PO-CH/NL/0025

PART G

**SECRET**

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PO -CH /NL/0025

PART G

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

DD's 25 years NA33 4-01-96.

PO -CH /NL/0025
PART G

22.2.88

CLOSED
CONTINUED ON:-
PART H

Tax Return.

TASK FORCE SECRET

Inland Revenue

Policy Division
Somerset House

Copy No. 2 of 14

FROM: I FRASER

DATE: 4 January 1988

Financial Secretary

PAYE TAX TABLES

1. This note is concerned with the format of the PAYE Tax Tables for the coming tax year and seeks a decision, in principle, to a change which would be particularly desirable if the basic rate band were to be increased in the Budget by significantly more than indexation.

Background

2. The PAYE tax tables (copies attached to top copy only) are, broadly speaking, divided into two parts. The first part (the Free Pay Tables - Table A) enables the employer to take the initial step of converting the employee's gross pay to his taxable pay, by deducting from his gross pay the appropriate amount of personal allowances reflected in his PAYE code. We do not propose any change to Table A.

3. The second part (the Taxable Pay Tables) enables the employer to calculate the amount of tax to be deducted from taxable pay or to be refunded on any given pay day.

The Taxable Pay Tables

4. The Taxable Pay Tables are divided into three parts:

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cc Chancellor
Chief Secretary
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Isaac
Mr Lewis
Mr Mace
Mr R H Allen
Mr M W Hogan
Mr Fraser
PS/IR

a. Table B shows the tax due at the basic rate on each pound of taxable income for the length of the basic rate band, ie from £1 to £17,900.

b. Table C specifies the amount of pay for each week or month at which the employer should consider whether tax falls to be deducted at the higher rate(s).

c. Table D provides simple reckoners for calculating the tax due at each of the higher rates.

5. For the next tax year, Tables C and D will, as usual, be amended to reflect any Budget changes in higher rates and thresholds.

6. The major part of the Taxable Pay Tables is Table B - the basic rate table. In the current year this runs to 51 pages. As the basic rate band increases, so the size and production costs of this Table grow. Increasing the basic rate band to (say) (a) £18,700 (indexation) (b) £20,000 (c) £25,000 would have the following effects:

| | Extra pages | Approximate additional cost |
|---|---|---|
| (a) | 2 | NIL |
| (b) | 6 | £ 40,000 |
| (c) | 20 | £120,000 |

7. The change we have in mind is to curtail the size of the basic rate table by printing it in an abbreviated format for higher income levels. The tax due at the basic rate would be shown, as now, on each pound of taxable pay up to a limit, but thereafter only at intervals to the point at which the basic rate band terminates. For any amount in excess of the given point the employer would have to add together two figures.

8. The change in format would not affect employers with computerised payrolls who now deal with about half of all PAYE taxpayers. Nor would it affect employers who do not use the

Taxable Pay Tables but who use calculators to determine the tax due. It would only affect employers (largely those with few employees) who use the Taxable Pay Tables to determine the tax due on any given pay day. They would be put to a little more work if the taxable pay of any of their employees exceeded the chosen limit since they would have to add together two figures to calculate the tax due - at present they just read off one figure. However by pitching the limit at (say) £14,000 (ie of taxable income equivalent to gross pay of about £17,800 for a married man) we could ensure that the part of the table in one pound steps covered most employees for the whole year (and a very much higher proportion of employees for the major part of the year). This would produce a saving, compared with the present tables of about £80,000 in production etc costs. This would of course be an annual saving, though its precise amount would depend on future tax changes.

9. A similar but more radical proposal was made in 1982 and consultation took place with various bodies. The limit suggested at that time was £3,000 (equivalent to about £4,000 or so in real terms now). The representative bodies' reactions were not strong but not wholly favourable. The NFU recommended a higher point (£4,500 (about £6,000 or so in real terms now)) which would then have covered most agricultural workers. Your predecessor eventually decided against proceeding with the change at that time but did not rule it out for the future.

10. In the normal way we would give representative bodies an opportunity to comment on proposals of this kind. But the need to order the necessary paper this month and to go to the printers on Budget Day means that, if the change in format is to be made to the tables issued to implement Budget changes, prior consultation will not be possible. Nevertheless as the previous paragraph explains the idea has been mentioned previously, without provoking any strong adverse reaction and we are now suggesting a relatively much higher limit which should be much more acceptable.

Question for decision

11. We should be grateful to know whether you are content for us to plan on the basis that if the basic rate band is increased up to a level exceeding say £20,000 we should change the format of Table B of the PAYE Tax Tables (as proposed at paragraph 7) showing the tax due on each pound up to £14,000 and thereafter at intervals? Even if this level is not reached this year, it is clearly not desirable that the tables should continue to grow as the basic rate band is increased. We may therefore need to return to the subject after the Budget with a view to consultations before the tax tables for 1989-90 need to be prepared.

I Fraser

I FRASER

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

FROM: R J EASON
DATE: 7 JANUARY 1988

copy no 1 of 12

1. MR CALDER ✓ 7/1
2. CHANCELLOR OF THE EXCHEQUER

Thanks. I take it the guts of this (H4) is being incorporated in the analysis I have asked for for Mr Culpin's Chevening paper

Yes, his.

**TAX REFORM : INCOME TAX**

1. You asked for an analysis of a further option (Option H4) comprising, in 1988-89,

(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 £17,900, the higher rate threshold for 1987-88.

Option H4 is therefore identical to Option H3 except for the indexation of the higher rate threshold in Option H3 to £18,700.

2. You also asked for more detailed income analysis of the gainers under Option H3 than we provided in Mr Mace's submission of 23 December 1987. I regret that we have now

| | | |
|---|---|---|
| cc. | Mr Scholar<br>Mr Culpin | Chairman<br>Mr Isaac<br>Mr Beighton<br>Mr Calder<br>Mr Cayley<br>Mr Mace<br>Mr Eason<br>Miss White<br>PS/IR |

discovered a small simulation error in our original costing of Option H3 which credited the self-employed with the wrong amount of tax relief. I apologise for this error and give below full details for both Options H3 and H4. Please therefore disregard the figures in Mr Mace's submission of 23 December.

Costs

2. The full year costs and costs in 1988-89 of Options H3 and H4 compared with indexation are as follows:-

| | £ billion | |
|---|---|---|
| | **1988-89** | **Full year** |
| Option H3 | | |
| Cut basic rate by 3p | -3.75 | -4.20 |
| Reduce higher rates to 44p | -0.69 | -1.30 |
| Option H3 total cost | -4.44 | -5.50 |
| Retain higher rate threshold at £17,900 | +0.13 | +0.22 |
| Option H4 total cost | -4.31 | -5.28 |

3. The cost of Option H3 in 1988-89 is about £900 million more than Option D (Mr Mace's submission of 17 December) and, by not increasing the higher rate threshold, Option H4 reduces this difference to £800 million.

## Distributional Effects

4. There would be no losers under Options H3 and H4 (except for the half million non-taxpayers with MIRAS arrangements whose payments would increase because of the basic rate cut). There are however taxpayers with higher marginal rates, but they would all be gainers compared with 1987-88 and indexation. The table below summarises the position.

**Tax Units With Higher Marginal Rates 1988-89 compared with indexation of 1987-88 regime**

| Option | Taxable Income Range (£) | Number of tax Units (000s) | Change in marginal rate | Minimum net(*) gain per individual |
|---|---|---|---|---|
| H3 | 18,700-21,300 | 400 | 40 to 44 | 457 |
| H4 | 17,900-18,700 | 200 | 27 to 44 | 401 |
| | 18,700-21,300 | 400 | 40 to 44 | 297 |

(*) gain achieved at top of income range quoted after allowing for gain from basic rate cut, £561 for H3, £537 for H4 offset by effect of higher marginal rate.

5. The number of higher rate taxpayers (tax units) would be 1.3 million for Option H3, the same as under indexation. Under Option H4, this would increase to 1.5 million, with consequent staffing implications, over twice the level of 700,000 expected under Option D.

... 6. The attached tables give the detailed analysis of gainers and gains compared with retaining the 1987-88 regime. Under Option H3, the average gain is £312 and it increases steadily with income. Under Option H4, the <u>average</u> gain is reduced by £10 to £302, but the reduction only occurs at incomes above £20,000 where gains exceed £400. Under both options about 2.2 million tax units gain more than £500 per annum.

**R J EASON**

BUDGET SECRET - TASK FORCE LIST

Option H3 1988-89: GAINS compared with 1987-88

Gainers ranged by total income (lower limit)

| Range of total income | Amount of gain | Number of gainers | Average gain |
|---|---|---|---|
| £000s | £million | 000s | £ |
| 0 | 2523 | 15401 | 164 |
| 15 | 243 | 780 | 311 |
| 16 | 210 | 625 | 336 |
| 17 | 230 | 634 | 362 |
| 18 | 197 | 504 | 391 |
| 19 | 176 | 435 | 406 |
| 20 | 177 | 406 | 437 |
| 21 | 149 | 316 | 473 |
| 22 | 135 | 271 | 498 |
| 23 | 117 | 219 | 535 |
| 24 | 103 | 181 | 571 |
| 25 | 433 | 653 | 662 |
| 30 | 286 | 369 | 774 |
| 35 | 192 | 204 | 944 |
| 40 | 157 | 128 | 1228 |
| 45 | 117 | 70 | 1657 |
| 50 | 1242 | 222 | 5603 |
| TOTAL | 6688 | 21418 | 312 |

GAINS

Gainers by range of income and amount of gain

| Income range (lower limit) | Amount of gain (£ per year) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| £000s | 0-50 | 50-100 | 100-200 | 200-300 | 300-400 | 400-500 | >500 | TOTAL |
| 0 | 1274 | 2871 | 6125 | 4109 | 1020 | 2 | 0 | 15401 |
| 15 | 0 | 0 | 14 | 306 | 420 | 40 | 0 | 780 |
| 16 | 0 | 0 | 1 | 172 | 369 | 83 | 0 | 625 |
| 17 | 0 | 0 | 1 | 110 | 341 | 182 | 0 | 634 |
| 18 | 0 | 0 | 0 | 40 | 235 | 217 | 11 | 504 |
| 19 | 0 | 0 | 0 | 5 | 208 | 193 | 29 | 435 |
| 20 | 0 | 0 | 0 | 4 | 119 | 217 | 65 | 406 |
| 21 | 0 | 0 | 0 | 0 | 59 | 162 | 95 | 316 |
| 22 | 0 | 0 | 0 | 0 | 6 | 141 | 124 | 271 |
| 23 | 0 | 0 | 0 | 0 | 5 | 71 | 143 | 219 |
| 24 | 0 | 0 | 0 | 0 | 1 | 34 | 146 | 181 |
| 25 | 0 | 0 | 0 | 0 | 0 | 15 | 638 | 653 |
| 30 | 0 | 0 | 0 | 0 | 0 | 0 | 369 | 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 | 1274 | 2872 | 6141 | 4747 | 2783 | 1357 | 2244 | 21418 |

BUDGET SECRET - TASK FORCE LIST

Option H4 1988-89 : GAINS compared with 1987-88

Gainers ranged by total income (lower limit)

| Range of total income £000s | Amount of gain £million | Number of gainers 000s | Average gain £ |
|---|---|---|---|
| 0 | 2523 | 15401 | 164 |
| 15 | 243 | 780 | 311 |
| 16 | 210 | 625 | 336 |
| 17 | 230 | 634 | 362 |
| 18 | 197 | 504 | 391 |
| 19 | 176 | 435 | 406 |
| 20 | 177 | 406 | 436 |
| 21 | 146 | 316 | 464 |
| 22 | 131 | 271 | 485 |
| 23 | 112 | 219 | 512 |
| 24 | 97 | 181 | 536 |
| 25 | 374 | 653 | 572 |
| 30 | 243 | 369 | 657 |
| 35 | 165 | 204 | 810 |
| 40 | 138 | 128 | 1080 |
| 45 | 105 | 70 | 1494 |
| 50 | 1202 | 222 | 5424 |
| TOTAL | 6470 | 21418 | 302 |

GAINS

Gainers by range of income and amount of gain

| Income range (lower limit) £000s | Amount of gain (£ per year) 0-50 | 50-100 | 100-200 | 200-300 | 300-400 | 400-500 | >500 | TOTAL |
|---|---|---|---|---|---|---|---|---|
| 0 | 1274 | 2871 | 6125 | 4109 | 1020 | 2 | 0 | 15401 |
| 15 | 0 | 0 | 14 | 306 | 420 | 40 | 0 | 780 |
| 16 | 0 | 0 | 1 | 172 | 369 | 83 | 0 | 625 |
| 17 | 0 | 0 | 1 | 110 | 341 | 182 | 0 | 634 |
| 18 | 0 | 0 | 0 | 40 | 235 | 217 | 11 | 504 |
| 19 | 0 | 0 | 0 | 5 | 208 | 193 | 29 | 435 |
| 20 | 0 | 0 | 0 | 4 | 119 | 217 | 65 | 406 |
| 21 | 0 | 0 | 0 | 0 | 59 | 162 | 95 | 316 |
| 22 | 0 | 0 | 0 | 0 | 6 | 143 | 121 | 271 |
| 23 | 0 | 0 | 0 | 0 | 5 | 82 | 132 | 219 |
| 24 | 0 | 0 | 0 | 0 | 1 | 44 | 136 | 181 |
| 25 | 0 | 0 | 0 | 0 | 0 | 29 | 624 | 653 |
| 30 | 0 | 0 | 0 | 0 | 0 | 1 | 368 | 369 |
| 35 | U | 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 | 221 | 222 |
| TOTAL | 1274 | 2872 | 6141 | 4747 | 2783 | 1397 | 2204 | 21418 |

FROM: J M G TAYLOR

DATE: 8 January 1988

MR EASON

cc Mr Scholar
Mr Culpin
Mr Battishill IR
Mr Isaac IR
Mr Calder IR
PS/IR

**TAX REFORM: INCOME TAX**

The Chancellor was grateful for your minute of 7 January.

J M G TAYLOR

**BUDGET SECRET: TASK FORCE LIST**

COPY NO. 10 of 10.

FROM: A C S ALLAN

DATE: 13 January 1988

MR CULPIN

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Cropper
PS/IR

**CGT ASSIMILATION**

The Chancellor was grateful for your minute of 17 January. But he sees some snags in your arguments:

(i) do we not also exempt corporate bonds from CGT? and

(ii) are we not concerned about the liquidity of the equity market?

2. He would be grateful for a further attempt.

ACSA

A C S ALLAN

H M Treasury
Parliament Street London, SW1P 3AG
Switchboard 01-270 3000
Direct Dialling 01-270 ..............

P J Cropper
Special Adviser

21 January 1988

Lord Brentford
Familybase
Jubilee House
3 Hooper Street
CAMBRIDGE
CB1 2NZ

Dear Lord Brentford,

Thank you for your letter of 20 January, covering the paper on Reform of Personal Taxation.

This paper is interesting, and I am copying it to Ministers. But I am afraid I cannot discuss the matter between now and the Budget. When Paul Mills rings I will tell him, as politely as I can, that I am now in purdah, and would get my head chopped off if I engaged in discussion of any tax matter.

Yours sincerely

Peter Cropper

P J CROPPER

FAMILYBASE

Jubilee House,
3 Hooper Street,
Cambridge
CB1 2NZ,
Tel: Cambridge
(0223) 311596

20 January 1988

Peter Cropper Esq
The Treasury
Parliament Street
LONDON SW1

Dear Mr Cropper

I was sorry that you were unable to manage the meeting of the group on Friday at the Lord Chancellor's office. We had a most interesting meeting.

Please find enclosed a copy of the paper we have prepared on the issue of personal taxation. Paul Mills will ring you in the near future to discuss the paper with you. We would be grateful if you could send us any comments you have on the paper, and if you feel it is appropriate, perhaps you could circulate it within the Treasury. Although we strongly support many of the ideas in the Green Paper, we are concerned that the new basis laid out will tend towards viewing couples simply as individuals, which we think will further undermine the status of marriage.

We look forward to hearing from you in due course, and hope to see you at the next meeting of the group.

With warm regards,

Yours sincerely

Brentford

Brentford

FAMILYBASE

Jubilee House,
3 Hooper Street,
Cambridge
CB1 2NZ,
Tel: Cambridge
(0223) 311596

# THE REFORM OF PERSONAL TAXATION IN THE UK*



## 1. Introduction.

The reform of personal taxation is an issue beset by complexity. Whilst the present system is widely recognised as being unsatisfactory, it seems that any proposal for reform has serious drawbacks. As a movement based on Christian principles, we believe it is important to establish the ethical foundation on which policy is to be built. This is especially true in an area where there appears to be cogency and sense on both sides of the argument. The moral dimension clarifies the direction that policy ought to follow.

The approach adopted in these proposals, therefore, is to suggest some of the Christian ethical presuppositions that are of relevance to the structuring of a personal income tax system. The direct implications for tax reform are then spelt out as well as a critique of the 1986 Green Paper on tax reform based on these presuppositions. The detailed policy proposals are then given with some discussion.

* This research was carried out for Familybase by the Jubilee Centre.

The conclusions drawn from the implications for policy in drawing up detailed proposals are open to question, even by those accepting the Christian ethical foundation. Although we trust that the proposals are broadly consistent with the principles outlined, consideration such as ease of administration may dictate amendment. The proposals are not as far-reaching as we would wish as some consideration was given to consistency with the present PAYE system and the scale and nature of reform that would be acceptable to the present government.

## 2. Some Christian Ethical Presuppositions.

a) In the intention of God, marriage is a lifelong commitment to a single partner of the opposite sex. Marriage creates a physical and emotional bond which cannot be broken without serious pain to the parties involved and their children. Society should therefore encourage permanency and fidelity in marital relationships.

b) Marriage as a legal institution is to be encouraged because it fosters greater commitment to each other in the couple's relationship, as well as responsibility in the parenting of children. However, a couple who are cohabiting are joined by the same emotional and physical bonds and have the same responsibilities towards each other that a married couple have and are 'married' in all but the legal sense.

c) Notwithstanding these beliefs, it must be recognised that divorce occurs. Whilst society must not encourage divorce, legal provisions are necessary to protect the interests of partners and children in this event.

d) Marriage is a union of co-equals. Whilst many Christians would wish to assert that a husband has leadership responsibility within the marriage, this is a difference in role rather than status. Therefore, the wife should be accorded an equal status with the husband by external authorities.

e) Work has inherent value and worth irrespective of whether the labour market prices the activity by establishing a wage rate or not. Therefore, the rearing of children by either parent, the work involved in caring for relatives and the voluntary work within neighbourhoods should not be regarded as having no social value simply because a wage is not paid.

f) Justice requires that couples with similar income levels should be taxed at the same rate. This should be the case regardless of the sources from which the income is derived.

3. Implications of the Reform of Personal Taxation.

a) Joint Taxation: The belief that a married couple have become a single entity and should regard themselves as such implies that external authorities should also recognise them as such. Hence, for tax purposes, a couple should be taxed as a single unit rather than as two individuals. Although the reality of many contemporary marriages may not equate with the ideal, external authorities should treat the couple as one unit so as to promote the ideal (with provision for exceptions where the couple feel strongly that they wish to be taxed separately). The retention of joint taxation is consistent with the trend in property law which already treats a couple's property as jointly owned.

b) 'Same Income - Same Tax' for Couples: The belief that external authorities should treat couples in the same circumstances equally implies that, for income tax purposes, couples with the same total income should be liable to pay the same total amount of tax. This is not achieved at present since couples with the same incomes pay less tax if both spouses are earning or the wife is the sole breadwinner. A system of joint taxation with set allowances irrespective of whether both spouses are earning or not ensures that couples with the same incomes pay the same amounts of tax. The desire for joint taxation and 'horizontal equity' means that the investment income of the couple also needs to be aggregated and taxed on the same basis as earned income.

c) 'Mutual Disclosure': Consistent with the belief that a couple should regard themselves as a single unit is the need for the tax authorities to encourage the 'mutual disclosure' of financial information between the couple. At present, when a tax return is made, only the husband's signature appears, with the result that his wife cannot maintain 'privacy' whereas he can. The answer to this asymmetry is not to give both spouses 'privacy' but require that both signatures appear on any tax return. Such a reform would discourage the attitude that husband and wife should have secrets from one another and hopefully foster greater trust and commitment within the relationship. Again, if the couple felt strongly enough, they could opt for separate taxation.

d) Removal of Tax Penalties on Marriage: In accordance with the belief that a cohabiting couple should have their 'marriage' legally recognised, then the tax penalties to marriage should be reduced as far as possible. In many cases, the tax system gives an incentive to marriage through the married man's allowance (MMA) but in some circumstances a penalty exists. The most obvious example is the loss of a tranche of mortgage interest relief to a cohabiting couple on marriage with the penalty increasing with the level of interest rates, the incomes of the couple and the size of the mortgage.

Consistency with the principles established implies that a married couple should enjoy the same total reliefs as a cohabiting one, irrespective of whether both people are earning or not.

e) Recognition of the Value of Unpaid Work: The belief that unpaid work has social value is contradicted by the present tax structure which grants a tax allowance to wives who engage in paid employment. The result is that couples where the wife wishes to look after children, care for relatives or undertake voluntary work face a tax penalty at the time when income may be declining through the loss of the wife's earnings. If the external authorities are going to recognise the value of one parent not taking full-time employment when children are still young, the care of the elderly within the family unit and voluntary workin the community, then a couple needs to be treated in the same way for tax purposes irrespective of whether one or both are in paid employment.

4. Areas of Agreement with the 1986 Green Paper.

a) No marriage disincentives: The Green Paper is scrupulous in its desire to remove any financial penalty that a couple might face when becoming married. This is consistent with the belief that society should not discourage legal marriage in the hope that this fosters greater permancy of relationships.

b) Equal treatment of husband and wife: The recent proposals ensure that the tax authorities treat husband and wife as co-equals within marriage.

c) No unpaid work disincentives: The Green Paper highlights the artificial tax incentives for both partners of a marriage to undertake paid employment and the penalty incurred when one spouse ceases to participate in the labour market. The proposals made would remove this penalty which occurs at a time in the lifecycle when the household income is likely to be declining in any event.

d) Easing of the poverty trap: The Green Paper cited the problem that attempts to alleviate the poverty trap by raising allowances is not cost effective in that most of the benefit is enjoyed by those not in the situation. The proposals would make it more effective to reduce the numbers facing high marginal tax rates through raising allowances.

5. Areas of Disagreement with the 1986 Green Paper.

a) Independent taxation: The Green paper proposed the adoption of completely independent and separate taxation. This paper is based on joint taxation, as a reflection of the nature of marriage. The other criticisms flow automatically from this choice.

b) <u>Same income, different tax</u>: Irrespective of whether a couple are allowed to transfer allowances or not, independent taxation ensures that couples with the same income levels pay different amounts of tax when the higher bands of tax are encountered. This is not acceptable under joint taxation.

c) <u>Disaggregation of investment income</u>: Independent taxation logically requires that investment income be taxed separately, although this encourages artificial transfers of property between spouses and raises difficulties in taxing income which has been derived from property jointly owned by the couple. (Note: No country in Europe taxes investment income of couples on an individual basis).

d) <u>'Privacy'</u>: One of the reasons for proposing the independent taxation was the desire to allow individuals to maintain financial privacy. This seems to encourage the view that couples should maintain privacy in preparation for the possible dissolution of the marriage, and is unacceptable in the light of our ethical presuppositions about the status of women within marriage.

6. <u>Proposed Reforms to the Present Tax System</u>.

a) Abolish the married man's allowance and allow both husband and wife to each claim a single person's allowance. (If it was desired that no couple should lose, the single person's allowance needs to be raised from £2425 to £3110 in line with the 1987/88 tax schedule).

b) Enable the main earner to claim all or part of the secondary earner's allowance if this is unused (ie. adopt the arrangements for fully transferable allowances outlined in the Green Paper).

c) Maintain the present PAYE (cumulative assessment) system with an end of year reassessment of couples who both pay tax at a higher rate when aggregated, (some 2% of all couples).

d) Maintain the aggregation of the investment and earned income of the couple.

e) Introduce a married couple's tax structure with significantly wider bands than the single person's structure so as to remove some of the disincentive to marriage faced by higher rate taxpayers that arises through the aggregation of earnings.

f) Require all tax returns to be signed by both husband and wife (whether they both work or not) whilst retaining the option for separate assessment if couples wish to maintain privacy.

g) Adjust mortgage tax relief so as to remove the disincentive to marriage. Rather than attaching the relief to the property, we believe this can best be achieved by allowing a single person to enjoy tax relief on mortgage interest up to a mortgage of either £15,000 or £20,000, with a married or cohabiting couple able to aggregate their reliefs to £30,000 or £40,000. (To help finance the more generous option, or help pay for the higher single person's allowance, relief should only be made available at the basic rate of tax.)

7. Discussion.

a) Fully transferable allowances: In order to be consistent with the ethical presuppositions, a system of fully transferable allowances is required. It is recognised that a system of partially transferable allowances has some advantages, notably greater administrative simplicity and removing the tax disincentive for wives to engage in paid employment. A partially transferable allowance system remains a compromise since it still maintains a tax penalty for forsaking or foregoing paid employment (if somewhat diminished) and does not ensure that couples with the same incomes pay the same tax. Although it is impossible to be dogmatic where there is a need to choose the lesser of two evils, in our judgment, given the prevailing materialistic ethos of society, it is more important not to discourage wives from giving priority to spending time with children and relatives and in voluntary work, than to positively encourage them to go out to paid work.

b) Mortgage interest relief: It seems clear that all mortgage interest relief artifically stimulates the demand for owner-occupied dwellings; the value of relief is largely capitalised into house prices. At a time when house price inflation is damaging the ability of many first-time buyers to make a purchase in some areas and ensuring that they have to take on the largest mortgage burden they can manage, it is not desirable to increase the overall level of mortgage interest relief. The suggestion that the relief be attached to the property rather than the mortgagors would certainly eliminate the disincentive to marriage but would be extremely punitive to those people who have taken out mortgages on a multiple basis. This is a feature more common in London and the South East, but only a maximum of 5% of the mortgages taken out would be affected. The suggestion to attach mortgage interest relief to the property also poses administrative difficulties when a property is jointly mortgaged. In situations where two or more individuals jointly take on mortgages on a single property, the Inland Revenue would require an inventory of mortgaged properties as well as a system for allocating the interest relief based either on the relative size of the mortgagors' incomes or on the size of their mortgage contributions.

If the proposal reducing the single person's mortgage interest relief to £20,000 then the most that a single mortgagor paying basic rate tax would be £278 a year at current interest rates. (This figure is only applicable if the mortgage exceeds £30,000). This loss would be at least partly offset by the rise in the single person's allowance, proposed above, or could be compensated through a fall in the basic rate of income tax.

18 January 1988

BUDGET SECRET: TASK FORCE LIST

Copy No ' of 26

# Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Nl/lom

FROM: A J G ISAAC
21 January 1988

CHANCELLOR OF THE EXCHEQUER

## ADDITIONAL PERSONAL ALLOWANCE

1. At Monday's Overview meeting you asked us to consider the possibility of disallowing APA in <u>all</u> cohabitation cases, not just those cases where an unmarried couple is claiming two APAs.

2. This note reviews (first) the distributional and policy implications and (second) the management implications.

### <u>Distributional and policy implications</u>

3. The DHSS/Treasury/Revenue paper of 23 December reported three main policy difficulties which officials saw in the options which involved withdrawing APA from <u>all</u> cohabiting couples.

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Miss Peirson
Miss Sinclair
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill
Mr Isaac
Mr Painter
Mr Lewis
Mr Corlett
Mr Beighton
Mr Mace
Mr Stewart
Mr Allen
Mr J C Jones
PS/IR

APA

a. It created 100-150,000 actual cash losers, who would see their existing APA withdrawn, and few of whom would see anything approaching equivalent compensation from other elements in the package. (Some might have increased entitlement to income-related benefits.)

b. It would mean that the cohabiting couple with a child would get less tax relief than <u>either</u> a married couple <u>or</u> a single parent with a child.

c. It would impose a "penalty on the family" - which the DHSS saw as socially undesirable. The man (in the typical case) would lose tax relief if he formed a stable family relationship with the mother and child.

4. Some of us saw the disadvantages at (a) as potentially acceptable, in the context of a broader OPB approach; and in the interests of avoiding the need for (what we saw as an at least equally sensitive) "penalty on the family" in the maintenance proposals (points (b) and (c) did not arise in that form on the OPB approach).. Others were more worried. Certainly, it seemed to us that there was a question whether these disadvantages were worth incurring, except in the context of what the Financial Secretary has described as the "radical" OPB approach.

<u>Management implications</u>

5. As we emphasised at your meeting on 15 January, we saw no realistic prospect in practice of effectively monitoring a "cohabitation rule". Like the DHSS, we could send a piece of paper to APA claimants every few years, reminding them to tell us if they were cohabiting. But we could not do much more than that, or realistically take any responsibility for looking at the facts behind the claimants' statements. The annual basis of tax (by contrast with the DHSS basis) is an added problem.

6. In the case of the "double APA" claimant, we came - with some considerable hesitation - to the conclusion that we could just about run a cohabitation rule, and defend its administration. The numbers would be reasonably small (up to 20,000). And the test would not be of cohabitation as such, but the claiming of two allowances by a single cohabiting couple. We think we might achieve the objective of restricting the double allowance by limiting a cohabiting couple to a single claim in respect of the youngest (or possibly oldest) child resident with them.

7. A general "cohabitation" rule would be a different kettle of fish. In some ways the question would be simpler ('Are you cohabiting?', rather than 'Are you cohabiting and, if so, is your partner also making a claim?') - though we already have to ask APA claimants generally if anyone else is making a claim in relation to their child. And withdrawal of APA altogether would itself be a simpler operation than its apportionment between two claimants. However, the numbers would be much larger (100-150,000). And, as I have said, we should be charged, not with policing a new benefit confined from the outset to "single parents", but with withdrawing an existing allowance from people who are now enjoying it.

8. In brief, <u>any</u> "cohabitation" rule in the tax legislation would face us with a prospect in which

- we might be expected to enforce the rule

- but we see no means of doing so.

A <u>"general"</u> cohabitation rule looks to us more difficult, on both counts. There could be a greater need for enforcement, because of the large numbers, and because existing APA recipients could regard the change as unfair* and could therefore be tempted to give themselves the benefit of any imaginative doubt as to what precisely constitutes cohabitation. But there would not be the objective fact of a 'double claim' to APA. This gives us anxiety in relation to our accountability and possible future review by NAO and PAC.

Linking APA to OPB

9. Another perhaps more promising approach, discussed in the official papers, would be to make APA conditional on receipt of OPB and other related benefits. There would be some technical "rough edges" (for example, single parents with children in higher education would have no compensation for their lost APA); and more generally,future changes in the OPB etc rules would affect future entitlement to APA ); but these points may not be decisive in themselves. However, the discussions which we have already had with DHSS make it clear that there would be a lot of hard, detailed work both in cutting away the rough edges and in working out the administrative arrangements for any necessary transfer of information between the Revenue and DHSS (which might themselves need legislative cover because of the confidentiality issues which would be raised). For a 1988 exercise, I am told that this work could well use up much of the few weeks now available to us before the Budget and Finance Bill - time which (I have to say) is already heavily pre-empted for the main income tax work and independent taxation. However, if you wish to pursue the wider withdrawal of APA, this seems to us a more promising option, on present information, and something which would be worth working up in more detail for the 1989 Budget.

10. There is one further presentational aspect. As you know, one of the few areas in which the Green Paper produced anything like a general consensus (amongst those who commented on the

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*because of the arguments at 3(b) and (c) above point) was in favour of substituting OPB for APA. People may ask why, if the Government are prepared to make the APA a "one-parent" allowance - and still more to tie APA to OPB - they have not been able to take the further step of subsuming APA within OPB, with the accompanying simplification and staff savings. The answer would presumably be that given at your meeting.

Penalty on marriage

11. You raised this issue at the Overview meeting, in the context of the tax penalty on marriage. The rules for APA for an unmarried couple will in some circumstances be more favourable than the rules for a married couple.

12. As we explained, the problem arises from the "vanishing exemption" for the MCA under independent taxation. As you replied at the time, it is very much a minority problem, in particular for the two-income couple with a high income man. The size of the problem will of course depend very much on the income level which is set for withdrawal of the MCA. This income level will also be important for staff costs (which further work suggests could turn out very much towards the top end of the range of estimates). Mr Mace will let you have a further note on all this, when we have completed the detailed work now in hand.

C.I.C.I.

A J G ISAAC

PV

COPY NO. 2 OF 32

FROM: C J RILEY
DATE: 28 JANUARY 1988

CHANCELLOR

cc PPS
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Sedgwick

Miss Sinclair
Miss C Evans
Mr Scotter
Mr A Hudson
Mr Cropper
Mr Tyrie
Mr Call

Inland Revenue
Mr Battishill
Mr Isaac
Mr Painter

Customs and Excise
Mr Unwin
Mr Knox

## CGT COSTINGS

I attach a paper by Ian Scotter and I. It reports the revised costings which we and the Revenue have produced, which are incorporated in today's scorecard. The minute I sent you on 11 November contains more detail on the basic analysis; it is attached (top copy only) for ease of reference.

2. The main differences from the figures in last week's scorecard are:

- new figures for companies;

- an explicit allowance for forestalling.

The figures for companies are rather higher than before, raising the revenue cost in 1989-90 and beyond; forestalling produces a small revenue gain in 1988-89. The figures are still provisional, and subject to further revision.

3. The modelling of company gains is still posing problems. Among the difficulties involved is the need to separate out the effects of the rise in tax on company gains in the 1987 Budget from the fall due to rebasing. My feeling is that the behavioural response to rebasing - the degree of unlocking - may perhaps be understated somewhat in the current estimate for 1988-89. If so, further work may produce some decline in the estimated cost of rebasing - but of course there may be other revisions which go the other way.

4. I cannot stress too much the considerable uncertainties involved in these calculations:

- the underlying forecast of CGT depends crucially on the prospect for asset prices and turnover, both of which are subject to wide margins of error;

- a wide range of behavioural responses to the new regime is possible, with significantly different implications for revenue;

- doubling the exemption for married couples under independent taxation may lead to some locking in over the next two years, but as yet we have not assessed the likely effects.

CJR

**C J RILEY**

## CGT COSTINGS

### Introduction

This note brings up to date the costings of CGT reform contained in Mr Cayley's minute of 9 November and Mr Riley's minute of 11 November. It sets out our views on the likely effects, but does not consider issues of presentation - for example the treatment in the FSBR. The figures are still provisional: we and the Revenue will be refining them further.

2. There have been a number of changes since November which affect the costings and are taken into account in the current note:

(i) Revised forecasts of the CGT base in the absence of reform - of equity prices and turnover, and of land prices. See Annex A for details.

(ii) The new income tax package, with a higher rate of 40p and a higher rate threshold of £20,000.

(iii) Improvements to the modelling of company gains within CT, and a substantial increase in the assumed amount of these gains.

A 'central' assumption about behavioural responses is suggested, consistent with those underlying earlier scorecards. We have also added in an explicit allowance for forestalling at the end of 1987-88.

3. The note looks separately at the effect of the reforms on revenue from <u>individuals and trusts</u> and from <u>companies</u>. For individuals and trusts it distinguishes:

- the effect of <u>assimilation</u> with income tax rates; and

- the effect of assimilation combined with <u>rebasing</u> of gains to 1982.

It does not look at rebasing alone on the basis of present (ie pre-reform) tax rates.

4. The main conclusions of the paper are that:

- using our central estimates of behavioural response, the overall cost of the reform in terms of <u>accruals</u> will be slightly higher from 1988-89 onwards than in earlier scorecards because of higher figures for companies; but forestalling will lead to a rise in accruals in 1987-88.

| **1987-88** | **1988-89** | **1989-90** |
|---|---|---|
| +150 | -420 | -520 |

- <u>receipts</u> lag behind accruals, and we expect the following pattern:

| **1988-89** | **1989-90** | **1990-91** |
|---|---|---|
| +70 | -270 | -520 |

- these estimates are highly uncertain. Alternative assumptions about behavioural responses significantly change the costings; the underlying forecast is subject to wide margins of error, and this too affects the costings.

## Individuals and trusts

### (a) Effect on tax rates

5. The two components of the reform - assimilation and rebasing - will each change effective tax rates for different categories of taxpayer/asset:

**Assimilation** will raise the effective tax rate on disposals by higher rate taxpayers, and will push some basic rate taxpayers into higher rate tax. Those who remain basic rate taxpayers will face lower effective tax rates;

**Rebasing** on its own will reduce effective tax rates on disposals of assets acquired before 1982. In general the reduction is larger the longer the asset has been held.

6. The latest data on CGT suggests that about half the total number of disposals by individuals in 1985-86 were made by basic rate taxpayers and about half by higher rate taxpayers. In terms of the value of gains, however, higher rate taxpayers account for a somewhat higher proportion - roughly two thirds - because the average size of their gains was greater than those of basic rate taxpayers. The reforms will mean that perhaps two thirds of the number of disposals, accounting for about 90% of gains, will now be subject to the higher rate . The proportion of pensioners' gains subject to the higher rate will be lower than for total gains - perhaps 55% by number and 80% by value.

7. For assets acquired before 1982 the effects of assimilation and rebasing interact. For those who remain basic rate taxpayers, rebasing further reduces the effective tax rate. For those who are, or who become, higher rate taxpayers, the reduction from rebasing offsets or partly offsets the increase in the nominal tax rate. On average higher rate taxpayers will face reduced effective tax rates on assets acquired before about 1979 and increased tax rates on later acquisitions.

8. At present the average effective tax rate on nominal gains is about 20%. The pattern of changes due to the proposed reforms is summarised in table 1 below. Annex B gives further details.

**Table 1 Changes in average effective tax rates (points)**

| | Basic rate taxpayers | Higher rate taxpayers | All taxpayers |
|---|---|---|---|
| Assimilation only | +2.0 | +5.5 | +3.8 |
| Assimilation and rebasing | -3.7 | -0.8 | -2.3 |

The directions of change are fairly intuitive with one exception: the average effective rate for those who are currently basic rate taxpayers rises on assimilation as some are drawn into higher rate tax.

9. In considering the significance of the new CGT rates, and in particular the increase to 40% for higher rate taxpayers, it is instructive to compare the implied rates of tax on income and gains. Even if the CGT threshold is ignored, indexation of gains (in all cases now, following rebasing) but not income, generally implies a lower tax rate on nominal gains than on nominal income. Three examples suffice to illustrate this:

- with inflation at 2% and real gains of 2% per annum, a 40% CGT rate is equivalent (in a steady state) to an income tax rate of 20%.

- with inflation at 5% and real gains of 3% per annum, a 40% CGT rate is equivalent to an income tax rate of 15%.

- with inflation at 6% and real gains of 2% per annum, a 40% CGT rate is equivalent to an income tax rate of 10%.

**(b) Behavioural response**

10. A reduction in effective tax rates is likely to 'unlock' some assets, making it worthwhile to dispose of them earlier than otherwise. Conversely an increase in tax rates may increase locking in, delaying disposals. Although there is general acceptance of the theoretical case for locking-in effects, there is no UK evidence of the size of these effects. Such evidence as there is comes from the US, but even this has led to a wide range of estimates.

11. The range of US estimates for disposals of equities is summarised in Table 2.

**Table 2 Percentage effect on the value of taxable gains on shares per 1 point reduction in marginal CGT rates**

| Study | Transitory effect | Permanent effect | Total in short run |
|---|---|---|---|
| Feldstein, Slemrod and Yitzhahi (1977) | - | 12.3 | 12.3 |
| Minarik (1981) | - | 3.0 | 3.0 |
| Auten-Clotfelter (1982) | 10.0 | 4.3 | 14.3 |
| US Treasury Office of Tax Analysis (1985) | 9.6 | 8.8 | 18.4 |
| Lindsey (1986) | 3.1 | 5.5 | 8.6 |

12. There are a number of reasons for believing that the higher estimates from the US studies would not apply in the current UK context:

- share ownership is more widespread in the US than here, and individuals are more active in the US market;

- US rates apply to all nominal gains, and there is no annual exempt amount;

- there are econometric worries. Some of the effects of an upturn in the US stock market may have been attributed mistakenly to cuts in tax rates;

13. As in the November work we have therefore focused on a slightly lower range of responses:

shares: 2-12% in the first year, 2-6% thereafter.

land: 1-4½% in the first year, 1-3% thereafter.

While in our view these ranges should span the likely responses, we would expect the latter if anything to be closer to the bottom end than the top.

14. There is a case for arguing that the responses to tax reductions may be greater than for tax increases: asset holders can in principle realise all their gains if they wish when tax rates fall, but can only hold off realising those they would otherwise have done when rates rise. Our view is that there is some merit in this argument, which points to a greater 'surge' of disposals for any given average change in tax rates.

15. We have therefore incorporated an asymmetry in the responses underlying our central estimates:

| | 1988-89 | | later years | |
|---|---|---|---|---|
| | shares | land | shares | land |
| Reduction in tax rate | 6 | 2½ | 3 | 1½ |
| Increase in tax rate | 3 | 1½ | 3 | 1½ |

Note that because of the asymmetry the central estimates do not always lie within the range of estimates based on symmetrical responses, though they do so in most cases.

16. One final point is worth noting. The introduction of independent taxation in 1990 will effectively double the annual exemption for married couples. This may lead to some additional locking in, with couples delaying disposals until they can take advantage of the higher exemption. We do not know the likely scale of this, and as yet we have not made any allowance for it in our calculations.

**(c) Costings**

17. The costings are set out in Annex C.

18. **Assimilation** of CGT and income tax raises the average effective tax rate. In the absence of any behavioural response this would raise CGT accruals by 300 million in 1988-89 and £460 million in 1989-90, rather more than with the pre-Chevening tax package. But the behavioural responses will on balance reduce disposals, and hence reduce the revenue gain; the responses we have examined imply reductions in accruals of up to £900 million in 1988-89, which is more than the ex ante increase.

19. Our central estimate for 1988-89 suggests a rather smaller fall in disposals, equivalent to nominal gains of about £1 billion, reducing accruals by about £220 million; for 1989-90 the effect is slightly larger, reflecting the underlying growth of share disposals in the forecasts. This leaves some overall increase in CGT accruals; £80 million in 1988-89 and £150 million in 1989-90.

20. **Assimilation and rebasing combined** have the effect of reducing average effective tax rates on balance. In the absence of a behavioural response this would reduce CGT accruals by £190 million in 1988-89 and £130 million in 1989-90. But the behavioural responses will lead to an increase in disposals, at least partially offsetting the revenue cost; the responses we have examined imply increases in accruals of up to £110 million in 1988-89. The range of effects is rather smaller than for assimilation alone because the change in average tax rates is smaller.

21. Our central estimate for 1988-89 suggests that there may be extra disposals equivalent to gains of about £½ billion, raising accruals by about £110 million. Because of the asymmetric responses we have assumed, this is at the top of the range of estimates. In 1989-90 the rise in disposals is likely to be rather less, as the 'surge' effect dies away. This leaves a small reduction in accruals in each year; £80 million in 1988-89 and £110 million in 1989-90.

22. The effects of **rebasing** on its own are similar to those of assimilation alone, but with the sign reversed. Effective tax rates fall, disposals increase, and the range of revenue effects indicated by the different behavioural assumptions is wide (roughly £1000 million in 1988-89). Our central estimate gives a reduction in CGT accruals of £160 million in 1988-89 and £250 million in 1989-90.

23. The behavioural responses to integration and rebasing tend to cancel each other out, leading to more stable figures for the combined package.

**Companies**

24. Since November, the modelling of taxation of company gains has been revised. It now takes account of the results obtained from the Revenue's sample of CGT data for individuals, adapted to allow for the different circumstances of companies as far as it has been possible to determine them from a quick examination of a number of company returns. However the estimates still depend largely upon judgement of a number of factors, and are very sensitive to changes in the assumptions made about these.

25. The underlying forecast of company gains has been revised up as a consequence of this new work, and hence the costings likewise. More information on the baseline is given in Annex A.

**(a) effect on tax rates**

26. The taxation of capital gains made by companies is affected only by rebasing. The current reform will therefore reduce the effective tax rate on gains on assets acquired before 1982. With no behavioural response, this would lead unequivocably to a loss of revenue. Any behavioural response will be all in one direction - an increase in disposals of pre-1982 assets.

**(b) Behavioural responses**

27. There is no evidence in either the UK or the US on the response of companies to changes in the tax rate on gains. Companies will undoubtedly respond to reductions in the tax rate on their gains. At the margin, disposal of pre-1982 assets will become more attractive. For instance, property investment companies regularly reviewing their asset holdings will find that it becomes worthwhile to sell off some assets which they would previously have just chosen to hold on to.

28. There is a case for arguing that the response by companies would be smaller than for individuals. Disposals by companies are by nature lumpy and infrequent events and cannot easily be varied at the margin; many of the 'share' transactions by non-financial companies appear to be disposals of wholly owned subsidiaries rather than adjustments within a portfolio of regularly traded shares. But against this, there will be companies who did not find it worthwhile to make their disposal under the existing tax system but will with rebasing - the behavioural response would be more companies trading assets rather than existing traders increasing their disposals.

29. The case for a larger behavioural response by companies, particularly in the short run, is that they are more heavily locked into existing assets than individuals. Companies do not have the benefit of the annual exemption which allows individuals to dispose of assets gradually without incurring any tax liability at all.

30. In the absence of evidence to the contrary, the central estimates for company gains assume the same behavioural response by companies as for individuals and trusts.

**(c) Costings**

31. In the time available it has not been possible to analyse a range of different responses for companies. We present central estimates only - ie including our best estimate of the behavioural response.

32. Because they are affected only by rebasing, the behavioural response by companies leads them to increase disposals. This partly offsets the increase in cost due to the higher underlying forecast. We now estimate that accruals will be reduced by about £340 million in 1988-89 and about £460 million in 1989-90.

**Forestalling**

33. Miss Sinclair's minute of 18 September 1987 set out the market implications of an announcement of the CGT reforms in advance of their start date. Some higher rate taxpayers will find it worthwhile to bring forward their disposals into the three week gap between announcement and commencement in order to have their gains taxed at the nominal rate of 30 percent under existing CGT rules rather than 40 percent after the reform. There will be no incentive for basic rate taxpayers, most holders of pre-1982 assets or companies to forestall.

34. The estimates have been revised to take account of the stock market fall in October and of the increase in the higher rate. The calculations are set out at Annex D in the same format as the earlier note. We estimate that about £1¼ billion extra disposals may take place in the three week period, largely in the form of bed and breakfasting. This will yield extra CGT accruals of

£100-£200 million in 1987-88. Although these extra disposals may otherwise have taken place over a number of years, we have made no adjustment to the base of disposals for future years because of relatively small numbers involved and the high proportion of bed and breakfasting expected.

## Equity prices

35. In aggregate the behavioural responses we have assumed will lead to increases in share disposals, particularly in 1988-89 when the high transitory response is assumed. The volume of share disposals by individuals and trusts in 1988-89 is estimated to rise by about 2 percent and disposals by companies will rise by a larger proportion. A priori, this might be expected to depress share prices. But as mentioned above, company share disposals are not generally stock market disposals so it is primarily the increase in volume by individuals which will affect equity prices.

36. The increased disposals are likely to be matched to a considerable extent by increased acquisitions of different equities as, for instance, taxpayers unlock long held assets with relatively low returns and buy into shares offering a better prospective return. Some of the capital realised will nonetheless flow out of the equity market into consumption or other assets such as gilts or property. There is no way of estimating the scale of this migration but, given that share holdings by individuals make up less than 30 percent of total shareholdings, the depressing effect on equity prices is likely to be small. It might perhaps lead to a fall in equity prices of no more than 1-2 percent in 1988-89 and less in subsequent years.

37. This estimate is well within the range of uncertainties which surround the forecasts of equity prices and trading volumes for 1988-89 and later. The costings have not therefore been adjusted to take any account of this possible effect.

## Overall costings

### (a) Accruals

38. Table 4 below shows the combined effect of the reforms on accruals of revenue, taking the central estimates of behavioural response and adding in the effect of forestalling.

**Table 4: Costings of total reform based on central estimates(£m accruals)**

| | Individuals and trusts | Companies | Total |
|---|---|---|---|
| 1987-88 | +150 | 0 | +150 |
| 1988-89 | -80 | -340 | -420 |
| 1989-90 | -110 | -460 | -570 |

### (b) Receipts

39. Table 5 below shows the combined effect of the reforms on receipts of revenue, again taking the central estimates of behavioural response. About 45 percent of accruals for individuals and trusts in a year come through as receipts in the subsequent financial year, about 35 percent in the next year, and the remaining 20 percent in later years. Timings for CT receipts are slightly different: nearly 85 percent comes through in the subsequent year and most of the rest in the year after.

**Table 5: Costings of total reform based on central estimates (£m receipts)**

| | Individuals and trusts | Companies | Total |
|---|---|---|---|
| 1987-88 | 0 | 0 | 0 |
| 1988-89 | +70 | neg | +70 |
| 1989-90 | +10 | -280 | -270 |
| 1990-91 | -70 | -450 | -520 |

ANNEX A

## CHANGES IN THE BASE FORECAST OF CGT ACCRUALS

### Individuals and Trusts

1. Since November the underlying forecast of the base 1988-89 CGT accruals has increased from £1.2 billion to £1.6 billion and forecasts for later years are also up. Three main factors have affected this:

(i) Early assessment data now coming in for the account which started in November 1987 indicates a higher level of assessment than previously forecast.

(ii) forecasts of growth in stock exchange turnover are much higher than previously used, implying a higher level of disposals and hence of capital gains.

(iii) The post-October share index is forecast to start from a higher point than that assumed in November, although the rate of growth thereafter is smaller.

2. These changes not only increase the CGT base but also substantially affect the composition of that base. The second and third of these factors affect only disposals of shares so that share disposals increase as a proportion of total disposals. In November it was assumed that about 45 percent of gains were shares, while the new forecasts suggest that the proportion has increased to 70 percent.

3. Growth in the CGT base increases the cost of the reforms before behavioural response but the cost increase is not strictly proportional to the increase in the base because of the compositional change. The change in composition substantially alters the sensitivity of the costings to different assumptions about behavioural response. Since higher behavioural responses are assumed for shares than land, the increased importance of shares gears up the behavioural responses.

## Companies

4. The estimated accrual of corporation tax on company gains in 1988-89 has been increased from £1.1 billion to £1.7 billion. The change has been made because:

(i) The model now uses more appropriate assumptions about acquisition prices and holding periods.

(ii) The assumed growth in the volume of transactions since 1984-85, the latest year for which company data are available, has been increased to reflect continuing market buoyancy.

(iii) Higher forecasts of growth in disposals and market prices, as for CGT, imply larger receipts of tax on companies' gains.

**ANNEX B**

## AVERAGE EFFECTIVE TAX RATES IN 1988-89

| | | Basic Rate Taxpayers (25%)[2,3] | Higher Rate Taxpayers (40%)[2,4] | Total |
|---|---|---|---|---|
| **Nominal gains[1]** | **£m** | **3790** | **4240** | **8030** |
| of which: | | | | |
| shares | pre-82 | 1980 | 2210 | 4190 |
| | post-82 | 640 | 720 | 1360 |
| | Total | 2620 | 2930 | 5550 |
| land | pre-82 | 1000 | 1120 | 2120 |
| | post-82 | 170 | 190 | 360 |
| | Total | 1170 | 1310 | 2480 |
| **Change in average effective tax rate (points)[5]** | | | | |
| **(a) tax rates only** | | | | |
| shares | | +1.7 | +5.6 | +3.5 |
| land | | +2.7 | +5.1 | +4.5 |
| Total | | +2.0 | +5.5 | +3.8 |
| **(b) tax rates and rebasing** | | | | |
| shares | pre-82 | -5.1 | -2.1 | -3.7 |
| | post-82 | +1.9 | +5.1 | +3.4 |
| | Total | -3.4 | -0.4 | -2.0 |
| land | pre-82 | -5.5 | -3.0 | -4.4 |
| | post-82 | +2.8 | +6.1 | -4.3 |
| | Total | -4.3 | -1.7 | -3.1 |
| Total | pre-82 | -5.2 | -2.4 | -3.9 |
| | post-82 | +2.1 | +5.3 | +3.6 |
| | Total | -3.7 | -0.8 | -2.3 |

1. Assumes no behavioural responses.
2. Before charging CGT to income.
3. Includes those who do not pay any tax on income, and ordinary trusts.
4. Includes discretionary trusts.
5. Tax rates under the present CGT regime, averaged over all taxpayers and all gains, are:

| | |
|---|---|
| Shares | 20.5 |
| Land | 19.0 |
| Total | 20.0 |

ANNEX C

## EFFECT OF CGT REFORMS ON ACCRUALS BY INDIVIDUALS AND TRUSTS

| Behavioural response (shares/land) | 1988-89 Shares | 1988-89 Land | 1988-89 Total | 1989-90 Total |
|---|---|---|---|---|
| **Assimilation with income tax alone** | | | | |
| None | +190 | +110 | +300 | +470 |
| 2/1 | + 60 | +80 | +140 | |
| Central estimate* | +10 | +70 | +80 | +150 |
| 12/4½ | -590 | -10 | -600 | |
| **Assimilation and rebasing** | | | | |
| None | -110 | -80 | -190 | -130 |
| 2/1 | -100 | -70 | -170 | |
| Central estimate* | -30 | -50 | -80 | -110 |
| 12/4½ | -60 | -30 | -90 | |
| **Rebasing** | | | | |
| None | -300 | -190 | -490 | -600 |
| 2/1 | -160 | -150 | -310 | |
| Central estimate* | -40 | -120 | -160 | -260 |
| 12/4½ | +530 | -20 | +510 | |

* The central estimate is that in 1988-89 behavioural response will be 6/2½ for assets with a reduction in effective tax rate on nominal gains and 3/1½ for assets with an increase in effective tax rate. For 1989-90 the central estimate of behavioural response is 3/1½ for all assets.

ANNEX D

## EFFECT OF FORESTALLING ON 1987-88 CGT ACCRUALS

| | £billion |
|---|---|
| Domestic equity as at end March 1988 | 339 |
| Less holdings by institutions and overseas | |
| leaves | 92 |
| Less shares acquired by them before 1979* | |
| leaves | 66 |
| Less shares acquired post-1979 showing a loss | |
| leaves | 38 |
| Less shares in this category which if disposed of would realise gains below CGT annual exemption** | |
| leaves | 19 |
| Less shares in this category held by basic rate taxpayers or non-income taxpayers | |
| leaves shares on which forestalling might be advantageous | 13 |
| Less 90 percent*** who will decide not to sell | |
| leaves | 1.3 |
| Of which 40 percent of value represents indexed gain | ½ |
| CGT at 30 percent | £150m |

* Gains on shares bought before this date will, on average, face a lower effective tax rate, even for higher rate taxpayers.

** With annual exemption of £6,600 only individuals with a total portfolio greater than £40,000 would incur a CGT liability by selling all their post-1979 shares on which they have made gains (allowing for indexation) - assume 50% of shares held by individuals are in such portfolios.

*** Derived from elasticities used in the central estimates.

BUDGET CONFIDENTIAL

FROM: R B WILLIS

Inland Revenue

Policy Division
Somerset House

28 January 1988

1. MR CORLETT  ~~AN~~ 29/1

2. FINANCIAL SECRETARY

STAMP DUTY: £30,000 THRESHOLD: STARTER 300

This note reports the latest forecasts of yield from stamp duty, and gives revised estimates of the cost of increasing the £30,000 threshold for transfers of land and buildings.

2. Your view in November was that there was a good case for doing nothing on stamp duty on land and buildings in 1988, although you wished to consider nearer the Budget the level of the threshold (Mr Heywood's minute of 23 November). You may wish to look again now, in the context of wider Budget changes, at the case for an increase in the threshold.

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Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Odling-Smee
Miss Sinclair
Mr Riley
Miss C Evans
Mr Hudson  AH 31.2
Mr Cropper
Mr Tyrie
Mr Call

Chairman
Mr Isaac
Mr Painter
Mr Corlett
Mr Beighton
Mr Calder
Mr Gonzalez
Mr Pipe
Mr Adderley
PS/IR
Mr Willis

STAMP DUTY ON LAND AND BUILDINGS

3. The forecast of house prices now shows rather smaller increases in the next couple of years, as a result of which the forecast yield for 1989-90 is about £200 million lower than in my note of 10 November. The revised forecasts, and the effects of increasing the threshold to £40,000 or £50,000 are as follows:

TABLE 1: LAND AND BUILDINGS

| | Revenue (£m) | | Staff effect | |
|---|---|---|---|---|
| | 1988/89 | 1989/90 | 1/4/89 | 1/4/90 |
| present position | 1,310 | 1,450 | +10 | +10 |
| | Revenue effect (£m) | | | |
| increase threshold to £40,000 | -310 | -360 | -10 | -10 |
| increase threshold to £50,000 | -490 | -570 | -20 | -20 |

5. The revenue cost in 1989-90 of a higher threshold is about 10% lower than before, corresponding to the lower forecast of yield. Apart from this, the arguments for and against an increase are unchanged from the paper we sent you in November. It is essentially a choice between, on the one hand, the tax revenue and, on the other, reducing the stamp duty paid by first-time buyers (and others) buying below the threshold and savings on Stamp Office staff and running costs.

6. There are no major operational pressures for an early decision. A straightforward increase in the £30,000 threshold could be implemented from Budget day provided we have a decision by, say, the end of February.

STAMP DUTY ON TRANSFERS OF SHARES

7. The forecasts of stamp duty and stamp duty reserve tax (SDRT) depend on the value of transactions. With the latest Treasury forecasts, showing much faster growth in turnover than previously assumed, the yield from stamp duty and SDRT would increase rapidly after 1988-89:

TABLE 2: SHARES

| | £m |
|---|---|
| 1987-88 | 970 |
| 1988-89 | 980 |
| 1989-90 | 1380 |

8. However these are highly uncertain forecasts and do not alter significantly the basis on which you decided not to change the rate of duty on shares in the 1988 Budget.

CAPITAL DUTY, UNIT TRUST INSTRUMENT DUTY AND LIFE ASSURANCE PREMIUM DUTY

9. The Treasury expect a massive decrease in the number and value of new equity issues. As a result the forecast yield from capital duty is much lower than the figures (over £m 300) previously expected.

10. Yield from unit trust instrument duty (UTID) and life assurance premium duty (LAPD) is also now expected to be lower.

11. The revised forecasts are as follows:

TABLE 3: OTHER DUTIES

£m

| | Capital duty | UTID | LAPD | total |
|---|---|---|---|---|
| 1987-88 | 240 | 30 | 70 | 340 |
| 1988-89 | 40 | 20 | 50 | 110 |
| 1989-90 | 55 | 25 | 55 | 135 |

12. We would not put a great deal of confidence in these forecasts. In particular the yield from capital duty is so far holding up well following the changes in the equity market. But the forecasts certainly make abolition of UTID or capital duty (or both) look more attractive.

13. The Chancellor has already indicated that abolition of UTID should be reconsidered next year.

14. Abolition of capital duty also seems likely to be a live issue for the 1989 Budget. The proposed exemption for building societies which is provisionally included in the 1988 Bill may well generate pressure (this year or next) for either a general relief for incorporations or for the outright abolition of the tax.

SUMMARY

15. The revised forecasts of yield from stamp duty do not affect significantly the arguments for and against a change in the 1988 Budget to the £30,000 threshold for land and buildings. It remains essentially a matter of judgement, in the context of the wider Budget package and arithmetic.

R B WILLIS

NL/25

COPY NO. 1 OF 32

FROM: C J RILEY
DATE: 28 JANUARY 1988

RILEY → CHEX 28/1

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cc PPS
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Financial Secretary
Paymaster General
Economic Secretary
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Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
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Mr Odling-Smee
Mr Sedgwick
Miss Sinclair
Miss C Evans
Mr Scotter
Mr A Hudson
Mr Cropper
Mr Tyrie
Mr Call

Inland Revenue
Mr Battishill
Mr Isaac
Mr Painter

Customs and Excise
Mr Unwin
Mr Knox

**CGT COSTINGS**

I attach a paper by Ian Scotter and I. It reports the revised costings which we and the Revenue have produced, which are incorporated in today's scorecard. The minute I sent you on 11 November contains more detail on the basic analysis; it is attached (top copy only) for ease of reference.

2. The main differences from the figures in last week's scorecard are:

- new figures for companies;

- an explicit allowance for forestalling.

The figures for companies are rather higher than before, raising the revenue cost in 1989-90 and beyond; forestalling produces a small revenue gain in 1988-89. The figures are still provisional, and subject to further revision.

3. The modelling of company gains is still posing problems. Among the difficulties involved is the need to separate out the effects of the <u>rise</u> in tax on company gains in the 1987 Budget from the <u>fall</u> due to rebasing. My feeling is that the behavioural response to rebasing - the degree of unlocking - may perhaps be understated somewhat in the current estimate for 1988-89. If so, further work may produce some decline in the estimated cost of rebasing - but of course there may be other revisions which go the other way.

4. I cannot stress too much the considerable uncertainties involved in these calculations:

- the underlying forecast of CGT depends crucially on the prospect for asset prices and turnover, both of which are subject to wide margins of error;

- a wide range of behavioural responses to the new regime is possible, with significantly different implications for revenue;

- doubling the exemption for married couples under independent taxation may lead to some locking in over the next two years, but as yet we have not assessed the likely effects.

CJR

**C J RILEY**

## CGT COSTINGS

### Introduction

This note brings up to date the costings of CGT reform contained in Mr Cayley's minute of 9 November and Mr Riley's minute of 11 November. It sets out our views on the likely effects, but does not consider issues of presentation - for example the treatment in the FSBR. The figures are still provisional: we and the Revenue will be refining them further.

2. There have been a number of changes since November which affect the costings and are taken into account in the current note:

(i) Revised forecasts of the CGT base in the absence of reform - of equity prices and turnover, and of land prices. See Annex A for details.

(ii) The new income tax package, with a higher rate of 40p and a higher rate threshold of £20,000.

(iii) Improvements to the modelling of company gains within CT, and a substantial increase in the assumed amount of these gains.

A 'central' assumption about behavioural responses is suggested, consistent with those underlying earlier scorecards. We have also added in an explicit allowance for forestalling at the end of 1987-88.

3. The note looks separately at the effect of the reforms on revenue from <u>individuals and trusts</u> and from <u>companies</u>. For individuals and trusts it distinguishes:

- the effect of <u>assimilation</u> with income tax rates; and

- the effect of assimilation combined with <u>rebasing</u> of gains to 1982.

It does not look at rebasing alone on the basis of present (ie pre-reform) tax rates.

4. The main conclusions of the paper are that:

- using our central estimates of behavioural response, the overall cost of the reform in terms of accruals will be slightly higher from 1988-89 onwards than in earlier scorecards because of higher figures for companies; but forestalling will lead to a rise in accruals in 1987-88.

| 1987-88 | 1988-89 | 1989-90 |
|---|---|---|
| +150 | -420 | -520 |

- receipts lag behind accruals, and we expect the following pattern:

| 1988-89 | 1989-90 | 1990-91 |
|---|---|---|
| +70 | -270 | -520 |

- these estimates are highly uncertain. Alternative assumptions about behavioural responses significantly change the costings; the underlying forecast is subject to wide margins of error, and this too affects the costings.

## Individuals and trusts

### (a) Effect on tax rates

5. The two components of the reform - assimilation and rebasing - will each change effective tax rates for different categories of taxpayer/asset:

**Assimilation** will raise the effective tax rate on disposals by higher rate taxpayers, and will push some basic rate taxpayers into higher rate tax. Those who remain basic rate taxpayers will face lower effective tax rates;

**Rebasing** on its own will reduce effective tax rates on disposals of assets acquired before 1982. In general the reduction is larger the longer the asset has been held.

6. The latest data on CGT suggests that about half the total number of disposals by individuals in 1985-86 were made by basic rate taxpayers and about half by higher rate taxpayers. In terms of the value of gains, however, higher rate taxpayers account for a somewhat higher proportion - roughly two thirds - because the average size of their gains was greater than those of basic rate taxpayers. The reforms will mean that perhaps two thirds of the number of disposals, accounting for about 90% of gains, will now be subject to the higher rate . The proportion of pensioners' gains subject to the higher rate will be lower than for total gains - perhaps 55% by number and 80% by value.

7. For assets acquired before 1982 the effects of assimilation and rebasing interact. For those who remain basic rate taxpayers, rebasing further reduces the effective tax rate. For those who are, or who become, higher rate taxpayers, the reduction from rebasing offsets or partly offsets the increase in the nominal tax rate. On average higher rate taxpayers will face reduced effective tax rates on assets acquired before about 1979 and increased tax rates on later acquisitions.

8. At present the average effective tax rate on nominal gains is about 20%. The pattern of changes due to the proposed reforms is summarised in table 1 below. Annex B gives further details.

**Table 1 Changes in average effective tax rates (points)**

| | Basic rate taxpayers | Higher rate taxpayers | All taxpayers |
|---|---|---|---|
| Assimilation only | +2.0 | +5.5 | +3.8 |
| Assimilation and rebasing | -3.7 | -0.8 | -2.3 |

The directions of change are fairly intuitive with one exception: the average effective rate for those who are currently basic rate taxpayers rises on assimilation as some are drawn into higher rate tax.

9. In considering the significance of the new CGT rates, and in particular the increase to 40% for higher rate taxpayers, it is instructive to compare the implied rates of tax on income and gains. Even if the CGT threshold is ignored, indexation of gains (in all cases now, following rebasing) but not income, generally implies a lower tax rate on nominal gains than on nominal income. Three examples suffice to illustrate this:

- with inflation at 2% and real gains of 2% per annum, a 40% CGT rate is equivalent (in a steady state) to an income tax rate of 20%.

- with inflation at 5% and real gains of 3% per annum, a 40% CGT rate is equivalent to an income tax rate of 15%.

- with inflation at 6% and real gains of 2% per annum, a 40% CGT rate is equivalent to an income tax rate of 10%.

## (b) Behavioural response

10. A reduction in effective tax rates is likely to 'unlock' some assets, making it worthwhile to dispose of them earlier than otherwise. Conversely an increase in tax rates may increase locking in, delaying disposals. Although there is general acceptance of the theoretical case for locking-in effects, there is no UK evidence of the size of these effects. Such evidence as there is comes from the US, but even this has led to a wide range of estimates.

11. The range of US estimates for disposals of equities is summarised in Table 2.

**Table 2 Percentage effect on the value of taxable gains on shares per 1 point reduction in marginal CGT rates**

| Study | Transitory effect | Permanent effect | Total in short run |
|---|---|---|---|
| Feldstein, Slemrod and Yitzhahi (1977) | - | 12.3 | 12.3 |
| Minarik (1981) | - | 3.0 | 3.0 |
| Auten-Clotfelter (1982) | 10.0 | 4.3 | 14.3 |
| US Treasury Office of Tax Analysis (1985) | 9.6 | 8.8 | 18.4 |
| Lindsey (1986) | 3.1 | 5.5 | 8.6 |

12. There are a number of reasons for believing that the higher estimates from the US studies would not apply in the current UK context:

- share ownership is more widespread in the US than here, and individuals are more active in the US market;

- US rates apply to all nominal gains, and there is no annual exempt amount;

- there are econometric worries. Some of the effects of an upturn in the US stock market may have been attributed mistakenly to cuts in tax rates;

13. As in the November work we have therefore focused on a slightly lower range of responses:

shares: 2-12% in the first year, 2-6% thereafter.

land: 1-4½% in the first year, 1-3% thereafter.

While in our view these ranges should span the likely responses, we would expect the latter if anything to be closer to the bottom end than the top.

14. There is a case for arguing that the responses to tax reductions may be greater than for tax increases: asset holders can in principle realise all their gains if they wish when tax rates fall, but can only hold off realising those they would otherwise have done when rates rise. Our view is that there is some merit in this argument, which points to a greater 'surge' of disposals for any given <u>average</u> change in tax rates.

15. We have therefore incorporated an asymmetry in the responses underlying our <u>central estimates</u>:

| | **1988-89** | | **later years** | |
|---|---|---|---|---|
| | **shares** | **land** | **shares** | **land** |
| Reduction in tax rate | 6 | 2½ | 3 | 1½ |
| Increase in tax rate | 3 | 1½ | 3 | 1½ |

Note that because of the asymmetry the central estimates do not always lie within the range of estimates based on symmetrical responses, though they do so in most cases.

16. One final point is worth noting. The introduction of independent taxation in 1990 will effectively double the annual exemption for married couples. This may lead to some additional locking in, with couples delaying disposals until they can take advantage of the higher exemption. We do not know the likely scale of this, and as yet we have not made any allowance for it in our calculations.

**(c) Costings**

17. The costings are set out in Annex C.

18. **Assimilation** of CGT and income tax raises the average effective tax rate. In the absence of any behavioural response this would raise CGT accruals by 300 million in 1988-89 and £460 million in 1989-90, rather more than with the pre-Chevening tax package. But the behavioural responses will on balance reduce disposals, and hence reduce the revenue gain; the responses we have examined imply reductions in accruals of up to £900 million in 1988-89, which is more than the ex ante increase.

19. Our central estimate for 1988-89 suggests a rather smaller fall in disposals, equivalent to nominal gains of about £1 billion, reducing accruals by about £220 million; for 1989-90 the effect is slightly larger, reflecting the underlying growth of share disposals in the forecasts. This leaves some overall increase in CGT accruals; £80 million in 1988-89 and £150 million in 1989-90.

20. **Assimilation and rebasing combined** have the effect of reducing average effective tax rates on balance. In the absence of a behavioural response this would reduce CGT accruals by £190 million in 1988-89 and £130 million in 1989-90. But the behavioural responses will lead to an increase in disposals, at least partially offsetting the revenue cost; the responses we have examined imply increases in accruals of up to £110 million in 1988-89. The range of effects is rather smaller than for assimilation alone because the change in average tax rates is smaller.

21. Our central estimate for 1988-89 suggests that there may be extra disposals equivalent to gains of about £½ billion, raising accruals by about £110 million. Because of the asymmetric responses we have assumed, this is at the top of the range of estimates. In 1989-90 the rise in disposals is likely to be rather less, as the 'surge' effect dies away. This leaves a small reduction in accruals in each year; £80 million in 1988-89 and £110 million in 1989-90.

22. The effects of **rebasing** on its own are similar to those of assimilation alone, but with the sign reversed. Effective tax rates fall, disposals increase, and the range of revenue effects indicated by the different behavioural assumptions is wide (roughly £1000 million in 1988-89). Our central estimate gives a reduction in CGT accruals of £160 million in 1988-89 and £250 million in 1989-90.

23. The behavioural responses to integration and rebasing tend to cancel each other out, leading to more stable figures for the combined package.

**Companies**

24. Since November, the modelling of taxation of company gains has been revised. It now takes account of the results obtained from the Revenue's sample of CGT data for individuals, adapted to allow for the different circumstances of companies as far as it has been possible to determine them from a quick examination of a number of company returns. However the estimates still depend largely upon judgement of a number of factors, and are very sensitive to changes in the assumptions made about these.

25. The underlying forecast of company gains has been revised up as a consequence of this new work, and hence the costings likewise. More information on the baseline is given in Annex A.

**(a) effect on tax rates**

26. The taxation of capital gains made by companies is affected only by rebasing. The current reform will therefore reduce the effective tax rate on gains on assets acquired before 1982. With no behavioural response, this would lead unequivocably to a loss of revenue. Any behavioural response will be all in one direction - an increase in disposals of pre-1982 assets.

**(b) Behavioural responses**

27. There is no evidence in either the UK or the US on the response of companies to changes in the tax rate on gains. Companies will undoubtedly respond to reductions in the tax rate on their gains. At the margin, disposal of pre-1982 assets will become more attractive. For instance, property investment companies regularly reviewing their asset holdings will find that it becomes worthwhile to sell off some assets which they would previously have just chosen to hold on to.

28. There is a case for arguing that the response by companies would be smaller than for individuals. Disposals by companies are by nature lumpy and infrequent events and cannot easily be varied at the margin; many of the 'share' transactions by non-financial companies appear to be disposals of wholly owned subsidiaries rather than adjustments within a portfolio of regularly traded shares. But against this, there will be companies who did not find it worthwhile to make their disposal under the existing tax system but will with rebasing - the behavioural response would be more companies trading assets rather than existing traders increasing their disposals.

29. The case for a larger behavioural response by companies, particularly in the short run, is that they are more heavily locked into existing assets than individuals. Companies do not have the benefit of the annual exemption which allows individuals to dispose of assets gradually without incurring any tax liability at all.

30. In the absence of evidence to the contrary, the central estimates for company gains assume the same behavioural response by companies as for individuals and trusts.

**(c) Costings**

31. In the time available it has not been possible to analyse a range of different responses for companies. We present central estimates only - ie including our best estimate of the behavioural response.

32. Because they are affected only by rebasing, the behavioural response by companies leads them to increase disposals. This partly offsets the increase in cost due to the higher underlying forecast. We now estimate that accruals will be reduced by about £340 million in 1988-89 and about £460 million in 1989-90.

**Forestalling**

33. Miss Sinclair's minute of 18 September 1987 set out the market implications of an announcement of the CGT reforms in advance of their start date. Some higher rate taxpayers will find it worthwhile to bring forward their disposals into the three week gap between announcement and commencement in order to have their gains taxed at the nominal rate of 30 percent under existing CGT rules rather than 40 percent after the reform. There will be no incentive for basic rate taxpayers, most holders of pre-1982 assets or companies to forestall.

34. The estimates have been revised to take account of the stock market fall in October and of the increase in the higher rate. The calculations are set out at Annex D in the same format as the earlier note. We estimate that about £1¼ billion extra disposals may take place in the three week period, largely in the form of bed and breakfasting. This will yield extra CGT accruals of

£100-£200 million in 1987-88. Although these extra disposals may otherwise have taken place over a number of years, we have made no adjustment to the base of disposals for future years because of relatively small numbers involved and the high proportion of bed and breakfasting expected.

**Equity prices**

35. In aggregate the behavioural responses we have assumed will lead to increases in share disposals, particularly in 1988-89 when the high transitory response is assumed. The volume of share disposals by individuals and trusts in 1988-89 is estimated to rise by about 2 percent and disposals by companies will rise by a larger proportion. A priori, this might be expected to depress share prices. But as mentioned above, company share disposals are not generally stock market disposals so it is primarily the increase in volume by individuals which will affect equity prices.

36. The increased disposals are likely to be matched to a considerable extent by increased acquisitions of different equities as, for instance, taxpayers unlock long held assets with relatively low returns and buy into shares offering a better prospective return. Some of the capital realised will nonetheless flow out of the equity market into consumption or other assets such as gilts or property. There is no way of estimating the scale of this migration but, given that share holdings by individuals make up less than 30 percent of total shareholdings, the depressing effect on equity prices is likely to be small. It might perhaps lead to a fall in equity prices of no more than 1-2 percent in 1988-89 and less in subsequent years.

37. This estimate is well within the range of uncertainties which surround the forecasts of equity prices and trading volumes for 1988-89 and later. The costings have not therefore been adjusted to take any account of this possible effect.

## Overall costings

### (a) Accruals

38. Table 4 below shows the combined effect of the reforms on accruals of revenue, taking the central estimates of behavioural response and adding in the effect of forestalling.

**Table 4: Costings of total reform based on central estimates(£m accruals)**

| | Individuals and trusts | Companies | Total |
|---|---|---|---|
| 1987-88 | +150 | 0 | +150 |
| 1988-89 | -80 | -340 | -420 |
| 1989-90 | -110 | -460 | -570 |

### (b) Receipts

39. Table 5 below shows the combined effect of the reforms on receipts of revenue, again taking the central estimates of behavioural response. About 45 percent of accruals for individuals and trusts in a year come through as receipts in the subsequent financial year, about 35 percent in the next year, and the remaining 20 percent in later years. Timings for CT receipts are slightly different: nearly 85 percent comes through in the subsequent year and most of the rest in the year after.

**Table 5: Costings of total reform based on central estimates (£m receipts)**

| | Individuals and trusts | Companies | Total |
|---|---|---|---|
| 1987-88 | 0 | 0 | 0 |
| 1988-89 | +70 | neg | +70 |
| 1989-90 | +10 | -280 | -270 |
| 1990-91 | -70 | -450 | -520 |

Annex A



ANNEX A

## CHANGES IN THE BASE FORECAST OF CGT ACCRUALS

### Individuals and Trusts

1. Since November the underlying forecast of the base 1988-89 CGT accruals has increased from £1.2 billion to £1.6 billion and forecasts for later years are also up. Three main factors have affected this:

(i) Early assessment data now coming in for the account which started in November 1987 indicates a higher level of assessment than previously forecast.

(ii) forecasts of growth in stock exchange turnover are much higher than previously used, implying a higher level of disposals and hence of capital gains.

(iii) The post-October share index is forecast to start from a higher point than that assumed in November, although the rate of growth thereafter is smaller.

2. These changes not only increase the CGT base but also substantially affect the composition of that base. The second and third of these factors affect only disposals of shares so that share disposals increase as a proportion of total disposals. In November it was assumed that about 45 percent of gains were shares, while the new forecasts suggest that the proportion has increased to 70 percent.

3. Growth in the CGT base increases the cost of the reforms before behavioural response but the cost increase is not strictly proportional to the increase in the base because of the compositional change. The change in composition substantially alters the sensitivity of the costings to different assumptions about behavioural response. Since higher behavioural responses are assumed for shares than land, the increased importance of shares gears up the behavioural responses.

**Companies**

4. The estimated accrual of corporation tax on company gains in 1988-89 has been increased from £1.1 billion to £1.7 billion. The change has been made because:

(i) The model now uses more appropriate assumptions about acquisition prices and holding periods.

(ii) The assumed growth in the volume of transactions since 1984-85, the latest year for which company data are available, has been increased to reflect continuing market buoyancy.

(iii) Higher forecasts of growth in disposals and market prices, as for CGT, imply larger receipts of tax on companies' gains.

Annex B



ANNEX B

## AVERAGE EFFECTIVE TAX RATES IN 1988-89

| | | Basic Rate Taxpayers (25%)[2,3] | Higher Rate Taxpayers (40%)[2,4] | Total |
|---|---|---|---|---|
| **Nominal gains**[1] | £m | 3790 | 4240 | 8030 |
| of which: | | | | |
| shares | pre-82 | 1980 | 2210 | 4190 |
| | post-82 | 640 | 720 | 1360 |
| | Total | 2620 | 2930 | 5550 |
| land | pre-82 | 1000 | 1120 | 2120 |
| | post-82 | 170 | 190 | 360 |
| | Total | 1170 | 1310 | 2480 |
| **Change in average effective tax rate (points)**[5] | | | | |
| (a) tax rates only | | | | |
| shares | | +1.7 | +5.6 | +3.5 |
| land | | +2.7 | +5.1 | +4.5 |
| Total | | +2.0 | +5.5 | +3.8 |
| (b) tax rates and rebasing | | | | |
| shares | pre-82 | -5.1 | -2.1 | -3.7 |
| | post-82 | +1.9 | +5.1 | +3.4 |
| | Total | -3.4 | -0.4 | -2.0 |
| land | pre-82 | -5.5 | -3.0 | -4.4 |
| | post-82 | +2.8 | +6.1 | -4.3 |
| | Total | -4.3 | -1.7 | -3.1 |
| Total | pre-82 | -5.2 | -2.4 | -3.9 |
| | post-82 | +2.1 | +5.3 | +3.6 |
| | Total | -3.7 | -0.8 | -2.3 |

1. Assumes no behavioural responses.
2. Before charging CGT to income.
3. Includes those who do not pay any tax on income, and ordinary trusts.
4. Includes discretionary trusts.
5. Tax rates under the present CGT regime, averaged over all taxpayers and all gains, are:

| | |
|---|---|
| Shares | 20.5 |
| Land | 19.0 |
| Total | 20.0 |

Annex C



ANNEX C

**EFFECT OF CGT REFORMS ON ACCRUALS BY INDIVIDUALS AND TRUSTS**

| Behavioural response (shares/land) | 1988-89 Shares | 1988-89 Land | 1988-89 Total | 1989-90 Total |
|---|---|---|---|---|
| **Assimilation with income tax alone** | | | | |
| None | +190 | +110 | +300 | +470 |
| 2/1 | + 60 | +80 | +140 | |
| Central estimate* | +10 | +70 | +80 | +150 |
| 12/4½ | -590 | -10 | -600 | |
| **Assimilation and rebasing** | | | | |
| None | -110 | -80 | -190 | -130 |
| 2/1 | -100 | -70 | -170 | |
| Central estimate* | -30 | -50 | -80 | -110 |
| 12/4½ | -60 | -30 | -90 | |
| **Rebasing** | | | | |
| None | -300 | -190 | -490 | -600 |
| 2/1 | -160 | -150 | -310 | |
| Central estimate* | -40 | -120 | -160 | -260 |
| 12/4½ | +530 | -20 | +510 | |

* The central estimate is that in 1988-89 behavioural response will be 6/2½ for assets with a reduction in effective tax rate on nominal gains and 3/1½ for assets with an increase in effective tax rate. For 1989-90 the central estimate of behavioural response is 3/1½ for all assets.

ANNEX D



**ANNEX D**

**EFFECT OF FORESTALLING ON 1987-88 CGT ACCRUALS**

| | £billion |
|---|---|
| Domestic equity as at end March 1988 | 339 |
| Less holdings by institutions and overseas | |
| leaves | 92 |
| Less shares acquired by them before 1979* | |
| leaves | 66 |
| Less shares acquired post-1979 showing a loss | |
| leaves | 38 |
| Less shares in this category which if disposed of would realise gains below CGT annual exemption** | |
| leaves | 19 |
| Less shares in this category held by basic rate taxpayers or non-income taxpayers | |
| leaves shares on which forestalling might be advantageous | 13 |
| Less 90 percent*** who will decide not to sell | |
| leaves | 1.3 |
| Of which 40 percent of value represents indexed gain | ½ |
| CGT at 30 percent | £150m |

* Gains on shares bought before this date will, on average, face a lower effective tax rate, even for higher rate taxpayers.

** With annual exemption of £6,600 only individuals with a total portfolio greater than £40,000 would incur a CGT liability by selling all their post-1979 shares on which they have made gains (allowing for indexation) - assume 50% of shares held by individuals are in such portfolios.

*** Derived from elasticities used in the central estimates.

* PSR Refund? re lollipop remark – transfer an giving ceiling perhaps doubling? to £240 p.a. re payroll

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Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
LONDON SW1

29 January 1988

Dear Nigel,

**TAX CHANGES TO BENEFIT THE ARTS**

The purpose of this letter is to draw your attention to some relatively modest tax adjustments which would, if implemented, help to make the arts less dependent on direct subsidy from the taxpayer.

As you know, I very much welcomed the introduction of the payroll giving scheme. The receipts to arts charities cannot yet be identified, but the overall take-up so far has been limited. I understand that the Charities Aid Foundation has channelled payroll donations of just over £0.5 million to some 500 charities of all kinds since the scheme began. Clearly it is early days yet, but I believe there is a case for enhancing the scheme's attractiveness. Arts bodies, for example, need to be persuaded that the gains to be reaped from investing time and effort in attracting the payroll giver will be worth it. The feedback I am getting suggests that at present the £120 ceiling per giver per annum is seen as far too low. On the other hand, the level of giving per individual has been high, suggesting that a higher maximum would be tolerated. I hope you will consider an increase to perhaps £600 per annum, allowing up to £50 per month to be donated, thus attracting the higher salary-earner who may be more willing to support arts charities.

I am also anxious to find ways of attracting giving by the smaller employer, and the self-employed. It concerns me that at present close companies are not eligible for relief from corporation tax on charitable donations. I appreciate that the Inland Revenue needs to keep a very close watch on potential fraud, but nevertheless the exclusion of close companies seals off a lot of potential benefactors. In the absence of a specific incentive for the individual one-off donor, a way of lifting the restriction on close companies would be widely welcomed.

There are two further points to mention. One is the availability of the Business Expansion Scheme to investors in theatre productions. The scheme is broad-based and needs well-defined controls, but it is difficult for investors in theatre productions to fulfil a 5-year time limit on the investment when long runs can rarely be guaranteed. I suggest that you might, therefore, consider whether there is scope for a shorter-term investment to be eligible on appropriate conditions, and perhaps to increase the individual limit.

My last point relates to capital allowances, and the way in which works of art can qualify for allowance as an item of plant and machinery. At present, a work of art such as a contemporary painting must have a demonstrable function as part of the equipment by which a tradesman carries out his trade. In addition, commercial buildings often do not qualify for allowances. Nevertheless there are many circumstances in which the purchase of works of art by businesses would both give an invaluable boost to struggling artists and improve the working environment. Would it be possible to relax the rules a little so as to enable purchasers of original works of art (limited perhaps to works by living artists) to offset them more easily against tax?

I very much hope that you will find these ideas useful. There is no doubt that a small concession which has fairly direct arts benefits (as last year's waiver of interest in some acceptance in lieu cases) creates great goodwill for us.

Yours

Richard

RICHARD LUCE

2799/048

**FROM:** P J CROPPER
**DATE:** 1 February 1988

**CHANCELLOR**

cc Financial Secretary
Mr Tyrie
Mr Call

**REFORM OF PERSONAL TAXATION**

I only copy this to you now because it is circulating in Hartley Booth's family policy group at No 10. I have firmly declined to comment on it in the run up to the Budget.

PJC

**P J CROPPER**

Thanks.

2. As part of the presentation of indep tax'n, we will want to consider whether we need to publish, or whether [illegible] some form of commitment towards indep. taxn – e.g. if so, which. (LFP pse)

NL

ps3/77T **BUDGET SECRET: TASK FORCE LIST**

COPY NO. 18 OF 29.

FROM: J M G TAYLOR

DATE: 1 February 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Odling-Smee
Miss Sinclair
Mr Riley
Miss C Evans
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Corlett - IR
Mr Willis - IR
PS/IR

**STAMP DUTY: £30,000 THRESHOLD: STARTER 300**

The Chancellor has seen Mr Willis's minute of 28 January.

2. He does not favour any change in the SD threshold this year. But it is worth looking again at the case for abolishing capital duty this year, and possibly UTID too, as part of a tax reform package. He would be grateful for the Financial Secretary's urgent views on this.

3. He would also be grateful for a note on how the CGT treatment of unit trusts and mutual life offices looks in the light of CGT reform.

J M G TAYLOR

ps3/85T

BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 2 February 1988

PS/FINANCIAL SECRETARY

**TAX CHANGES TO BENEFIT THE ARTS**

The Chancellor has seen Mr Luce's letter of 29 January.

2. He has asked that an increase in the payroll giving ceiling - perhaps doubling it to £240pa - should be included in the lollipop trawl.

JT

J M G TAYLOR

RJ8.84 BUDGET CONFIDENTIAL

PMP

FROM: J M G TAYLOR
DATE: 2 February 1988

MR CROPPER

cc PS/Financial Secretary
Miss Sinclair (with previous papers)
Mr Tyrie
Mr Call

**REFORM OF PERSONAL TAXATION**

The Chancellor was grateful for your minute and enclosures of 1 February.

2. He has commented that, as part of the presentation of independent taxation, we will want to indicate whether we are pioneers, or whether any other countries have some form of independent taxation - and, if so, which. He would be grateful for advice from FP on this.

J M G TAYLOR

psl/33A

BUDGET CONFIDENTIAL

Type for sig please

FROM: CHANCELLOR
DATE: 3 February 1988

MR ISAAC - Inland Revenue
MR SCHOLAR

cc PS/Financial Secretary
Sir P Middleton
Mr Culpin
Miss Sinclair
Mr Michie

Mr Battishill - IR
Mr P Lewis - IR
Mr Prescott - IR
PS/IR

**FRINGE BENEFIT TAX**

I would just like to record how grateful I am to you and all those in the Revenue and Treasury who have put in so much work on the possibility of introducing a fringe benefit tax. I was most impressed with the speed and thoroughness with which advice on so many complicated issues was prepared.

2. It is always inevitable that some Budget starters fall by the wayside as more detailed study brings out some of the obstacles more clearly. But experience shows that this work is never wasted. I should be grateful if you could pass on my thanks to all your team.

NIGEL LAWSON

Ch

Worth sending something like this? (I doubt it's necessary to do also for Customs on "project 6")

AA

psl/33A

**BUDGET CONFIDENTIAL**

pup

FROM: CHANCELLOR
DATE: 4 February 1988

MR ISAAC - Inland Revenue
MR SCHOLAR

cc PS/Financial Secretary
Sir P Middleton
Mr Culpin
Miss Sinclair
Mr Michie
Mr Battishill - IR
Mr P Lewis - IR
Mr Prescott - IR
PS/IR

**FRINGE BENEFIT TAX**

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NL

NIGEL LAWSON

BUDGET SECRET: TASK FORCE LIST

COPY NO 10 OF 11

FROM: A C S ALLAN
DATE: 5 February 1988

MR CAYLEY - IR

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

**CAPITAL GAINS TAX**

The Chancellor would be grateful for a urgent note giving advice and rough costings on a different CGT package, aimed primarily at simplification:

(i) rebase to 1 January 1983;

(ii) keep the rate at a flat 30 per cent; and

(iii) indexation to be abolished completely (for both the past and the future).

ACSA

A C S ALLAN

COPY NO 17A OF 17

FROM: J M G TAYLOR
DATE: 5 February 1988

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Riley
Mr Cropper
Mr Tyrie
Mr Battishill - IR
Mr Painter - IR
Mr Isaac - IR
Mr Johns - IR

**NORTH SEA FISCAL REGIME AND CAPITAL GAINS TAX CHANGES**

The Chancellor has seen Mr Johns' minute of 4 February.

2. Subject to the Economic Secretary's views, he does not see how we could explain excluding North Sea licences from CGT rebasing.

JT

J M G TAYLOR

BUDGET CONFIDENTIAL

FROM: A C S ALLAN
DATE: 5 February 1988

MR MACE

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Cropper

Mr Isaac - IR
PS/IR

ACSA → MACE 5/2

**ADDITIONAL PERSONAL ALLOWANCE**

The Chancellor would be grateful for advice on one additional option on the APA, as soon as possible. This is to withdraw the APA over the same range of incomes as the MCA is to be withdrawn. The objective would be to reduce another tax penalty on marriage, accepting that it would also hit rich single parents, and that two earner co-habiting couples could make sure that the lower earner claimed the APA. The number of people affected would persumably be small, but so should the additional cost to the Revenue.

ACSA

A C S ALLAN

BUDGET SECRET: TASK FORCE LIST

COPY NO 11 OF 11

FROM: A C S ALLAN

DATE: 5 February 1988

MR CAYLEY - IR

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

**CAPITAL GAINS TAX**

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(i) rebase to 1 January 1983;

(ii) keep the rate at a flat 30 per cent; and

(iii) indexation to be abolished completely (for both the past and the future).

ACSA

A C S ALLAN

BUDGET SECRET: TASK FORCE LIST

**Inland Revenue**

Policy Division
Somerset House

Ch/ Do you want to proceed further with any of these?

Copy No of

FROM: M F CAYLEY
DATE: 9 February 1988

1. MR PITTS 9/2.
2. MR ISAAC 9.2
3. CHANCELLOR

Urgent views of FST possible but option (iii) @ least would seem worth doing

CGT: MINOR SIMPLIFICATIONS OF INDEXATION

1. At yesterday's Overview meeting you said that you wanted to have another look at the possible minor simplifications of indexation canvassed in my note of 6 July 1987 (copy attached for ease of reference).

2. In outline, the three options identified were as follows:-

(i) A change from a monthly to a quarterly basis for giving indexation relief.

(ii) Rebasing the 1982-86 RPI figures (which would need to be preceded by consultation with the Department of Employment).

---

cc. Sir P Middleton
Financial Secretary
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Pitts
Mr Calder
Mr Beighton
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Michael
PS/IR

(iii) Simplified rules for shares acquired since 1982 (and possibly other assets generally).

3. Because it would require prior consultation with the Department of Employment, we do not think the second option would now be feasible for 1988 (and if it is not done this year, it is not worth doing in a future year), time is tight for the other two options. In any event our view remains that none of the options is worth the candle, and that minor changes of this kind may be regarded by the outside world as irritants rather than as helpful. But we would be grateful for Ministers' views on whether they would wish to proceed further with any of them.

M F CAYLEY

**BUDGET SECRET: TASK FORCE LIST**

Copy No. 1 of 22
**FROM: ROBERT CULPIN**
**DATE: 9 February 1988**

CULPIN → CH/EX 9/2

**CHANCELLOR**

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Miss Sinclair
Mr Riley
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill: IR
Mr Isaac: IR
Mr Painter: IR
Mr Eason: IR
Mr Mace: IR

Thanks. We clearly need figures now on the 200,000 losers; but I would imagine they are all gainers taking the 1988 Budget package as a whole. Pse cross-check on this. yes.

PS. And some - it would be helpful to know all this - how presumably so many of those who gain from Indep. Taxation ...

**INDEPENDENT TAXATION: DISTRIBUTIONAL EFFECTS**

I should like to draw attention to paragraph 7(iv) of the paper by Mr Eason which Mr Isaac sent you on 5 February. It will be relevant to our discussion of presentation.

2. I assume we shall sell independent taxation as privacy for <u>women</u> plus recognition of marriage. We need to keep in mind that it will have quite marked effects on <u>men</u>.

3. Briefly:

(a) about 350,000 men will gain an average of about £500 per year;

(b) about 200,000 men will lose an average of about £400 a year.

These are quite large numbers - and quite odd results.

4. If I understand it correctly, about 350,000 men will gain because you are giving them the married man's/couple's allowance when

- they do not enjoy it now and

- they do not expect, in a million years, to be given it.

They are mostly in relatively well-off couples, where the wife has already elected to have her earnings taxed separately.

5. As I understand it, about 200,000 men will lose because you are taking the married man's/couple's allowance away from them when they do get it at the moment. Their wives have little or no income, so they are not exercising the wife's earnings election; but the husbands are well paid enough to see their MCA vanish under independent taxation. They will not necessarily have offsetting gains when independent taxation is introduced: the higher rate reductions will be over and done with by then.

6. All these figures are approximate and depend on the precise details of the scheme - in particular, when and how the MCA vanishes. But I assume, subject to correction, that the broad orders of magnitude should be roughly right.

7. The effects on men are probably too arcane for anyone to notice straight away. But if and when people fathom them, I suspect they will look a bit rum. They come, of course, from combining a move to independence for women with a joint allowance (in virtue of marriage) paid to, and withdrawn from, men.

8. My note on presentation flags the general issue, very briefly. But I found the figures in Mr Eason's paper striking enough to highlight here.

RC

**ROBERT CULPIN**

MACE → CHEX 9/2

BUDGET SECRET: TASK FORCE LIST

**Inland Revenue**

Policy Division
Somerset House

FROM: B A MACE

DATE: 9 FEBRUARY 1988

Thanks. I am somewhat surprised that the IR concern don't [illegible] stepparents, given that the take [illegible]. Suggest that each extra IR official collects between £1m & £2m of revenue: not a bad ratio. But got put on [illegible] agenda: it's right that this should be reconsidered.

1. MR ISAAC 9.2

2. CHANCELLOR OF THE EXCHEQUER

## INDEPENDENT TAXATION: WITHDRAWAL OF MCA AND ADDITIONAL PERSONAL ALLOWANCE

1. This note considers the level of income at which withdrawal of the MCA under Independent Taxation should begin and the rate of withdrawal. It also responds to Mr Allan's note of 5 February asking for advice on withdrawal of the APA over the same range of income.

### Withdrawal of MCA

2. At your meeting on 8 December you provisionally decided that withdrawal of the MCA from 1990-91 (at the rate of £1 of allowance for every additional £10 income) should begin if the income for tax purposes (before deducting personal allowances) of the spouse receiving the MCA exceeded £40,000. (The measure of income on which withdrawal would be based is the same as the measure used for withdrawing age allowance.) The starting figure of £40,000 was chosen in the light of the figures for the yield

---

| | |
|---|---|
| cc Financial Secretary | Mr Chairman |
| Sir P Middleton | Mr Isaac |
| Sir T Burns | Mr Painter |
| Mr Scholar | Mr Beighton |
| Mr Culpin | Mr Lewis |
| Mr Cropper | Mr Eason |
| | Mr Mace |
| | Mr J C Jones |
| | Mr Yard |
| | Mr Boyce |
| | Miss Dyall |
| | PS/IR |

433.txt

from withdrawing the allowance given in my submission of 7 December. Those figures were, however, on the basis of an assumed top rate of income tax of 35 per cent. We need to set the level of withdrawal in relation to the proposed top rate of 40 per cent for 1988-89 and subsequent years and in the light of the further work which we have been doing on the operational and staffing consequences of withdrawal.

Operational and Staffing Consequences

3. We think that the operational consequences of accommodating withdrawal of the MCA in the system are manageable but (as Mr Isaac indicated in his note of 21 January on the additional personal allowance) the staff costs of the withdrawal are significant. The staff costs are directly related to the number of taxpayers who are within the withdrawal band. For taxpayers in employment who likely to be within the band we shall need to make an estimate of their income before the start of the tax year so that a restricted amount of MCA can be included in their PAYE codes. (We have to make some estimate of the restriction in the size of the MCA for PAYE coding; otherwise the taxpayer could be faced with a substantial overpayment or underpayment of tax at the end of the year.) Since these estimates of income are however, almost certain to turn out to be wrong it will then be necessary to make assessments after the end of the tax year to give the correct amount of MCA, once the taxpayer's income is finally known. For all taxpayers within the withdrawal band we will need to bring together information about all the taxpayer's sources of income at the end of the year so that the extent to which his total income exceeds the withdrawal limit can be determined. For those taxpayers whose incomes clearly exceed the point at which the benefit of the MCA runs out there will be no additional work: they will get the benefit only of the basic allowance in any PAYE code and no further adjustment to their affairs will be necessary for this reason after the end of the tax year. We shall of course be looking at ways in which our initial estimates of the staff costs for this work might be reduced. But the conclusion that the costs are directly

related to the numbers of taxpayers in the band is unlikely to change.

4. Administrative considerations therefore point to keeping the numbers within the withdrawal band as low as possible. But restricting the numbers in the band is desirable for other reasons too since those in the band effectively suffer a higher marginal rate of tax than those with incomes above or below the band. In addition, with a given starting point, the yield from the measure increases if the rate of withdrawal is faster.

Number of taxpayers in the withdrawal band

5. The number of taxpayers within the withdrawal band is determined by two factors:

(i) the level of income at which withdrawal starts (which might be called the MCA limit) and

(ii) the rate at which the allowance is withdrawn.

6. In my submission of 7 December I assumed a withdrawal rate of £1 of allowance for every £10 of income above the MCA limit. This rate of withdrawal was designed to ensure that the total combined marginal rate of income within the withdrawal band (including NICs above the UEL) did not exceed 50 per cent. Now that NICs above the UEL are no longer part of the Budget package it would be possible to increase the rate of withdrawal of the MCA while still keeping the marginal rate of income within the withdrawal band below 50 per cent. A faster rate of withdrawal would also reduce the disparity with the age allowance (which is withdrawn at the rate of £2 of allowance for every £3 of income above the aged income limit.)

Possible Options

7. The table attached shows the effects of various possible options for withdrawal of the MCA under Option 3 of the main

income tax packages indexed to 1990-91 levels. Details are shown for four different starting points for withdrawal each combined with two different rates of withdrawal - £1 of allowance for every £10 of income (implying a marginal rate over the withdrawal band of 44 per cent) and £1 of allowance for every £5 of income (implying a marginal rate over the withdrawal band of 48 per cent). Yields are at 1990-91 income levels.

8. As the table shows with withdrawal starting at income for tax purposes of £40,000 and a withdrawal rate of £1 of allowance for every additional £10 of income (Option A) there would be a full year yield from the measure of £110 million at 1990-91 income levels. But there is a high staff cost under this option because of the substantial number of taxpayers (160,000) who are within the withdrawal band. At this level the withdrawal band crosses what is still a relatively thick part of the income distribution.

9. Options with a withdrawal rate of £1 of allowance for every £5 of income above the MCA limit (Options B, D, F and H) have considerably fewer taxpayers within the withdrawal band. For the same reason they are more cost effective in staff terms. Option D (starting point £45,000) and Option F (starting point £50,000) look attractive since the yield is significant (£100 million for Option D, £80 million for Option F at 1990-91 income levels) and the numbers within the withdrawal band are relatively small. Under Option F withdrawal would affect broadly only those taxpayers who would have been liable at the 60 per cent rate under the present tax regime. This might be a useful presentational point.

## Withdrawal of the APA

10. Mr Allan's note of 5 February asked for advice on withdrawing the Additional Personal Allowance on the same basis as the withdrawal of the MCA.

11. As an operational matter it would be possible to handle withdrawal of the APA on the same basis as the MCA. The number of individuals affected is likely to be very small: about 4,000 if withdrawal started at income of £40,000 and just over 2,000 if it started at £50,000. There would be an additional staff cost of a unit or two on top of the staff cost for withdrawing the MCA. The yield from withdrawal would be about £1-2 million.

12. As Mr Allan's note points out, withdrawing the APA over the same income range would reduce the tax penalty on marriage created by the withdrawal of the MCA, though a two earner unmarried couple could continue to get the benefit of the allowance (perhaps only at the basic rate rather than the higher rate) by ensuring that the lower earner claimed it. We are doubtful, however, about the justification for taking the APA away from single parents with incomes above the limit. As I have suggested in my previous notes on withdrawal of the MCA the effect of withdrawal on married couples where the wife has little or no income may not be easy to defend in principle. For the married couple, however, it is possible to point to the other benefits which the couple may obtain on the change to Independent Taxation in 1990-91 - in particular the disaggregation of the wife's investment income, and (in some cases) the restoration of the MCA to couples currently making a wife's earnings election - to help support the case for withdrawing the allowance at higher income levels. There are no corresponding changes affecting single parents on the move to Independent Taxation against which to defend withdrawal of the APA.

B A Mace

We understand the attractions that you see in the vanishing MCA. In practice, it will in many ways be a troublesome new complication. If you see Option F as achieving your objectives, it would help to keep the cost and practical problems to the unavoidable minimum.

B A MACE

C.f.e.? 9.2

BUDGET SECRET: TASK FORCE LIST

WITHDRAWAL OF MCA

| Option | Starting Point (Total Income £) | Rate of Withdrawal | Number of taxpayers in withdrawal band 000s | Number of taxpayers above withdrawal band 000s | Full Year Yield (1990-91 income levels) £ million | Full Year Staff Cost (Units) |
|---|---|---|---|---|---|---|
| A | 40,000 | £1 for £10 | 160 | 100 | 110 | 120 |
| B | 40,000 | £1 for £5 | 100 | 160 | 130 | 75 |
| C | 45,000 | £1 for £10 | 110 | 80 | 80 | 80 |
| D | 45,000 | £1 for £5 | 65 | 125 | 100 | 50 |
| E | 50,000 | £1 for £10 | 75 | 70 | 65 | 55 |
| F | 50,000 | £1 for £5 | 50 | 95 | 80 | 40 |
| G | 60,000 | £1 for £10 | 40 | 50 | 40 | 30 |
| H | 60,000 | £1 for £5 | 25 | 65 | 50 | 20 |

**Inland Revenue**

Policy Division
Somerset House

This does not cover one of the main pts I have in mind – viz that last year, under pressure, we agreed to maintain the CGT rate for mutual life offices @ 30%, while putting all other corporate gains up to 35% (small companies apart). This was @ that time the CGT rate: it will be so no longer.
NL

Copy No 2 of 23

FROM: M F CAYLEY
DATE: 9 February 1988

1. MR PITTS 9/2.

2. FINANCIAL SECRETARY

CGT REFORM: UNIT TRUSTS AND MUTUAL LIFE OFFICES

1. Mr Taylor's minute of February to your Private Secretary asked for a note on how the CGT treatment of unit trusts and mutual life offices looks in the light of CGT reform. We are not sure precisely what is in Ministers' minds, and if this note does not cover the desired ground, we can endeavour to supply further information.

UNIT TRUSTS

2. Unit trusts are divided for CGT into two broad groups: the unauthorised, and those authorised by DTI. Only the latter can be freely advertised.

---

cc. Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Pitts
Mr Cayley
Mr Haigh
Mr Spence
Mr Michael
PS/IR

Authorised Unit Trusts

3. Authorised unit trusts are exempt from tax on their gains, as are approved investment trusts. Investors pay CGT when they sell their units if their gains exceed the annual exemption. Authorised unit trusts can therefore switch from one share to another without a tax charge on their gains. The rationale for this is that these vehicles are intended primarily for relatively small investors, to provide them with a spread of investments that would otherwise be available only for the wealthy; and that most investors would be below the capital gains exemption on share switches if they invested in shares etc direct. But wealthier investors who do not mind surrendering control of their investments to unit trusts managers can find authorised unit trusts a useful means of delaying the CGT that would be payable on portfolio changes if they owned shares direct (and other things being equal this will increase their ultimate gains compared with direct shareholding, where on portfolio switches they would have to allow for tax in deciding how much to reinvest).

4. The overwhelming majority of authorised unit trust investors are below the CGT annual exemption, so CGT deferral is irrelevant to them. This year's reform will increase somewhat the incentive for higher rate taxpayers above the exemption to invest in authorised unit trusts, since they will be deferring tax at a higher rate: and it will reduce somewhat the tax attractions of authorised unit trusts for basic rate taxpayers above the CGT exemption - though the non-tax attractions will of course remain and will normally be dominant in people's minds.

As regards

5. The position on sale of units for the minority of investors whose gains exceed the annual exemption, the effects of the reform will be the same as for anyone else:-

(i) rebasing will be beneficial if they acquired units before 1982

(ii) the rate changes will involve a reduction for basic rate people and an increase for higher rate taxpayers.

6. The implications of the CGT reform for authorised unit trusts will thus be fairly peripheral for the vast majority of investors.

Unauthorised Unit Trusts

7. Unauthorised unit trusts, which are not subject to DTI investment controls and regulation, pay tax on their gains at corporation tax rates. The Budget proposals will not affect this. But such unit trusts will benefit from rebasing.

8. When they sell units, investors in unauthorised unit trusts are liable in the normal way if their gains exceed the annual exemption. They too will of course benefit from rebasing; if they are basic rate taxpayers, they will also benefit from a reduction in the tax rate: if higher rate taxpayers, any benefit from rebasing will be offset by a rate increase. But investors will often be able to stagger disposals to keep within the annual exemption.

9. On balance, and looking at unauthorised unit trusts and their investors together, the likelihood is that the CGT reform will for some existing unit trusts reduce somewhat the burden of tax on gains - and hence the disadvantage of not having authorised unit trust treatment. But in many cases the effect may be small.

## Conclusion on Unit Trusts

10. In general the effects of the CGT reform on unit trusts and their investors will commonly be fairly small. For some unit trusts established before 1982, the reform is likely if anything to reduce a little the importance of the difference in treatment between the authorised and the unauthorised.

11. Ministers decided last year to maintain the tax distinctions between authorised and unauthorised unit trusts. There is nothing in this year's CGT reform which need lead one to reopen that decision.

12. Finally, it is perhaps worth mentioning that if there were to be specific changes in the tax regime for unit trusts, DTI would have a major interest.

## MUTUAL LIFE OFFICES

13. The only effect of this year's reforms for mutual offices will be - as for large companies generally - from rebasing. This may reduce tax liabilities on gains on pre-82 investments, so reduce the amounts that offices have to regard as "earmarked" against these liabilities, and thus increase their solvency.

14. One particular aspect of this - which applies to all life companies, not just the mutuals - is that some of these unrealised pre-82 assets were bought out of the premiums paid by past policy holders who are not now on the office's books to collect their share of this benefit. As you will recall from last year's discussion on companies' capital gains, life offices have to take account of contingent tax liabilities in fixing their policy pay-outs. The level of these tax reserves is (within the limits of the DTI regulatory regime) a matter for each company to determine.

But established companies are probably holding significant reserves in respect of pre-82 gains which will no longer be required following the Budget. How this benefit feeds through, and how it shows up in the office's books, varies from case to case.

15. In the case of traditional life business (ie not "unit-linked") most of the tax reserves are probably held implicitly in the form of higher "free assets" (and hence lower levels of emerging "surplus") than would otherwise be necessary. To this extent, life office assets will look much the same following the Budget as before - but they will in practice be more "spendable". Most of the benefit (in the case of mutuals, the whole) will go sooner or later to current and future with-profits policy holders in the form of higher bonus rates than would otherwise be possible.

16. It will not generally be possible to quantify what part of a given policy holder's total eventual bonus is attributable to the Budget CGT package, unless (just conceivably) offices declare a "special" bonus on this account. In current market circumstances, it seems unlikely that actuaries will want to make large immediate increases in bonus rates, but they may be able to hold current bonus rates, particularly "terminal bonus", for longer than otherwise. In the case of proprietary offices, shareholders will get their smallish (usually about 10%) share as pre-82 gains are "released into surplus".

17. In the case of unit-linked policies, an adjustment on account of contingent tax liabilities is made explicitly in the form of a deduction from the gross asset value of "linked units" at the time the policy pays out. But the rate of deduction is still set at the actuary's judgment. There are two different ways of handling the adjustment. In both cases, there should in principle be some reduction following the Budget in the tax deduction taken from current policy holders on account of their share of pre-82 gains.

The difference lies in the fate of the tax already reserved (with hindsight, unnecessarily) out of pay-outs already made to past policy holders. In one case, it rests with the office (ie with shareholders, or possibly with traditional with-profits policy holders); in the other it rests in the "linked funds" and so belongs to current and future linked policy holders.

18. How far these effects will show up as significant one-off adjustments to reserves, or to unit prices, is not clear. In principle, they probably should. But offices may find it embarrassing to be seen handing out this element of windfall gain to current policyholders or (particularly) to shareholders, when the "moral" claim to it lies with past policyholders.

19. More generally, the CGT reform will have little implication for the arguments on how far life policies (particularly unit-linked ones) have a level playing field with unit trusts: these arguments focus largely on new business, where rebasing has little or no relevance.

Michael Cayley

M F CAYLEY

COPY NO. 21 OF 22 .

FROM: J M G TAYLOR
DATE: 10 February 1988

JMGT → CULPIN 10/2

MR CULPIN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Miss Sinclair
Mr Riley
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Eason - IR
Mr Mace - IR

**INDEPENDENT TAXATION: DISTRIBUTIONAL EFFECTS**

The Chancellor was grateful for your minute of 9 February.

2. He has commented that we clearly need to know more about the 200,000 losers; but he would imagine that they are all gainers taking the 1988 Budget package as a whole. He would be grateful if you could cross-check this.

3. He has commented, further, that some of these losers will presumably be married to wives who gain from independent taxation. It would also be helpful to know a bit more about this.

J M G TAYLOR

**Inland Revenue**

Policy Division
Somerset House
Copy No 1 of 36

FROM: M F CAYLEY
DATE: 10 February 1988

Ch/ Do you want to keep this option open?

1. MR PITTS

2. MR ISAAC 10.2

3. CHANCELLOR

Thanks

10/2

Discuss at overview on Monday, or have special meeting on Friday?

CAPITAL GAINS TAX: REBASING AND ABOLISHING INDEXATION

1. This note is in response to your request for us to look quickly at a scheme under which

(i) there is rebasing to 1982,

(ii) indexation is abolished,

(iii) gains of individuals and trusts are not added to income, and

(iv) the CGT rate is either 30% or 25%.

I think we can forget this option. N.

---

cc. Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Sir G Littler
Mr J Anson
Sir A Wilson
Mr M C Scholar
Mr R Culpin
Mr P Sedgwick
Mr J Odling-Smee
Miss C Evans
Mr G Michie
Mr P Cropper
Mr A Tyrie
Mr M Call
Miss C E Sinclair
Mr C J Riley
Mr Unwin C&E

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr McGivern
Mr Pitts
Mr Deacon
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Spence
Mr Michael
Mr Heggs
PS/IR

KEY FIGURES

3. In the time available we have been able to come up with only very provisional figures. Using the central behavioural assumptions (see Mr Riley's note of 28 January), the effect on revenue and taxpayer numbers on a full year accruals basis can be summarised as follows:-

(a) Yield

| | CGT | CT | TOTAL |
|---|---|---|---|
| 30% rate | nil or small cost | 0 to - £m100 | Cost of up to say £m100 |
| 25% rate | - £m100 | 0 to - £m100 | Cost of £m100 - 200 |

(b) Taxpayer Numbers (CGT only)

| | |
|---|---|
| 30% rate | No change |
| 25% rate | + 15% (about 20,000) |

Why is there any difference?
? behavioural effects.

SIMPLIFICATION

4. Abolishing indexation would be a significant simplification of the legislation, and should enable several pages of legislation to be repealed. (How many would depend on how Counsel approached the task.)

5. In 1986-87, we said that packages including the abolition of indexation could produce sizeable staff savings. But the options then being considered did not

involve rebasing, and the bulk of the staff savings would have stemmed (as we have explained to the Financial Secretary in the past) from no longer having to establish 1982 values. With rebasing, the need to ascertain 1982 values would remain - and indeed become more important (since more will turn on those values). We would not therefore anticipate any sizeable reduction in our staffing need. 1982 values aside, our staff have relatively little involvement in the detail of indexation computations: most of the work is done by taxpayers and their advisers.

6. For taxpayers, abolishing indexation would be a useful simplification. While we are not in the best position to estimate the compliance burden of indexation, we do receive regular complaints. But we suspect that most of the compliance work for CGT would remain. The simplification would be most marked for eg investors in unit trust monthly savings scheme (for whom indexation calculations can be very finicky), but only a very small proportion of such investors are above the CGT exemption. The reduction in the compliance burden would be limited, for pre-82 assets, by the continuing need for 1982 valuations.

7. A number of representative bodies have suggested the abolition of indexation - but they have done so in the context of pressing for either the total abolition of CGT or exemption of long-term gains. We have seen no recent suggestions from the representative bodies for abolishing indexation while keeping long-term gains within the charge; and indeed the most common complaint we see is about the fact that inflationary gains arising before 1982 are not protected from tax.

GAINERS AND LOSERS

8. In the time available, we have not been able to look in any detail at the pattern of gainers and losers, but the following generalisations can be made. Whether the CGT rate

is 30% or 25% makes little difference to the picture (and none at all for companies).

9. Those with large (inflationary or real) gains accrued before 1982 would tend to emerge fairly well. This group would be likely to include many holders of agricultural land.

10. In contrast, those with large (inflationary or real) gains accrued since 1982 would frequently pay more tax. This group would include many holders of shares and of non-agricultural real property.

11. Potentially the worst affected group would be those whom indexation currently shelters from tax completely. For someone who owned an asset on 31 March 1982, indexation relief is about 30% of the 1982 value. Thus no tax would currently be payable on an asset bought for £1000 in 1982 and sold for £1300. Under the proposal, ignoring the CGT exemption, the tax would be £90 (at 30%) or £75 (at 25%). In some cases very large paper gains would suddenly be brought into tax. No change in rates could prevent this. In other cases real losses would be turned into (taxed) paper gains.

12. There would be a large number of losers. A substantial increase in the annual exemption would help to reduce the proportion of losers, but would do nothing for companies and little for those with large post-82 (paper or real) gains; it would benefit some people who lost little from the abolition of indexation; and it would increase the generosity of the annual exemption for married couples following independent taxation. Any such increase in the exemption would be difficult to reverse when the reason for it - compensation for abolishing indexation - became less relevant.

Ch
Looking at proportional losers is rather
misleading.

## REACTIONS

13. When we considered in the winter of 1986/87 a rather different (and, for many individuals and trusts, more generous) package involving the removal of indexation, the Bank of England commented strongly that abolition of indexation would cause a very big row. I attach a copy of Mr Cassell's minute to you of 8 January 1987. There would undoubtedly be vociferous allegations of retrospection - taking away indexation relief which people had "banked".

14. These complaints might well be louder because of rebasing than they were with the 86/7 ideas: the position of people with large pre-82 gains (indexation does not extend back beyond 1982, and these gains would suddenly be taken out of tax) could well be contrasted with that of those with large post-82 paper gains, which would suddenly lose the anticipated protection of indexation and be brought into tax.

15. Rebasing would be harder to justify. If indexation continues, rebasing can be justified as the only practicable way of dealing with the problem of pre-82 inflationary gains. If indexation is abolished, that justification disappears. Instead the rationale would presumably have to be that 1982 saw the end of a period of high inflation, in which an unindexed system had created clear unfairness: with inflation contained to relatively low levels, the benefits of the fine tuning of indexation no long justify the costs and complexities involved. But such a rationale might be difficult to square with a six year period, from 1982 to 1988, in which post-82 inflationary gains were protected by indexation, but earlier inflationary gains were not.

## INSURANCE COMPANIES

16. The abolition of indexation for both past and future could pose difficulties for some life assurance companies.

When making past payouts to people whose policies have matured, the companies will have made a provision for future tax on gains on the assumption that indexation would continue. In some cases, the provision might prove insufficient, because the disappearance of indexation would increase the prospective gains charge. You will remember that in the 1986/87 discussions anxiety was expressed that some life assurance companies would face a solvency problem.

COMMENCEMENT

17. Mr Cassell's note of 8 January 1987 records the Bank's view that, if indexation is to be abolished, Budget Day commencement (rather than 6 April) would be essential in order to prevent massive disruption in the markets as investors sought to crystallise their existing indexation relief before it was removed. There would be operational difficulties in applying a rate reduction to 25% before the new tax year. So we would envisage abolishing indexation from Budget Day and applying any change in tax rate from 6 April.

AVOIDANCE

18. The abolition of indexation would reduce somewhat the scope for tax avoidance. Ministers have already acted to deny indexation on gilts, qualifying bonds, and Building Society shares, and have agreed to include in the Finance Bill measures to deny it on some arrangements within company groups specifically set up to create indexed losses. If indexation were abolished, provisions on two Starters could be dropped from the Bill - though as one is fully and the other largely drafted, there would be little saving of Parliamentary Counsel's time. It would also reduce the scope for tax avoidance if COBO is abolished (Mr Ilett's note of 8 February) - the main advantage (a return which partially escapes tax) would remain, but the scope in some

cases for creating indexed losses would disappear. But as long as indexation relief continues there will be an incentive for people to enter into arrangements which give them part of their return in a capital form sheltered by indexation, or which create indexed losses. An example which has recently surfaced is the creation of indexed investments in the USA for Lloyds members. Abolishing indexation would put an end to this.

FEASIBILITY

19. From the work we did in 86/7, it is clear that abolishing indexation across the board would not be straightforward. Part of the problem is that the share pooling arrangements (as reintroduced in 1985) presuppose the existence of indexation and would need some rewriting; part, that there are other provisions which refer to indexation, so there would be a range of consequential amendments. We have done a lot of the spadework, but even so there would be a good deal of work for both us and Parliamentary Counsel. We have not at this stage spoken to Counsel, but given his other pressures, it must be doubtful how far at this very late stage he could draft the necessary provisions in time for inclusion in the Bill as first published. The likelihood must be that much of the legislation to remove indexation would have to be introduced at Committee. We can if you wish have a word with Parliamentary Counsel in advance of the Overview meeting on 15 February.

20. At the operational end, Budget Day commencement would involve some extra costs: tax returns and the guidance on their completion have already been printed, and we would need to prepare some supplementary material and to tell people to identify separately disposals on or after Budget Day.

CONCLUSION

21. A reform on these lines would probably be not far off revenue-neutral, but there would be large numbers of losers. The abolition of indexation would be controversial, and there would be allegations of retrospection. To avoid major market disruption, it would be necessary to deny indexation from Budget Day. On the plus side, abolishing indexation would be a useful simplification of the system (though there would not be any substantial effect on our staff need), and would eliminate one area of creative tax planning.

22. If you wish to keep this option open, we shall have to work very urgently on the details and instruct Parliamentary Counsel very quickly. Even so, we are doubtful how far legislation could be prepared in time for the Bill as first published - much might have to be left for introduction at Committee.

Michael Cayley

M F CAYLEY

Indexation would be a useful simplification. But for all the cries of complexity, people do not want to lose it unless they also get major surgery on the CGT system. Sadly, I doubt they would see rebasing as sufficient compensation - even rebasing and a 25% CGT rate would leave losers - and there would be strong objection to the indexation proposal on grounds of retrospection, notwithstanding the history of inflation.

The Revenue staff effect does not greatly vary whether you go for indexation by itself (as now): rebasing plus indexation: or rebasing without indexation. This is because each involves valuations as at 1982 and that is where most of the staff cost is (much of it in the Valuation Office). Until disposals of assets acquired pre-82 dwindle, only neither rebasing nor indexation would make a substantial difference.

DP

D Y PITTS

SECRET AND PERSONAL

FROM: F CASSELL
8 January 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mrs Lomax
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr A C S Allan
Mr Battishill )
Mr Isaac ) IR
Mr Houghton )
Sir Angus Fraser, C&E

**CGT AND THE FINANCIAL MARKETS**

We have discussed with the Bank the possible market reactions to a CGT reform along the lines envisaged in paragraphs 9-15 of the Chevening paper on Tax Issues.

2. We found it helpful analytically to divide the package into three components:

a. The removal of post-1982 inflation relief.

b. The loss of on-going indexation of capital gains for the future.

c. The changes in tax rates applied to chargeable gains.

We found (not surprisingly) that a. is by far the most important of these components. It is the removal of past inflation relief that produces the net revenue yield from the package and creates most of the "hard cases". The Bank had no doubt that it would cause a "helluva row" in the City, since it would bring into tax gains that investors had already "banked" as being free of tax. There would be serious charges of retrospection. Investors might not like the complexity of the present indexation provisions but they would like the removal of those provisions even less!

3. By comparison components b. and c. of the package are relatively modest and should cause no problems, given current inflation rates and the proposed tax rates. But the Bank argued strongly for some form of 'top-slicing' that would enable the taxation of capital gains to be at rates determined by income alone.

4. The Bank confirmed that if a. is to be part of the package the market must be prevented from getting any hint of what is envisaged and that the change would have to take effect from the beginning of Budget day. (Inland Revenue will be letting you have a submission on this aspect.) Otherwise there would be a massive and totally disruptive effect on the market as investors scrambled to realise their post-1982 gains before inflation relief was removed from them.

5. With that one crucial reservation, our discussions have not identified any significant effects on markets as a result of the change. In broad terms, since for many investors the taxation of capital gains would be higher under the new regime than under the present one, assets such as gilt-edged that are exempt from taxation on capital gains would become more attractive in comparison with equities and property. Obviously, this effect will vary with the particular tax position of the investor; for most small investors the attractions of equities would, if anything, be likely to be enhanced (though not the attractions of PEPs), especially if the capital gains threshold is significantly increased. But so far as we can see, and assuming that inflation remains relatively low, none of these effects look likely to cause any serious market problems.

6. The Bank did not share the view that some of us have felt that the changes could lead to more "locking in" of investments than is assumed in the Revenue's calculations. They believe

that, provided top-slicing or some other arrangement to offset the progressive income tax were in place, the changes in rates and loss of on-going indexation would have little effect on turnover. Companies would still switch between assets on the basis of their judgement of market developments: the post-tax profitability of such switches would be reduced but switches would still generally be worth doing. Arbitrage and anomaly switches, which account for the bulk of turnover in the securities markets have not been greatly affected by the indexation provisions, because such operations involve short holding periods.

7. In sum, these discussions with the Bank (which have been limited to only three people and have necessarily been in fairly general terms) suggest that a regime along the lines at present contemplated could, once in place, work well. But the Bank do warn strongly that the withdrawal of post-1982 relief for inflation will be seen as retrospective and inequitable. They believe that some means of preserving the indexation from 1982-87 is necessary - in effect confining the package to components b. and c.

F CASSELL

V2719.18

**BUDGET SECRET: TASK FORCE LIST**

Copy No. 1 of 30
**FROM ROBERT CULPIN**
**DATE: 11 February 1988**

CULPIN → CH/EX 11/2

**CHANCELLOR**

| cc | | |
|---|---|---|
| | Principal Private Secretary | Miss Evans |
| | Chief Secretary | Mr Hudson |
| | Financial Secretary | Mr Cropper |
| | Paymaster General | Mr Tyrie |
| | Economic Secretary | Mr Call |
| | Sir P Middleton | Miss Sinclair |
| | Sir T Burns | Mr Riley |
| | Sir G Littler | Mr Scotter |
| | Mr Anson | |
| | Sir A Wilson | Mr Battishill ) |
| | Mr Byatt | Mr Isaac ) Inland |
| | Mr Scholar | Mr Painter ) Revenue |
| | Mr Sedgwick | Mr Calder ) |
| | Mr Odling-Smee | |
| | | Mr Unwin ) Customs |
| | | Mr Bryce Knox) & Excise |

Spent major effort: pts here. [illegible] for [illegible].

**BEHAVIOURAL EFFECTS OF BUDGET MEASURES**

"Behavioural effects" seem to come up at every Overview. I thought it might be helpful to take stock of work we are doing, or intend to do. This is essentially a check list, and is about internal assessments, not what to publish in the FSBR.

**Capital Gains Tax**

2. As you know, we have covered CGT pretty exhaustively. We now need to tidy up the figures, particularly on forestalling, in the light of Bank and Revenue comments. That is in hand. It should be reflected in next week's Scorecard.

**CGT under Independent Taxation**

3. There are two loose ends on the interaction with Independent Taxation. That of course will double the £6,600 CGT exemption for married couples, and increase the gains on which they need only pay basic rate tax.

4. First, I mentioned at an Overview that couples will have some incentive to defer realising gains until 1990-91, when the effective tax rate they face will fall. Mr Scotter has produced the attached assessment, which suggests that the effects could be significant. Between £0 and £150 million of CGT accruals

could be deferred from each of 1988-89 and 1989-90. It might be reasonable to guess about £60 million for 1988-89 and £75 million for 1989-90. The Revenue are content.

5. If the accruals loss were of this order, the revenue loss comparable to other Scorecard figures would be approximately:

| | | | £ million |
|---|---|---|---|
| **1988-89** | **1989-90** | **1990-91** | **1991-92** |
| neg | -20 | -60 | -45 |

6. This is not in the Scorecard. It would be consistent with our practice on other CGT costings to put it in. It would be a cost of Independent Taxation, and belongs on that line. We could, if you wish, disaggregate the costing of Independent Taxation, either in the Scorecard tables or in the notes, to show income tax and CGT effects separately.

notes

7. Second, the Scorecard has for several weeks included a revenue cost of £40 million, in 1991-92, for doubling the CGT exemption for married couples when Independent Taxation comes in. The notes have said that this makes "some" allowance for changes in the ownership of assets between partners. The Revenue have now set out their assumptions, and we are discussing them at technical level.

8. But if we are right that accruals of CGT will be deferred from 1988-89 and 1989-90, some (not all) of them will be moved into 1990-91. There will be extra revenue on that account to offset part of the cost of doubling the CGT exemption.

9. Again, this is not in the Scorecard; and since it only affects revenue in 1991-92, it is scarcely a priority. But we are trying to tidy this up too.

**Income Tax under Independent Taxation**

10. That leaves at least three other questions about Independent Taxation.

(a) To what extent will married women switch their existing savings out of accounts which attract the composite rate into forms which either pay interest gross or allow tax to be reclaimed? The Treasury instinct is not much. The issues are discussed in Mr Kent's note of 10 February. behind.

(b) To what extent will higher taxed married men (to simplify) pass investment income to their lower taxed wives? We have not really looked at this. The Revenue are trying to assess the potential tax loss, and aim to have results (on which they will consult the Treasury) by the end of next week.

(c) To what extent will wives then switch any of the transferred investment income out of composite rate accounts into savings on which they can avoid tax? This is raised briefly in Mr Kent's note. It may (or may not) be appropriate to think a bit more about it when we have the work on (b).

There is no allowance for any of these effects in the Scorecard.

**Housing**

11. You should be getting notes today, for the next Overview, on taxing subsidised mortgages, and options for the private rented sector. Both sets of notes will incorporate at least some preliminary assessments of likely behavioural effects.

12. Mr Bredenkamp is looking at the possible effects of abolishing tax relief on home improvement loans. His preliminary guess is that this might reduce real investment in home improvements by about 2 per cent a year. But this makes no allowance for the possibility that people will take out larger mortgages when they buy houses, to cover the potential costs of improving them. Nor does it allow for the effect of restricting mortgage relief to the residence basis in stimulating the sub-division of houses. We shall be looking into this further next week.

**Cars**

13. You already have a note by Mr Monck on the possible industrial effects of raising car scales. As agreed, we are doing further work in the Treasury, which we hope to have available next week. This should cover both effects on the car industry and effects on pay and revenue. We expect to be suggesting somewhat smaller effects on the car industry than in Mr Monck's initial assessment.

**Tax Shelters**

14. The Inland Revenue hope to produce a note within (say) the next fortnight on the probability that reducing tax rates will reduce the use of tax shelters. They are at present looking at the possible effects of this, shelter by shelter.

**The FSBR and Presentation**

15. All these pieces of work are about what we think the effects of Budget measures might be, accepting that our estimates are bound to be highly uncertain. They are about analysis, not presentation. And they are about limited, specific effects, not general supply side improvements.

16. There are separate questions about what approach to follow in costing measures for this year's FSBR. As already promised, there will be an FP note on that in due course, following consultation with the Revenue Departments.

17. There may also be questions about what we should say in public about the possible effects of particular measures, whatever conventions we adopt in the FSBR. We may well need to consider that when it comes to briefing. But we can't sensibly do it until (a) we have some internal assessments to go on, and (b) we have established a presumption about our FSBR conventions.

RC

ROBERT CULPIN

## CAPITAL GAINS TAX REFORMS: RESPONSE TO INDEPENDENT TAXATION

From April 1990, couples will be separately taxed for CGT as well as for income tax. As CGT will have been assimilated with income tax by then, couples subject to CGT will have two potential sources of reduction in their CGT liabilities:

(i) They will be entitled to two annual exempt amounts, reducing their joint chargeable gains by a further £6,600 (at 1988-89 levels of exemption).

(ii) They will be entitled to two tranches of tax (CGT and income tax) at the basic rate of income tax. This will reduce the effective tax rate on gains for most couples, the extent of the reduction depending on their income tax position.

2. These reductions in liability to CGT will affect capital gains behaviour of couples after 1990. On the assumptions made for rebasing and assimilation, couples can be expected to increase their disposals permanently after 1990, with a temporary 'surge' effect in 1990-91. But the change to independent taxation will be announced in March 1988. The anticipation of lower future effective tax rates may cause couples to defer disposals they would otherwise have made in 1988-89 or 1989-90, until 1990-91 or later. Since the change will be announced before the end of the tax year, there could be some deferrals from 1987-88 as well, but there are only three weeks for couples to work out the effects of independent taxation, so we expect this effect to be negligible.

3. This note concentrates on the likely extent of deferral. Behavioural effects in 1990-91, after the change is in place, will not result in any tax receipts until 1991-92, but deferral would affect receipts from 1989-90 onwards. The note largely abstracts from the question of ownership of the capital on which the gains arise. In some cases deferred disposals will be assets owned by the wife, or jointly owned, but in other cases a transfer of ownership will be needed before the advantages of independent taxation can be realised.

## Returns to deferral

4. The benefits of deferral depend upon the income tax position of the couple, especially the wife, and upon the size of the gain to be realised. This section looks at some specimen couples to see how they might gain from deferral. In common with other CGT work it assumes that the couple are disposing of average assets made up of a basket of typical holding periods and with average price increments within each holding period. It assumes that CGT has been assimilated with income tax and that gains have been rebased to 1982. All figures are at constant prices. Tax thresholds/ exemptions are assumed to be indexed.

5. The benefits of deferral also depend upon the pattern of the couples' planned disposals over the 1988 to 1991 period:

(i) If they have an even pattern of disposals of divisible assets (like shares), realising roughly the same level of gains each year in real terms, circumstances in which deferral is worthwhile and the benefits of deferral are straightforward to calculate.

(ii) If they have an uneven pattern of disposals, then the circumstances in which deferral is worthwhile are less obvious. In particular it matters whether the irregular disposals are a result of indivisible assets or because the couple have chosen that pattern.

6. There is no time series evidence from which to identify whether regular disposals are a common feature of the CGT system or whether disposals are more typically irregular. Regular disposals might be a feature of portfolio management, of retired couples disposing of their lifetime investments for income and of others who take income in the form of gains. Irregular disposals might be more common in land transactions where assets are less divisible, particularly relatively small disposals such as selling a second home. Irregular disposals might also be a result of 'forced' disposals such as takeovers.

7. Much of the analysis below is for a couple with regular disposals but there are also comments on the situation where disposals do not follow a regular pattern.

**(a) Double exemptions**

8. In 1988-89 and 1989-90, a couple will not pay any tax on their first £6,600 of net indexed gains. From 1990-91, if they each have gains of over £6,600, they will not pay tax on the first £13,200 of gains. Their tax liability will be reduced by £1,650 if they were paying CGT at the basic rate or £2,640 if they were higher rate taxpayers. The effect of this reduction on deferrals of disposals in 1988-89 and 1989-90 depends upon the pattern of those disposals and on planned realisation of gains in 1990-91.

9. Couples would benefit from deferral if, with their planned profile of disposals before taking account of independent taxation:

- they would have unused exemptions (up to £13,200) under independent taxation, in 1990-91 or later years <u>and</u>

- they plan disposals in 1988-89 and 1989-90 yielding gains in excess of the exemption available in each year (£6,600 per year).

If a couple do not meet <u>either</u> of these conditions, there will be no incentive to defer realisations.

10. A couple who had planned disposals yielding net indexed gains of £8,600 a year from now on could delay some of their disposals so that they realised £6,600 in 1988-89 and 1989-90 and £12,600 in 1990-91. As net indexed gains average about 25 percent of disposal value, this means delaying disposals of about £8,000.

11. Basic rate taxpayers would save £1000 in tax and higher rate taxpayers would save £1,600. The tax saving on a disposal deferred from 1988-89 would be equivalent to an extra real return of about 3 percent per year for a basic rate taxpayer. For the disposal delayed one year from 1989-90 it is an extra real return of

6 percent. Equivalent returns for higher rate taxpayers are 5 and 11 percent. The returns would be greater the later in the year the disposal would otherwise have taken place. The returns from delaying a disposal from March 1990 to April 1990 would be very large (over and above the existing return from delaying the tax payment for one year).

12. Some couples with irregular disposals might have an incentive to defer even under the present regime, but choose not to do so. This would be a couple realising net indexed gains of £13,200 in 1988-89 on a holding of shares, with no disposals in subsequent years. They could at present avoid tax by deferring half of their disposal to 1989-90 and being below the annual exemption in both years; independent taxation makes no difference in this case. They would presumably be acting rationally, nevertheless preferring to dispose now and pay tax rather than wait and avoid tax because of other expected 'costs' associated with waiting. They would not be affected by the onset of independent taxation.

13. But couples disposing of indivisible assets such as houses might find it more worthwhile to wait. They cannot at present save any tax by deferring because the chargeable gain will stay the same whichever year they sell in. They will be able to reduce their tax bill by waiting. For a couple with exactly a £13,200 net indexed gain paying higher rate tax, the reduction in tax would be equivalent to an extra return of about 8 percent over one or two years (based on net indexed gains 40% of disposal value for land). The return is lower here than in para 11, because the whole disposal has to be delayed.

**(b) <u>Double basic rate band</u>**

14. The extreme example here would be where the husband is a higher rate taxpayer on his income but his wife has income less than the single person's allowance. Any chargeable gains to the couple will be taxed at 40 percent in 1988-89 and 1989-90 but in 1990-91, if the gains are charged to the wife, the first £20,000 will attract tax at only 25 percent, a reduction in tax bill of £3,000.

15. As with the annual exemption, there will be no incentive to defer for couples who realise chargeable gains of more than £20,000 every year which are subject to higher rate tax. They will be using up their extra basic rate band planned disposals anyway. But for couples with irregular disposals or disposals of less than £20,000 each year, there will be an incentive to defer. For instance, a couple realising chargeable gains of £7,000 a year could delay all of their disposals above the annual exemption until 1990-91 when only £1,000 would incur any tax (and that could be deferred until 1991-92). They would save £1,050 in tax on a disposal of £28,000, equivalent to an extra return of almost 2 percent a year on disposals deferred from 1988-89 and 4 percent on disposals deferred from 1989-90. Where the wife has income above the single person's allowance, the potential savings are reduced as less gain can be taxed at the basic rate.

16. Again couples with irregular or lumpy disposals might find it worthwhile to delay disposals with up to £20,000 of gain. A higher tax rate couple planning a one-off disposal of £80,000 in 1988-89 could save tax of £3,000 by delaying disposal until 1990-91 - an extra return of 2 percent a year.

**Numbers affected**

17. The analysis above suggests that the couples who will have an incentive to defer disposals until 1990-91 are:

(i) Basic and higher rate taxpayers with regular net indexed gains of between £6,600 and £13,200 a year.

(ii) Those with regular chargeable gains of which up to £20,000 is taxed at the higher rate, the amount likely to be deferred being smaller the higher the wife's taxable income.

(iii) Couples with irregular, and possibly lumpy, disposals of up to, say, £40,000.

18. About 56 percent of individuals and trusts who pay CGT are couples and they realise about 62 percent of current net indexed gains. There will be about 95,000 couples paying CGT after the reforms and they will pay roughly £1 bn of the 1988-89 CGT total.

19. Some 48,000 of them will have net indexed gains between £6,600 and £13,200, representing chargeable gains of £120m at risk from deferral due to the double annual exemption, if they are all couples making regular disposals of this amount. They would pay £30-50m in CGT.

20. Some 40,000 couples (41 percent) may be higher rate taxpayers before their gains are taken into account. Taking their gains into account the number may rise to 70 percent or 66,000 representing over 90 percent of gains by couples. Three-quarters of them (50,000) will have chargeable gains of under £20,000 representing total chargeable gains of about £300,000 and a tax accrual of £120m.

21. If all disposals were regular annual events, tax revenue of up to £170m could be at risk in each of 1988-89 and 1989-90 from deferrals in anticipation of independent taxation. Taking account of lumpy indivisible disposals amongst the 30 percent of disposals which are land transactions might increase this figure to about £200m a year. But the actual figure is likely to be much smaller than this maximum. To some extent there is an overlap between the figures in paragraphs 19 and 20. Most couples will not be able to take advantage of the full £20,000 extra basic rate band because the wife has some income above the single person's allowance. On the other hand some larger disposals might be deferred and spread over several years after 1990-91. These factors might reduce the yield at risk to perhaps £150m of accruals in each year.

**Behaviour**

22. Ideally we would want to analyse the likely deferral in terms of a model which incorporated behavioural responses to differences in expected returns on different assets and different holding periods. But information on CGT payers is not available to build such a model. The deferral described here must therefore be

quantified in terms of the 'conventional' elasticities which have been used for the main CGT costings. However they would be being used in rather different circumstances from those in which they were developed. The standard elasticities have been derived from responses to a tax cut which has already taken place whereas, for deferrals, the response we need to model is to a prospective tax cut up to two years ahead.

23. Although many couples would have an incentive to defer their realisations, other factors will counterbalance this. For instance there is the uncertainty of the price of the asset if disposal is delayed for up to two years. The extra 2 percent return which delaying disposal represents in some cases may not be enough to offset the risk of price falls. Or the extra return from delay may be less than the return from the alternative use of the proceeds of the realisation. If the couple were going to consume the proceeds then their time preference rate may exceed the extra return [or the total expected return from holding on]. These factors suggest that the incentive to defer may be less in 1988-89 than in 1989-90 both because the risks involved are larger and because the couple may be less able to afford to wait two years before disposal.

24. Also important is that some couples may not trust each other so that the husband will not be prepared to transfer assets to his wife. In these instances no incentive would be great enough to bring about a change in behaviour. On theother hand, ownership only has to be transferred shortly before each disposal (probably a matter of days for shares) so the period of 'trust' is short so long as the couple can ensure that the proceeds of the disposal are used for some mutually beneficial purpose. Also, it is not only CGT which will give an incentive to transfer. Independent taxation of income will give a separate incentive for couples to transfer income yielding assets in order to reduce income tax liabilities.

25. In addition, the elasticities used elsewhere in CGT costings may not be suitable to use here because the range of reductions in effective tax rates is outside the range of circumstances in which the elasticities were derived. For couples with disposals between

£6,600 and £13,200, taking the benefit of the double exemption, the effective tax rate would fall from its post reform rate of roughly 18 percent to zero. This would imply that almost all of these disposals would cease with transitional elasticities. For the higher rate taxpayers with chargeable gains of less than £20,000, the effective tax rate might fall by 7 points implying a 42 percent fall in disposals of shares - which might be rather more tenable.

**Conclusions**

26. A reasonable assumption might be that deferral would occur on up to half of the disposals at risk with the figure slightly lower in 1988-89 - representing perhaps £60m of CGT accruals deferred from 1988-89 and £75m from 1989-90 to 1990-91 and later years. This would be reflected in receipts as shown in the following table.

**Effect of deferral of disposals on CGT receipts (£m)**

| 1988-89 | 1989-90 | 1990-91 | 1991-92 |
|---|---|---|---|
| Neg | -20 | -60 | -45 |

42/2.BTW.1234/35

**BUDGET: CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 12 February 1988

MR KENT IR

1 agree with the FST.
2 - This issue can be blown up far too much. None of these women are any worse off as a result of the change - & the composite rate system is an [illegible] which makes life simpler for Government.

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Miss Sinclair
Miss Noble
Mr I Rich
Mr Cropper
Mr Tyrie
Mr Call
PS/IR

**INDEPENDENT TAXATION: COMPOSITE RATE**

The Financial Secretary was most grateful for your minute of 10 February.

2. He thinks we should go on to the attack with the first two indents of paragraph 19.

9/2

**JEREMY HEYWOOD**
Private Secretary

BUDGET CONFIDENTIAL

**Inland Revenue**

Policy Division
Somerset House
FROM: R KENT
DATE: 10 FEBRUARY 1988

1. MR MACE ✓ BAM 10/2
2. MR ISAAC 10.2.
3. FINANCIAL SECRETARY

KENT 10/2

INDEPENDENT TAXATION: COMPOSITE RATE

Introduction

1. This submission explains how the composite rate tax regime in force for banks, building societies and other deposit takers will affect non-working married women under Independent Taxation and discusses how the retention of the composite rate regime might best be defended against criticism from married women in this category. It also discusses the possible changes in their investments and the implications of these changes for the financial institutions. The Treasury (FIM and MG1 National Savings) have contributed to this part of the note.

Implications for Married Women

2. The implications of Independent Taxation for the composite rate were discussed in Mr Mace's note of 7 July 1987 and at the Chancellor's meeting on 17 July 1987, where it was generally agreed that they were awkward.

3. At present, married women have no allowance to set against investment income, and the composite rate tax on any bank or

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| | | | |
|---|---|---|---|
| Chancellor | Miss Noble | Mr Isaac | Mr Dearman |
| Chief Secretary | Mr I Rich | Mr Lewis | Mr R Kent |
| Paymaster General | Mr Cropper | Mr Beighton | BTR |
| Economic Secretary | Mr Tyrie | Mr Johns | |
| Sir P Middleton | Mr Call | Mr Calder | |
| Sir T Burns | | Mr Mace | |
| Mr Scholar | | Mr O'Connor | |
| Mr Culpin | | Mr Kuczys | |
| Miss Sinclair | | | |

draft.txt

building society interest they have will satisfy the husband's basic rate liability on the interest. By contrast, under Independent Taxation married women will have a personal allowance to set against any kind of income. Many will not be in paid employment, and of these a high proportion, perhaps as many as 3 or 4 million, will have some composite rate interest from a building society or bank account but have total income below the tax threshold. They will not, of course, be able to obtain a repayment of the composite rate tax deducted.

4. Married women receiving bank or building society interest will not suffer any reduction in the amount they receive on their shares or deposits on the change to Independent Taxation. Indeed, other things being equal, the net rates of interest paid will rise very slightly since the composite rate charge will fall slightly* (with a one year time lag if the present arrangements are still in force) as a larger proportion of investors will be non-taxpayers. However, it seems likely that many married women with building society or bank accounts will be disappointed that their new independence within the tax system will not give them any financial benefit unless they move their savings elsewhere. This will probably lead to a sharp increase in the pressure on the composite rate regime from married women unable to obtain repayment, to add to the existing criticism from other non-taxpayers such as children and the elderly.

5. At the Chancellor's meeting last year Ministers agreed that this pressure would have to be resisted firmly. A change, either to an arrangement where interest was paid gross (and the tax assessed by the Revenue), or to an arrangement where tax was deducted in full and was repayable, would carry an extremely large staff cost, possibly over 3,000 staff units.

* Before the behavioural changes discussed at paragraphs 6-13 are taken into account the composite rate should fall by approximately 1/2 a percentage point. In practice, the fall will be even smaller as a result of the overall effect of those behavioural changes.

Changes in Investments

6. It is clear that there will be some switching by married women of their savings into investments either paying interest gross (for example, the National Savings Investment Account) or under deduction of tax (for example equities and unit trusts). It is very difficult, however, to predict the extent of this switching.

7. The Treasury take the view that the movement of funds will probably be limited. This is based on a number of factors, the most significant being

- the considerable degree of inertia among small investors. The effort involved in reinvestment would be out of proportion to the small tax savings.

- the absence of alternative "safe havens" offering the same services, instant access to money and convenience as banks and building societies while not being subject to the composite rate.

In forecasting the likely extent of switching the Treasury have noted that the extension of the composite rate to banks in 1985 was followed by only a marginal movement of funds out of the banks into National Savings. They have also noted that some £15 billion is currently held by non-taxpayers in building society accounts (which have been subject to composite rate tax for several decades). This is doubtless due to the factors mentioned above, which will also influence the behaviour of married women.

8. For our part, we accept that the Treasury's assessment above is within the range of realistic outcomes. However, we see this possible range as rather wide, and we do not feel able to dismiss the possibility that the movement of funds could be much more significant. We feel that the previous precedents may not be the best indication of the probable investment behaviour of married women, who, seen as a group, differ from existing non-taxpayers in

two significant respects.

9. First, the only people (other than children) adversely affected by the composite rate regime under the present system are those in low income <u>households</u>, where the household income, including earned and investment income, is below the tax threshold. Inevitably, they tend to be among the least sophisticated of all investors. This will often not be the case for non-working married women, who may be part of reasonably high-income, financially sophisticated households even though at a particular time they have low incomes individually. Second, a high proportion of existing non-taxpayers with building society accounts are pensioners. One would expect a large proportion of this group to be unwilling to change habits learned during their working lives. Again, this will not necessarily be the case with married women.

10. The financial pages of the press will not miss the opportunity to advise married women on their tax affairs under Independent Taxation. Their advice to non-taxpaying married women on where to invest their money may be more frequent and more effective than the attention now paid to existing non-taxpayers.

11. Married women wishing to move their savings away from building societies will have a range of alternative investment opportunities. Some of these (such as loans to local authorities) are also subject to the composite rate, while others (such as PEPs, and certain National Savings products) give tax-free income already and should in principle be no more attractive to married women under Independent Taxation than they are now. However, many types of investment pay income either gross and subject to tax or net with tax refundable. Some examples (and some comments on the extent to which married women may make use of them) are given in the Annex.

12. Many married couples where the wife has no earnings will consider not only moving the <u>wife's</u> investments away from the

composite rate institutions but also moving the husband's investments both into the wife's name (or joint names) and away from the composite rate institutions so that the wife's new allowance can be set against what was previously the husband's investment income as well as her own. Where the husband wished to retain a degree of control over the capital and income he could transfer his savings into a joint account where both signatures were required for a withdrawal. Under the rules Ministers have approved for taxing income from jointly held property he would then be taxed on only half of the interest. Where a husband felt no desire to retain control (and was willing in effect simply to give his wife his savings in order to reduce their overall tax liability) he could transfer the money into an account in her name only, and the couple would then pay no tax on interest of up to £2,425 per year (using 1987-88 allowance figures).

13. The extent to which husbands would be willing to transfer money from their own name into joint names or their wife's name or from joint names into their wife's name merely in order to minimise the couple's joint tax liability may well be limited. Probably only a small proportion would do so. But this is a small proportion of a large amount, since we estimate that the composite rate income currently accruing to these husbands is around 4 or 5 times the amount accruing to the wives.

Revenue Costs

14. The reduction in the composite rate on the introduction of Independent Taxation has already been taken into account in the figures we have provided for the revenue costs of Independent Taxation. The movement of funds already belonging to non-working married women out of composite rate institutions into other investments should not affect the revenue yield because the level of the composite rate would be adjusted to take account of any

such movement of funds.* As Mr Isaac mentioned in his note of 5 February we are currently examining whether we can make any reasonable estimate of the effect of possible transfers of assets between husbands and wives.

Effect on Building Societies

15. The implications of asset-switching for the building societies are difficult to predict, but the Treasury do not consider they would present a serious problem for the societies. On the basis of our figures for composite rate interest we estimate that only about 2 per cent of building societies' total liabilities consists of funds held by women who will become non-taxpayers under Independent Taxation. We think the holdings of men married to this group of women are of the order of about four or five times this amount, but much less of this is likely to move. The Treasury feel that, since the recent increase in the limit on building societies' wholesale funding has eased societies' dependence on retail funds, they should be able to cope with the degree of asset-switching which might occur on the introduction of Independent Taxation in 1990. The Treasury have also suggested that, if too much money started to shift towards National Savings, the relative interest rate might be adjusted in order to discourage the trend, as is already current practice.

Presentation

16. In view of the need to continue the composite rate arrangements for banks and building societies and the possible pressure from married women to change them Ministers will want to consider carefully what line they will take on this issue.

17. The line taken at present with existing non-taxpayers is that they can receive interest gross by investing in National Savings. The obvious line to take with non-earning married women

* There is however a time-lag effect which may result in a composite rate "too low" by one quarter of a percentage point for one year, worth £m35.

who resent the effect of the composite rate under Independent Taxation is to point out that they also can invest in National Savings. Ministers may wish also to mention shares and unit trusts in this context. It is a matter for political judgment what relative weight to give these alternatives in the presentation. We imagine Ministers will want to use these solely as defensive points. The financial press might be encouraging married women to use their new tax allowance by moving their money out of building societies, and if Ministers were also to do so, the societies might find this provocative.

18. A number of possible criticisms might be made:

(i) In the past, Ministers have fended off criticism that the composite rate arrangements give the Department for National Savings an unfair advantage over building societies and banks in attracting the savings of non-taxpayers. Such criticism might be revived.

(ii) Similarly, it might be suggested that Ministers were using the composite rate arrangements to discourage married women from investing in deposit accounts and artificially to boost the spread of wider share-ownership.

(iii) The Opposition might criticise giving married women a full personal allowance against investment income on the grounds that, in conjunction with the composite rate, it was of real financial benefit only to those who were sufficiently well off to make the effort of moving their funds into shares or National Savings worthwhile. (The Labour Party's own policy on the taxation of husband and wife is now very unclear. The TUC, in their response to the Green Paper, specifically opposed independent taxation of investment income.)

19. In answer to criticism of the type at (i) and (ii) above it could be argued that the new tax position of married women is not relevant to the administrative need for the composite rate, which

has been serving an important role for several decades and that taxation is only one of many factors influencing investment decisions. If Independent Taxation is criticised along the lines of (iii) above, the following points could be made

- A married woman should have a full personal allowance in her own right. (Do the critics want to retain a tax penalty on marriage or not give married women independence?)

- The replacement of the wife's earned income allowance by a full personal allowance will be of particular benefit to large numbers of elderly women, mostly on modest incomes, who will for the first time have an allowance to set against a state pension based on their husbands' contributions.

- National Savings accounts are open to all investors and provide an opportunity for non-taxpaying married women with modest means to use their new allowance.

- The number of existing married women shareholders benefiting from the new allowance will be considerable and by no means restricted to those with large incomes.

However, given that many non-working married women with small accounts will not wish to move into equities or National Savings, and will thus get no financial benefit from Independent Taxation (as will many other married women who have no savings at all), Ministers may wish to give relatively less weight to the change in the availability of the tax allowance for married women and place the emphasis instead on the other benefits of Independent Taxation, for example independence and privacy in their tax affairs for <u>all</u> married women.

<u>Conclusion</u>

20. There are up to 3 or 4 million married women whose only investment income is building society interest and whose total income will be below the tax threshold. These women, if they do

not move their funds elsewhere, will get no benefit from the full personal allowance which is to replace the wife's earned income allowance. Do Ministers agree that, bearing in mind the sensitivity of the building societies, it should be left to the financial pages of the press to draw attention to the opportunities for a married woman to maximise the benefit from her tax allowance, and that this aspect of Independent Taxation should have a relatively low profile in the presentation.

RK

R KENT

ANNEX: INVESTMENTS YIELDING INCOME WHERE TAX ALLOWANCE WILL BE USABLE

- National Savings Investment Accounts. These allow withdrawal at 1 month's notice and offer a competitive interest rate (currently 10%) paid gross and particularly attractive to non-taxpayers. These accounts seem likely to be the most popular destination of funds moved out of building societies. The minimum investment is only £5.

- National Savings Income Bonds and National Savings Deposit Bonds. These already draw in quite large amounts and also pay interest gross at rates very attractive to non-taxpayers (currently 10.5%). 3 months notice is required for withdrawals. The minimum investments are £2,000 and £100 respectively.

- Gilts (including index-linked gilts). The National Savings Stock Register enables small investors to buy gilts and pays dividends gross. This will also become more attractive to non-working married women. There is no minimum investment, and the commission charges are less than $^{1}/2$% on any purchase over £200.

- Equities and unit trusts. There are of course many more important factors which govern an individual's willingness to risk fluctuation in the value of his or her capital and we do not expect the new tax position of married women to have much effect here. Commission charges will discourage many small investors.

- National Savings Ordinary Account. The interest rate here (currently a maximum of 5% gross) is not competitive enough to attract much money away from the societies even with the tax advantage, since societies rates currently range from 4% to 7.5% net.

- Debentures. The tax on interest on debentures is refundable for non-taxpayers and they involve a much smaller risk than ordinary shares and unit trusts. However, the brokers' charges are likely to discourage smaller investors.

- Local authority bonds. If these are quoted on the stock exchange they are exempt from the composite rate. However, there will be brokers' charges to pay.

- Offshore deposits. These will be very attractive to non-taxpaying women with substantial capital. A number of banks and other financial intermediaries already offer offshore deposit facilities. Under the present system the ostensible benefit of such an arrangement to the taxpayer consists of a cashflow advantage, since tax is paid only after the year end, but there is a hint of a covert benefit in that the offshore bank will not declare the interest to the UK Revenue if the taxpayer does not enter it on his own return. Under Independent Taxation non-working married women will have a substantial and legitimate tax incentive to invest in a bank in, say, the Isle of Man, and this will enhance the legitimacy of publicity in fact aimed not at those women but at taxpayers seeking to evade tax. The developments described in the attached press cutting suggest that offshore subsidiaries of UK building societies might attract a substantial amount of money under Independent Taxation.

Daily Telegraph

# Society launches a tax-free first

15

## Abbey National Jersey accounts will pay interest gross

FOR the first time, United Kingdom residents are now able to get building society interest paid with no tax deducted. This week, the Abbey National Building Society announced that its Jersey subsidiary is offering two accounts paying interest gross.

The accounts from Abbey National (Overseas) are intended for expatriates and United Kingdom non-residents, but a spokesman for the mainland headquarters agreed there was nothing to stop British residents applying for an account.

"They can apply from anywhere in the world and that includes mainland Britain."

Those applicants for either the Offshore Plus or Offshore 90 account who give a United Kingdom address will be sent a leaflet by the society reminding them of their obligation to declare the interest and pay tax on it if they are a taxpayer.

But non-taxpayers, including children and many pensioners, will have to pay no tax on the interest.

Unlike expatriate accounts offered by building societies in the United Kingdom, investors will not be required to complete a declaration of non-residence for tax purposes.

Investors will receive a plastic account card which will allow them to pay money into their Abbey National Jersey account from their bank accounts anywhere in the world. These instructions will be sent electronically to the London office of First Chicago bank.

To make a withdrawal investors will have to contact Abbey National (Overseas) directly and state in which currency and at which bank they would like to receive the cash. The instructions will have to be made in writing or by fax or telex and confirmed later in writing.

The Offshore Plus account, which offers instant access, requires a minimum balance of £500 and up to £1,999 pays 7·25 p.c. From £2,000 to £9,999 it pays 8 p.c.

This compares with the society's Five Star account paying 5·75 p.c. from £500 to £1,999; 6 p.c. up to £5,000 and 6·5 p.c. up to £9,999.

The Offshore 90 account requires 90 days' notice for withdrawals and a minimum opening balance of £1,000. Between £1,000 and £9,999 it pays 8·25 p.c. which compares with the society's mainland Sterling Asset account paying 6·75 p.c. up to £10,000. The offshore account rises to 9·125 p.c. on sums over £50,000.

The society acknowledges the rates it is paying on these accounts are not attractive to taxpayers when compared with its mainland rates, but it plans to offer a wider range of products through Jersey, shortly.

Taxpayers have the advantage of not paying the bill on their investment income for about 18 months, but, as basic rate payers, currently they pay 27 p.c. instead of the current composite rate tax deducted at source by mainland banks and building societies of 24·75 p.c.

From April 6, composite rate tax will be cut to 23·25 p.c.—although interest rates offered by societies are unlikely to be increased to take this change into account and, by then, the basic rate tax could well have been reduced to 25 p.c.

The Halifax Building Society, which will open a Jersey branch office in a couple of months intended to attract expatriate customers, will require investors to sign a declaration that they are not resident in the United Kingdom, even though tax legislation does not require this.

Although British taxpayers who have offshore accounts must declare the interest on their tax return.

The Inland Revenue confirmed that Jersey branches of banks and building societies are not obliged to send information to the mainland about interest on deposit accounts.

"There is no other obligation on them to provide us with information. We could not, for example, go into a Jersey building society and ask what they knew about a person."

When composite rate tax was imposed on bank deposit accounts in 1985 there was a subsequent rise in the number of people using the Jersey and Guernsey accounts of the high street banks to avoid instant taxation.

Many of them are taxpayers, who for reasons of cash flow or to shift a tax burden into a more convenient year when their main income will be lower, chose to bank offshore.

Lloyds Bank says its high interest cheque account, which from Jersey pays 6·4 p.c. on sums over £5,000, is popular. It pays interest monthly, which helps to compensate for the slightly higher tax bill the investor eventually pays.

Midland Bank offers all the accounts available in United Kingdom branches through its Channel Islands offices, with the interest paid gross.

The one-month fixed term account, which requires a minimum investment of £5,000, pays 7·75 p.c. The six-month term account with the same minimum sum pays 8·75 p.c. and the one-year term account pays 9 p.c. on £5,000.

Its high interest cheque account pays 7·31 p.c. on sums between £2,000 and £9,999. The Saverplus account gives access to autobanks in the United Kingdom and pays 7 p.c.

National Westminster's special reserve account, which is available through Jersey and Guernsey, pays 7.5p.c. on investments of £2,000 to £9,999. Through its wholly owned subsidiary, NatWest Finance (Channel Islands), it pays 7·25 p.c. on its seven-day notice account on sums over £5,000.

Barclays in Jersey pays 6·875 p.c. on sums up to £10,000 in its higher rate deposit account.

Information on investing in the high street banks through their offshore branches is available from their United Kingdom branches, although the banks do not market the gross interest paying accounts on the mainland.

The building societies are looking to increase their business through the expatriate market and Abbey National estimates that expatriates invest over £440m per month with financial institutions.

The society has produced a booklet Investing Offshore with Abbey National in Jersey, which is available free from Abbey National (Overseas) Ltd, PO Box 545, Abbey National House, Ingouville Place, St Helier, Jersey.

**Lindsay Cook**

Saturday January 23 1988

21-

3975/20

**BUDGET SECRET: TASK FORCE LIST**

Mr Cropper
Good points
neither emphasise nor rule out TAs — [illegible]

Copy No 1 of 9 Copies

FROM: P J CROPPER
DATE: 11 February 1988

CHANCELLOR

[illegible] relevant to Overview [illegible]

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Tyrie
Mr Call

**HUSBAND AND WIFE**

Thinking about the presentation of the Budget, it strikes me that Ministers, both inside and outside the Treasury, are going to need a very clear "party line" on the question whether we simply regard the present proposals as a staging post towards fully transferable allowances, or whether we really do expect them to stick.

2. Sarah Hogg, in her recent piece on the Budget, said "The anachronistic married man's allowance is clearly doomed". She will be flummoxed on 15 March to find it has partially survived.

3. There is going to be widespread criticism of individual aspects of the new system - everybody will find something wrong with it. We know that there is no perfect solution to the taxation of husband and wife. The person in the street, indeed the non-Treasury Minister in the street, may not fully accept this, even now.

4. Are we expecting the Party to mount an energetic campaign in favour of the 15 March proposals, and put down the critics? Or are we going to take the line that "This is an insoluble problem: we have produced what we think is the best compromise: take it or leave it: if you can think of something better, then get up and say what it is". Or will we say, or imply, that we are quite happy to move on to fully transferable allowances in due course?

5. I am particularly mindful of the criticism that will arise from the more old-fashioned end of the Party, that the present proposals do nothing for the stay at home wife with children but no wealth. I believe that Emma missed out badly in not representing that particular viewpoint to us during the Green Paper consultation period; altogether too much emphasis on high flyers. Be that as it may, I think we will find that a lot of the people who sat on their hands during the second consultation process will suddenly wish they hadn't. Will we just say to them "that's your bad luck", or will we respond positively?

6. My own doubts arose entirely from the discovery that a no-losers fully transferable allowances scheme would cost £5.4 billion. I wondered whether a solution of the husband and wife problem was worth £5.4 billion in terms of other tax cuts foregone. If the scheme had been put forward on a nil cost basis I would have been strongly in favour - taking away from the two earner couple in order to give separate taxation to the one earner couple. Which just goes to show that everyone thinks differently!

P J CROPPER

COPY NO 12 OF 13

FROM: J M G TAYLOR
DATE: 12 February 1988

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
Mr Pitts - IR
Mr Cayley - IR
PS/IR

**CGT: MINOR SIMPLIFICATIONS OF INDEXATION**

The Chancellor has seen Mr Cayley's note of 9 February. He would be grateful for the Financial Secretary's urgent views on this. He has commented that option (iii) - simplified rules for shares acquired since 1982, and possibly other assets generally - at least seems well worth doing.

J M G TAYLOR

BUDGET SECRET: TASK FORCE LIST

1 87-24

**Inland Revenue**

Policy Division
Somerset House

FROM: B A MACE

DATE: 12 FEBRUARY 1988

This ppr not formally on agenda.

1. MR ISAAC n.2

2. CHANCELLOR OF THE EXCHEQUER

Option F or nothing: See para 12 re APA

INDEPENDENT TAXATION: DISTRIBUTIONAL EFFECTS

1. Mr Taylor's note of 10 February to Mr Culpin asked two questions about those husbands who will lose on the change to Independent Taxation because of the withdrawal of the married couple's allowance (MCA) where income for tax purposes exceeds a certain level.

2. We have looked at these two points very quickly. (As Mr Isaac indicated in his note of 5 February, figures for the distributional effects of Independent Taxation are provisional at this stage.)

3. First, as I indicated in my note of 7 December, we think it is true that any husband who loses in 1990-91 because of withdrawal of the MCA will almost certainly have gained more (and probably substantially more) from the tax reductions in the 1988 Budget. In the typical case the maximum loss from withdrawal of the MCA at its 1990-91 indexed level will be about £650; the gain to someone with income for tax purposes in excess of £40,000 from

— back of this section

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Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Miss Sinclair
Mr Riley
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call
Mr Culpin

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Mr Eason
Mr Mace
PS/IR

the 1988 Budget changes is likely to be at least £2,000. There could be a handful of exceptional cases where the husband might gain less from the 1988 Budget changes than he loses when the MCA is withdrawn (if, for example, he was paying exceptionally large subscriptions under the BES scheme or sheltering income in some other way) but these cases are likely to be very unusual. The 1988 Budget changes will, of course, be well in the past when Independent Taxation comes in in April 1990.

4. Second, of the just over 200,000 husbands who lose from withdrawal of the MCA (if withdrawal starts at income for tax purposes of £40,000) about 50,000 are in couples who <u>gain</u> overall from the change to Independent Taxation (because of the disaggregation of the wife's income). But about 160,000 are in couples who <u>lose</u> overall (because the benefit from disaggregating the wife's income (if she has any) is insufficient to outweigh the loss from withdrawal of the MCA. About 70,000 of these couples lose more than £500 per year on the introduction of Independent Taxation.

5. These figures may overstate to some extent the actual number of losers because our present information about <u>joint</u> investment income of husband and wife is not complete. Such income will at present tend to be allocated wholly to the husband where there are doubts about the precise position. Losses could also be mitigated to the extent that husbands transfer income-bearing assets to their wives in anticipation or in consequence of Independent Taxation.

6. On a quick look it appears that the number of losers could be roughly halved if the starting point for withdrawal of the MCA were set at income for tax purposes of £50,000.

B A Mace.

B A MACE

COPY NO 13 OF 13

FROM: J M G TAYLOR
DATE: 12 February 1988

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
Mr Pitts - IR
Mr Cayley - IR
PS/IR

**CGT: MINOR SIMPLIFICATIONS OF INDEXATION**

The Chancellor has seen Mr Cayley's note of 9 February. He would be grateful for the Financial Secretary's urgent views on this. He has commented that option (iii) - simplified rules for shares acquired since 1982, and possibly other assets generally - at least seems well worth doing.

JT

J M G TAYLOR

FROM: J M G TAYLOR

DATE: 15 February 1988

MR CAYLEY - INLAND REVENUE

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Battishill - IR
Mr Isaac - IR
Mr Pitts - IR
PS/IR

**CGT REFORM: UNIT TRUSTS AND MUTUAL LIFE OFFICES**

The Chancellor has seen your minute of 9 February.

2. He would be grateful for a note on one further point about how the CGT treatment of unit trusts and mutual life offices looks in the light of CGT reform. This was that, last year, under pressure, we agreed to maintain the capital gains rate for mutual life offices at 30 per cent, while putting all other corporate gains up to 35 per cent (small companies apart). This was at that time the CGT rate: it will be so no longer. What are the implications of this?

J M G TAYLOR

V2720.03

**BUDGET SECRET: TASK FORCE LIST**

Mr Rank.
v. interesting — & useful
Budget background briefing.
2. I [illegible] gather for the
1st table cd be redone
with 1987 substituted
for 1986.
M.

Copy No. 1 of 31
FROM: ROBERT CULPIN
DATE: 18 February 1988

**CHANCELLOR**

| | | | |
|---|---|---|---|
| cc | Principal Private Secretary | Mrs Lomax | |
| | Chief Secretary | Mr Pickford | |
| | Financial Secretary | Miss Sinclair | |
| | Paymaster General | Mr Riley | |
| | Economic Secretary | Mr Courtney | |
| | Sir P Middleton | Mr Scotter | |
| | Sir T Burns | Miss Evans | |
| | Sir G Littler | Mr Hudson | |
| | Mr Anson | Mr Cropper | |
| | Sir A Wilson | Mr Tyrie | |
| | Mr Byatt | Mr Call | |
| | Mr Scholar | | |
| | Mr Sedgwick | Mr Battishill ) | Inland Revenue |
| | Mr Odling-Smee | Mr Isaac ) | |
| | | Mr Painter ) | |

**EFFECTIVE RATE OF CAPITAL GAINS TAX**

I promised to illustrate the point that if the top rate of CGT is 40 per cent on real gains, that will be lower, in most cases, than the US Federal Government's 28/33 per cent on nominal gains.

**Historical data**

2. The first table below shows:

(a) what the average annual gain on shares has been over five post-War periods; and

(b) what 40 per cent of the real gain would have been as a percentage of the nominal gain.

| Period | Average annual gain on shares (%) (a) Nominal | (b) Real | 40% of column(b) as % of column(a) |
|---|---|---|---|
| 1945-1986 | 8.5 | 1.6 | 7½ |
| 1965-1986 | 9.8 | 0.5 | 2 |
| 1969-1986 | 10.6 | -0.1 | neg |
| 1979-1986 | 21.1 | 10.3 | 20 |
| 1983-1986 | 21.6 | 16.0 | 29½ |

3. The table concentrates on shares because they account for about two-thirds of CGT for individuals, and there is a reasonably long run of figures readily available. Different periods would give different results; but the table shows a reasonable range. It over-estimates the true impact of the 40 per cent CGT rate you are proposing, because it makes no allowance for the £6,600 CGT exemption. (The Americans, of course, have no such thing.)

**Theoretical possibilities**

4. The second table performs the same piece of arithmetic for hypothetical but plausible combinations of inflation and real gains.

| (a) Inflation | (b) Real gain | (c) Nominal gain (rounded) | (d) 40% of column(b) as % of column(c) |
|---|---|---|---|
| 3 | 1 | 4 | 10 |
| 3 | 2 | 5 | 16 |
| 3 | 3 | 6 | 20 |
| 3 | 4 | 7 | 23 |
| 4 | 1 | 5 | 8 |
| 4 | 2 | 6 | 13 |
| 4 | 3 | 7 | 17 |
| 4 | 4 | 8 | 20 |

**Conclusion**

5. The table in paragraph 4 suggests that over fairly wide normal ranges, a 40 per cent rate on real gains, with a £6,600 exemption, is likely to be equivalent to something in the teens on nominal gains. Indeed - though this is scarcely a point of mass appeal - it is likely to be close to the 18 per cent which Lindsey believes to the revenue maximising rate (for the US).

6. The table in paragraph 2 suggests that the Lawson years could be a minor embarrassment, of sorts, for this thesis.

7. For small savers, of course, the rate will be much lower - in many cases nil.

8. And to put the US comparison the other way round, their 33 per cent top Federal rate on nominal gains could eat up two-thirds of real gains if both inflation and real gains are 4 per cent.

9. The Bank - FIM note on pros and cons is on its way.

RC

ROBERT CULPIN

FINANCIAL SECRETARY TO THE TREASURY

**FROM: J J HEYWOOD**
**DATE: 17 February 1988**

**PS/CHANCELLOR**

Ch/ Agree with FST's conclusions?

OK

26 17/2

cc Sir P Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Cayley IR
PS/IR

**CGT: MINOR SIMPLICATIONS OF INDEXATION**

The Financial Secretary has discussed Mr Cayley's note of 9 February with officials. He is not attracted to any of the proposed minor simplifications.

**Quarterly Basis**

2. If this were introduced only for assets acquired in the future, we would have a very messy system with two bases existing side by side. If it replaced the monthly basis for all assets, losers could only be avoided at some unquantifiable cost to the Exchequer. The degree of simplification would be minimal.

**Rebasing the 1982-86 RPI Figures**

3. The Revenue advise that this is probably not feasible for 1988 (since DE would need to be consulted). Moreover, taxpayers will by now be becoming familiar with the 'linking formula' and a further change - even if it could be implemented in time - would probably be regarded with some irritation.

**Simplified Rules for Shares Acquired since 1982**

4. The Chancellor thought that this seemed worthwhile (your note of 12 February). The Financial Secretary has looked at it and does not think that what is proposed would amount to much of a simplification.

5. Effectively, there are two aspects to this:

(i) The removal of one extremely simple step in the tax computation: but the Revenue have already issued public guidance that they will accept the 'simplified' computation. The proposal would merely give this guidance more prominence. The simplification itself is trivial.

(ii) But as a consequence of (i), investors would no longer have to keep for tax reasons any records of the actual amounts of money they have invested - they would only need to keep records of their indexed expenditure.

6. As far as (ii) is concerned, the Financial Secretary thinks that in most cases investors will choose to keep their records on actual expenditure, even if they do not actually need to. Therefore, the Financial Secretary does not believe that in practice this proposal will simplify things much at all. Moreover, if investors do not keep records of actual expenditure, it will become impossible at some future date to remove accrued entitlement to indexation relief. This would be, in the Financial Secretary's view, an unwelcome limitation of our freedom to deny indexation relief with retrospective effect in situations where abuses come to light.

7. The Financial Secretary's conclusion is that none of these measures is worth pursuing. But he has agreed that if the Unit Trust Association makes representations about the complexity of applying the indexation rules to assets bought by non-CGT-exempt investors under monthly savings plans, then the Revenue should explore with them the scope for simplifications in that particular area.

J.H.

**JEREMY HEYWOOD**
**Private Secretary**

mjd 2/135Jn

BUDGET CONFIDENTIAL

FROM: J M G TAYLOR

DATE: 18 February 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Mr Kemp
Mr Scholar
Mr Culpin
Miss Peirson
Mr McIntyre
Miss Sinclair
Mr Gibson
Mr Portes
Mr Cropper
Mr Tyrie
Mr Call

Mr Mace - IR
PS/IR

**APA FOR INCAPACITATED WIVES: CONVERSION TO BENEFIT**

The Chancellor has seen your minute of 17 February. He agrees with the Financial Secretary's view that the idea of converting this relief into a benefit should not be pursued any further.

J M G TAYLOR

V2720.03

BUDGET SECRET: TASK FORCE LIST

15 [illegible]
2 prep

Copy No. 2 of 31
FROM: ROBERT CULPIN
DATE: 18 February 1988

CHANCELLOR

cc Principal Private Secretary
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Scholar
Mr Sedgwick
Mr Odling-Smee
Mrs Lomax
Mr Pickford
Miss Sinclair
Mr Riley
Mr Courtney
Mr Scotter
Miss Evans
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call
Mr Battishill ) Inland Revenue
Mr Isaac )
Mr Painter )

**EFFECTIVE RATE OF CAPITAL GAINS TAX**

I promised to illustrate the point that if the top rate of CGT is 40 per cent on real gains, that will be lower, in most cases, than the US Federal Government's 28/33 per cent on nominal gains.

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(a) what the average annual gain on shares has been over five post-War periods; and

(b) what 40 per cent of the real gain would have been as a percentage of the nominal gain.

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**Conclusion**

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8. And to put the US comparison the other way round, their 33 per cent top Federal rate on nominal gains could eat up two-thirds of real gains if both inflation and real gains are 4 per cent.

9. The Bank - FIM note on pros and cons is on its way.

RC

**ROBERT CULPIN**

83/G/MAD/1322/28b

**BUDGET SECRET - TASK FORCE LIST**

**COPY NO** 1 **OF 25**

**FROM: MRS R LOMAX**
**DATE: 18 February 1988**

**CHANCELLOR**

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Anson
Mr Byatt
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Ilett
Mr Riley
Miss Sinclair
Mr Courtney

Mr Battishill, IR
Mr Unwin, C&E
PS/IR
PS/C&E
Mr George, B/E
Mr McConnachie, B/E

Thanks. I would be grateful for unquantified analysis on X: eg likely effect on yields? (presumably less of a spread) likely effect on takeovers etc mortgage mania? (presumably some cooling down) anything else you can think of? N.

**CGT PACKAGE: RATIONALE**

I attach a note on the rationale for the CGT package, prepared jointly by FIM and the Bank. It has been approved by Mr George.

2. One point which is not specific to the CGT package, but which the Bank feel is worth underlining, is the possibility that the cut in top rates of tax will lead higher rate taxpayers to shift funds into capital-certain interest bearing assets, such as high interest bank and building society accounts. I understand that the forecasters recognise this effect, though in the normal way of things income tax costings make no allowance for behavioural changes.

RL.

**RACHEL LOMAX**

## RATIONALE FOR CGT PROPOSALS

The pros and cons of the change relative to the present system, and for a given fiscal and monetary framework, are set out below. The **changes** are:-

- charge CGT at the new income tax rates, retaining indexation and the existing separate exemption (£6,600);

- rebase to 1982.

**Pros**

1. The **main advantage** is that it reduces the **distorting** effect of the different tax treatment of income and gains on investment decisions. In this sense it is a simplification.

X

- **Higher rate** taxpayers currently have an incentive to invest in assets showing a capital gain rather than an interest or dividend yield. This introduces an undesirable bias into investment decisions. Under the proposed arrangements, the higher rate taxpayer would pay 40% on income and capital gains alike (though in the latter case only above the threshold and with indexation, so protecting the real value of his capital). So he would be more nearly indifferent between income-yielding and capital-appreciating assets and should have less recourse to artificial schemes for tax avoidance by converting income into capital gains.

- **Basic rate** income taxpayers, on the other hand, may be currently discouraged from investing in assets showing a capital gain by the fact that beyond the gains tax threshold, the capital gains tax rate slightly exceeds the income tax rate.

2. The particular case for **rebasing** is that it provides an offset for those otherwise facing a rise in the capital gains

tax rate. More generally it meets a long-standing grievance that the authorities have been charging tax on pre-1982 inflationary gains. The result of rebasing will be to help free up the market in shares and agricultural land by unlocking many assets owned by individuals and companies since before 1982.

3. **Pre-announcement** is desirable to diminish the force of charges of retrospection, even though it may result in some substantial market turnover (and adverse press comment) as people rearrange their affairs to take advantage of the three week period before the new rates come into effect.

**Cons**

1. The **main disadvantage** is the **cost** in the longer-term (£730 million in 1991-92, admittedly with a wide margin of uncertainty).

2. The **distorting** effect of tax on investment decisions is **not eliminated** entirely (because of the capital gains tax threshold and the indexation of gains). As long as income is unindexed, the investor will still have some incentive to take his return in the form of capital gain, if there is any inflation. **For example**, at an inflation rate of 3%, and a marginal tax rate of 40%, a nominal return of 5% will become a post-tax real rate of return of 0% if taxed as income, but 1.2% if taxed as a capital gain. Eliminating distortions altogether would involve doing away with the separate gains threshold and <u>either</u> abandoning indexation of capital gains <u>or</u> indexing income (notably interest income).

3. The increased capital gains tax rate that will be paid by higher rate taxpayers could, by encouraging them to delay taking capital gains, have some **locking-in** effect. But rebasing (including the incentive to crystallise pre-1982 capital losses before the end of this tax year) will work in the opposite direction. Given that higher rate taxpayers own only some 15% of equities, and that others (such as basic rate taxpayers and

companies) would have an incentive to move into equities if their prices tended to fall, the change is unlikely to have much net effect on **equity prices.**

## Indexation

### For

1. The main point is that there is **no simple way** of getting rid of indexation without charges of retrospection or complicated provisions to preserve past indexation.

2. Retaining indexation also allows the investor to **keep his capital intact** and avoids him having to pay the tax out of savings. This matters, even at low rates of inflation. **For example:** for a nominal gain of 5%, made up of a real gain of 2% and inflation of 3%, taxing unindexed gains at 40% is equivalent to taxing the real gain at 100%.

3. Indexation also cushions the effect on the small to medium shareholder of a marginal tax rate of 25-40% once the capital gains tax threshold is reached. **For example:** at 3% inflation and with a 40% marginal tax rate, gains of 5% will attract tax at a rate equivalent to 16% of the nominal gain, once indexation is allowed for.

### Against

1. The main drawback to keeping indexation is the perceived **lack of simplicity** in the tax system. But abolition without grandfathering of past indexation would be unwelcome especially to the institutions and could lead to market turbulence.

## Comparison with the American CGT system

1. In the **US**, CGT is charged on **nominal** gains at **marginal income tax rates** - 15% and 28% (33% for an intermediate band

of higher rate taxpayers) plus a typical effective top rate of 6½% for State income taxes charged on the Federal definition of the tax base. But there is **no indexation** and **no separate threshold.**

2. The proposed CGT package should typically mean lower rates of capital gains tax than in the US, after allowing for indexation and the separate threshold.

**Examples:**

- **small savers** in the UK will typically not pay CGT at all because of the annual exemption; in the US they pay 15% on the nominal gain (which represents 30% on the real gain, for a nominal return of 8% made up of a real rate of return of 4% and inflation 4%);

- **top rate taxpayers** in the UK will pay 40% on the **real** gain: in the US the top rate is 28% on the nominal gain (which represents 56% on the real gain, for a nominal return of 8% made up of a real rate of return of 4% and inflation of 4%).

18 February 1988

1/39

BUDGET ~~CONFIDENTIAL~~

BUDGET - SECRET - TASK FORCE LIST

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

FROM: R J EASON

DATE: 19 FEBRUARY 1988

1. MR CALDER R Seen in draft.
2. CHANCELLOR OF THE EXCHEQUER

**INDEPENDENT TAXATION : BEHAVIOURAL CHANGE**

1. The principal behavioural change expected when independent taxation is introduced is the transfer of investment income from husband to wife to reduce tax liability. This may take two forms:

---

cc.

| | |
|---|---|
| Principal Private Secretary | |
| Chief Secretary | Chairman |
| Financial Secretary | Mr Isaac |
| Paymaster General | Mr Painter |
| Economic Secretary | Mr Beighton |
| Sir P Middleton | Mr Calder |
| Sir T Burns | Mr Lewis |
| Sir G Littler | Mr Mace |
| Mr J Anson | Mr Cayley |
| Sir A Wilson | Mr Eason |
| Mr I Byatt | Mr Ko |
| Mr M C Scholar | Miss White |
| Mr R Culpin | PS/IR |
| Mr P Sedgwick | |
| Mr J Odling-Smee | |
| Mrs C Evans | |
| Mr A Hudson | |
| Mr P McIntyre | |
| Mr P Cropper | |
| Mr A Tyrie | |
| Mr M Call | |
| Miss C E C Sinclair | |
| Mr C J Riley | |
| Dr Courtney | |
| Mr Unwin (Customs & Excise) | |
| Mr Knox ( " & " ) | |

Thanks.
X is an odd way of putting it. It is not a matter of transfer of assets from husband's name to wife's name – beneficial ownership has to pass. And given the high incidence of divorce these days, I believe there will be less of this than Mr Eason's paper suggests. I also find Y ~~[illegible]~~ on the high side, partly for the reason given @ Z. Has the experience of the consequences of introduction of composite rate for banks ~~[illegible]~~ etc been assessed in this context? And what account has been taken of the ~~extra tax avoidance~~ incentive that indep. tax'n will provide for lovers to save?

In the circs, I do not see that any fig can be given for the cost of behavioural changes. NL.

(1) Income splitting: where the source of the investment income is unchanged but the title is transferred to the spouse with the lower marginal tax rate.

(2) Asset switching: where the couple move investments out of Building Society and Bank accounts subject to composite rate tax on interest payments into equities or other investments where tax payments can be reclaimed by non-taxpayers. In most circumstances, this will also involve some income splitting as the title to the asset will be passed to the non-taxpaying wife (either totally or jointly with her husband).

2. We have attempted to estimate the costs of both income splitting and asset switching by computer simulations using the 50,000 sample of taxpayers in the Survey of Personal Incomes. We have projected incomes to 1990-91 levels and assumed that the tax regime is Option 3 indexed from 1988-89 to 1990-91. The data on investment income held in tax offices and recorded in the SPI is incomplete and the division of investment income between spouses may not be totally accurate. Our forecasts for 1990-91 will therefore be speculative and provide no more than orders of magnitude of possible tax costs.

... 3. The attached table summarises our estimates. Each type of married couple shown will have a different incentive to transfer income to the wife. The incentive is highest for couples where the wife has no income and the husband is a higher rate taxpayer. In this situation, investment income to the extent of the personal allowance (£2,835 for 1990-91) can be transferred saving over £1,100 of tax and increasing the net yield by two thirds and the rate of return on the

## INCOME SPLITTING AND ASSET SWITCHING

| | Type of Couple | | | |
|---|---|---|---|---|
| | Husband basic rate wife non-taxpayer | Husband higher rate wife non-taxpayer | Husband higher rate wife basic rate | All |
| Number of couples (000) | 6,500 | 460 | 380 | 7,300 |
| Increase in net income | $\frac{25}{75} = 33\%$ | $\frac{40}{60} = 67\%$ | $\frac{15}{60} = 25\%$ | - |
| Husband's Investment Income (£ billion) | | | | |
| Total | 4.2 | 2.5 | 2.7 | 9.4 |
| : composite rate | 3.0 | 1.4 | 1.8 | 6.2 |
| : non-composite rate | 1.2 | 1.1 | 0.9 | 3.2 |
| Income Splitting | Direct costs (£m) | | | |
| (1) Transfer all investment income | 200 | 250 | 100 | 550 |
| (2) Transfer $^1/_3$ of investment income | 90 | 170 | 80 | 340 |
| (3) Transfer to use available allowance | 210 | 170 | - | 370 |
| (4) Guess | 50 | 150 | 50 | 250 |
| Asset switching | | | | |
| (5) Switch out of CRT assets where beneficial | 400 | 40 | - | 440 |
| (6) Guess | 75 | 25 | - | 100 |
| Combined Effect | | | | |
| (7) Guess | 125 | 175 | 50 | 350 |

investment by perhaps 4 percentage points if the gross yield is 10%. It will be beneficial to transfer more than £2,835 if it is taxed at 25% as the wife's income rather than 40% as the husband's.

4. <u>For income splitting</u> we costed the three alternatives shown in the table. If all investment income were transferred to wives, the cost would be about £550 million. More realistic scenarios are that perhaps up to a third might be transferred where it was tax efficient, or alternatively, sufficient income to cover any unused personal allowance of the wife. Both these alternatives would cost about £350 million.

5. We have made a guess at the likely outturn by assessing the various factors that will influence each couple's decision, such as

- the monetary gain and increase in net income;
- X the willingness or unwillingness of husbands' to put assets in their wives' names;
- costs of and other restrictions on transferring assets;
- investors' inertia, based on experience of the introduction of composite rate and the extent of building society deposits held by non-taxpayers.

Some of these aspects were discussed in Mr Kent's submission to the Financial Secretary of 10 February. Precise quantification of the behavioural changes is not however possible.

On the limited evidence available, we believe basic rate husbands with generally small investments will not transfer much to their non-taxpaying wives, say transfers costing £50 million out of the total £200 million. Higher rate husbands with non-taxpaying wives may well however be prepared to make transfers so that investment income covers more of their wives' personal allowances, say at a cost of £150 million out of possible £250 million. In the third category, where the wife is a taxpayer, there will still be an incentive to save higher rate liability, so we have opted for £50 million out of the possible £100 million. This gives an estimate in total of £250 million.

6. <u>For asset switching</u>, (and the necessary income splitting to move the asset to the non-taxpayer), the maximum cost is an additional £440 million, arising mainly from basic rate taxpayers moving out of composite rate investments. However, banks and building society accounts offer many practical advantages for small investors. We therefore guess that a cost of £100 million might be a reasonable estimate.

7. The table below examines these guesses in terms of the proportion of investments that would have to be moved to reduce tax liability.

| | Type of couple | | |
|---|---|---|---|
| | Husband basic rate wife non-taxpayer | Husband higher rate wife non-taxpayer | Husband higher rate wife basic rate |
| Income splitting | | | |
| tax cost (£m) | 50 | 150 | 50 |
| income moved (£m) | 200 | 375 | 330 |
| - as % of total non-composite rate income | 17 | 34 | 12* |
| Asset switching | | | |
| tax cost (£m) | 75 | 25 | - |
| income moved (£m) | 300 | 63 | - |
| - as % of total CRT income | 10 | 5 | - |

*including composite rate income

8. Our guess is therefore broadly consistent with husbands who pay at the basic rate moving or changing the title to about 15 per cent of their assets and higher rate husbands with non-taxpaying wives moving rather more because of the higher incentives and the larger sums involved. (The low tax cost for asset switching in this group is because a substantial part of available personal allowances for wives are assumed to have been covered by the income splitting.)

y

9. These estimates imply that asset switching could lead to about £4 billion worth of deposits being moved out of banks and building societies into other forms of investment, probably equities, gilts, and national savings. This is not out of line with changes in recent years. However national savings will probably appeal to many basic rate taxpayers and a large inflow of national savings would not (I understand) currently be welcome. Any change to interest rates to dampen the inflow would have an effect on our assumptions.

z

10. These estimates have been agreed with appropriate Treasury officials. The figures for behavioural changes are compatible with the elasticities derived from empirical work on changes in the portfolio composition of liquid assets in response to relative interest rate changes.

<u>Conclusion</u>

11. This analysis only gives a broad indication of the probable costs of behavioural changes when independent taxation is introduced. The estimated costs of £350 million are highly uncertain, but they are large both in absolute terms and compared with the direct costs of almost £1 billion. A separate submission is being prepared on the treatment of behavioural effects in the FSBR and the scorecard and you may wish to consider these estimates in that wider context.

**R J EASON**

COPY NO 29 OF 30

pg

FROM: J M G TAYLOR
DATE: 22 Februay 1988

MR CULPIN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Scholar
Mr Sedgwick
Mr Odling-Smee
Mrs Lomax
Mr Pickford
Miss Sinclair
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Mr Courtney
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Miss Evans
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Mr Tyrie
Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR

**EFFECTIVE RATE OF CAPITAL GAINS TAX**

The Chancellor was most grateful for your minute of 18 February. He has commented that it is very interesting, and useful Budget background briefing.

2. He would be grateful if the first table could be redone with 1987 substituted for 1986.

J M G TAYLOR

19 of 34

**Inland Revenue**

Policy Division
Somerset House

FROM: P LEWIS
DATE: 18 FEBRUARY 1988

Chancellor

FRINGE BENEFITS: CAR PARKING

1. This note seeks decisions (or confirmation of decisions) on

- the extent to which car parking should in future to be taxed
- the starting date
- how past years are to be handled
- the way in which the changes are to be introduced (legislation or ESC)

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Monck
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Olding-Smee
Miss Sinclair
Mr Riley
Mr Hudson
Miss Evans
Mr Cropper
Mr Tyrie
Mr Call
Mr Unwin
Mr Knox
Mr Jenkins (Parliamentary Counsel)
Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Miss Rhodes
Mr Prescott
Mr Northend
Mr R H Allen
Mr I Stewart
PS/IR

## Coverage

2. The provision of a car parking space at or near the place of work is very common. We estimate that about 4 million director and higher paid employees use employer provided parking spaces. There is at present a charge to tax, but it is not consistently applied. The present rules are difficult to operate. They depend on identifying the annual value of a parking space where it is owned by the employer; and there are various practical difficulties, for example, employees are often not given the exclusive use of a space.

3. In previous discussions Ministers have concluded that the choice lies between either a general exemption or only exempting parking on the employer's own premises, possibly combined with some "de minimis" limit for the charge on "off site" parking.

4. On a limited exemption the main arguments are

- it would tax some of the most obvious, and largest benefits

- it would only tax payments made specifically for parking, thus avoiding the valuation problem for owned premises

On the other hand

- it would leave many cases still liable, thus increasing employers' and Revenue compliance costs

- the distinction between "on" and "off" premises looks likely to create many and anomalies may not be easy to define *

---

* For example, why should the expensive private parking space at the bottom of the City office block be exempt because the firm owns/leases the premises, but a cheaper less convenient space in a commercial car park nearby be taxed? If a firm rents some overflow spaces in the car park of the firm next door, why should its employees using them be chargeable when there is no liability for employees of either firm using their own firm's premises? Why should a separate patch of ground leased for parking give rise to liability when, if it formed part of the business premises, there would be no charge?

5. On a full exemption the main points are that it would

- exempt some large and obvious benefits, which it would be difficult to justify

- in principle forgoes a significant revenue yield.

But it

- would not increase employers' compliance and Revenue staff requirements

- would avoid a dividing line between "on" and "off" premises parking which would not be easy to defend in principle or operate in practice.

6. If you decide to retain a charge on off-site parking, it could be focused on larger cases by some "de minimis" limit. One possibility would be £200, like cheap loans. This would reduce the number of cases and thus the additional work for employers and the Revenue; and you might feel it was more consistent with your approach to dining rooms. On the other hand, there is no obvious justification for a statutory de minimis rule just for this benefit; at present the cheap loans de minimis limit is the only one.

Starting date/earlier years

7. Whichever is the choice, we do not see any particular compliance or operational considerations which would point to a starting date other than 6 April 1988.

8. Whichever exemption you go for, we would need to say how we would handle liabilities for previous years. We suggest this should be along the lines that any unsettled liabilities for past years would be settled in accordance with the new rules, but

where the liability was settled at Budget Day we would not repay tax which had correctly been paid in accordance with the law applying for those years. This is the approach you authorised for the new relief for third party entertainment announced in September.

Implementation

9. If there is to be a charge on off-site parking a special in-year exercise in 1988/89 to identify employees with this type of benefit might be worthwhile particularly if it could be combined with similar special action on directors' dining rooms. Alternatively, cases could be identified as the 1988/89 P11Ds come in after April 1989. We would need to consider further which would be the better approach.

Yield

10. We cannot estimate the cost of exempting car parking generally, or on-site parking only. Although theoretically quite large, in practice it would probably be small or negligible. In the FSBR the actual tax loss would be shown.

Legislation or ESC?

11. This was a point noted for further discussion at the Overview on 8 February.

12. Extra statutory concessions are essentially an administrative device under which, by virtue of their general "care and management" of the taxes they administer, the Board indicate that they will not collect tax in respect of certain specific, minor, types of liability. ESCs have to be published, and reported and justified to NAO. (The annex looks briefly at the difference between ESCs, Statements of Practice, and administrative ("de minimis") arrangements.)

13. Existing ESCs are inevitably something of a mixed bag, having grown up over a long period in response to specific, but widely varying, problems. Essentially, however, they are all at the margins of the tax code. Examples are minor extensions of reliefs where the legislation did not quite fully cover its intended target (or where circumstances have subsequently changed creating another small class which clearly would have benefitted had it existed when the legislation was enacted); relief of unintended hardship; transient problems or very small classes of cases where legislation, if it needed to be complex, would be a disproportionate solution. They thus have, in one way or another, an administrative flavour to them and, with very few exceptions - and those generally where perceptions have changed with the passage of time - are uncontroversial.

14. It is difficult to see how an exemption for car parking - whether a general exemption or one only applying to parking on "own premises" - could be fitted into the accepted concept of an ESC

- the number of taxpayers involved, and the amount of revenue at stake are (in theory) both large

- there is no question of hardship

- there is no question of the benefit having being caught inadvertently - it is squarely within the charge - or being different in kind from the sort of benefits at which the legislation is aimed

- remedial legislation would not be disproportionately long or difficult

- although applying the law would in some cases be troublesome and time consuming in others it would be relatively straightforward (and some tax is being collected). We could not say that the present rule was either impossible to administer or that the yield would be de minimis in relation to the administrative cost. Thus there is no administrative basis on which the Board could decide that these benefits should not be taxed

15. If you confirm that you wish to introduce a limited exemption an ESC would seem particularly inappropriate as the Board could not properly make a value judgement of the kind envisaged between benefits "on" and "off" premises. But if you decide on a general exemption the importance and scope of the relief increases making it less suitable for an ESC on those grounds.

16. In short we think it would be difficult to justify disregarding the law on either basis by means of an ESC, and that we should be open to criticism if the change were not given a proper statutory basis in the Finance Bill.

Points for decision

1. Is the exemption for car parking to be general, or to apply only to parking on the employer's premises?

2. If the latter, is there to be a de minimis exemption from the charge on off-site parking? If so, is £200 about right? Yes

3. Is the starting date to be 6 April 1988?

4. Should past years be handled in the same way as third party entertainment?

5. Is it agreed that the change should be included in the Finance Bill?

Peter Lewis

P LEWIS

ANNEX

Extra-Statutory Concessions, Statements of Practice, and Administrative ("de minimis") Arrangements

1. The circumstances in which Extra Statutory concessions are made are discussed in paragraphs 15 and 16. The distinctive feature is that they are concessions ie a tax liability which is clear in strict law is waived. Ministers have undertaken that all ESCs will be published.

2. In contrast, a Statement of Practice simply set out how the Revenue will interpret and apply a particular piece of tax law which has given rise to uncertainty among tax practitioners. It is thus a matter of clarification and practice, rather than concession.

3. The third category, administrative ("de minimis") arrangements, are concerned with not collecting tax in circumstances where the cost of doing so would probably be disproportionate to the yield. The most important one is the "assessing tolerance" under which we do not make assessments for small amounts of tax.

BUDGET SECRET: TASK FORCE LIST

**Inland Revenue**

Policy Division
Somerset House

Thanks. As Mr Cayley says, useful + defensive material.

Copy No 1 of 30

FROM: M F CAYLEY
DATE: 22 FEBRUARY 1988

CHANCELLOR

CGT: COMPARISON WITH US FOR HIGHER RATE TAXPAYERS

1. At Overview on 15 February, we were asked to produce material on how, following the CGT reform, the tax burden for a higher rate payer in the UK would compare with that in the USA. Mrs Lomax's minute of 18 February on the rationale of the CGT package discussed this briefly, but you may find a fuller note of interest. This note complements Mr Culpin's of 18 February, headed "Effective Rate of CGT", and contains, I think, some very useful defensive material.

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Odling-Smee
Miss Sinclair
Mr Riley
Mr Cropper
Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Calder
Mr Pitts
Mr Cayley
Mr Gonzalez
Mr Mace
Mr Michael
Mr Quinn
Mr Lester
PS/IR

2. It may be helpful to start with a very summary comparison of the UK and US systems from 6 April 1988.

| | UK | US |
|---|---|---|
| Annual exemption | £6,600 | Nil |
| Higher rate | 40% | 28% (federal tax only) |
| Indexation? | Yes | No |
| Base date | 1982 | about 1913 |

The higher rate threshold in the USA - 29,750 dollars, or some £17,000 at present exchange rates - is lower than it will be in the UK. US State and local taxes are frequently payable in addition, typically making the total tax rate in the USA around 34.5 per cent. As will be apparent the inclusion of State and local taxes (which are often overlooked) makes a substantial difference, and for legitimate comparisons they need to be brought in.

3. The immediately obvious point is that for people below the UK annual exemption, no tax is payable in the UK, but they would pay tax in the USA. In addition, many UK higher rate taxpayers above the annual exemption will pay less tax than in the USA because of the exemption. Even if there were no indexation relief, the crossover point would be £22,000 on Federal tax alone, or typically over £48,000 if State and local taxes are brought into account: all higher rate taxpayers with gains less than the crossover point would be better off than in the USA. (These figures assume a UK exemption of £6,600 - and would be lower if the exemption were reduced.) Indexation relief pushes up the crossover point - how much depends of course on how much relief is due. So does rebasing for those with pre-82 gains - how much depends on how far gains accrued before 1982. For large disposals, the value of indexation and rebasing can be very considerable. All this means that the vast majority of higher rate payers will pay less tax than they would in the USA.

4. I now move to the other extreme - the "worst case" that can be quoted. This is the person who has exhausted his annual exemption and has no pre-82 gains. If we assume inflation at 4 per cent, then, looking at Federal tax alone, a higher rate taxpayer will - because of indexation - be better off in the UK if his asset has appreciated by 13 per cent or less. In other words, nominal gains have to accrue at almost three and a half times the rate of inflation for the UK person to be worse off. If State and local taxes are brought into account, the figure typically becomes over 29 per cent, or more than seven times the inflation rate: this percentage goes up or down as the inflation assumption is raised or lowered but remains about seven and a quarter times the postulated level of inflation. Where there are pre-82 gains, or some annual exemption is available, the figure will be higher.

5. Two stylised examples are attached.

Michael Cayley

M F CAYLEY

EXAMPLES

EXAMPLE ONE

| | |
|---|---|
| Asset acquired 1970 for | £10,000 |
| Value in 1982 | £30,000 |
| Value on disposal in 1988 | £45,000 |

Indexation relief at 30%

<u>Tax in US system</u>

(a) Federal tax only

Gain £35,000 x 28 per cent = £9,800

(b) With 6.5 per cent State/local tax

Gain £35,000 x 34.5 per cent = £12,075.

<u>Tax in UK system</u>

| | |
|---|---|
| Gain since 1982 | £15,000 |
| <u>less</u> indexation | £ 9,000 |
| | £6,000 covered by annual exemption |

No tax payable.

EXAMPLE TWO

Asset acquired 1983 for £100,000

Value on disposal in 1988 £200,000

Indexation relief at 25%

<u>Tax in US system</u>

(a) Federal tax only

Gain £100,000 x 28 per cent = £28,000

(b) With 6.5 per cent State/local tax

Gain £100,000 x 34.5 per cent = £34,500.

<u>Tax in UK system</u>

| | | |
|---|---|---|
| Gain | | £100,000 |
| <u>less</u> indexation | £25,000 | |
| exemption | £ 6,600 | |
| | £31,600 | £31,600 |
| | | £68,400 |

Tax £68,400 x 40 per cent = £27,360

COPY NO. 24 OF 25

FROM: A C S ALLAN
DATE: 22 February 1988

MRS LOMAX

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Anson
Mr Byatt
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Ilett
Mr Riley
Miss Sinclair
Mr Courtney

Mr Battishill IR
Mr Unwin C&E
PS/IR
PS/C&E
Mr George B/E
Mr McConnachie B/E

**CGT PACKAGE: RATIONALE**

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

2. He would be grateful for a further (unquantified) note expanding on the first indent in paragraph 1 of your note - ie that the incentive for higher rate tax payers to invest in asset showing a capital gain rather than an interest or dividend yield would be greatly reduced. The sort of points he would wish to see covered are: what is the likely effect on yields (presumably less of a spread)?; and what is the likely effect on takeovers and merger-mania (presumably some cooling down)? Plus any other points you think are relevant.

ACSA

A C S ALLAN

COPY NO 30 OF 30

FROM: J M G TAYLOR

DATE: 22 Februay 1988

MR CULPIN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
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Mr Call
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR

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2. He would be grateful if the first table could be redone with 1987 substituted for 1986.

J M G TAYLOR

BUDGET SECRET: TASK FORCE LIST

pup.

COPY NO. 2 OF 3

FROM: C J RILEY
DATE: 23 FEBRUARY 1988

CHANCELLOR

cc Principal Private Secretary
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Monck
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Sedgwick
Miss Sinclair
Mr Bredenkamp
Miss C Evans
Mr Hughes
Ms Munro
Mr A Hudson
Mr Cropper
Mr Tyrie
Mr Call
<u>Inland Revenue</u>
Mr Battishill
Mr Isaac
Mr Painter
Mr Lewis
Mr I Stewart
<u>Customs and Excise</u>
Mr Unwin
Mr Knox

**CARS AND HOUSES: BEHAVIOURAL EFFECTS**

I attach two notes. The first assesses the effects of doubling the car scales, drawing on work by MP1, EI and the Revenue. The second, by Alison Munro, considers the implications of the proposed changes in mortgage interest relief.

2. The notes set out our best guesses on the likely scale of effects. They are inevitably very uncertain. And we do not consider how the indirect effects should be treated in the FSBR. At present the Scorecard takes account only of direct effects, ignoring behavioural responses, and the conventional treatment in the FSBR is generally to do likewise.

<u>Cars</u>

3. This note takes forward the work reported by Mr Monck in his minute of 28 January. The main conclusions are as follows:

- the reduction in company cars for private use might be of the order of 100 thousand, out of a total of 1.2 million which might have been expected otherwise. This is slightly lower than the number reported by Mr Monck;

- the effect is likely to be spread over perhaps three years. There will be offsetting increases in pool and hire cars, and some increase in private demand;

- the implications for UK production are likely to be slight - perhaps a fall of around 1% compared with what otherwise would have happened;

- the increase in scales will lead to some upward pressure on wages, as some employees cash out their company cars and others seek compensation from their employers;

- the behavioural effects will tend to augment the increase in revenue which occurs directly as a result of the higher scale charges. They could add around £100 million in 1990-91.

4. The forecasters foresee continued growth in UK car sales and production, with the UK car industry now more confident than for several years. The cuts in personal taxation in the Budget will help the industry, so the increase in car scales should be no more than a fairly minor irritant - though UK producers may not see it that way.

**Houses**

5. The main change, in quantitative terms, is the removal of Mortgage Interest Relief on home improvement loans. The note concludes that:

- there may be some compensating increase in loans for house purchase, and probably some forestalling. This will offset some of the increase in revenue occurring as a direct consequence of withdrawing the relief, but we guess the effects are likely to be quite small - perhaps of the order of £50 million after three years.

- there is likely to be some reduction in expenditure on home improvements - perhaps around 2% in the longer term, equivalent to about 1% of total private investment in dwellings;

- the effects on house prices and the condition of the housing stock are likely to be negligible.

The effects of moving to a residence basis for MIR are likely to be very small.

6. The changes in MIR are expected to occur against a background of rising housing investment - perhaps around 2½-3% per year. As with cars, the cuts in personal tax in the Budget will help sustain housing expenditure - and house prices.

CJR

C J RILEY

Cars.

BUDGET SECRET: TASK FORCE LIST

## CARS: BEHAVIOURAL EFFECTS AND IMPLICATIONS FOR REVENUE

### Introduction

This paper assesses the likely behavioural responses to the proposed doubling of the car scales in 1988-89. It follows up the work reported by Mr Monck in his minute of 28 January, and examines the likely effect on the demand for cars, the implications for pay, and the overall effect on revenues.

### The present position

2. The Revenue estimate that in the absence of any behavioural changes, there would be roughly 1.2 million company cars provided in 1988-89 for the private use of directors and employees above the proposed £10,000 P11D threshold. Before assessing the likely effects of increasing the car scales, it is as well to discuss briefly the incentive which presently exists for employees to take remuneration in the form of company cars rather than pay, and what this implies for take-up.

3. There is at present a strong fiscal incentive to provide company cars rather than pay of the same value because:

- neither employer nor employee NICs are payable on cars;
- income tax is applied to less than the (estimated) full value of the car.

Given these incentives, it makes sense to have a company car rather than equivalent pay even if the employee's valuation of the car is less than 100% of the gross cost of providing it. As long as the employee's valuation exceeds 65-75% of the cost, depending on his tax status, it is generally worth having a car rather than pay given the present car scales. Further details are set out in Table 1 below.

**Table 1: Valuation of company cars, as a percent of gross cost, above which it is worthwhile to have a car rather than pay**

| | Non-perk Cars (90%) | | Perk Cars** (10%) | |
|---|---|---|---|---|
| | Present Scales* | Proposed Scales | Present Scales* | Proposed Scales |
| **Basic rate taxpayer** | | | | |
| below UEL | 66 | 72 | 70 | 78 |
| above UEL | 74 | 80 | 78 | 86 |
| **Higher rate taxpayer** | 65 | 74 | 70 | 83 |

* The figures for "present scales" relate to the position in 1988-89 assuming post-budget tax rates and only a 10% increase in scale charges.

** "Perk cars" are those company cars used for less than 2500 business miles per year, or second company cars.

4. The figures in the table take no formal account of the value which employers attach to their employees having a company car. Insofar as they do attach a value to it, and are thus prepared to spend more on providing a car than paying cash, the valuation threshold for the employee would be reduced. In a sense, therefore, the figures in the table should be taken to refer to the joint valuation of the car by employers and employees.

**Increasing the car scales**

5. The proposed doubling of the car scales in 1988-89 will raise the valuation thresholds, as indicated in Table 1. For non-perk cars the threshold will rise by 6-9 percentage points; the increase in scale charges is equivalent to roughly a quarter of the employee's marginal tax rate. This means that in some cases it will no longer be worthwhile for the employee to have a company car rather than pay. However many employers may not be willing to allow their employees to take cash instead of a car if the latter is required for business use.

6. The impact of increasing the car scales will be felt in the first instance by employees. There is no direct incentive on employers to change the way in which they remunerate their

employees, because their tax liability is unaffected. But employees have an incentive to urge changes on their employers, because they do face additional tax liability.

7. In essence there are three main options for the employee:

(i) keep the company car and absorb the higher tax liability;

(ii) keep the company car, but obtain extra pay or allowances from the employer to finance at least part of the extra tax liability;

(iii) cash out the company car to obtain higher pay.

8. The extent of <u>cashing out</u> will depend on the proportion of those with company cars whose valuation of them lies above the present threshold (see table 1) but below the threshold under the proposed new scales - ie between 66% and 72% of the gross cost of the car for basic rate taxpayers below the UEL. It is difficult to judge what this proportion might be. But on the assumption that most employees value their cars at close to or even above 100% of the cost, we would expect the proportion to be quite low - perhaps around 10%.*

9. On this basis, the number of company cars for private use might be reduced by around 100 thousand, out of the present total of 1.2 million. (This is somewhat below the estimate put forward in Mr Monck's note.) There would be a compensating increase in pay and allowances which is taken into account in the revenue calculations given below.

10. For those who keep their company cars, the issue is how much <u>compensation</u> for the extra tax companies will be prepared to provide. The Treasury macroeconomists generally assume that companies compensate employees for about half of any rise in income

---

* If the valuations were spread evenly between the old threshold (66%) and 100%, the rise in car scales would reduce the number of company cars by (72-66) ÷ (100-66) - ie by 17½%. But with some valuations likely to be higher than 100%, taking the employee and the company together, the percentage would be lower than this.

tax, but we would expect somewhat higher compensation in this case for two reasons:

- companies can finance some of the increase in pay by giving employees cheaper cars - ie trading down;

- employers may be willing to take on a greater share of the extra burden because of the benefit they themselves get from company cars.

Our tentative view is therefore that about threequarters of the extra tax payments will ultimately be compensated by higher cash payments.

11. The increase in car scales will provide both employers and employees with an incentive to trade down. For employers the incentive arises because their employees will be seeking higher pay or allowances. Companies can finance some of the extra pay by buying a less expensive car, even though this may not involve any change in the employee's tax liability. Employees have an incentive to trade down only insofar as they can obtain a car with a lower scale charge.

12. We have very little to go on in assessing the extent of trading down. Attempts to model this depend crucially on how the employee's valuation varies with the size of car. We have assumed fairly arbitrarily that about a half of those who retain company cars trade down to some extent, perhaps by about 10% in value terms. Employees who obtain no cash compensation from their employers are likely to trade down more than the average in order to move to a lower scale.

13. The overall effect on the demand for cars will reflect three separate influences:

- the reduction in company cars as a result of cashing out;

- an offsetting increase in pool and hire cars for use by company employees;

- an increase in demand for private cars by those who have cashed out.

In addition, the average purchase price will be reduced as a result of trading down. Our assessment of the scale of these effects is extremely tentative.

14. It seems unlikely that the increase in pool and hire cars will be a very high proportion of the reduction in company cars due to cashing out; cashing out will affect those cars which are least highly valued by employees <u>and</u> employers. The offset might perhaps be of the order of 25%. The same argument applies to the increase in demand for private cars; again we think that 25% is a plausible figure. So in total we would expect no more than a half of the reduction in company cars to be reflected in increased company and private demand. This suggests a net reduction in car demand of about 50,000.

15. Changes in <u>the value of car sales</u> will reflect both the change in numbers and the degree of trading down. If trading down proceeds as we have suggested in paragraph 12, the average price of company cars is likely to be about 5% lower under the proposed 1988-89 scales than it otherwise would have been - say £9,500 compared with £10,000. The additional private and company demand will also be at a lower price. The overall effect on the value of car sales might be as follows:

| | £million |
|---|---|
| reduction in company cars | -1,000 |
| increase in private and company demand | + 500 |
| reduction in value of existing company cars | - 600 |
| Total | -1,100 |

16. These figures for car demand all relate to the <u>stock</u> of cars. Adjustment will be spread over a number of years - we have assumed three, given the average frequency with which company cars are replaced - so the effect on car sales in any one year will be rather less. Even after the adjustment period is complete, however, car sales will remain lower because a lower car stock implies lower annual turnover. Our estimates are summarised in Table 2 below.

**Table 2: Effects on Car Sales**

| | 1988-89 | 1989-90 | 1990-91 | Later Years |
|---|---|---|---|---|
| thousands | - 15 | - 20 | - 15 | - 10 |
| £million | - 350 | - 450 | - 400 | - 300 |
| % of current value | 2.2 | 2.6 | 2.2 | 1.7 |

**Implications for revenue**

17. These behavioural responses will lead to indirect effects on revenue which are not currently allowed for in the scorecard. The scale of these effects will depend on the way in which employers choose to compensate their employees - eg whether by increased pay or by an annual allowance which would largely avoid employee NICs. We have assumed some combination of the two. The overall effects are set out in Table 3 below.

**Table 3: Effects on Revenue**

| £million | 1988-89 | 1989-90 | 1990-91 | 1991-92 |
|---|---|---|---|---|
| **Direct effect** (no behavioural change) | + 230 | + 280 | + 290 | + 290 |
| **Indirect effects** of which: | + 35 | + 50 | + 95 | + 70 |
| Income Tax | + 35 | + 60 | + 85 | + 90 |
| Employee NICs | + 10 | + 20 | + 35 | + 35 |
| Employer NICs | + 20 | + 35 | + 55 | + 55 |
| Corporation Tax | - | - 20 | - 35 | - 60 |
| Indirect Taxes | - 30 | - 45 | - 45 | - 50 |
| **Total revenue effect** | **+ 265** | **+ 330** | **+ 385** | **+ 360** |
| **Memo items:** | | | | |
| Increase in pay/allowances | + 200 | + 425 | + 675 | + 700 |
| Net effect on company expenditure (including taxes/NICs) | + 25 | + 50 | + 100 | + 125 |

18. It can be seen from the table that the behavioural responses add to the gain in revenue which occurs directly as a result of the increase in car scales. It is worth commenting on this result since we would usually argue that behavioural responses tend to reduce tax payments rather than increase them. The rationale is as follows:

- raising the car scales reduces the incentive to exploit the tax/NIC loophole;

- employees substitute pay and allowances for company cars, which raises revenue because some tax/NIC advantage for cars still remains;

- because the employees who give up their cars value them at less than 100% of the gross cost, they can be better off at the same time as paying extra tax/NIC.

19. Our estimates imply that the indirect revenue effects are likely to be quite large in relation to the direct effects, rising to about a third - nearly £100 million - in 1990-91. But they are very uncertain. And we do not discuss here the appropriate treatment in the FSBR.

**Effects on the UK car industry**

20. Since UK badges dominate company car sales (87% in 1986), the brunt of the 75,000 net reduction in company car purchases is likely to fall on manufacturers with UK facilities. However the impact on UK production will depend upon the sourcing decisions of these manufacturers and, fundamentally, on the cost and quality performance of their UK plants. Using 1987 estimates of the UK-produced proportion of UK-badged company cars suggests that about 50,000 of the net reduction in company car sales would be at the expense of UK production (currently around 1 million units).

21. But this downward effect on UK production is likely to be offset partially by the effects of trading down and extra private car purchases. Private car purchases are mainly for foreign badged cars (about 70%) but UK-badges dominate the lower price

bracket of UK domestic sales. The scale of the overall offset could therefore be quite large. Given our assumption that the effects will be spread over three years, the net effect on UK production might therefore be only around 1%.

22. Little concrete can be said about the impact of the proposed changes on particular manufacturers; the uncertainties are too large. But:

- Austin Rover Group accounted for 12% of company cars in the 1986 survey. Its share of the fall in company cars is less than 2% of 1987 Group output (of cars, vans and land rovers). spread over 3 years, with trading down and private car purchase offsets, the net impact is likely to be very small.

- Jaguar are heavily export oriented and have a queue of unsatisfied customers. They are unlikely to be significantly affected.

**Conclusion**

23. The increase in car scales should not pose undue problems for the UK car industry, though some small downward effect is likely. The background is of rising production and sales, and this picture should not be materially affected.

24. The direct effects on revenue are likely to be augmented by further increases in revenue as some employees cash out their company cars and others seek compensation from their employers.

Houses.

BUDGET SECRET: TASK FORCE LIST

## HOUSING: EFFECTS OF CHANGES IN MIR

This note summarises the main effects on revenue, the construction industry and the housing market of the withdrawal of Mortgage Interest Relief (MIR) on home improvement loans. It also considers very briefly the effects of moving to the residence basis.

### The Current Position on Improvement Loans

2. It is expected that about 1½ million home improvement loans will have been taken out in 1987-88. About a half are for more than £3000, and about a sixth for more than £6000. The value of tax relief on all home improvement loans eligible for MIR in 1987-88 is estimated at £500 million.

3. A Revenue survey of MIRAS loan applications indicated that about 7½ percent of loans involved providing additional living accommodation, and of these about a quarter were for more than £6000. 87 per cent of loans did not involve any extensions (including garages, conservatories etc); of these the majority were for works such as double glazing or central heating.

4. The Revenue estimate that about 20 percent of loans are used to buy goods and services other than home improvements.

### The Change

5. Relief will be withdrawn with effect from 6 April 1988. The three week delay reflects the need to allow pre-Budget commitments to be finalised and to allow lenders a short time to change their systems. Landlords will continue to be eligible for relief for improvements against rental income.

### Revenue Effects

6. If relief had remained available, we would have expected the future growth of eligible loans to be increasingly constrained as more people hit the £30,000 ceiling on relief. The average

outstanding mortgage is already £22,000. To reflect this, the scorecard costings assume that, in the absence of action, the total value of MIR would remain constant (at about £450 million at Budget tax rates) over the next four years, ie the value of new loans just offsets the value of expired loans. On this basis the direct revenue savings from withdrawal of relief are:

| | **1988-89** | **1989-90** | **1990-91** | **1991-92** |
|---|---|---|---|---|
| £million | 80 | 200 | 300 | 400 |

These figures include no allowance for forestalling or other behavioural effects.

**Forestalling**

7. Some people with plans to take out loans in 1988-89 will try to beat the 6 April deadline. Their propensity to do so will depend on how well advanced their plans are, and their success will largely depend on lenders' procedures - eg whether they require estimates - and their ability to process applications. Assuming that lenders will try to be accommodating, some degree of forestalling seems probable.

8. We have very little idea what the scale of forestalling might be. But we guess that perhaps an eighth of new loans might be brought forward from 1988-89 into 1987-88 - ie about six weeks worth of loans. In this case, the profile of revenue savings would be:

| | **1987-88** | **1988-89** | **1989-90** | **1990-91** | **1991-92** |
|---|---|---|---|---|---|
| £million | 0 | 60 | 180 | 280 | 380 |

## Other Behavioural Effects

9. To some degree, purchasers of unimproved homes will be able to compensate for the loss of MIR on improvement loans by increasing their house purchase loans to cover the cost of improvements. The scope for this will be constrained by whether the loan would then exceed 100 per cent of the price (though the average new purchase loan is for only 70 per cent). Many lenders apply special conditions - eg higher interest rates or higher insurance cover - for loans over 75 per cent of value. The scope for increasing house purchase loans will also be constrained by how frequently unimproved homes change hands, and the proportion of improvements carried out within a few years of purchase.

10. We can only guess at what the combined effects of these considerations will be; especially as equity withdrawal - where people borrow more than they need - already occurs to a degree at present. It seems unlikely that more than a few per cent of the savings identified above for 1988-89 will be offset by an increase in MIR for house purchase, though the figure might rise to say 10 percent by 1991-92, as more unimproved homes change hands. The profile of savings, including also the effects of forestalling, would then be as shown below:

| **£ million** | 1987-88 | 1988-89 | 1989-90 | 1990-91 | 1991-92 |
|---|---|---|---|---|---|
| After behavioural effects | 0 | 60 | 170 | 260 | 340 |
| Before behavioural effects | 0 | 80 | 200 | 300 | 400 |

## Effects on the construction industry

11. Withdrawal of relief will raise interest costs, and thus have a direct effect on the level of investment in home improvements. The evidence we have suggests an interest elasticity of investment of around -1.75: for each 1 percentage point increase in interest costs, investment eventually falls by 1.75%.

12. With an interest rate of 10%, withdrawal of MIR raises interest costs by 2.5 percentage points. Allowing for lags and the proportion of improvements which are not usually financed by eligible loans, we estimate that private sector investment in home improvements will be reduced by about 1½% in 1988-89, and 2% in subsequent years, compared with what it would otherwise have been. The long run effect represents a reduction of about 1% in total private sector domestic construction (including new building); and a reduction of about $^{1}/_{3}$% in total construction output. Any indirect revenue effects associated with this (eg through VAT receipts) are likely to be negligible.

13. These calculations assume that 80% of loans actually finance home improvements. Similar calculations have been made to estimate the effect of withdrawal of relief for the 20% that might have been spent on consumer durables; our estimates suggest that any effect would be a negligible proportion, say 0.1%, of total investment in consumer durables.

__Effects on the housing market__

14. Much of the investment discouraged by the withdrawal of relief would probably have been in central heating, double glazing etc. So while the quality of the housing stock will be affected, it seems unlikely that the withdrawal of relief will significantly affect the number of houses in poor condition. The worst cases will continue to be eligible for home improvement grants.

15. The effect on house prices is also likely to be negligible. New improvement loans apply to only about 10 per cent of the owner-occupied stock annually; and Mr Riley's paper of 17 December concluded that the effects of much larger changes in the MIR ceiling would be very small. The price of unimproved houses might decline very slightly relative to the price of new or improved houses; but on a 10 year loan for £3000, the present value of the relief withdrawn is less than £500; and the scope to increase purchase mortgages to cover the cost of improvements will mean that actual relief withdrawn is less than this.

16. Withdrawal of relief might encourage some people to move to larger or improved accommodation, rather than carry out extensions/ improvements on their current homes. But since the costs of moving are generally at least £2000, the gain in MIR will only justify moving where the improvement loan would have been large - probably over £12,000. In 1987-88 only about 4% of loans were above this level.

**Change to the Residence Basis for MIR**

17. The change to the residence basis for MIR will produce a small increase in revenue:

| | 1988-89 | 1989-90 | 1990-91 | 1991-92 |
|---|---|---|---|---|
| £million | 5 | 20 | 40 | 50 |

This is due to the reduced relief available to unmarried sharers - about 5% of all new borrowers, or 80,000 new loans, in 1988-89.

18. The change to the residence basis may stimulate the subdivision of properties to create separate "residences". It is impossible to quantify this effect; but given the small proportion of people for whom this will be an attractive proposition, the effects on the revenue figures above and on the construction industry are considered to be very small.

**Conclusions**

19. Our conclusions on the main effects of withdrawing MIR for home improvement loans are:

- behavioural effects (forestalling and increased house purchase loans) may reduce the revenue gains shown in the scorecard, by about £20 million in 1988-89 and possibly up to £60 million by 1991-92;

- investment in home improvements may be reduced by about 2% in the longer term, and total investment in private dwellings by about 1%;

- the effects on house prices and the condition of the housing stock will be negligible.

These changes are against a background of expected growth in private sector investment in housing of around 2½-3% per annum; and longer term growth of house prices broadly in line with incomes.

20. The effects of moving to the residence basis for MIR are likely to be negligible.

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FROM: J M G TAYLOR
DATE: 22 February 1988

MR EASON - INLAND REVENUE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Odling-Smee
Mrs C Evans
Mr A Hudson
Mr McIntyre
Miss Sinclair
Mr Riley
Dr Courtney
Mr Cropper
Mr Tyrie
Mr Call
Mr Unwin - C&E
Mr Knox - C&E
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Beighton - IR
Mr Calder - IR
PS/IR

**INDEPENDENT TAXATION: BEHAVIOURAL CHANGE**

The Chancellor was grateful for your note of 19 February.

2. He thinks that "the willingness or unwillingness of husbands to put assets in their wives' names" is an odd way of describing this particular influence (your paragraph 5). It is not a matter of the transfer of assets from the husband's name to the wifes name - beneficial ownership has to pass. And given the high

incidence of divorce these days, he believes there will be less of this than your paper implies. He also thinks that the estimate of £4 billion worth of deposits being moved out of banks and building societies into other forms of investment is on the high side, partly because of the effect on the assumptions of possible changes in interest rates.

3. He has asked whether the experience of the consequences of introducing the composite rate for banks etc has been assessed in this context. He also wonders what account has been taken of the incentive that independent taxation will provide for wives to save.

4. He has commented, finally, that in the circumstances he does not see that any figure can be given for the cost of behavioural changes.

J M G TAYLOR