this is so.

1. Often, acreage swaps are driven by one party's explorationists having a more favourable geological view of an area than the others. If a province is to be efficiently explored and developed these different perspectives must be brought to bear on it - evidence the number of discoveries that have occurred on relinquished acreage.
2. There are also concrete efficiencies to be exploited due to the availability of infrastructure to one party, his specialised knowledge of an area, the potential for more efficient use of manpower resources, etc. In many cases, small discoveries are only economic if developed through facilities in which the owners have an interest, rather than by paying a tariff to a third party.
3. Often the effect of a swap is to eliminate a small percentage interest in a field by swapping with an existing interest owner. Reducing the number of coventurers can streamline decision-making, particularly where a party leaving the venture has a completely different order of priorities from those remaining.
4. Swaps will almost certainly result in increased exploration and appraisal activity, as the acquired acreage typically requires more work if any value is to be realised, and the new owner probably attaches a higher priority to the acreage than the previous owner.
5. To the extent that this increased activity leads to commercial discoveries, and new developments it will add to Government revenues. Only a very slight increase in the probability of this outcome would be needed to justify the small amount of revenue which may be foregone by altering the Capital Gains treatment of swaps.



While the Government representatives at our meeting appeared to see the merit of swaps, they appeared less than convinced that these transactions could be inhibited by Capital Gains Tax. Neither UKOOA nor Brindex are in a position to provide specific examples of abortive swap transactions; perhaps individual members may choose to do so. However, we believe that there is a powerful logical case to support our claim that swaps are being inhibited. Lower oil and gas prices have put pressure on the UK oil industry to consolidate and restructure. Swaps have a potentially useful role to play in this process. Yet there have been relatively few of them. A review of the benefits and costs of a typical transaction will highlight the negative role played by CGT.

1. The acreage being given up is perceived as of relatively little value to the 'seller'.
2. He receives no cash.
3. The acreage he is acquiring needs additional expenditure in order to realise any value.
4. This benefit is uncertain and likely to be at some time in the future.
5. Any value he attributes is subjective - the 'seller' perceives little or no value.
6. The size of his exposure to Capital Gains Tax is indeterminate.
7. This exposure is immediate and in cash.

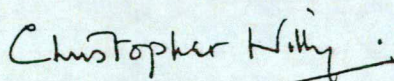
This combination of circumstances should often be enough to inhibit the initiation of commercially sensitive negotiations and to condemn all but the most outstanding transactions.

The treatment of swaps should be the same, and for the same reasons, as work programme farm-outs. The attached matrix suggests that swaps have more in common with work programme farm-outs than with licence rearrangements in which cash changes hands. Not only is there no cash profit possible in either work programme farm-outs or swaps, but the common motive of both is to upgrade UKCS acreage portfolios. This is not necessarily the case in a cash transaction, where the seller may be reducing his UKCS commitment.

Naturally, to the extent that a swap involved an element of cash or of post-Annex B acreage, other arrangements would have to apply. We believe that extension of the proposed concession on work programme farm-outs to embrace swaps would be entirely within the spirit of the Economic Secretary's statement of 16th July in which he said, "it is in the public interest for licences to be in the hands of those most enthusiastic to develop them and who have the cash to do so."

As this subject involves matters of a broad policy nature affecting the future development of the UKCS, we are copying it to the Department of Energy.

Yours sincerely



C D C Willy  
Director - External Affairs



A COMPARISON OF THE KEY FEATURES OF LICENCE REARRANGEMENTS IN THE EXPLORATION PHASE

	Work Programme Farm-outs	Swaps	Cash
Motive to upgrade UKCS portfolio	Yes	Yes	Not necessarily
Will result in increased N. Sea activity	Yes	Probably	Probably
Uncertainty regarding CGT exposure	Yes	Yes	No
Difficulty of valuing consideration	Yes	Yes	No
Cash available to pay tax	No	No	Yes



. . . .  
G J Hearne Esq  
Enterprise Oil plc  
5 Strand  
LONDON WC2N 5HU

FARM OUTS AND LICENCE EXCHANGES

Thank you for your letter of 23 November.

I am grateful for your appreciation of our review of capital gains tax on farmouts. You have set out in a most helpful way the reasons why Enterprise think it important that there should be a measure of capital gains relief for licence swaps at the exploration stage. As you may know, this is an issue which my officials have been discussing with UKOOA over recent weeks, and UKOOA have also provided a good deal of information about this type of licence exchange.

There are obviously some similarities and some differences between work programme farmouts and licence swaps.)

The Inland Revenue have not been intending to express a final view one way or another in their discussions but rather to identify what these similarities and differences are. You may be assured that your arguments will be considered very carefully when we make our proposals for the next Finance Bill

PL





**NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY,  
AT 3.00PM ON THURSDAY 10 DECEMBER 1987**

Present: Chancellor of the Exchequer  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Sir T Burns  
Mr Scholar  
Mr Culpin  
Miss Sinclair  
Mr Michie  
Mr Cropper  
Mr Tyrie

Mr Battishill - IR  
Mr Isaac - IR  
Mr Lewis - IR  
Mr Prescott - IR  
Miss Rhodes - IR

.....

**TAX REFORM: BENEFITS IN KIND**

Papers: Mr Isaac's minute of 9 December to the Financial Secretary;  
Mr Prescott's minute of 8 December to the Chancellor;  
PS/Economic Secretary's minute to PS/Chancellor of 4 December;  
Mr Scholar's annotated agenda of 8 December and papers listed  
there.

The meeting considered the questions listed in Mr Scholar's annotated agenda. In response to the first set of questions, the Chancellor said that the spread of fringe benefits should be curbed in any event. Abolishing the employees' UEL reinforced the need to do this. The only practicable alternative to the current proposals



was to take as many benefits out of tax as possible. But this was highly undesirable at this stage. There was, however, something to be said for an approach on these lines should the main proposals be dropped from the package. In response to the second question, he agreed that a wider tax looked better than a narrow one.

2. On the third question, the Chancellor said that the annex to Mr Lewis' top paper did not suggest that the wider approach should be ruled out on compliance/operational grounds. It was worth going for simplification, where possible, and it might be appropriate for simpler car scales to be examined further.

3. The Chancellor thought that, on the basis of the evidence in Mr Prescott's note, it should be possible to extend the employer based tax to all benefits without imposing significant additional burdens on most employers. Some special arrangements for the self-employed might, however, be required (see paragraph 10 below). Mr Isaac said that, without question, employers would complain voliferously about the change. They would have grounds for some complaint when the tax was first introduced. The Chancellor thought that employers would complain about the extra tax burden rather than the administrative implications of the tax.

4. In further discussion of this point, it was noted that the change implied removing the burden from a large number of employees, and placing it on a small number of employers. There should be administrative savings for the Revenue from such a change.

5. The Chancellor said that the wider approach would involve a shift towards self-assessment by companies. This was consistent with the Government's wider tax objectives.

6. The Chancellor said that the need to simplify valuation rules, and for Revenue staff to be willing to help would not be



significantly different from the present discussions between the Revenue and those employers operating dispensations.

7. The Chancellor confirmed that the wider tax should be pursued. No further work should be done on a 3-pronged narrower tax. The Chancellor agreed that there would be an extra tax burden on companies. He thought it impossible to introduce the new tax without a corporation tax offset. Since the cost ex-ante was £600 million a reduction of 2% in 1990 was implied. He did not wish to make a greater reduction at this stage, since companies could always 'cash out' many benefits. But he noted the Economic Secretary's observation that the gross additional tax burden would amount to £1½ billion.

8. The Chancellor said that the proposed change would provide a route for dealing with the undervaluation of car benefits. But it would not be appropriate to deal with this simultaneously with the introduction of legislation for the new tax; it could be considered in 1989.

9. The Chancellor said that the tax should be set at 50% and should be non-deductible for CT purposes. This decision should be subject to a further note on the yield, distribution, and behavioural effects of the new tax. He invited the Revenue to prepare this note in consultation with FP.

10. The Chancellor said that the self-employed and partners should be outwith the new tax. They should continue to be taxed as now, in relation to their own incomes. Small businesses should be included in the coverage of the new tax.

11. On the exemptions listed in Miss Rhodes' paper, the Chancellor concluded that: some social/welfare benefits provided for staff generally should be exempt; benefits which were difficult to tax effectively should be exempt; some concessionary exemptions should be exempt; workplace nurseries should not, however, be exempt. Not



all the current extra statutory exemptions should in general remain ESCs, and all exemptions should be made specifically. He invited the Financial Secretary to consider further the detailed treatment of particular benefits, including the options for car parking.

12. The Chancellor said that his provisional view was that the FBT should be supported by the schedule F system. The Revenue should first confirm, however, that this would be the cheapest to administer.

13. The Chancellor did not wish to pursue the possibility of an additional charge on higher rate employees who received benefits.

14. The Chancellor said that, if the change were to be introduced, it should follow the pattern of these decisions. He invited those present to say whether, in view of the provisional conclusions reached, the tax should be introduced. Following a tour de table a clear consensus emerged in favour of introducing the tax. It was agreed that this should be considered a firm starter for next year's Budget. The Revenue were invited to instruct Counsel.



J M G TAYLOR

14 December 1987

Copies to:  
Those present.



bt 11/12



FROM: J M G TAYLOR

DATE: 10 December 1987

MR SCHOLAR

cc PS/Financial Secretary  
Mr Culpin  
Mr Cropper

**VANISHING EXEMPTION**

... I enclose a note from the Financial Secretary to the Chancellor.

2. The Chancellor *would* be grateful for urgent comments from you, Mr Culpin and Mr Cropper.

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

J M G TAYLOR

JMGT  
→  
SCHOLAR  
10/12



FST-SCOTT  
SELF  
EMPLOYED  
NICS  
11 DEC.

42/2.BTW.1234/35

CONFIDENTIAL

*ppp*



cc: *ppp*  
PPS, CSTT  
Sic. P. Middleton  
Sic. T. Buens  
Mr. Byatt  
Mr. Cassell  
Mr. March

Treasury Chambers, Parliament Street, SW1P 3AG

Nicholas Scott Esq MP  
Minister of State for Social Security  
and the Disabled  
Department of Health and Social Security  
Alexander Fleming House  
Elephant and Castle  
LONDON  
SE1 6BY

Miss. Peirson.  
Mr. Scholok  
Mr. Culpin  
Mr. Riley  
Miss. Sinclair

11 December 1987

Mr. Gibson  
Mr. Macpherson  
Mr. Cleppel  
Mr. TykIE  
Mr. Call  
Mr. MAEE PL

*Dear Nick*

**NICS: SELF EMPLOYED**

Thank you for your letter of 16 November.

I very much welcome your proposal that further work should be done on the possibility of merging the class 2 and class 4 contributions. As you say, this would offer considerable advantages. I would like Treasury officials as well as those from the Revenue to be associated with this further work.

As you point out in your letter, officials will need to consider a number of both policy and operational matters before they are in a position to report to us. Some changes in the NIC rules may be necessary if a merger were to offer a worthwhile simplification. As we are now well into Budget preparations, I doubt whether it will be feasible for this work to start until after the Budget. I think we ought, therefore, to expect a report sometime next Autumn rather than in mid-year as you suggest.

I am sending a copy of this letter to David Young.

*Mr. Marshall PL*  
*PS/PL.*  
*Y*  
*N*

**NORMAN LAMONT**





Inland Revenue

Policy Division  
Somerset HouseFROM: B A MACE  
DATE: 11 DECEMBER 1987

Copy no 1 of 26

1. MR ISAAC *11.12*
2. CHANCELLOR OF THE EXCHEQUER

NATIONAL INSURANCE CONTRIBUTIONS: OUTSTANDING ISSUES

1. You have been considering the proposal (originally discussed in Mr McIntyre's submission of 18 November) to abolish the present tax relief on 50 per cent of the Class IV contributions paid by the self employed. The resulting revenue yield would be used to finance either a reduction in Class II contributions or an increase in the LPL. The Financial Secretary's minute of 7 December mentions that raising the LPL would have little effect on DHSS or Revenue manpower.

2. Since Mr McIntyre's original submission was prepared we have been doing further work on the possible effect of CODA on the procedures for giving Class IV relief, and how far we can use the new computer system to carry out automatically the work processes which are so staff intensive under the present manual system. In

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 Mace  
Mr Boyce  
PS/IR



the light of this further work, we now think that, once CODA is fully in operation, it should be able to handle automatically virtually all the work of giving tax relief for Class IV NIC.

3. The effect, therefore, is that abolition of the Class IV relief would save 80 staff but that, without abolition, nearly all these savings would come through in any event as a result of CODA (60 by 1/4/89 and the balance in 1989/90).

4. In a similar way, once CODA is in place, the work of tax office staff in calculating the actual amount of Class IV contributions due would be substantially reduced. So there would be only a very small staff saving for us in taking some 360,000 self employed out of the Class IV charge by raising the LPL to £6,400.

B A Mace

B A MACE



FROM: J P MCINTYRE  
DATE: 14 December 1987

CHANCELLOR (1)

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

MEETING WITH MR MOORE, WEDNESDAY 16 DECEMBER:

NATIONAL INSURANCE CONTRIBUTIONS

ADDITIONAL PERSONAL ALLOWANCE

Your postponed meeting with Mr Moore has now been fixed for 16 December. This brief covers NICs and the APA.

NICs

2. At your meeting with officials on 19 November, you envisaged consulting Mr Moore in two stages. You would tell him first about cuts in employees' NICs at the lower end. But you preferred not to consult him about the other changes, notably UEL abolition, until just before Christmas. Since then, of course, Mr Moore's illness has prevented any meeting.

3. In view of the delay, we recommend that you now tell Mr Moore about all your NICs plans on Wednesday. As I explained in my minute of 23 November, we need to consult DHSS



a. to make sure that any operational or policy considerations we have not identified are picked up, so they can be resolved in time to allow an October 1988 start; and

b. so that work can begin in preparing a Social Security Bill, for early introduction after the Budget. DHSS cannot instruct Parliamentary Counsel until the Lord President has agreed it should be included in the legislative programme. The Bill may be relatively simple. But until DHSS and Parliamentary Counsel have considered what is involved, we cannot be certain of that.

4. Without consulting DHSS we cannot be sure that the October 1988 timetable can be delivered or at least that the changes will be managed as smoothly as they ought to be.

5. Of course, we will do all we can in consulting DHSS officials to protect the security of your plans. Initially, Mr Mace and I would 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. It may be that Mrs Bowtell and Mr Fanning would tell us that 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. We propose to extend the Task Force arrangements to the limited number of DHSS officials who have to be involved.



7. The changes at the lower end are set out at Annex A, and a list of the other changes is at Annex B.

#### Self Employed NICs

8. Mr Scott wrote to the Financial Secretary (16 November) proposing further work by officials on simplification of self employed NICs. The Financial Secretary has now replied (11 December). At present, the Revenue collect Class 4 contributions and DHSS Class 2. The main proposal to be examined would be a single profits-related NIC collected by the Revenue. Mr Scott proposed that officials should prepare a report for Ministers by the middle of next year.

9. The Financial Secretary's reply welcomed the idea of a study and said he was content for further work to be done. But Budget preparations were bound to be a heavy drain on Revenue time in the next few months so that it would be better to leave the work until after the Budget, aiming for completion by the Autumn of next year.

10. Mr Moore might mention this, though I understand that DHSS are happy with the Financial Secretary's reply including the delayed timetable. You could tell Mr Moore that your current proposals for the self employed would not rule out a merger of Class 2 and Class 4 in the longer term.

#### Additional Personal allowance (APA)

11. You wrote to Mr Moore on 16 October giving him the assurance he had sought on the public expenditure consequences of a decision to convert APA into benefit. Officials from DHSS, Treasury, and Revenue are now working on a report for Ministers setting out the options, which we aim to have ready by the end of the year.

12. You will recall that your main objective is to remove the tax penalty on marriage arising from the fact that APA can be claimed by each partner in an unmarried couple bringing up two or more children. By contrast, the married man's allowance available to a married couple is the equivalent of only one APA plus the single person's allowance. This means that a two earner unmarried couple



with two children are entitled to allowances of £7,590 (over three times the single person's allowance) compared with allowances of £6,220 for a two earner married couple (2½ times the single allowance). It is not necessary to do anything about APA as a result of introducing independent taxation. It could remain, but you asked us to consider its replacement by benefit as a means of getting rid of a tax penalty on marriage.

13. The official group is looking at a number of options for dealing with what is a relatively small-scale problem - only around 25,000-50,000 unmarried couples are thought to claim two APAs; the number is probably nearer the bottom of this range. In this context, conversion of APA into benefit could be a sledgehammer to crack a nut. Moreover, it would have disadvantages:

- i. higher taxation payable by current APA claimants;
- ii. higher public expenditure on social security benefits - at odds with the government's general aim of curbing the benefit culture. And the cost of conversion on a no-loser basis would be high, because of the mis-match between people currently receiving APA and those eligible for the relevant benefits.

For these reasons, you can expect Mr Moore to be cool about the idea.

14. On the other hand, an increase in one parent benefit could in principle help to solve another problem, arising from your plans to remove tax relief on maintenance payments to children: this would mean that there would be no tax relief of any kind on maintenance paid to unmarried mothers. (DHSS are not aware of this proposal.) You have asked the Chief Secretary to consider the possibilities, and we aim to provide him with advice very shortly.

15. The other main options being considered for dealing with the APA abuse are for the Revenue to impose a cohabitation test, and



for one parent benefit and other relevant benefits to become qualifying conditions for APA. Neither is without difficulty but might be preferable to increasing one parent benefit.

16. In view of these developments, you may not want to raise APA with Mr Moore, pending the officials report. But we thought you should be aware of how the work <sup>is</sup> shaping up, in case Mr Moore should raise the subject.

17. This submission has been prepared in consultation with FP.

*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 (%)	
	<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

**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 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 public expenditure savings (roughly £50 million in 1989-90) as a result of these benefit reductions.



**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. [For consideration: Tax relief on 50 per cent of Class IV contributions to be abolished. In return, LPL to be raised from £4,750 to £6,400; this will take 360,000 people out of Class 4 contributions.]

**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 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.



(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



SECRET



NOTE OF A MEETING HELD IN THE  
CHANCELLOR'S ROOM HM TREASURY  
AT 11.30 AM ON MONDAY 14 DECEMBER

Present:

Chancellor  
Chief Secretary  
Financial Secretary  
Economic Secretary  
Sir P Middleton  
Mr Byatt  
Mr Cassell  
Miss Sinclair  
Mr Instone  
Ms Hay  
Mr Cropper  
Mr Tyrie  
Mr Call

Mr McGivern - IR  
Mr Elliott - IR

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**TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION**

Papers: Mr Cropper's minute of 11 December to the Chancellor; Financial Secretary's minute of 9 December to the Chancellor; PS/Chancellor's minute of 23 November to PS/Financial Secretary; Mr Cassell's note of 19 November to the Chancellor, and enclosed report.

2. The Chancellor was most grateful to Mr Cassell for chairing the Inter-departmental Group, and for producing such a lucid report. He noted that the Financial Secretary had held a meeting on the report, and had concluded that targetted grants were preferable to tax concessions as a means of encouraging the development of the private rented sector. His own preliminary view was that there was a case for taking some action. But he was extremely reluctant to follow the grant route, since it was



uncertain where this might lead. His own preference was for the tax route.

3. Continuing, the Chancellor noted that the true objection to writing down allowances lay in their cost. Writing down allowances were the logical solution, should the tax route be followed. But if they were introduced, would it be possible to hold the line and not extend them to commercial property?

4. Mr McGivern estimated that in the shorter term the cost of extending writing down allowances to commercial property might be in the £100 million range. He would look further at this. But he saw a more substantive objection to this proposal, in that extending this relief to dwelling houses would provide a tax incentive for investing in an asset which would be likely to appreciate in real terms over the first 25 years or so.

5. Mr McGivern said that one way of holding the line would be to make the allowance available only for new buildings or "substantial reconstructions". But the owner might dispose of his property rather than continuing to rent it out. The Chancellor noted that this risk existed under the present system. Confining the relief would reduce overall and deadweight costs, and relieve pressure for further extensions. It might, on the other hand, be attacked on grounds of unfairness.

6. In further discussion, the following points were noted;

- (i) if a writing down allowance were pursued, thought would need to be given to its schedule. A straight line allowance seemed the most appropriate method;
- (ii) attaching a writing down allowance to "new lets" would cause difficulties because of the need to determine historic cost;
- (iii) a writing down allowance would replace the existing allowance linked to the assured tenancy scheme.



7. The Chief Secretary said that the tax route was preferable to the public expenditure route. Few of the tax options in the paper were attractive, but writing down allowances were defensible. The Economic Secretary noted that any proposal would, to be fully effective, need to offset the central bias in the housing market, ie the absence of taxation under schedule A.

8. Mr Cassell said that if a writing down allowance were introduced it would only half close the yield gap. Mr Ridley would be likely, therefore, to press for sideways relief also to be introduced. This would go too far. If the tax route were pursued, therefore, he would prefer to make use of the BES.

9. Mr Tyrie noted that exemption (up to a fixed ceiling) of rental income from letting a room in one's own home was one option. This seemed the right psychological gesture to make to encourage a change in sentiment towards the idea of letting property. If it were thought desirable to go further, the BES seemed sensible: BES concessions could always be removed at a subsequent stage. The Economic Secretary suggested that a "half BES" might be appropriate. It could be more attractive than a 4 per cent writing down allowance, because of the front loading of tax relief. The Chancellor noted that the shortage of accommodation would be at its worst in about 5 years. A "front loaded" relief, such as BES, had advantages in dealing with this.

10. Summing up, the Chancellor concluded that though a writing down allowance seemed best in logic, it would be unlikely to suffice and would also lead to pressure for extension to commercial property. It should therefore be ruled out. There might be some attractions in a (suitably circumscribed) extension of the BES. The exemption for rental income shall also be examined further. He invited Mr McGivern to take these options forward, consulting with FP, LG and Mr Byatt as appropriate. This further work should consider both a full BES, and a half BES, as suggested by the Economic Secretary. Limits on BES relief should also be explored. Mr McGivern undertook to provide advice by the end of the year. The Chancellor would discuss the possibilities with Mr Ridley early



in the New Year. If a package along these lines were included in the Budget, the Revenue would need to prepare suitable publicity.



J M G TAYLOR

14 December 1987

Distribution:

Those present  
Paymaster General  
Sir Terence Burns  
Mr Scholar  
Mr Culpin  
Mr Painter - IR  
PS/IR





FROM: J M G TAYLOR  
DATE: 14 December 1987

MR CROPPER

cc PS/Financial Secretary  
Mr Scholar  
Mr Culpin

### VANISHING EXEMPTION

The Chancellor has seen your note of 10 December.

2. He is not sure that the IFS would undoubtedly make fun of the marginal tax rate/income diagram arising from the vanishing exemption. The US tax reform - about which everyone raved - does this to an even greater extent: the marginal tax rate goes 15-28-33-28.

3. But even if the IFS did make fun of it, so what?

4. This can be discussed at Chevening.

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

J M G TAYLOR

JMG  
7  
CROPPER  
14/2



CH/14/25

meeting will be about  
1 1/2 hours long.



15/12

CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	INDEPENDENT TAXATION
DATE AND TIME	TUESDAY 15 DECEMBER 4:00 PM
VENUE	Chancellor's Room, Treasury/ <del>No. 11/Conference Room/House of Commons</del>
PAPERS	Papers to follow
THOSE ATTENDING	<p> <i>CVT</i>  FST  PMG  EST  Sir P Middleton  Sir T Burns  Mr Echolar  Ms Sinclair    Mr Culpin  Mr Cropper  Mr Tyrie  Mr Battishill + TEAM - Inland Revenue  Mace? </p> <p style="text-align: right;"> cc. CST:  Mr Casell  Mr A Allan  Mr A Hudson </p>





Inland Revenue

TASK FORCE SECRET

Copy No 1 of 26  
The Board Room  
Somerset House  
London WC2R 1LB

FROM: A J G ISAAC  
15 December 1987

CHANCELLOR OF THE EXCHEQUER

NATIONAL INSURANCE CONTRIBUTIONS AND  
ADDITIONAL PERSONAL ALLOWANCE

1. Might I briefly underline one point in Mr McIntyre's brief to you of 14 December, for your meeting with Mr Moore tomorrow.
2. So far we have been looking at the prospect that an increase in one-parent benefit (OPB) could be necessary to achieve two objectives:
  - ending the tax penalty on marriage, arising from the misuse of the additional personal allowance and

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

Mr Battishill  
Mr Isaac  
Mr Lewis  
Mr Corlett  
Mr Mace  
Mr C Stewart

PS/12



- compensating children and unmarried mothers, who might otherwise lose out on the reform of tax relief on maintenance payments.

3. At this stage, Treasury Divisions are (quite correctly) looking at each proposal on its independent merits, and are clearly worried in each case by the implied increase in public expenditure. But I imagine that you will not wish to take "no" for an answer from Mr John Moore, until you have had a chance to take a broader view and satisfy yourself whether there is an adequate alternative to an increase in OPB in the context of the two (quite different) proposals taken together.

*clen*

A J G ISAAC





Ch;

## Agenda.

- 1) NICs and APAs ;
- 2) Child Benefit - should the review cover taxation / means testing ?
- 3) Ways of improving the internal market in the NHS.

Briefs on each of these are included behind each divider. On 1), Mr McIntyre suggests that you may wish to expose the whole NICs package, but that you may prefer not to raise APAs. Mr McIntyre is not, of course, aware that the NICs package may be revised, especially by retaining the UEL.

You may like to express the NICs proposals in suitably tentative terms.

JF  
15/11





Ch

Mr Moore is v unhappy  
about terms of reference for  
Child Benefit review not  
covering tax (you'll see  
CST was v keen that it  
shouldnt cover tax CB &  
you had earlier ruled at CTA).

His officials want him to  
write to you. But easier to  
con this @ Waterloo.

AA



TASK FORCE SECRET

COPY NO OF 13

FROM: A G TYRIE

DATE: 15 DECEMBER 1987

CHANCELLOR

cc Chief Secretary  
 Financial Secretary  
 Paymaster General  
 Economic Secretary  
 Sir P Middleton  
 Mr Anson  
 Mr Scholar  
 Mr Culpin  
 Mr Cropper  
 Mr Call

TYRIE  
 TO  
 CX  
 15 DEC

CHILD BENEFIT: MEETING WITH MR MOORE

I don't see much chance of getting means testing of child benefit. When it came to the crunch the manifesto pledge would rule it out.

So if we are going to do anything on child benefit I see no alternative but the tax system, even though it doesn't help with the public expenditure totals.

What about taxing child benefit in the hands of higher rate tax payers only? The yield would only be £120 to £150 million, depending on the new top rate, post budget. But it might just be wearable, politically, in a year in which a great deal was being done for top rate payers. [Incidentally, I think it would be preferable to counterweigh our generosity to higher rate payers with this than with vanishing MCAs!]

We would have seized a big prize if we established the principle that child benefit was not universal.

In sum, with tax excluded, the review is bound to run into the ground. There is a chance, albeit small, of it getting somewhere with tax included.

AGS.

A G TYRIE



FROM: J P MCINTYRE  
DATE: 15 December 1987

CHANCELLOR ←

cc Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Mr Anson  
Mr Kemp  
Mr Scholar  
Mr Culpin  
Miss Peirson  
Mr Turnbull  
Mr Gibson  
Mr Cropper  
Mr Tyrie  
Mr Call

MEETING WITH MR MOORE, WEDNESDAY 16 DECEMBER: CHILD BENEFIT

I understand from DHSS officials that Mr Moore is likely to raise the terms of reference for the review of child benefit.

2. The draft terms of reference, drawn up by DHSS officials but not at that stage put to their Ministers, were discussed in my minute to the Chief Secretary of 14 October (copy attached). Mr Moore was expected to write shortly afterwards, but this has been delayed by his illness.

3. The point Mr Moore will want to tackle you on is taxation. He believes that taxation of child benefit and restoration of child tax allowances (CTAs) ought to be considered by the review. He does not necessarily favour either of these options but believes that the review's conclusions will carry less weight if these possibilities have not been examined. He also feels that the PM would be hostile to other reform measures, such as means testing, unless she were convinced that CTAs had also been properly considered.

MACINTYRE  
TO  
CX  
15 DEC



4. Ms Ryding's minute of 16 October recorded your view that it was essential that the review does not cover CTAs, because it affected the whole structure of the personal tax system. You did not mind the review covering taxation of child benefit, but the Chief Secretary (Ms Rutter's minute of 20 October) would prefer taxation not to be covered since he regards the purpose of the review as looking at ways of reducing public expenditure.

*Jm*

J P MCINTYRE



FROM: J P MCINTYRE  
DATE: 14 October 1987

CHIEF SECRETARY

cc Chancellor  
Financial Secretary  
Sir P Middleton  
Mr F E R Butler  
Mr Anson  
Miss Peirson  
Mr Scholar  
Mr Turnbull  
Mr Gibson  
Mr Cropper

**CHILD BENEFIT: REVIEW**

You agreed with Mr Moore during the bilaterals that officials should carry out further work on the reform of child benefit. DHSS officials have now given us a draft of the terms of reference for the review, which they plan to put to their Ministers at the weekend. They have asked if we have any comments, stressing that it is very much a first shot and without prejudice to their Ministers' views. It would be helpful if you could let us know tomorrow (Thursday) whether you agree with what we propose to say.

2. We have the following comments on the draft (for ease of reference, I attach a marked-up copy of the draft as well as the original version).

Preamble

3. The reference to targeting as an objective should be deleted if we want the review to cover the possibility of a lower rate (eg for 2nd and subsequent children or for all children). This would not of course target assistance on those who need it most. But I think we ought to keep the option open: it would be more easily reconciled with pre-election pledges and would be administratively simpler (thus enabling savings to be made earlier).



Para 3

4. This raises the question of whether we allow the review to consider taxation of child benefit and restoration of child tax allowances (CTAs). DHSS officials tell us that Mr Moore is convinced that the PM would be hostile to other reform measures, including means testing, unless she were convinced that CTAs had also been properly considered. On the other hand, the 1984-85 review of benefits for children and young people came down against the idea of giving people a choice between child benefit (to help non-taxpayers) and tax allowances on the grounds that it would:

- (i) benefit higher rate taxpayers;
- (ii) involve heavy staff costs;
- (iii) add to the PSBR (1984-85 estimate: £100 million)
- (iv) go to fathers rather than mothers in the case of many CTAs.

Treasury Ministers endorsed this conclusion.

5. On balance, I would try to persuade DHSS to omit CTAs from the scope of the review. Although they would produce public expenditure savings they would probably be small in relation to the total cost of child benefit (£4<sup>3</sup>/<sub>4</sub> billion this year), because only higher rate tax payers would have an incentive to switch to CTAs. Moreover, they would add to the PSBR and have the other disadvantages listed above. And if the PM or other colleagues ask about them, we can refer back to the 1984-85 work. Their omission would also help to sharpen the focus of the review on the measures we are really interested in.

6. The 1984-85 review also rejected taxation of child benefit. As taxation would also have the disadvantage of producing no public expenditure savings, you may agree that we should continue to take the line that it should be ruled out.



7. Instead of taxation and CTAs, paragraph 3 of the draft needs to refer to differential rates, as the alternative to means testing.

Para 4

8. We need to complete the review of APA ahead of the other work, so that a decision on conversion into benefit could be announced in the next Budget, assuming that is what Ministers choose to do. DHSS officials agree that, if necessary, an interim report on APA could be produced.

Para 7

9. A report to Ministers by end-February would fit with Mr Moore's proposal, in his letter to you of 25 September that the work be ready "before the next Survey". I do not think we need dissent from the end-February date. But we will need to watch the handling of the issue after that. On the one hand, early completion of the review would be good in so far it would enable earlier decisions, earlier implementation and earlier savings. But on the other, there could be advantage in putting the conclusions of the review to the PM and other colleagues during the Survey in the context of the large and growing expenditure on social security generally. This might point to some delay before approaching colleagues, until the summer for example, when we will know the size of Mr Moore's bids.

General

10. The draft makes no reference to the possibility of abolition, with some compensating action being taken to increase family credit (to help low income families in work) and the children's allowances and family premia in Income Support (for those out of work). I think there is a good case for this being considered in the review.

11. It could of course involve a large reduction in the number of families receiving child support: around 1.8 million families are



expected to receive income-related benefits next year, compared with 6.8 million families receiving child benefit. However, if this were thought too great a reduction, the rules for family credit (currently expected to go to about 450,000 working families next year) could be changed so as to enable more families to become entitled to it.

12. Abolition would have administrative advantages, compared with means testing child benefit, because we would be building on existing means testing machinery rather than creating a new system. This might enable us to go ahead earlier. A more generous family credit would also alleviate the poverty trap for many working families on low incomes.

13. We would welcome your views on this option and whether you would like us to suggest to DHSS now that it be included within the terms of the review. If you want a little longer to think about it, we would simply give DHSS the other comments on their draft and say that Treasury Ministers may have further comments when Mr Moore writes.

#### Conclusions

14. If you agree, we will go back to DHSS officials with the comments shown on the draft attached. We would also be grateful to know whether you would like us at this stage to propose that the possibility of abolition be considered in the review, with compensating action for those on income-related benefits.

15. Mr Moore is likely to write to you shortly, proposing the terms of reference.

*Jm*

J P MCINTYRE



Having regard to Ministers' objectives of achieving public expenditure savings and of removing support from well off families and targetting it on the poorest,

1. to devise and cost a system or systems for means-testing child benefit, including access to tax information, at a number of different income levels
2. to identify and make costed proposals for dealing with the consequences for other benefits (eg one-parent benefit, child dependency additions, income-related benefits)
3. to identify and cost other possible options including taxation and tax allowances for better targetting of child maintenance
4. to review the options for abolishing, adapting or replacing the additional personal allowance
5. to assess the operational consequences, including the use of information technology
6. to consider the costs and benefits of the options including their implications for incentives/dependency and family incomes and consequences for other benefits and operational considerations
7. to report to Ministers by the end of February 1988



Having regard to Ministers' objectives of achieving public expenditure savings <sup>to offset the continuing increase in</sup> ~~and of removing support from well-off~~ <sup>benefit expenditure</sup> families and targetting it on the poorest,

1. to devise and cost a system or systems for means-testing child benefit, including access to tax information, at a number of different income levels
2. to identify and make costed proposals for dealing with the consequences for other benefits (eg one-parent benefit, child dependency additions, income-related benefits)
3. to identify and cost ~~other possible options~~ <sup>for different</sup> ~~taxation and tax allowances for better targetting of child~~ <sup>rates of child benefit, payable in respect of different numbers of</sup> ~~children~~ <sup>children</sup> ~~maintenance~~
4. to review the options for abolishing, adapting or replacing the additional personal allowance; <sup>an interim report on this issue to be produced by end-November.</sup>
5. to assess the operational consequences, including the use of information technology
6. to consider the costs and benefits of the options including their implications for incentives/dependency and family incomes and consequences for other benefits and operational considerations
7. to report to Ministers by the end of February 1988



*I'm afraid to do in this. Withholding at tax is not to be done for 1988. CHANCELLOR*

*Withholding tax back in the bible for Chevening? (I have doubts: although X is right, the losers vs. handout to the rich problem with introducing w/h tax this year is as alive as ever)*

CHANCELLOR

FROM: A G TYRIE

DATE: 16 DECEMBER 1987

cc Chief Secretary  
 Financial Secretary  
 Mr Cropper  
 Mr Call

WITHHOLDING TAX ON INVESTMENT INCOME

*14/12*

I was sorry to see this proposal bite the dust as a starter for this year.

Nonetheless I don't think we can ignore the withholding tax this year. Our decisions on CGT this year interacts with it. There would be a lot to be said for aligning the CGT rate with any flat rate withholding tax. It would look very curious to move from a flat rate CGT this year to a two rate system and then back to a one rate system only a year later in the context of a flat rate withholding tax.

I think this points to considering the withholding tax proposal alongside the CGT proposal at Chevening.

*M. May*

*ppp* A G TYRIE





COPY NO 6 OF 7

FROM: J M G TAYLOR  
17 December 1987

MR TYRIE

cc PS/Chief Secretary  
PS/Financial Secretary  
Mr Cropper  
Mr Call**WITHHOLDING TAX ON INVESTMENT INCOME**

The Chancellor has seen your minute of 16 December.

2. His decision stands: withholding tax is off the menu for 1988, and will not, therefore, be considered afresh at Chevening.

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

J M G TAYLOR



CONFIDENTIAL



FROM: P D P BARNES  
 DATE: 17 December 1987

*P.D.P.*

PS/CHANCELLOR

cc PS/Financial Secretary  
 Mr Scholar  
 Mr Culpin  
 Mr C J Riley  
 Miss Sinclair  
 Mr Williams  
 Miss Hay

*Ch/Content?*

*OK - 18/12*

Mr Jenkins - Parly Counsel

Mr Painter - IR  
 Mr Johns - IR  
 Miss Hill - IR  
 Mr Beauchamp - IR  
 PS/IR

**BS353 : CAPITAL GAINS AND FARM OUTS**

The Economic Secretary has discussed Miss Hill's submission of 10 December with officials.

2. For the reasons set out in Miss Hill's submission, the Economic Secretary recommends that the CGT relief proposed for pre-Annex B work-programme farm-outs should be extended to pre-Annex B licence swaps, and that any consideration which is deemed to have a nil value for CGT purposes should be treated as having a nil value for capital allowance purposes also.

3. The Economic Secretary would be grateful to know whether the Chancellor would be content for him to instruct Parliamentary Counsel to draft clauses along these lines, and for Revenue officials to discuss the details in confidence with the oil industry.

*PR*

P D P BARNES  
 Private Secretary





## Inland Revenue

Policy Division  
Somerset House

FROM: B A MACE

DATE: 17 DECEMBER 1987

copy no 1 of 9

*get cost of 24/44,  
with the threshold  
of £18,700*

1. MR ISAAC *Seen in draft BAm*
2. CHANCELLOR OF THE EXCHEQUER

*Ch / Copied at this stage only to  
Mr Scholar + Mr Culpin in HMT.*

*17/12*

TAX REFORM: INCOME TAX

1. You asked for information on options for 1988-89 involving
  - (i) retention of the UEL/UPL;
  - (ii) a basic rate of 25 per cent;
  - (iii) a single higher rate of either 40 per cent or 45 per cent with the higher rate threshold set at a level so that the overall cost of the package is the same as Option D of my submission of 17 November.
2. For this note we have looked at options with the same full year costs as Option D. At 1988-89 income levels this is just over £4.1 billion on top of indexation. For the same cost it would be possible to introduce income tax rate structures as follows:

Option H1

Basic Rate: 25 per cent

Higher Rate: 40 per cent

Higher Rate Threshold: £17,100 of taxable income (compared with £17,900 in 1987-88)

cc Mr Scholar  
Mr CulpinChairman  
Mr Isaac  
Mr Beighton  
Mr Calder  
Mr Mace  
PS/IR



Option H2

Basic Rate: 25 per cent

Higher Rate: 45 per cent

Higher Rate Threshold: £20,600 of taxable income

Option H1

3. Table 1 shows the distribution of gains from Option H1 in 1988-89 compared with 1987-88. There are no losers under this option. (Some taxpayers would be brought into higher rate tax but their gains from the basic rate cut would more than offset their additional higher rate liability.) For those with gross incomes up to £16,000 gains under Option H1 are the same as under Option D (without phasing) (see Table 3 of my note of 17 November). For those with incomes between £16,000 and £25,000 gains are on average larger under Option H1. Above £25,000 gains are on average lower under Option H1.

4. The first year (1988-89) cost of Option H1 would be about £3.3 billion, some £0.2 billion less than the cost of Option D (without phasing). This is because the yield from the abolition of the UEL in October 1988 under Option D comes in rather more slowly than the yield from the higher rates under Option H1.

5. Option H1 does, however, involve a reduction in the higher rate threshold (to £17,100 of taxable income) compared with both its current (1987-88) level of £17,900 and its indexed level of £18,700. There would be about 1.6 million higher rate taxpayers under Option H1 compared with about 1.3 million under indexation, about 1.2 million in 1987-88 and about 700,000 under Option D.

6. Setting the higher rate threshold at the indexed level (£18,700 of taxable income) under Option H1 would avoid the increase in the number of higher rate taxpayers. This variant would cost about £4.5 billion in a full year (about £400 million more than Option H1 and Option D). The first year cost would be about £3.5 billion, £200 million more than Option H1 and about the same as the first year cost of Option D (without phasing). All those with taxable incomes above £18,700 would gain an additional £240 compared with Option H1.



Option H2

7. Table 2 shows the distribution of gains from Option H2 at 1988-89 income levels compared with 1987-88. Again there are no losers. For those with incomes up to £16,000 gains are the same as under Option D. Those with incomes between £16,000 and £35,000 gain on average more than under Option D (and more than under Option H1). Above £35,000 average gains are smaller than under Option D (and smaller than under Option H1 at the highest levels).

8. Option H2 would cost around £3.3 billion in 1988-89 (about £200 million less than Option D).

9. Under Option H2 the threshold for higher rate tax would be £1900 higher than under indexation. There would be about 1 million higher rate tax units under this option compared with 1.6 million under Option H1. The threshold for the higher (45 per cent) rate (at £20,600 of taxable income) would, however, be lower than the threshold for the present 45 per cent rate under indexation (£21,300). This means that some taxpayers would face increased marginal rates. This could be avoided by raising the higher rate threshold under Option H2 to £21,300. This variant would cost about £4.3 billion in a full year (about £200 million more than Option H2 and Option D). The first year cost would be about £3.4 billion, about £100 million more than Option H2 and about £100 million less than Option D (without phasing).

10. There would be just over 900,000 higher rate taxpayers under this variant of Option H2. All those with taxable incomes above £21,300 would gain an additional £140 under this variant, compared to Option H2.

B A Mace



Option H1: 1988-89: Gainers compared with 1987-88

## GAINERS R

Gainers ranged by total income (lower limit)

Range of total income	Amount of gain	Number of gainers	Average gain
£000s	£million	000s	£
0	1877	15401	122
15	175	780	224
16	151	625	241
17	164	634	260
18	140	504	279
19	126	435	289
20	124	406	306
21	100	316	318
22	90	271	331
23	75	219	340
24	63	181	347
25	248	653	379
30	194	369	526
35	164	204	804
40	157	128	1226
45	131	70	1859
50	1517	222	6845
TOTAL	5495	21418	257

## GAINS R

Gainers by range of income and amount of gain

Income range (lower limit)	Amount of gain (£ per year)							TOTAL
	£000s	0-50	50-100	100-200	200-300	300-400	400-500	
0	1692	4344	7656	1710	0	0	0	15401
15	0	0	216	562	2	0	0	780
16	0	0	94	515	16	0	0	625
17	0	0	47	489	98	0	0	634
18	0	0	2	342	159	0	0	504
19	0	0	1	267	166	0	0	435
20	0	0	4	179	223	0	0	406
21	0	0	0	116	200	0	0	316
22	0	0	0	58	213	0	0	271
23	0	0	0	22	189	7	0	219
24	0	0	0	12	156	12	0	181
25	0	0	0	14	446	150	42	653
30	0	0	0	1	72	110	186	369
35	0	0	0	0	3	24	177	204
40	0	0	0	0	1	1	126	128
45	0	0	0	0	0	0	70	70
50	0	0	0	0	0	0	221	222
TOTAL	1692	4344	8022	4288	1944	305	823	21418

Note: Estimates of gains exclude ACT etc effects



Option M2: 1988-89: Gainers compared with 1987-88

## GAINERS R

Gainers ranged by total income (lower limit)

Range of total income	Amount of gain	Number of gainers	Average gain
£000s	£million	000s	£
0	1877	15401	122
15	175	780	224
16	151	625	241
17	164	634	260
18	140	504	279
19	126	435	289
20	126	406	311
21	107	316	339
22	98	271	363
23	88	219	402
24	81	181	450
25	410	653	628
30	293	369	794
35	195	204	956
40	158	128	1230
45	116	70	1648
50	1187	222	5356
TOTAL	5493	21418	256

## GAINS R

Gainers by range of income and amount of gain

Income range (lower limit)	Amount of gain (£ per year)							TOTAL
	£000s	0-50	50-100	100-200	200-300	300-400	400-500	
0	1692	4344	7656	1710	0	0	0	15401
15	0	0	216	562	2	0	0	780
16	0	0	94	515	16	0	0	625
17	0	0	47	489	98	0	0	634
18	0	0	2	342	159	0	0	504
19	0	0	1	267	166	0	0	435
20	0	0	4	167	229	5	0	406
21	0	0	0	91	200	13	12	316
22	0	0	0	36	207	8	20	271
23	0	0	0	6	163	22	29	219
24	0	0	0	1	95	46	38	181
25	0	0	0	1	107	110	436	653
30	0	0	0	0	3	4	362	369
35	0	0	0	0	0	0	204	204
40	0	0	0	0	0	0	128	128
45	0	0	0	0	0	0	70	70
50	0	0	0	0	0	0	222	222
TOTAL	1692	4344	8022	4188	1446	207	1520	21418

Note: Estimates of gains exclude ACT etc effects.





Inland Revenue

Policy Division  
Somerset House

FROM: B A MACE

DATE: 17 November 1987

1. Mr Isaac

*del*  
*17.12*

2. Chancellor of the Exchequer

*Tray (A) option X (30)*  
*X (B) option X with*  
*option B1*  
*MS appns - ir*  
*opt B2*  
*MS B*  
*with phase*  
*MS B2*  
*app*  
*full hand*  
*phase.*

TAX REFORM: INCOME TAX AND NIC

1. This note sets out the latest estimates of the cost and distributional effects of the income tax and NIC (UEL/UPL abolition) changes currently under consideration. It also responds to the questions raised at your meeting on 20 October and provides information about the four variants of the package described in Mr Allan's note of 2 November. You may find the note useful for your meeting on 19 November.

MACE  
→  
CH/EX  
17/11

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

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



Basic Assumptions

2. For this further analysis we have taken account of the internal Autumn Statement forecast of changes in the economy, and estimates of the revenue effects of the proposals (and of gainers and losers) have been made for 1989-90 and 1990-91 at the levels of income forecast for those years (instead of at 1988-89 levels as before). Projections based on the 1985-86 Survey of Personal incomes are not yet available, however. We hope to take this further change on board shortly together with a facility to enable us to analyse the effect of increasing the mortgage interest relief ceiling on gainers and losers and the size of their gain or loss. For the time being therefore, the figures in this note do not take account of the further reduction in the number of losers which would be achieved by raising the mortgage interest relief ceiling.

3. The following points should also be noted:

- (i) As in my note of 29 September the tables showing the distributional analysis use unrounded estimates direct from the computer model; rounding would be needed if the figures were required for wider use.
- (ii) Changes to NICs already announced for 1988-89 have been built into the base. So distributional comparisons isolate the effect of the tax changes and abolition of the UEL/UPL.
- (iii) We have not attempted to incorporate any of the options for changes to NICs at the lower end into the analyses at this stage.
- (iv) Figures for the effect of the options on receipts assume that abolition of the UEL/UPL takes effect from October 1988. But, as before, distributional effects are shown in terms of full year tax and NIC liabilities throughout. This means that, for 1988-89, the analysis effectively



shows a comparison of the individual's weekly or monthly liability after October 1988 (against either the 1987-88 tax regime or with indexation in 1988-89 as appropriate) but with the resulting gains or losses converted to annual amounts.

(v) As before the analysis does not bring in the further effects of Independent Taxation from 1990-91.

(vi) All the estimates are, of course, liable to further revision in the light of future forecasts.

Option D (without phasing)

4. As the starting point for this analysis we look at the following option (Option D) for 1988-89:

- (i) Reduce basic rate from 27 per cent to 25 per cent.
- (ii) Raise higher rate threshold to £25,000 of taxable income.
- (iii) Above the higher rate threshold charge a single higher rate of 35 per cent.
- (iv) For employees (both contracted-in and contracted-out) charge NIC at 9 per cent above the UEL (£15,860 for 1988-89).
- (v) For the self-employed charge Class IV NIC at 6.3 per cent above the upper profits limit (UPL) with tax relief on half of this additional charge.
- (vi) Index personal allowances in line with prices (4 per cent for 1988-89).

5. For 1988-89 this corresponds to Option A (without phasing)



of my note of 29 September but with the higher rate reduced from 40 per cent to 35 per cent and with the Class IV NIC charge above the UPL for the self-employed reduced from 9 per cent without tax relief to 6.3 per cent with relief.

Costs

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

Option D (without phasing)	
Full year direct revenue costs/yield: 1988-89	
	£ billion
Reduce basic rate by 2 points* (including ACT etc effect)	- 2.80
Raise higher rate threshold*	- 1.35
Abolish higher rates above 35 per cent*	- 1.76
Additional tax relief on Class IV NIC above UPL	- 0.06
	-----
Total income tax cost	- 5.97
Less:	
Yield from abolition of UEL/UPL	+ 1.85
Net cost	----- - 4.12 -----

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



7. Comparison of this table with the corresponding table in paragraph 8 of my note of 29 September shows that the full year cost of Option D (without phasing) at 1988-89 income levels is same £800 million more than the corresponding cost of Option A. Very broadly this is caused by the further changes to the higher rate structure (costing about £700 million); the changed treatment of the self-employed (costing about £150 million); and changes in economic forecasts.

Effect on receipts

8. The table below shows the overall effect on receipts of Option D for the years 1988-89, 1989-90 and 1990-91 in money of the day terms (the basis for figures in the Budget Scorecard and the FSBR), that is at the income levels of the years concerned and, for 1989-90 and 1990-91, with both the 1988-89 indexed base and the Option D allowances and thresholds further indexed by the appropriate factors (4 3/4 per cent for 1989-90, 4 per cent for 1990-91).

Option D (without phasing)

	Effect on receipts: £ billion:		
	1988-89	1989-90	1990-91
Income tax: cost	- 4.22	- 6.60	- 7.28
NIC: yield	0.71	1.85	2.41
	-----	-----	-----
Net cost	- 3.51	- 4.75	- 4.87



Distributional Effects

A. Comparison with indexation in 1988-89

9. Table 1 (attached) shows for Option D (without phasing) the familiar picture in 1988-89, with the great majority of tax units (counting husband and wife as one) gaining. About 18 million tax units with incomes under £20,000 gain less than £200 per year on average and some 805,000 tax units with incomes above £20,000 gain more than £500 per year.

10. Table 2 shows the number of losers in 1988-89 under Option D (without phasing) compared with indexation.

11. The total number of losers compared with indexation is around 760,000 of which all but about 23,000 would be liable at the basic rate under the proposed regime. (There are very few losers liable at the proposed higher rate under any of the options discussed in this note). About 50,000 of the losers would be self-employed, the majority with total income less than £30,000 and losing less than £200 per annum.

B Comparison with retaining the 1987-88 tax regime

12. Tables 3 and 4 correspond to Tables 1 and 2 but give comparisons with the 1987-88 tax regime applied to 1988-89 incomes and therefore show cash gains and losses. The number of losers in cash terms is about 530,000 of which fewer than 10,000 would be higher rate taxpayers under the proposed regime. About 26,000 of the losers would be self-employed.

13. The table below summarises the position for both gainers and losers compared with retaining the 1987-88 tax regime in 1988-89. For those with incomes between £20,000 and £30,000 over 20 per cent are losers; while of those with incomes over £30,000 over 70 per cent gain more than £400 per annum.



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Option D (without phasing) in 1988-89  
 Percentage Distribution of Losers and Gainers by Income  
 Comparison with 1987-88 Tax Regime

Income: lower limit £000	Loss £			Gain £			Tax units (thousands)
	over 400	200- 400	less than 200	less than 200	200- 400	Over 400	
0	-	-	-	89	11	-	15,400
15	-	-	2	28	70	-	3,000
20	1	5	15	15	44	20	2,000
30	1	3	4	8	13	72	560
40	1/3	-	2/3	2	3	94	420
All	1/4	1/2	1 <sup>3</sup> / <sub>4</sub>	70	22	5 <sup>1</sup> / <sub>2</sub>	21,400

Phasing in Option D

14. In the following paragraphs we look at the effect of phasing in Option D over three years on the following pattern:

	1988-89	1989-90	1990-91
NIC charge above UEL for employees*	7%	8%	9%
Higher rate	37%	36%	35%

\* NIC charge above UPL for self employed is unchanged at 6.3 per cent throughout.



Receipts effect of Option D with phasing

15. The table below shows the effect on receipts of Option D with phasing, using money of the day and the same assumptions as in paragraph 8. Comparison of this table with that in paragraph 8 shows that phasing-in the changes in the way proposed has a minimal effect on net receipts.

Option D (with phasing)

	Effect on receipts: £ billion:		
	1988-89	1989-90	money of the day 1990-91
Income tax: cost	- 4.12	- 6.44	- 7.23
NIC: yield	0.58	1.67	2.39
	-----	-----	-----
Net cost	- 3.54	- 4.77	- 4.84

Option D (with phasing) Distributional Effects

16. For gainers who are employees the effect of phasing in the NIC change and the higher rate reduction is mainly to increase the size of the gains of those with earnings above the UEL/UPL in 1988-89 (compared with introducing the full 9 per cent charge immediately). (There might be a very few taxpayers (some of the elderly for example) with taxable incomes above the higher rate threshold but earnings below the UEL whose gains would be slightly reduced because the higher rate is initially set at 37 per cent rather than 35 per cent.) In subsequent years those with earnings above the UEL would see losses (year on year) as a result of the phasing-in of the NIC change, reducing the gains made in 1988-89. For the self-employed liable at the higher rate, gains in 1988-89 would be reduced by the 37 per cent rate but there would be further gains in 1989-90 and 1990-91.



17. The table below shows the pattern of losers compared with indexation over the three year phasing period with each of the years taken at the corresponding income level. For example, the table shows that there would be 687,000 tax units at 1989-90 income levels whose liability under the rates proposed for 1989-90 (assuming indexation of allowances and the £25,000 higher rate threshold in 1989-90) is greater than their liability under the 1987-88 regime indexed to 1989-90.

Option D (with phasing): Number of losers

Comparison with indexation: money of the day  
000s

	1988-89	1989-90	1990-91
Total	481	687	1,002
of which:			
self employed	49	49	53
higher rate	4	12	42

18. As the table shows the effect of phasing-in the NIC charge above the UEL is to reduce the number of losers compared with indexation in 1988-89 from about 760,000 (under Option D (without phasing) - see paragraph 11 above) to some 480,000. In subsequent years the number of losers compared with indexation of the 1987-88 regime rises both because of the phasing-in of the additional NIC charge above the UEL and because earnings are forecast to rise more rapidly than prices, so increasing the number of taxpayers and the total amount of earnings above the UEL. As the table shows there is a fairly steep rise in the number of losers between 1989-90 and 1990-91.



19. The table below shows losers under Option D with phasing ( and with indexation of allowances and the higher rate threshold in 1989-90 and 1990-91) compared with retaining an unindexed 1987-88 regime throughout. The figures for each year are at the income levels of that year.

Total number of losers: Option D with phasing  
Comparison with 1987-88: money of the day  
000s

	1988-89	1989-90	1990-91
Total	300	253	268
of which:			
self-employed	26	12	6
higher rate	neg	neg	neg

20. The effect of phasing-in Option D is thus to reduce the number of losers in cash terms in 1988-89 from around 530,000 (see paragraph 12 above) to around 300,000, a reduction of 230,000. In 1989-90 and 1990-91 the number of cash losers falls to about 1/4 million but this is because in making the comparison against the unindexed 1987-88 regime the phased Option D package in effect takes credit for further indexation of personal allowances and the higher rate threshold in 1989-90 and 1990-91. All taxpayers therefore gain in the comparisons from the further indexation of allowances in 1989-90 and 1990-91. The cost of indexation is about £1.5 billion in 1989-90 and about £1.4 billion in 1990-91 (full year figures).



Effect of phasing on losers

21. At the meeting on 20 October I was asked to provide a more detailed analysis of the effect of phasing on losers. For this purpose we have examined the position in 1988-89 of the 230,000 tax units who would move from being cash losers under Option D (without phasing) to become cash gainers with phasing. Nearly all of these are basic rate taxpayers (under Option D) and therefore the benefit of phasing is the reduction of 2% (from 9% to 7%) in the NIC charge above the UEL. Tables 5 and 6 show that the majority of the 230,000 tax units gain only small amounts from the phasing. Bearing in mind that the figures provide a comparison of the position post October 1988 with 1987-88 on an annualised basis (see paragraph 3(iv)) the tables show, for example, that the 40,000 with incomes between £20,000 and £21,000 move from losing £46 per year (88p per week) on average to gaining £38 (73p per week) a total gain of £84 (£1.61 per week). The amounts involved are obviously larger for those on higher incomes and the few higher rate taxpayers.

22. As you pointed out at the meeting, the effect of phasing-in the NIC change for employees is not only to reduce the number of losers, but to reduce the size of the loss of those who remain losers. This is shown in the table below. Because the Class IV NIC charge above the UPL remains at 6.3 per cent throughout the small number of self-employed losers are affected only by the phased reduction of the higher rate from 37 per cent to 35 per cent.



Losers in 1988-89 compared with 1987-88

Range of total income £000s	Option D (without phasing)		Option D (with phasing)	
	Number of losers 000s	Average loss £	Average loss £	Number of losers 000s
0	0	0	0	0
18	7	17	0	0
19	43	36	20	3
20	62	71	30	22
21	66	104	39	40
22	62	138	71	41
23	66	183	93	52
24	49	189	115	33
25	128	232	143	86
30	37	233	165	19
35	5	281	459	2
40	4	242	379	1
45	1	248	200	1
50	1	1331	1243	1
Total	533	161	105	300

Self-employed

23. As the earlier part of this note shows, the effect of charging NIC above the UPL at 6.3 per cent (with tax relief) is to reduce self-employed losers to a small number. Compared with 1987-88 there are only about 25,000 self-employed losers in 1988-89 under Option D with or without phasing.

24. If tax relief were not to be given on the NIC charge above the UPL the overall cost of Option D would be reduced by about £60 million in a full year at 1988-89 income levels. Compared



with 1987-88 the number of self employed losers under Option D (with or without phasing) would increase by about 11,000 to about 37,000 with a corresponding increase in the total number of losers.

25. ST Division will be letting you have separately a note about the option described in Mr Allan's note of 2 November (abolish tax relief on Class IV NIC and reduce Class II).

#### Further Options

26. Mr Allan's note of 2 November asked for information on four further options:

- (i) reducing the basic rate to 24 per cent rather than 25 per cent (which we have called Option E1);
- (ii) cutting the main employees' NIC rate to 8 per cent (called Option E2);
- (iii) an increase in allowances with the same full year cost as (i) (called Option E3A). The equal cost increase in allowances is 7.6 per cent;
- (iv) an increase in allowances with the same full year cost as (ii) (called Option E3B). The equal cost increase in allowances is 8.9 per cent.

27. We have assumed that each of these options is combined with the other features of Option D (without phasing) in 1988-89. We have also assumed under Option E2 that the contracted-out rebate on earnings up to the UEL remains at 2 per cent for 1988-89 (so that contracted-out employees would pay 6 per cent up to the UEL in 1988-89 and 8 per cent above this level.)

#### Costs

28. The full year costs at 1988-89 income levels of Option E1 and E2 compared with the cost of Option D (without phasing) are



about £1.5 billion\* and £1.8 billion respectively. Under Option E2 the cost of the reduction in the NIC rate in a full year almost completely offsets the full year yield from abolishing the UEL/UPL. The full year effects and the effects in 1988-89 on receipts of the four options compared with Option D are:

	£ billion	
	First year (1988-89)	Full year
Option E1	- 1.36	- 1.53
Option E2	- 0.75	- 1.78
Option E3A	- 1.22	- 1.53
Option E3B	- 1.42	- 1.78

Distributional Effects

29. Compared with Option D, (without phasing), Option E1 is worth up to an additional £250 per annum to all taxpayers. The benefit from Option E2 depends on the size of the individual's earnings and will be rather more than the effect of the basic rate cut for everyone whose income is all earned. Compared with Option D (without phasing) Option E3A is worth an additional £72.50 per annum to non-elderly married men who are basic rate taxpayers and £47.50 per annum to non elderly single basic rate taxpayers. Option E3B is worth an additional £82.50 (married) and £55 (single) to non-elderly basic rate taxpayers.

Losers

30. The table below shows the number of losers in 1988-89 (again on the basis of full year liability) under each of the Options, compared with 1987-88.

\* This is larger than the cost of basic rate reduction shown in the table in paragraph 7 because the further cut to 24 per cent is assumed to be made after raising the higher rate threshold to £25,000.



Number of losers in 1988-89: comparison with 1987-88

	000s
	Total
Option D (without phasing)	533
Option D (with phasing)*	300
Option E1	208
Option E2	148
Option E3A	351
Option E3B	332

\* 7 per cent NIC above UEL; 37 per cent higher rate.

31. As the table shows Option E1 and E2 are more effective at reducing the losers in 1988-89 than increasing allowances. Option E2 (8 per cent main NIC rate) is the most effective in reducing the total number of losers since it gives greatest benefit to those with earnings above the UEL and nothing to those without earnings, who cannot be losers from the reform. It is, however, very expensive in a full year. There is also the familiar point that allowance increases give greater proportionate benefit than rate cuts to those with the lowest incomes. Compared with indexation Options E3A and E3B would reduce the total number of taxpayers (counting husband and wife separately) by about 730,000 and 840,000 respectively. Compared with Option D, Option E3A would therefore reduce our staffing requirement in a full year by about 160 units and Option E3B by about 180 units.

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Table 1 Option D (without phasing) 1988-89 : Gainers compared with indexation

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

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	4596	4723	5457	351	0	0	0	15127
15	0	32	540	209	0	0	0	780
16	0	9	469	147	0	0	0	625
17	20	50	366	192	5	0	0	634
18	56	47	196	153	22	0	0	474
19	26	27	125	174	15	0	0	367
20	24	18	69	202	23	0	0	334
21	9	15	29	150	17	10	0	229
22	9	7	16	119	33	8	3	195
23	12	11	17	47	44	5	6	140
24	9	7	15	37	40	2	8	117
25	18	22	49	56	130	43	150	467
30	8	10	25	33	34	30	160	301
35	6	8	15	18	15	13	111	186
40	1	2	4	9	6	7	92	120
45	0	1	1	1	2	2	61	68
50	0	0	1	1	1	1	215	219
TOTAL	4794	4987	7392	1897	386	122	805	20382

## Gainers ranged by total income (lower limit)

Range of total income £000s	Amount of gain £million	Number of gainers 000s	Average gain £
0	1293	15127	85
15	135	780	173
16	111	625	177
17	108	634	170
18	79	474	167
19	70	367	189
20	71	334	211
21	53	229	230
22	50	195	255
23	36	140	256
24	33	117	280
25	218	467	467
30	201	301	669
35	167	186	899
40	156	120	1299
45	125	68	1839
50	1509	219	6892
TOTAL	4413	20382	217

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



Table 22 Option D (without phasing) 1988-89 : Losers compared with indexation

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

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	0	0	0	0	0	0	0	0
16	0	0	0	0	0	0	0	0
17	0	0	0	0	0	0	0	1
18	25	5	0	0	0	0	0	30
19	30	30	7	0	0	0	0	68
20	13	23	35	1	0	0	0	72
21	18	18	38	12	0	0	0	87
22	11	13	27	18	6	0	0	76
23	6	10	22	20	20	1	0	79
24	8	8	15	12	13	7	0	64
25	22	19	35	34	29	23	24	186
30	12	8	12	12	8	7	12	69
35	5	4	4	2	1	0	1	18
40	2	2	2	1	0	0	1	8
45	0	0	0	0	0	0	0	2
50	0	0	0	0	0	0	1	3
TOTAL	154	141	198	113	78	39	39	762

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	0	0	0
16	0	0	0
17	0	1	48
18	1	30	29
19	4	68	57
20	7	72	99
21	10	87	120
22	12	76	158
23	17	79	209
24	14	64	214
25	49	186	266
30	18	69	269
35	3	18	186
40	2	8	230
45	1	2	276
50	3	3	955
TOTAL	141	762	185

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



Table 3 Option D (without phasing) 1988-89 : Gainers compared with 1987-88

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

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	1709	0	0	0	15401
15	0	0	217	562	2	0	0	780
16	0	0	157	458	10	0	0	625
17	1	27	176	377	53	0	0	634
18	35	63	66	256	78	0	0	497
19	30	29	35	208	89	0	0	392
20	14	22	24	132	148	4	0	344
21	19	10	26	81	98	4	11	249
22	11	10	15	39	119	3	12	209
23	7	15	17	18	76	8	12	153
24	6	11	15	16	48	25	11	132
25	21	15	38	53	77	76	245	526
30	5	6	18	22	26	39	216	332
35	1	3	13	15	14	15	138	199
40	2	1	2	2	7	5	105	124
45	0	0	1	1	1	1	65	69
50	0	0	0	1	0	1	218	220
TOTAL	1842	4558	8474	3950	846	181	1034	20886

## 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	175	780	224
16	143	625	229
17	142	634	224
18	105	497	212
19	92	392	234
20	92	344	267
21	69	249	276
22	64	209	309
23	48	153	310
24	44	132	336
25	298	526	567
30	262	332	789
35	212	199	1069
40	190	124	1535
45	149	69	2159
50	1609	220	7309
TOTAL	5571	20886	267

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



## Table 4 Option D (without phasing) 1988-89 : Losers compared with 1987-88

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

Income range (lower limit) £000s	Amount of loss (£ per year)							TOTAL
	0-50	50-100	100-200	200-300	300-400	400-500	>500	
0	0	0	0	0	0	0	0	0
15	0	0	0	0	0	0	0	0
16	0	0	0	0	0	0	0	0
17	0	0	0	0	0	0	0	7
18	7	0	0	0	0	0	0	43
19	32	11	1	0	0	0	0	62
20	24	20	18	0	0	0	0	66
21	14	19	30	3	0	0	0	62
22	12	9	24	16	1	0	0	66
23	7	8	23	17	10	0	0	66
24	8	7	12	12	8	3	0	49
25	16	17	32	22	19	14	8	128
30	8	4	7	6	9	2	3	37
35	1	1	1	0	0	0	1	5
40	1	1	1	0	0	0	1	4
45	0	0	0	0	0	0	0	1
50	0	0	0	0	0	0	1	1
TOTAL	130	97	149	77	48	19	13	533

## Losers ranged by total income (lower limit)

Range of total income	Amount of loss	Number of losers	Average loss
£000s	£million	000s	£
0	0	0	0
15	0	0	0
16	0	0	0
17	0	0	0
18	0	7	17
19	2	43	36
20	4	62	71
21	7	66	104
22	9	62	138
23	12	66	183
24	9	49	189
25	30	128	232
30	9	37	233
35	1	5	281
40	1	4	242
45	0	1	248
50	2	1	1331
TOTAL	86	533	161

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



Tab 5 Option D in 1988-89 : Losers under 9% NIC rate/35% higher rate who gain under 7% NIC rate/37% higher rate

Losers ranged by total income (lower limit)

Range of total income	Amount of loss	Number of losers	Average loss
£000s	£million	000s	£
0	0	0	0
15	0	0	0
16	0	0	0
17	0	0	0
18	0	6	16
19	1	41	32
20	2	40	46
21	1	27	49
22	1	20	47
23	1	14	59
24	1	16	68
25	3	41	85
30	2	18	108
35	0	4	114
40	0	3	117
45	0	1	163
50	0	1	256
TOTAL	14	232	60

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

Income range (lower limit)	Amount of loss (£ per year)							TOTAL	
	£000s	0-50	50-100	100-200	200-300	300-400	400-500		>500
0	0	0	0	0	0	0	0	0	0
15	0	0	0	0	0	0	0	0	0
16	0	0	0	0	0	0	0	0	0
17	0	0	0	0	0	0	0	0	0
18	6	0	0	0	0	0	0	0	6
19	32	9	0	0	0	0	0	0	41
20	24	16	0	0	0	0	0	0	40
21	13	13	0	0	0	0	0	0	27
22	11	8	1	0	0	0	0	0	20
23	5	7	1	0	0	0	0	0	14
24	7	5	4	0	0	0	0	0	16
25	13	14	13	2	0	0	0	0	41
30	7	3	6	3	0	0	0	0	18
35	1	1	1	0	0	0	0	0	4
40	1	1	1	0	0	0	0	0	3
45	0	0	0	0	0	0	0	0	1
50	0	0	0	0	0	0	0	0	1
TOTAL	120	77	28	6	1	0	0	0	232

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



Tab 6 Option D in 1988-89 : Gainers under 7% NIC rate/37% higher rate who lose under 9% NIC rate/35% higher rate

Gainers ranged by total income (lower limit)

Range of total income	Amount of gain	Number of gainers	Average gain
£000s	£million	000s	£
0	0	0	0
15	0	0	0
16	0	0	0
17	0	0	0
18	0	6	44
19	2	41	38
20	2	40	38
21	1	27	42
22	1	20	49
23	1	14	50
24	1	16	59
25	4	41	92
30	3	18	148
35	1	4	190
40	0	3	130
45	0	1	159
50	0	1	238
TOTAL	15	232	65

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

Income range (lower limit)	Amount of gain (£ per year)							TOTAL	
	£000s	0-50	50-100	100-200	200-300	300-400	400-500		>500
0	0	0	0	0	0	0	0	0	0
15	0	0	0	0	0	0	0	0	0
16	0	0	0	0	0	0	0	0	0
17	0	0	0	0	0	0	0	0	0
18	5	2	0	0	0	0	0	0	6
19	27	13	0	0	0	0	0	0	41
20	28	12	0	0	0	0	0	0	40
21	15	12	0	0	0	0	0	0	27
22	10	9	1	0	0	0	0	0	20
23	7	6	1	0	0	0	0	0	14
24	6	7	2	0	0	0	0	0	16
25	13	10	15	3	0	0	0	0	41
30	2	4	8	5	1	0	0	0	18
35	0	0	1	1	1	1	0	0	4
40	1	1	1	0	0	0	0	0	3
45	0	0	0	0	0	0	0	0	1
50	0	0	0	0	0	0	0	0	1
TOTAL	115	76	30	9	2	0	0	0	232

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



FROM: J P MCINTYRE  
DATE: 15 December 1987  
18

*Yes - Tom  
for H  
Content for  
DHSS to involve  
Mr Whippman?  
15/12*

CHANCELLOR

cc PS/Chief Secretary  
Miss Peirson  
Mr Culpin  
Mr Gibson

**NICS: CONSULTATION WITH DHSS**

Following your talk with Mr Moore on Wednesday, I have arranged to see Mrs Bowtell of the DHSS this afternoon to discuss the changes at the lower end and abolition of the Treasury Supplement. Mrs Bowtell has told me she would very much like to involve a third DHSS official (in addition to herself and Mr Fanning); he is Mr Whippman of the Finance Division.

2. We know Mr Whippman well from our day to day dealings with the Department, and I think he could be relied upon. Mrs Bowtell believes it would be very helpful to have someone of his general experience involved in the discussions for the beginning. I hope therefore that you will be prepared to agree to Mr Whippman being included in these initial discussions.

*Jm*

J P MCINTYRE



Copy No. 1 of 21  
FROM: ROBERT CULPIN  
DATE: 18 December 1987

CHANCELLOR

- cc Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir T Burns
- Sir G Littler
- Mr Anson
- Mr Scholar
- Miss Sinclair
- Mr Riley
- Miss Evans
- Mr Cropper
- Mr Tyrie
- Mr Call

*W. Miller points  
allowance  
NIC stops  
Physicists on NHS  
refunds etc*

Mr Battishill: IR  
Mr Mace: IR

Mr Unwin: C&E

**TAX REFORM**

This is the tax paper for Chevening. It brings together the provisional decisions reached so far, and tries to show what the next Budget might look like, in the round. It deliberately stands back from a number of details - though it may not look it, from the length. I shall supplement it with an annotated agenda just before Chevening.

**The Prospect**

2. The 1988 Budget offers the best chance to reform personal taxes since the Government came into office. The prospect, at this stage, is as follows:

- Lower income tax across the board.

People have come to discount a basic rate of 25p, but it will be the lowest since at least the war. And if the Budget brings the top rate below the present 60 per cent, it will be the first time for at least forty years.

- A reform of National Insurance which will take from the better paid and give to the lower paid.

- Smaller tax breaks, as the allowances come to be worth less.



- **Independence for women:** complete abolition of the 180-year-old rule which treats their income as their husbands'.
- **An end to several tax penalties on marriage.**
- **A reform of capital gains tax** to end the taxation of paper gains.
- **A streamlining** of the taxation of benefits in kind, and of income transfers through covenants and maintenance payments.
- Other welcome changes, such as a **lightening of inheritance tax.**

Companies could be offered **lower Corporation Tax** by the end of the decade, giving them once again the lowest rate in the world.

3. This adds up to the **largest set of tax reductions,** in real terms, this Government has ever made.

4. The **most striking problems** are these:

- The package **raises National Insurance contributions** for nearly 2½ million people.
- It **makes hundreds of thousands worse off,** because they lose more on National Insurance than they gain on income tax.
- It **raises the marginal rate** of tax and National Insurance for about 1<sup>1</sup>/<sub>3</sub> million taxpayers.
- It gives what will be called **obscene gains** to the higher paid.
- And it will come at a time when political argument has focussed on whether Dukes should pay the same as doormen in **community charges.**



A lot of these problems will come, directly or indirectly, from the abolition of the ceiling on National Insurance contributions.

5. In addition:

- The National Insurance changes stretch the contributory principle to the limit, yet duck integration with income tax.

- The reform for married women looks nothing like the proposals the Government has advocated.

- There are awkward edges to the changes on mortgage interest relief, covenants and so on.

- There is nothing for companies next year, and they are threatened with a new tax on fringe benefits in the medium term.

- And there is nothing to tackle the emotive privileges of the pensions industry.

6. This paper goes through the package item by item, and then considers how it measures up to a number of tests. The full scorecard is at Annex A.

#### Income tax

7. All the serious options include:

- a cut in the basic rate from 27p: the realistic range is 24-26p, with 25p far the most likely

- drastic reductions in the higher rates, to a single top rate of tax, which might be phased in: the range is probably 30-40p, with 35p the front runner

- a reduction in the number of higher rate taxpayers, with a real increase in the higher rate threshold.



If the package were announced tomorrow, the only surprise here would be the boldness of the higher rate reliefs: collapsing five bands into one, at a lower rate than people are so far expecting.

8. Given the likely costs, there are bound to be familiar criticisms: a better health service is a higher priority; increases in basic allowances would be a better buy; and so on. But the answers should, by now, be at least as familiar as the criticisms.

9. The new elements this time will be:

- The UK will have one of the lowest top rates of income tax in the OECD (nominally 28 per cent in the USA, 56 per cent in Germany, and 84 per cent in Japan).

- It will have one of the simplest income tax regimes, with only two rates of tax.

- The reduction in higher rates will significantly reduce the value of tax breaks, and so make possible a more neutral system.

- It will, however, be argued that a quite disproportionate amount of the benefit goes to the very highest paid. Their gross earnings are already increasing much faster than the average; and they could see reductions of (say) 16 percentage points in their marginal rate of tax and National Insurance on earnings, and 25 points in their marginal rate of tax on investment income.

10. The setting of the top rate of tax and the higher rate threshold turn, in part, on whether the ceiling on National Insurance Contributions is to be abolished. This is discussed briefly in paragraphs 20-26 below.

cf  
23-pmc  
W.H. in a  
1979



11. This apart, the main question on income tax is whether to set a new medium-term objective - Son of 25p. Possibilities include:

- a further 20 per cent real increase in thresholds, which would cost about £4½-5 billion
- a basic rate of no more than 20p, which would cost about £7½-8 billion.

✓ Experience suggests that a public objective of this kind is helpful; and a 20p basic rate looks the best bet.

### National Insurance

12. To help finance the income tax reductions, and to meet other objectives (paragraphs 13 and 14), there are far-reaching proposals on the table to overhaul National Insurance contributions. These would:

- abolish the ceiling on contributions by employees and the self-employed
- phase in existing contribution rates above it
- reduce employees' contributions for the lower paid
- abolish the tax relief on profit-related contributions by the self-employed, and use the proceeds to reduce contributions for some or all of them - probably by raising the point at which profit-related contributions start
- abolish the Treasury supplement to the National Insurance Fund, which comes out of general taxation
- leave benefits unchanged
- leave employers' contributions unchanged.

*do, how if relevant  
NIF a stat fund?*



TASK FORCE SECRET

13. This reform would produce a smooth profile of marginal rates of tax and National Insurance, all the way from top to bottom.

- It would reduce the combined marginal rates for the lower paid.

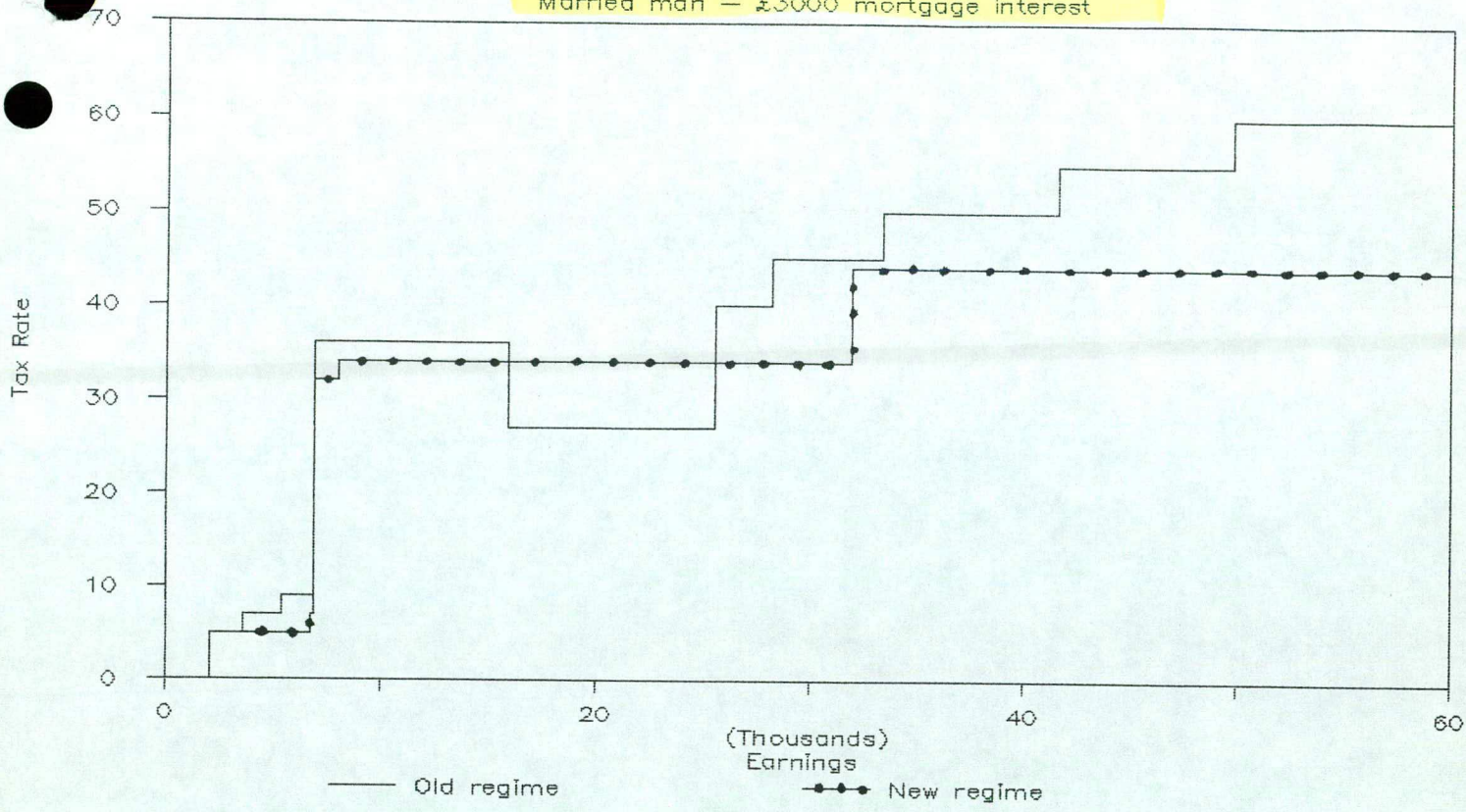
- It would remove the present "kink" in which people see their marginal rate fall at the National Insurance ceiling, only to rise sharply at the threshold for higher rate tax.

The charts on the following page show how the pictures of marginal and average rates would change.



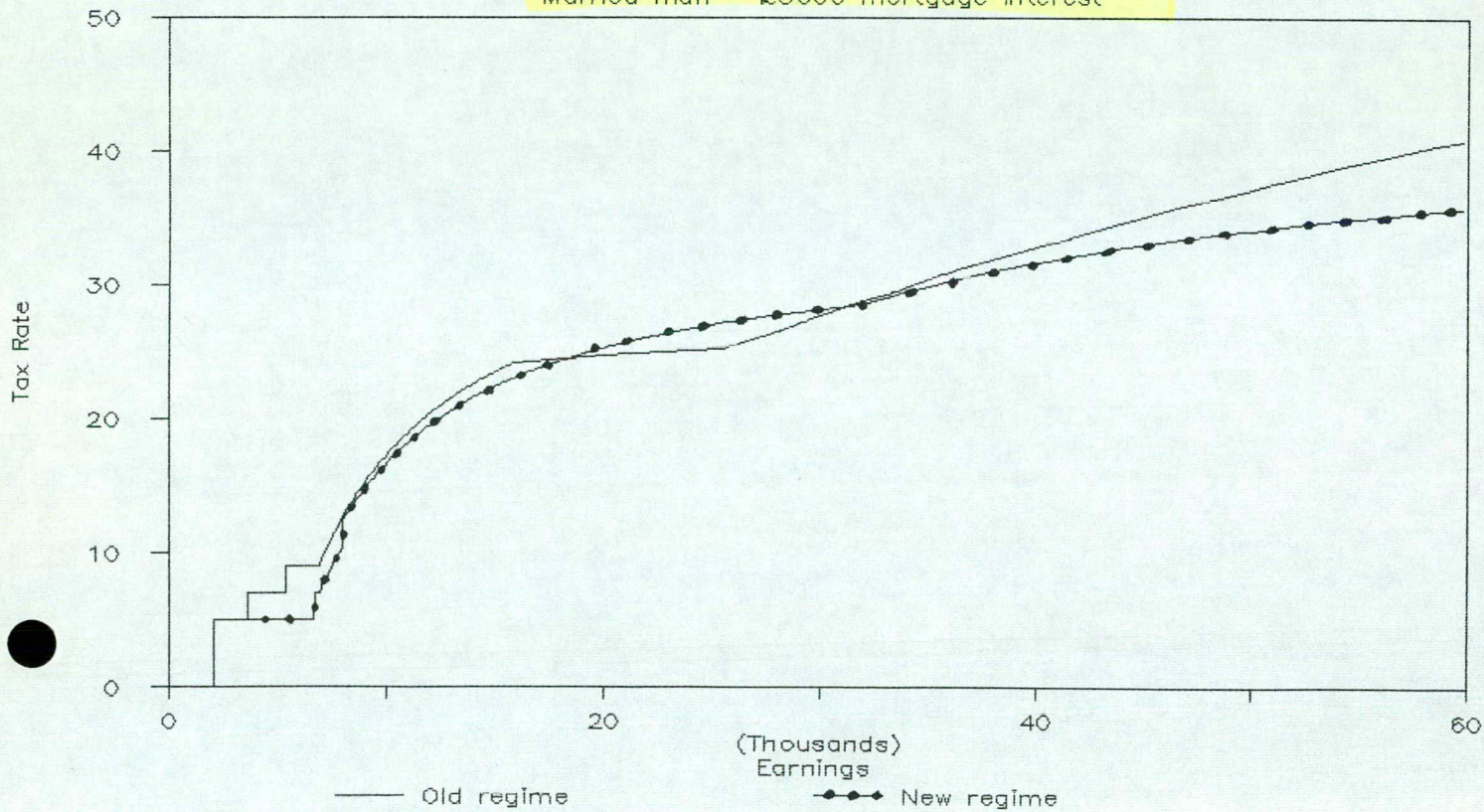
### Marginal rate of income tax and NIC

Married man — £3000 mortgage interest



### Average rate of income tax and nic

Married man — £3000 mortgage interest





14. The reform would reduce the burden on the lower paid.

- It would allow around six million to keep more of what they earn. They would gain between £1.40 and £5.20 a week in lower National Insurance contributions.

- It would get about 75,000 tax units right off means-tested benefits.

- It would help (with the basic rate reduction) take about 90,000 tax units out of the unemployment trap - about 20 per cent of the total - and about 75,000 out of the poverty trap - about 14 per cent of the total.

- It would be of particular benefit to those on about half average earnings, who have so far done least well from the tax and National Insurance changes made by this Government.

15. It can just about be said to preserve the contributory principle, in the sense that you don't get benefits without contributions.

16. But this could easily be one of the most contentious parts of the Budget. At the most general, it may look a con-trick: what you give in taxes you take in National Insurance contributions. It's tricks with mirrors - too clever by half.

17. To be more specific, we should have to answer the following charges:

- It raises marginal rates and thus reduces incentives for people with the earnings of Principals, Assistant Secretaries and MPs with only a Parliamentary salary. This includes many middle managers in the private sector. And there are well over a million people in this position.

*How do 'traps' depend?*



- It even raises average rates for people over a wide income band, as is clear from the bottom chart on page 7. It makes these people absolutely worse off.

- It puts the last nail in the coffin of the contributory principle. It is one thing to abolish the upper earnings limit for employers, as we did in 1985: there was no relation between what employers paid and what their employees received. But, so far, extra employees' contributions have bought extra benefits. That link will now be broken. And the breach will be explicit: the SERPS rules will have to say that contributions above the present ceiling buy no extra pension whatever.

- It imposes on people the main cost of integrating tax and National Insurance - you have to pay contributions throughout the income range - without the main benefit - a single, simpler system with one set of rules.

- It does nothing about the worst disincentive faced by the lower paid - that once they earn enough to go from a lower band of National Insurance contributions to a higher one, they have to pay the higher rate on all their earnings.

- It does little to smooth the untidy jumps in marginal rates which the lower paid have to face. Indeed, it moves them to points on the earnings scale where more people are affected.

- Over half the benefit goes to married women and teenagers, not those we normally think of as poor.

- Those on housing benefit and family credit gain practically nothing, because what they win on National Insurance contributions they lose on benefits.

*miss*

*50?*



18. Most of the answers are in paragraphs 13 and 14. They are simply variants of the same set of points. But the more we have to defend the National Insurance package, the more we shall be driven to acknowledge that National Insurance contributions are a tax, just like any other. We shall clearly be taking income tax and National Insurance together in trying to smooth the progression of marginal rates, and in balancing a reduction in the higher rates of income tax against an increase in the ceiling for contributions. It will be more difficult to argue that National Insurance is distinguished by being a hypothecated tax (though abolishing the Treasury supplement will help), because there will be no relation between the extra contributions levied and extra benefits. Yet we shall still be maintaining two entirely different sets of rules for income tax and National Insurance, when it is a major objective of the Budget to simplify the tax system. Critics are bound to ask why we don't go the whole hog and merge the two.

19. This was last addressed systematically in the 1986 Green Paper on the Reform of Personal Taxation. Briefly, integration would

- require new rules to be devised for entitlement to benefit
- make it more difficult to target help on low earners (paragraph 21 below)
- require either higher marginal rates or lower allowances, and
- either hit non-earning taxpayers, such as pensioners, or require special rules for them.

However, abolition of the National Insurance ceiling would remove one of the major obstacles to integration singled out in the Green Paper.



Taking contributions and tax together

20. As long as tax and National Insurance are not integrated, two main differences are particularly relevant to the design of the package.

- You only pay National Insurance on cash earnings (or profits), but income tax falls on investment income and benefits in kind as well. Investment income and benefits are therefore taxed less heavily than earnings. And if the National Insurance ceiling is abolished, this will be so over a wider range of incomes than before.

- Income tax has allowances, National Insurance contributions don't. Once you earn enough to pay National Insurance contributions, you pay them on the whole of your gross earnings (up to a limit), and not just on your taxable income.

This second feature is crucial in two respects.

21. First, it makes it possible to reduce the burden on the lower paid much more cheaply through the National Insurance than the income tax system. The benefit can be confined to them, because there are no allowances to extend it to the better-off. Reducing National Insurance contributions for the lower paid is thus the most cost-effective way of approximating to reduced rate bands of combined income tax and National Insurance.

22. Second, abolishing the National Insurance ceiling for the higher paid can have the effect of reducing the value of tax breaks. If the higher National Insurance contributions are used in part to finance a lower top rate of tax, as is proposed, people in aggregate will pay contributions against which there are no allowances in place of a tax against which there are many. Indeed, the combination of abolishing the National Insurance ceiling and reducing the higher rates of income tax may come as close as is politically practicable to the effects of confining allowances to the basic rate.



23. The following figures illustrate this for mortgage interest relief, assuming no change in the present effective £30,000 limit.

- At current tax and interest rates, it would cost about £5 billion next year. The vast bulk of this is basic rate relief. Eliminating higher rate relief would save about £370 million.

- Reducing the basic rate to 25p and the top rate to 35p, with a £25,000 threshold, would save considerably more than this - about £600 million.

- It would reduce the higher rate element in mortgage relief from about £370 million to about £100 million.

- It would thus come within £100 million of full effect of restricting relief to the basic rate.

24. The problem - already discussed - is that switching from higher rate tax to National Insurance contributions hurts those who have income above the National Insurance ceiling but below the point at which higher rate gains build up substantially. They would much rather keep the National Insurance ceiling and see less generosity on the higher rates. And it would be hard to ask them to accept losses for the abstract benefit of reducing the tax breaks of those who are better off, and will make large gains from the Budget.

25. In principle, it would be perfectly possible to keep the National Insurance ceiling and concede less on the higher rates. Many options are open. A simple one, for example, would be to set a 40% top rate and simply index the present threshold. Under that option, there should be no losers at all. It would give more to people in the middle and less to people at the top.

26. To put the point about tax reliefs in perspective:

- Mortgage interest relief, with the present £30,000 limit, would cost roughly £130 million more with a 40 per cent top rate and a threshold approaching £20,000 than with a 35 per cent top rate and a £25,000 threshold.

X = effect of this on  
Govt expenditure  
taxation



- If it were possible to afford a £25,000 threshold in both cases, the difference between a 35 per cent and 40 per cent top rate would only be about £50 million. (However, this would produce a wider "kink" - a wider band of relatively low marginal rates between the National Insurance ceiling and the higher rate threshold.)
- If there were no losers, there would be much less pressure on that account to raise the effective limit on mortgage relief.

All these figures are highly approximate.



### Independent taxation

27. The taxation of married women has been crying out for reform for ages. The Government has published two recent Green Papers, and the public debate has gone on for years. The main problem is that the tax system treats a married women's income as her husband's; and technically all allowances go to him.

28. The Budget proposals are as follows:

- husband and wife would be **taxed separately**
- **each would have a single person's allowance**
- **in addition, they would receive a married couple's allowance, worth about half the single allowance**
- **this would go to the husband unless he had insufficient income to use it, in which case the rest would go to his wife**
- **it would be withdrawn from men with high earnings.**

29. This would give **maximum independence to married women with minimum disruption.** For most people, it would replicate the present pattern of the main personal allowances, so that:

- a one-earner married couple would continue to get roughly  $1\frac{1}{2}$  times the single allowance, and
- a two-earner married couple would continue to get roughly  $2\frac{1}{2}$  times the single allowance.

**But while the couple's total allowances would in many cases be unchanged, the wife would now be given hers entirely in her own right, and would no longer have to lump either her earnings or her savings with those of her husband for tax purposes.**



30. A number of other tax penalties on marriage would be removed:

- married couples would be given two separate thresholds, where now they share one, for capital gains tax, the Business Expansion Scheme, deferred annuity contracts and the accrued income scheme
- the Additional Personal Allowance for one-parent families would either be abolished and replaced by benefit or denied to co-habiting couples
- there would be changes in the rules on mortgage interest relief and on maintenance and covenants, discussed in separate sections below.

31. This reform would:

- sweep away a nonsense which has lasted 180 years - the tax rule that a married woman's income is her husband's
- allow married women complete privacy and independence in tax matters
- ensure that a married woman's marginal rate reflects her own circumstances rather than those of her husband
- remove the present tax bias in favour of cohabitation and substitute one in favour of marriage.

It would achieve this at a cost of only £½-¾ billion a year - much less than other options which have been canvassed. And it would do it with effect from 1990-91.



32. However, it falls short of the aspirations in the 1986 Green Paper towards a system of independent taxation (which will be achieved) with transferable allowances (which will not). In particular:

- it does nothing to help one-earner couples where the wife (say) stops work to look after children or elderly relatives
- it keeps the married man's allowance in all but name, when everyone agrees in principle that this is an anachronism.

The short answer is that:

- there is not, as everyone knows, sufficient support for the Green Paper scheme
- it could not, anyway, be implemented this Parliament
- the present reform leaves options open for the future.

33. Keeping the married man's allowance is indeed a bit of an oddity: in a world of independent taxation, it is far from obvious why people should have a tax allowance simply in virtue of being married. And, far from eroding the allowance, the reform in one respect entrenches it: couples who currently forfeit the allowance by exercising the wife's earnings election will find themselves given it back. However:

- it builds a recognition of marriage into the tax system
- it could only be removed at the expense of either a large number of losers or an expensive increase in the single person's allowance or enhanced social security benefits for a lot of people



- the Budget proposals would allow it to be transferred from husband to wife in certain circumstances, and would withdraw it from high earners.

34. The reform is bound to be criticised as a handout to the rich, because the greatest gains will be made by couples where the wife has substantial investment income. But this is an inevitable consequence of allowing independence to married women. And the gains can be curbed by withdrawing the married couple's allowance from well-paid men. *ditto*

35. Some of the more academic critics may ask why the Government has not adopted a system of partially transferable allowances, which might seem, at first sight, more consistent with the Green Paper. Perhaps the simplest answer is that it could not be implemented this Parliament. In any case, all variants either involve an increase in the single allowance, which would be expensive; or losses for many two-earner couples. And none of the options would increase the allowances of a one-earner couple relative to a single person. All would involve the complications - both for taxpayers and the Revenue - which are one of the drawbacks of the Green Paper proposals for fully transferable allowances. They would be cheaper than the latter, but otherwise offer little which cannot be achieved at less cost under the current proposals.

#### Capital Gains Tax

36. At present, capital gains are in general taxed much more lightly than earnings for many higher rate taxpayers. This gives them a strong incentive to convert income into capital gains. This incentive will be greatly reduced if the Budget brings down the top rate of income tax appreciably.

37. At present, tax is levied only on real gains since 1982, but still on paper gains before 1982. In effect, the rules index away low inflation (since 1982) but not high inflation (before then). It is impossible to apply indexation generally



before 1982, because the necessary records often do not exist. The alternative is to deem all assets acquired before April 1982 to have been acquired at March 1982 values (unless the purchase price was higher). The result would be that only real capital gains made since 1982 would be subject to tax. This is the proposal in the scorecard. It would apply both to companies and to individuals.

38. At present, married couples and single people are each allowed £6,600 a year of capital gains tax free. Under independent taxation in 1990, this will be doubled for married couples, as husbands and wives get an exemption each. Meanwhile the annual exemption is to be frozen.

39. The remaining question on capital gains tax is whether the rate should be aligned with income tax: that is, whether gains by individuals above the CGT exemption should be taxed as the marginal slice of income at (say) 25% and 35%, or whether they should continue to be taxed at 30% as now. (In either case, capital gains by companies would continue to be charged at corporation tax rates.)

40. The main arguments for the status quo are these:

- If the income tax rates are reduced to, say, 25p and 35p, they will be near enough to the present CGT rate. There will then be much less difference, at the margin, between the taxation of income and capital gains. It is not obvious that precise alignment of rates would achieve a great deal more.

- Completely equal treatment is in any case ruled out, for all practical purposes. There are provisions for capital gains which simply do not apply to income - the £6,600 exemption, indexation, rollover and deferral relief for business assets and gifts, exemption of an individual's main residence, special rules for gilts.



- Ministers might still want to consider, for the future, a single-rate tax on savings, though this has been ruled out for the next Budget. A dual-rate CGT would sit oddly with that.

41. On the other hand, there remain arguments in favour of alignment.

- Realised capital gains are to all intents and purposes income. There is an argument of fairness for taxing them in the same way as (say) an ordinary person's interest on a building society account.

- Increasing the CGT rate on higher rate taxpayers could help meet claims that the Budget is just a hand-out to the rich.

- And, similarly, reducing CGT for basic rate payers (provided gains were not large) would have some obvious appeal. At present the nominal rate on their gains is higher than on their income.

42. If the rate of CGT were to be aligned with income tax, the change would be announced on Budget day but would not come into effect until 6 April. This would give shareholders an opportunity to avoid the higher rate tax on existing gains by means of bed and breakfasting and would give some defence against charges of retrospection.

*align - but point  
if top rate 40%  
but not of higher*



### Mortgage Interest Relief

43. At present, income tax relief is available on the interest on the first £30,000 of a home loan, subject to certain conditions. At current tax rates and the present mortgage interest rate of 10¼ per cent, this relief would cost £5 billion in revenue foregone in 1988-89.

44. The cost and value of the relief will come down automatically with the reductions in the basic and higher rates of tax.

- If there were no change at all in the £30,000 ceiling, the total cost might come down by about £600 million, to about £4.4 billion (ignoring behavioural effects).

- For a top-rate taxpayer with a mortgage of £30,000, the value of the relief will be reduced from about £1,850 a year to about £1,100.

45. There are two further Budget objectives:

- To end the tax penalty on marriage which arises because married couples and single people face the same £30,000 ceiling, so that two single people living together can get twice as much relief as a married couple.

- To end relief on home improvements, much of which just subsidises double-glazing, central heating, and so on.

A major constraint is that the manifesto promised that "We will keep the present system of mortgage tax relief".

46. Home improvement loans account for about £½ billion of the £5 billion cost in paragraph 43. The present relief is being abused, and has been the subject of PAC criticism. But abolition would be criticised on two grounds.



- It conflicts with the objective of renovating the existing housing stock, particularly in inner cities.

- It is unfair to those who want, say, to convert a floor of their house into a self-contained flat for children or elderly relatives.

47. In principle, the case for abolishing home improvement relief stands or falls on its own. In practice, there is probably a political trade-off with the general ceiling on mortgage relief: the lower the ceiling, the more difficult it will be to abolish home improvement relief - and the higher the ceiling, the easier to curb improvement relief.

48. On the ceiling proper, there are three main questions:

- Should it be £X per house ("the residence basis"), or £Y per person ("the individual basis" - with two slices per married couple)?

- Should it be raised to help compensate those who lose from abolition of the National Insurance ceiling, and/or to help buy out relief on home improvements?

- What should X and Y be?

49. The 1986 Green Paper on the Reform of Personal Taxation suggested that one way of dealing with the tax penalty involved in the present system would be to tie mortgage relief to the residence. If this option were chosen, the present relief - for mortgages in the future - might be redefined as £30,000 per house (or flat). This would reduce the relief available to cohabiting couples and single people sharing, and that would save about £10 million in the first year. Alternatively, the ceiling could be raised to (say) £35,000 or £40,000.



50. The main problems are these:

- Any realistic ceiling per residence would reduce the relief available in future to people sharing.

- There would have to be pretty complex rules to define residence and to apportion the ceiling between individuals.

- There would probably still be some tax penalty on marriage, because married couples would only be able to claim on one house, whereas cohabiting couples could claim on one each.

51. The alternative of redefining relief as £Y per person (with two slices available to a married couple) was not mentioned in the Green Paper. It might be natural under this option simply to allow each married partner £30,000 per head. But this would double the relief available to married couples, and give them a strong incentive to take out larger mortgages. In principle, it would be possible to set the ceiling at, say, £20,000 or £25,000 per person. But reducing the present relief to single people in this way might be difficult to reconcile with the Manifesto commitment.

52. The choice between £X per house and £Y per person probably turns, in practice, on how much mortgage tax relief Ministers want to allow married couples.

53. Some increase in the ceiling could reduce the losses from abolishing the National Insurance ceiling. It might, say, reduce the number of losers from 300,000 tax units to 250,000. But it would in addition benefit all 1½ million mortgage holders who currently have mortgages of £30,000 or more. It would thus be very poorly targeted. And since the combination of higher National Insurance Contributions and a lower top rate is designed to reduce the value of tax reliefs, it would be pretty curious to compensate by deliberately increasing one of the largest.



54. An increase in the ceiling would give some stimulus to extra borrowing and higher house prices. The effect on house prices is unlikely in itself to be more than about 2 or 3%. But they have already been rising fast; and they will tend to be increased by the rise in personal disposable incomes resulting from the Budget, and the abolition of local authority rates in 1990.

55. The costs of some possible combinations are as follows, assuming income tax rates of 25p and 35p, and a top rate threshold of £25,000, and ignoring behavioural effects.

		1988-89		1989-90	
				£m	
Cost of existing system		5000		5750	
Cost after rate changes and before change in basis		4400		5050	
		Home improvement relief retained	Home improvement relief abolished	Home improvement relief retained	Home improvement relief abolished
<u>Residence basis</u>					
Ceiling	£30,000	4390	4310	5020	4820
	£35,000	4570	4490	5270	5070
	£40,000	4700	4620	5450	5250
	£50,000	4860	4780	5700	5500
<u>Individual basis</u>					
Ceiling	£20,000	4610	4530	5290	5090
	£25,000	4760	4680	5540	5340
	£30,000	4830	4750	5670	5470

*and pays for  
cost of x  
(separate m)*

( see table overleaf )



COSTS OF M.I.R. CHANGES.

Ch / Corrected figs. below.  
You were quite right.

ps3/17T

	1988-89		1989-90	
	Home improvement relief retained	Home improvement relief abolished	Home improvement relief retained	Home improvement relief abolished
<b>A. Cost of existing system</b>	5000		5750	
<b>B. Cost after rate changes and before change in basis</b>	4400		5050	
<b>C. Additional costs/yields of changes in basis (compared to B)</b>				
<u>Residence basis</u>				
Ceiling				
£30000	+10	+90	+30	+230
£35000	-170	-90	-220	-20
£40000	-300	-220	-400	-200
<del>£50000</del>	<del>-460</del>	<del>-380</del>	<del>-650</del>	<del>-250</del>
				450 X
<u>Individual basis</u>				
Ceiling				
<del>£20000</del>	<del>-210</del>	<del>-130</del>	<del>-240</del>	<del>-40</del>
£25000	-360	-280	-490	-290
£30000	-430	-350	-620	-390
				420 Y

Post check the figs  
 @ X = Y, which looks wrong.  
 (In all other cases, no diff  
 for retention & abolition of  
 HIR is £800 in yr ① &  
 £200 in yr ②. 23A in yr ① &  
 £2300 in yr ②. 5 in X £4000  
 in yr ②).



Maintenance and Covenants

56. The tax treatment of maintenance and covenants needs to be reformed for three related reasons.

- There are all sorts of anomalies in who gets tax relief and who does not. Most obviously, cohabiting couples get reliefs which are simply not available to married couples.

- Under independent taxation, the scope for abuse would become enormous. Married couples could enter into all sorts of arrangements with each other for the sole purpose of claiming tax relief.

- The rules involve people in quite unnecessary transactions with the Revenue, and are needlessly complicated.

*This could be used as original capital to pay tax*

*also Sherdley*

57. The system of maintenance relief:

- rewards divorce, by providing unlimited relief for the support of children of the divorced (eg to pay school fees) which is not available to married couples living together

- penalizes marriage, by providing relief for unmarried couples with children which married couples do not get

- has recently been extended by the courts, in the Sherdley case, so that relief is even available to a divorced man who gets a court order made against himself to support a child who lives with him. In effect, only those who are and remain married are denied relief for children

- requires tax relief in many cases to be given to the father only for the tax to be collected from the mother, creating unnecessary paperwork for everyone concerned



- has different rules for different types of maintenance, which is confusing
- can discourage recipients of alimony and maintenance from working, because their personal allowances are used up and they have to pay tax on any earnings.

Similarly, covenant relief:

- penalizes marriage, by allowing unmarried couples to covenant to each other and get potentially unlimited relief
- allows the better-off and better-advised (by a simple stroke of the pen on a page of mumbo-jumbo) to reduce their tax, for no obvious social or economic reason
- tempts people to defraud, for example by claiming relief on reciprocal payments (A covenants to B's child, and B covenants to A's child)
- has become an administratively cumbersome method of giving students indirect support through the tax system instead of direct support through grants
- can discourage student recipients from working in the holidays, because their covenant payments use up their personal allowances, so that they have to pay tax on any money they earn.

58. To sort this out, the Budget proposals are as follows:

- make maintenance payments <sup>(covenants to individuals)</sup> entirely tax free in the hands of recipients - mainly divorced and separated wives, and students



- retain tax relief for maintenance payments to divorced or separated spouses, but only up to a monetary limit, equivalent to the single person's allowance

- abolish tax relief on all other maintenance payments

- retain relief on covenants to charities

- but abolish relief on covenants between individuals

- apply these rules only to future arrangements, with protection for existing ones

- if possible, make compensating adjustments for students through the grants system, and for one-parent families through the Social Security system, the details of which have still to be settled.

*parents contribute*

59. These reforms will be:

- a major simplification for all concerned - the taxpayer, the tax practitioners, the courts and the Revenue

- fairer all round and especially to married couples

- consistent with independent taxation.

60. There will, however, be losers compared with the present system. The most difficult will be that tax relief will no longer be available:

(a) for affiliation order or maintenance payments in respect of:

- children looked after by third parties



- children of unmarried mothers living alone, who will no longer get the benefit of tax relief on maintenance payments under affiliation orders;

(b) for covenants to students, especially where the student is getting little or no grant.

60A. The main outstanding questions are:

- what compensating changes to make to the student grant arrangements

- what, if any, compensating arrangements to make through the social security system for children

- what fallback to have if it proves impossible to withdraw relief entirely from payments for children.



**Benefits in Kind**

61. Benefits in kind are, at present, seriously under-taxed, by something of the order of £1-1½ billion a year. Yet they are a source of increasing aggravation for taxpayers and the Revenue. And some of the rules are arbitrary.

62. Benefits are notified to the Revenue by employers, and most are taxed in the hands of employees who earn more than £8,500. That figure has been deliberately frozen throughout the Government's term of office. There is no basis for it other than administrative convenience, and no good reason of principle to raise it. Indeed, all benefits should in principle be taxable for all employees. But the longer the threshold stays frozen, the more awkwardnesses arise, and the more pressure there is to raise it.

63. The problems will get worse if the Budget abolishes the ceiling on employees' National Insurance contributions. That will make benefits in kind much more attractive, relative to earnings in cash, because benefits do not attract National Insurance contributions.

64. There is no realistic solution available under the present system. In principle it would be possible to increase substantially the taxation of company cars, or to invent a new National Insurance charge on benefits; but political difficulties apart, this would hurt some of those who already lose from the abolition of the National Insurance ceiling.

65. The Budget proposal is therefore as follows:

- stop taxing benefits in kind in the hands of employees
- tax them in the hands of employers instead, regardless of their recipients' income
- cast the net wide, to bring in more benefits than at present; but simplify the rules as far as possible



- charge employers a flat-rate tax of 50 per cent, which cannot be deducted for Corporation Tax

- make a compensating reduction of 2 per cent in the main Corporation Tax rate

- make the change in April 1990

- leave the arrangements for the self-employed unchanged.

66. This would:

- relieve about 2 million employees of about £800 million of tax in 1990-91

- raise up to £1,400 million from the new fringe benefits tax on employers (making no allowance for behavioural effects)

- return about £1,200 million to employers in lower Corporation Tax.

It would:

- reduce compliance cost for employees

- require perhaps 250 extra Revenue staff in 1989-90 to get the scheme going, but then save about 450-500 posts a year from 1992-93 onwards

- transfer compliance costs (net) to employers.

67. For companies paying Corporation Tax, at above the small companies rate, the choice between giving their employees cash and benefits would in principle be this, if all benefits were correctly valued and timing differences are ignored:

- for basic rate employees, cash would be better than benefits (because it would attract slightly less tax)



- for higher rate employees, benefits would be better than cash (again, because they would attract less tax).

For employers who do not pay Corporation Tax, benefits would in all cases be better than cash.\*

68. Introducing a Fringe Benefits Tax would do nothing, in and of itself, to remedy the worst defect in the present arrangements, which is that the benefit of company cars is grossly under-valued. A Rover, for example, is valued for tax purposes at only about £1,000 a year, but is probably worth about £4,500. Car benefits are bound to remain relatively attractive so long as they stay under-valued in this way. But it might be easier to raise the valuation of cars once new tax arrangements were in place.

69. Moving to a Fringe Benefits Tax would:

- give a more neutral and simpler tax system
- reduce the overall resource cost of taxing benefits
- put the administrative burden on those best able to bear it
- reduce significantly, in 1990, the number of losers from abolishing the National Insurance ceiling
- encourage employers to pay in cash rather than kind, which would be economically more efficient.

\* One way of putting the reason is as follows. Non CT-paying employers find it more expensive to provide either cash or benefits than their CT-paying counterparts, because they cannot get CT deductions on either. But the Fringe Benefits Tax would be no more expensive to them than to CT payers, precisely because it would not be deductible for Corporation Tax.



ans:  $\theta$  angle higher rate of  $15^\circ$ ,  
 $\gamma$  angle rate of  $145^\circ$ ,  
and  $\alpha$  look inside to return single rate of car?



70. But:

- employers would complain at the extra burden of a self-assessed tax imposed on them without consultation, despite the off-setting Corporation Tax relief
- some would criticise the change on the ground that benefits are employees' income and should be taxed in the hands of recipients
- it might look odd to give a windfall benefit to those recipients by relieving them of tax, though one would expect gross pay to adjust to some extent over the years.

71. Perhaps the simplest answer is that a Fringe Benefits Tax would be largely a voluntary tax. Employers could avoid it by paying their employees in cash; and that would, incidentally, save them a lot of inconvenience in organising benefit packages. It would be thoroughly desirable, economically and socially, for them to do so.

Inheritance Tax

72. The Budget proposal is to increase the Inheritance Tax threshold to £105,000 and introduce a single rate of 40 per cent, following last year's reduction in the bands from seven to four. This would reduce the number of taxpaying estates by 6,000 compared with simply indexing the threshold.

73. The proportion of estates liable to tax has already come down from 8.6% in 1975 to 3.9% in 1987-88. Yet the continuing rise in house prices, especially in the South East, means that comparatively modest estates are being drawn into tax. A further increase in the threshold will help. And a single rate of 40 per cent would be simple. But it would also be a high starting rate for relatively modest estates.

(see table overleaf)

*Handwritten notes:*  
 1) No one expecting this. But...  
 2) What rate of FBT? appropriate?  
 3) What can simple opposition (as an estimate) be? open up?



7Fs

EFFECTIVE RATES OF IHT

<u>Size of estate</u>	<u>Main option (£105,000; 40%)</u> <u>Tax Payable</u>	<u>Effective rate</u>
£000	£000	%
100	NIL	NIL
150	18	12
200	38	19
250	58	23
300	78	26
400	118	29.5
500	158	31.6
1000	358	35.8
2000	758	37.9

Note: The specimen estates on which these calculations are made assume prior deduction of all reliefs.



74. Compared with "Healey CTT", revalorised by reference to the average RPIs for 1975-76 and 1988-89, the tax would be less onerous for all estates on death. But if Healey is revalorised by reference to the RPIs of the Decembers before those years (the statutory basis for indexing thresholds), this would not be true for a middle range of estates.

75. Some will criticise the change as just another hand-out to the rich: substantial gains would go to the larger estates - £46,000 less tax on a £½ million estate, £146,000 on £1 million. There is a case for saying that less ought to go there, and more to the middle range.

76. In principle, there may also be a case for charging less inheritance tax if a family business is left to a son or daughter than to (say) a cousin. Some other countries do this.

77. In principle, too, there are good arguments for a more radical reform, to move to a genuine donee-based inheritance tax. Many other countries have one, and it could help wider ownership. But to switch from a donor to a donee-based tax would in practice be too complicated to be worthwhile.

*Look @ the implications for businesses.*

Other measures

78. Annex D discusses the remaining measures currently in play. The most controversial are likely to be:

- company residence and migration
- in-year assessment of Schedule D income
- forestry
- disclosure of importers' information
- Customs' powers to search
- Lloyd's
- the response to EC infraction proceedings on VAT.



The package as a whole

79. The package as a whole will be judged against a number of objectives:

- prudence;
- a lower tax burden;
- a simpler,
- fairer, and
- more neutral system.

80. It should pass most reasonable tests of prudence. On present prospects, taxes are likely to be much the same proportion of GDP next year as this. And the Budget surplus is likely to be larger.

81. Within that constraint, most people will see clear reductions in taxes. Their combined income tax and national insurance contributions will be unequivocally lower (though see paragraphs 85-88 below).

82. It is possible both to reduce taxes for most people and yet to maintain them as a proportion of GDP for three main reasons.

- Buoyant profits are producing more Corporation Tax.
- Buoyant earnings yield more income tax for given tax rates, as basic allowances are raised only in line with prices. The married man's allowance, for example, is likely to be down to about 31½% of average earnings next year, compared with 33½% in 1985-86.
- Local authorities are likely to jack up the rates yet again.

83. This makes it possible to give the vast majority of taxpayers combined income tax and national insurance rates which are both lower and simpler. That is true on any of the serious options for the basic and higher rates of tax. And the graphs on page 7 illustrate the leading one - a 25p basic rate, a higher rate threshold of £25,000, a single higher rate of 35 per cent and



no national insurance ceiling. (The graphs ignore, for simplicity, the facts that the last two changes might be phased in, and the married couple's allowance withdrawn from well-paid men.)

84. On this basis:

- A lot more people will be able to forget altogether about the higher rates: the numbers of tax units paying them will be nearly halved, from about 1.3 million to roughly 700,000. That is about the same number as in 1979-80.
- About 19½ million tax units will see reductions in their marginal rates, and
- just over 20 million in their average rates.

85. The big snag is that many middle managers will see increases in their marginal rates, and some of them will see their tax bills rise. They will lose more from the abolition of the National Insurance ceiling than they will gain from the rest of the package. And this will be especially difficult to present, because the better off will be making very large gains.

86. The package, in other words, will take from people near the middle and give to the better off. So while, for most people, rates will be both lower and simpler, it is not obvious that the overall result will be fairer.

87. The following table gives the detail. Taking income tax and national insurance together, it shows embarrassing figures for 1988-89:



		If changes not phased	If changes phased
Number of tax units with higher marginal rates		1.3m	1.3m
No. of losers	real	762,000	481,000
	cash	533,000	300,000
Average loss	real	£185 pa	£127 pa
	cash	£161 pa	£105 pa
Total losses	real	£141m	£61m
	cash	£86m	£31m
Income range of losers with full mortgage but no other reliefs			
- single		£18,800	to £28,700
- couple		£18,400	to £31,200
Average gain for earner on £50,000 per annum			
		real	£6892 pa
		cash	£7309 pa
			£6540 pa
			£6980 pa

88. Even if the package is phased in:

- It may take about £30 million next year from some 300,000 tax units.

- That's over half a million voters: probably about 550,000.

- And it includes people just below board level in the private sector.

- It would give the money to people like Sir Ralph Halpern.

- Backbench MPs could lose £2 a week. Cabinet Ministers could gain as much as a nurse has to live on.

89. There is no option on the table which would concentrate help on the losers. They are losers precisely because the National Insurance ceiling is being abolished, and they are hurt more by that than they are helped by lower income tax; and there is no known measure which would exclusively benefit people in that position - except of course retaining the national insurance ceiling.



90. A fringe benefits tax on employers could reduce the number of losers by up to 100,000, but only in 1990-91, and only if behavioural changes are ignored. Independent taxation could also reduce the number of losers a bit, but again not until 1990-91.

91. That apart, the main options for mitigating the losses are these:

- a lower basic rate: that would reduce absolute losses, but also increase absolute gains; it would not change the pattern that people at the top and bottom do better than people near the middle;

- higher allowances: compared with a lower basic rate, these would turn fewer losers into gainers, for equivalent cost;

- an increase in the ceiling on mortgage interest relief: that might reduce the number of losers by up to 50,000, but only at the expense of benefiting well over a million others, and increasing the value of tax breaks;

- a lower initial rate of contributions above the National Insurance ceiling: at the time of going to press, this looks probably the best bet. Since it is the increase in National Insurance contributions which causes the problem, the most obvious solution is to mitigate the increase.

*but  
doesn't  
amount  
anything*

92. If, on the other hand, we were to keep the National Insurance ceiling and thus solve the losers problem at a stroke, that would alter the balance of argument on a number of other parts of the package. For example:

- The higher rate threshold could more easily be set below £25,000. That figure was chosen to match (roughly) the indexed 45 per cent threshold, in order to avoid imposing higher combined rates of tax and National Insurance on those in the present 40 per cent band.



- If the top rate of tax were (say) 40 per cent instead of 35 per cent, it might be more difficult politically to align capital gains tax and income tax - though the objective case for it would probably be stronger.

- It might be easier to correct the under-valuation of cars, under the present system for taxing benefits, though there would still be a case for moving to a Fringe Benefits Tax on employers.

*discuss*

- There would be still less of a case for raising the effective limit on mortgage interest relief.

93. Beyond a certain point, it simply has to be accepted that, if the Budget is to abolish the national insurance ceiling, some people are bound to lose on that account, either absolutely or relatively. The change would have to be justified as a necessary cost of ending an anomaly and simplifying the system. And the losers would have to be consoled with the prospect of tax cuts to come - the hope, perhaps, of a 20p basic rate.

94. Whatever the decision on this set of issues, the Budget's main contributions to **simplicity** are likely to be on:

- income tax, reducing the plethora of rates to two
- maintenance and covenants, eliminating mumbo-jumbo and a whole lot of transactions between ordinary people and the Revenue
- benefits in kind, taxed together, more or less at source
- inheritance tax, reduced to a single rate.

*also consider simplified great (via value)*



95. The main contributions to fairness will be that:

- married women are given independence and privacy
- tax penalties on marriage are abolished
- the tax advantages of converting income into capital are reduced
- capital gains tax is lifted entirely from paper gains
  
- students are freed from an "earnings trap" (paragraph 57, last point.)

96. The principal contributions to neutrality are likely to be that:

- the drastic reductions in the higher rates will both reduce the value of tax breaks and reduce the difference between the taxation of income and capital gains
  
- the tax treatment of company financing will be much more neutral as a consequence
  
- a fringe benefits tax will reduce the difference between the taxation of payments in cash and in kind.

97. The package will, however, widen the present difference between the taxation of earned and investment income. The difference arises because national insurance is charged on earnings but not investment income; the abolition of the national insurance ceiling will mean that it extends right up the income scale. The lower charge on investment income may perhaps be regarded as mitigating the double taxation of savings which is inherent in income tax.



## TASK FORCE SECRET

98. The annexes expand as follows:

A Scorecard

B Staff Effects

C Distributional Effects

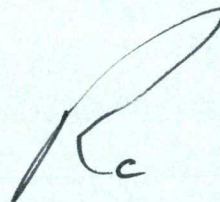
D Main Budget Issues Not in Reform Package

E Excise Duties Ready Reckoner

F Timetable for Decisions on Budget Measures

G Timetable for Implementation of Changes in Tax, NICS and Social Security, and Introduction of Community Charge

H The Self-Employed and Small Companies



ROBERT CULPIN

NS/VAT



PERSONAL

COPY NO 1 OF 2 COPIES

FROM: M C SCHOLAR  
DATE: 18 DECEMBER 1987

CHANCELLOR OF THE EXCHEQUER

**COMMUNITY CHARGE**

I have been thinking further about a fall-back position which retained a rating system as well as the Community Charge for properties above a given value. The purpose of this would be to counter the argument that the Budget and the Community Charge together gave too much to the rich.

2. I have established, I think, that the administrative problems, although not easy, should not be insurmountable. The Revenue's Valuation Office, which will need to be kept in being anyway for CGT/IHT, motorway compensation valuations and so on, could take on this task. There would need to be a reporting system so that local authorities became aware of new properties over the limit, and old properties which by inflation, addition or improvement crossed the threshold. There would be pressure on the valuation appeals system, as people would have a large incentive to have their valuation pushed just below whatever the threshold was. And local authorities would have to retain a residual rate collection system alongside their Community Charge collection system.

3. But the main problem as I see it is that this arrangement would give local authorities a supplementary tax base targetted on the better-off. If they were allowed the freedom to set rate poundages at what level they pleased, the left wing ones would fillet and de-gut the better-off. If they were denied this freedom it would be clear that central government and not local government was really responsible for these tax bills.



4. There are unattractive possibilities for going down this latter path but hiding what we were doing--: freezing the (injustices of the) existing rate poundages in perpetuity, for example, or constructing some analogue to the National Non-Domestic Rate (changes in whose value might perhaps be linked in each case to changes in each authority's Community Charge).

5. There are other problems too. It would clearly be best to run this system on a capital value rather than a rental value base. But if you were driven back to rental values there would be a presentational difficulty in retaining a system the attack on which forms an important part of the Community Charge platform. There would also be distributional problems because there are distortions at the top end of the rental value scale: a country-mansion, for example, may have a lower rateable value than a modest town house, because the latter would command a larger rent than the former. Then there is the old lady on her own in a big house who can just about manage the Community Charge, but would have to give up her home if she were slugged for rates on top.

6. I do not find all this a very attractive prospect. But I am afraid that I have no positive suggestion to offer.

Thanks.  
The author says 3 of  
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M.C.

M C SCHOLAR

(\* with the  
same RPI  
safeguard)

X





Inland Revenue

TASK FORCE SECRET

Copy No 1 of 20

The Board Room  
Somerset House  
London WC2R 1LB

*Ref paper 5-8, essential  
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FROM: A J G ISAAC  
18 December 1987

CHANCELLOR OF THE EXCHEQUER

BILATERAL WITH MR MOORE

TASK FORCE/DHSS INTERFACE: CHILD TAX ALLOWANCES

1. Following your meeting with Mr John Moore on 16 December, you have asked about the proportion of people not paying income tax up to 1940.

2. Precise data on this are not available but in broad terms you could say that until 1940 over 85 per cent of the adult population did not pay income tax (counting husbands and wives separately). This compares with current figures of just over 40 per cent of the adult population not paying income tax (again counting husbands and wives separately).

3. The attached PQ also gives some interesting information. It shows that about one-third of families would not benefit in full if child benefit were replaced by child tax allowances of the same value.

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

- Mr Battishill
- Mr Isaac
- Mr Lewis
- Mr Beighton
- Mr Mace
- Mr Northend
- Mr R H Allen
- Mr Glassberg
- PS/IR



4. You may also want to bear in mind that although child tax allowances were given in 1799 when the income tax was first introduced, they were withdrawn when the provisions were recast in 1805 and did not reappear until 1910.
5. Looking further ahead, you have "eventually" agreed with Mr Moore that there should be some more work done on the possibility of taxing child benefit (but not child tax allowances). Please forgive me, if I make an urgent plea about the timing of this further work.
6. I need not labour the size of the ~~en-a~~ portfolio of major reforms of personal taxation on which we are already working: notably, a variety of income tax options, NIC options, independent taxation and a new regime for taxing benefits in kind. As Mr Lewis has noted in another minute today, much of the work on these falls on the same small group of people in Policy Divisions, Operational Divisions and at Telford. It is this competition for scarce time which has resulted (as Mr Mace reported to you a week or two ago) in our being not as far advanced with independent taxation as we had hoped, or would have wished at this stage; and which underlay my request at one of your recent meetings that we should seek to narrow the Budget options, so far as can reasonably be done.
7. My short point, therefore, is that we should now give overriding priority to getting the work done for the Budget and Finance Bill, and done well. And that priority means not taking people off Budget and Finance Bill work to look at longer term options, such as the taxation of child benefit.



8. I bracket together "Budget and Finance Bill". As you know, our work at this end of the Strand is at least as heavy in the run-up to the Finance Bill and its passage through Committee as it is during the run-up to the Budget itself.

Cler

Pst ~~miss~~ let me have a note on follow:

Child Tax Allowance

There were paid for more tax system when Pitt first introduced the tax in 1799, but were abolished six years later (also by Pitt). They were introduced in 1910. Moreover, (as recently as 1940, from now 15% of the adult population paid income tax at all, so CTAs of seemed to be far more played a part in the financing of child maintenance than in the population at large.

A J G ISAAC

PS. (Roughly) a third of all allowances made by C.B. are more than the total per capita income.



Table 1  
Allowances and Reliefs—Employees

	United Kingdom £	Germany £ (see note 1)
Personal allowances		
Single person	2,455	(a) Basic exemption (zero rate band) Single person 990
One-earner married couple	3,695	One-earner married couple 1,985
Two-earner married couple	6,150	Two-earner married couple 1,985
		(b) Minimum deduction for employment expenses, given to all employees, regardless of whether any such expenses are incurred or not.
		Single person and one-earner married couple 125
		Two-earner married couple 250
		(c) Employment income deduction
		Single person and one-earner married couple 105
		Two-earner married couple 210
		(d) Christmas allowance, given against end of year pay
		Single person and one-earner married couple 130
		Two-earner married couple 260
		(e) Minimum deduction for certain personal expenditures (regardless of whether any are incurred) eg donations, church taxes etc
		Single persons 60
		Married couple 120
		(f) (Complex) minimum deduction for "provident expenses" eg Social Security contributions, life assurance premiums etc. Minimum deduction 18 per cent of gross earnings less Christmas allowances (see (d))—all employees

## Notes:

- Conversions from DM to £ sterling have been made on the basis of the latest available OECD estimates of purchasing power parity.
- In Germany the principal relief for married couples is the "income splitting" system which normally reduces the tax payable by a married couple.
- In Germany there are also child allowances, single-parent allowances, and various other comparatively minor personal allowances.

Table 2

## Income Tax Scales

United Kingdom (all taxpayers)		Germany (single persons —see Note 3 re married couples)	
Rate per cent	Band of taxable income £	Rate per cent	Band of taxable income £
27	1-17,900	0	1-990
40	17,901-20,400		(see table 1— zero bracket amount)
45	20,401-25,400	22	990-1,750
50	25,401-33,300	22-56	1,750-28,840
55	33,301-41,200		(see note 2)
60	over 41,200	56	over 28,840

## Notes:

- Conversions from DM to £ sterling have been made on the basis of the latest available OECD estimate of purchasing power parity.
- The tax in this band is computed by complicated arithmetical formulas, which have the effect of progressively increasing the marginal rate from just over 22 per cent. to just under 56 per cent.
- As mentioned in note 2 to table 1, married couples are normally taxed on the income-splitting system. This will have the effect of doubling all the taxable income figures in this table for such married couples.

## Consultancy Costs

Mr. Tim Smith asked the Chancellor of the Exchequer what is the estimated expenditure in the current year on management and computer consultancy by (a) the Inland Revenue, (b) Her Majesty's Customs and Excise and (c) the Department of National Savings.

Mr. Norman Lamont [pursuant to his reply, 21 October 1987]: The estimated expenditure in the current financial year on management and computer consultancy is as follows:

	£ million
(a) The Inland Revenue	12.5
(b) Her Majesty's Customs and Excise	4.3
(c) The Department for National Savings	0.54

## Child Benefit

Sir Brandon Rhys Williams asked the Chancellor of the Exchequer if he will estimate how many and what proportion of families with children receive more in child benefit than they pay out in income tax.

Mr. Norman Lamont [pursuant to his reply, 21 October 1987]: In 1987-88, it is estimated that some 2¼ million families, about one third of the total number of families claiming child benefit, will receive more in child benefit than they pay in income tax.

## Consultancy Costs

Mr. Tim Smith asked the Chancellor of the Exchequer what is the estimated expenditure of all Government Departments in the current year on management and computer consultancy.

Mr. Brooke [pursuant to his reply, 21 October 1987]: Comprehensive information on consultancy costs is not gathered centrally and could be provided only at disproportionate costs, but it is estimated that about £100 million will be spent on computer consultancy in 1987-88, and about £25 million on management consultancy.





COPY NO. 14 OF 14.

FROM: A C S ALLAN

DATE: 17 December 1987

MR MCINTYRE

cc PS/Chief Secretary  
PS/Financial Secretary  
Sir P Middleton  
Mr Scholar  
Mr Culpin  
Miss Peirson  
Miss Sinclair  
Mr Cropper  
  
PS/IR  
Mr Isaac - IR  
Mr Mace - IR

**BILATERAL WITH MR MOORE**

The Chancellor reported to me the following points from his bilateral with Mr Moore.

**APA**

2. Mr Moore was cautious about making any commitments on this until he had seen the report by officials. He understood that there were considerable problems with scrapping the APA and increasing one parent benefits, and wanted to consider whether there were any other alternatives.

**NICs**

3. The Chancellor explained that he definitely wanted to make changes at the bottom end, and he thought there should be very discreet consultations between Treasury, Revenue and DHSS officials on these. Mr Moore said he wanted to consider further which officials in DHSS should be involved. The Chancellor said he was also thinking about the abolition of the UEL, but until he confirmed that this was a definite plan, he would not wish DHSS officials to be consulted.

4. Mr Moore said he had no problems with the lower-end package, but was not at all keen on abolishing the UEL. He thought this





would cause considerable problems for the contributory principle, which he had ideas for beefing up in other ways, by bringing extra benefits in etc. If the Chancellor did decide to go ahead, he would be grateful for a paper by Treasury officials for his personal use making the case for the change, and answering the points which would inevitably be made by DHSS officials.

5. He accepted the need for a fast-track bill and was content for the Treasury supplement to be abolished.

#### Child benefit

6. Mr Moore felt very strongly that tax options should be covered in the review. The Chancellor eventually agreed that the review could cover the taxation of child benefit, but not the re-introduction of child tax allowances.

7. The Chancellor made one point to Mr Moore on which he would be grateful for help on the figuring from the Inland Revenue. Some of those who favour child tax allowances argue that ever since the time of Pitt there has been help via the tax system for children. But until very recently the vast majority of people did not pay income tax and so did not benefit in any way from child tax allowances. Could the Revenue provide figures on the lines that up till, say, 1940, X per cent of people did not pay income tax.

#### NHS internal market

8. The Chancellor and Mr Moore agreed to return to this topic in January.

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

A C S ALLAN





Inland Revenue

Policy Division  
Somerset House

FROM M A JOHNS  
DATE 21 DECEMBER 1987

PS/ECONOMIC SECRETARY

BS353: CAPITAL GAINS AND FARMOUTS

We spoke about your note of 17 December. As I explained, we have already had very full discussions with the industry (without disclosing what decisions Ministers have taken or are likely to take). These have led to the various detailed amendments to the proposals in Miss Hill's various notes. They were based on the Economic Secretary's original authorisation for discussions on capital gains and farmouts (announced in the Summer Finance Bill Committee). The only further consultation which would be valuable would be to show the industry the clause in draft. If Parliamentary Counsel's timetable were to permit this we could still do so but at this stage I would not be sanguine about the feasibility of this. There seems no advantage in telling the industry what Ministers have decided unless the draft clause is available. I would therefore only envisage further discussions if, at a later date, it appears that the drafting timetable makes this possible. I hope this is acceptable to the Economic Secretary.

M A JOHNS

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cc PS/Chancellor  
PS/Financial Secretary  
Mr Scholar  
Mr Culpin  
Mr C J Riley  
Miss Sinclair  
Mr M L Williams  
Mr Jenkins (Parliamentary Counsel)

Mr Painter  
Mr Johns  
Mr Beighton  
Miss Hill  
Mr Elliss  
Mr Cleave  
PS/IR





Inland Revenue

Policy Division  
Somerset House

FROM M A JOHNS  
DATE 22 DECEMBER 1987

PS/ECONOMIC SECRETARY

BS353: CAPITAL GAINS AND FARMOUTS

Since writing my note of 21 December I have learnt that Miss Hill (who is currently on leave) did envisage the possibility of further detailed discussions with the oil industry on one aspect of this proposal. This is the capital allowances consequential. My note was therefore based on a misunderstanding and I would be grateful if you could destroy it. My apologies for the mix-up.

M A JOHNS

---

cc PS/Chancellor  
PS/Financial Secretary  
Mr Scholar  
Mr Culpin  
Mr C J Riley  
Miss Sinclair  
Mr M L Williams  
Mr Jenkins (Parliamentary Counsel)

Mr Painter  
Mr Johns  
Mr Beighton  
Miss Hill  
Mr Elliss  
Mr Cleave  
PS/IR





Inland Revenue

Policy Division  
Somerset House

*Spoke Mace  
He will deal, consulting  
with Mr Culpin*

FROM: B A MACE  
DATE: 23 DECEMBER 1987

CHANCELLOR OF THE EXCHEQUER

TAX REFORM: INCOME TAX

1. You asked for an analysis of an option (Option H3) for 1988-89 involving

- (1) retention of the UEL/UPL;
- (2) a basic rate of 24 per cent;
- (3) a single higher rate of 44 per cent starting at the higher rate threshold for an indexed 1988-89 regime, £18,700 of taxable income.

*Man Aches.  
How much will cost to HR threshold  
reduced by KAPP  
@ £17,900?  
Gratified if table of  
gainers of £  
Some says (income  
2000) as table  
with 5% rate of  
17% threshold  
options  
H1 & H2.*

Costs

2. The full year costs and costs in 1988-89 of Option H3 compared with indexation are as follows:-

	£billion	
	1988-89	Full Year
Cut basic rate by 3p	3.75	4.20
Reduce higher rates to 44p	0.58	1.10
Total Cost	4.33	5.30

*PS. I accept,  
of course,  
Mr Paul  
→ n  
Qma 7.*

cc. Mr Scholar  
Mr Culpin

Chairman  
Mr Isaac  
Mr Beighton  
Mr Calder  
Mr Cayley  
Mr Eason  
Mr Mace  
PS/IR



3. The 1988-89 cost of Option H3 is about £800 million more than the first year cost of Option D (my submission of 17 November).

Distributional Effects

4. There are no losers from this Option amongst taxpayers\* but about 400,000 tax units with taxable incomes between £18,700 and £21,300 would have higher marginal rates. Under Option H3 they would pay at 44 per cent whereas their marginal rate under the present regime indexed to 1988-89 would be 40 per cent. These tax units all gain at least £561 from the basic rate cut (3 per cent of £18,700) but the maximum offset from the higher marginal rate is £104 (4 per cent of £2,600).

5. There would be about 1.3 million higher rate tax units under this option.

6. The average gains and distribution of gains under Option H3 compared with the 1987-88 regime are shown in the attached tables. Average gains are £316 and increase steadily with income. Over 2<sup>1</sup>/<sub>4</sub> million tax units gain more than £500 per annum.

7. You will want to bear in mind that a higher rate of 40 per cent or more must make it more difficult to gain acceptance for the proposal to charge capital gains tax at income tax rates. There would be an increase in the number of losers and the size of losses from the capital gains tax change.

*B A Mace*

B A MACE

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\*As with all options involving a reduction in the basic rate there is the familiar point that about 500,000 non-taxpayers who have mortgages under MIRAS would face increases in their net interest payments.



TASK FORCE SECRET.

Option 13: 1988-89: Gainers compared with 1987-88

GAINERS R

Gainers ranged by total income (lower limit)

Range of total income	Amount of gain	Number of gainers	Average gain
£000s	£million	000s	£
0	177	3056	58
5	1060	7181	148
10	1380	5471	252
15	1051	2883	365
20	664	1293	513
25	427	618	690
30	274	338	812
35	187	184	1017
40	162	120	1357
45	119	65	1825
50	1269	210	6043
TOTAL	6769	21418	316

1  
3  
5  
7  
10

GAINS R

Gainers by range of income and amount of gain

Income range (lower limit)	Amount of gain (£ per year)							TOTAL
	£000s	0-50	50-100	100-200	200-300	300-400	400-500	
0	1210	1817	28	0	0	0	0	3056
5	63	1022	4989	1108	0	0	0	7181
10	0	33	1120	3133	1182	3	0	5471
15	0	0	5	503	1486	825	64	2883
20	0	0	0	1	110	517	665	1293
25	0	0	0	0	0	5	613	618
30	0	0	0	0	0	0	337	338
35	0	0	0	0	0	0	184	184
40	0	0	0	0	0	0	120	120
45	0	0	0	0	0	0	65	65
50	0	0	0	0	0	0	210	210
TOTAL	1274	2872	6141	4745	2779	1349	2258	21418

Note: Estimator of gains exclude ACT etc effects.





FROM: J M G TAYLOR

DATE: 24 December 1987

MR ISAAC - IR

cc PS/Chief Secretary  
PS/Financial Secretary  
Sir P Middleton  
Mr Scholar  
Mr Culpin  
Miss Peirson  
Miss Sinclair  
Mr Riley  
Mr Cropper  
Mr Tyrrie

Mr Battishill - IR  
PS/IR

**BILATERAL WITH MR MOORE; TASK FORCE/DHSS INTERFACE:  
CHILD TAX ALLOWANCES**

The Chancellor has seen your minute of 18 December.

2. He has commented that it is of course essential that over-riding priority is given to Budget and Finance bill work, and that any work on the taxation of child benefits must not be allowed to interfere with this. However, when the time comes to do this work in the context of child benefit, it should not take too long, given the work that has already been done in the recent past on the taxation of child benefit.

3. He is grateful for the interesting historical information, and for the Written Answer.

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

J M G TAYLOR