PO-CH/NL/0208

PART A

Park. A.

SECRET
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[notif]y REGISTRY of movement)

Begins: 21/10/86.
Ends: 24/11/87.

PO -CH /NL/0208
PART A

Chancellor's (Lawson) Papers:

THE TAX TREATMENT OF
FORESTRY

PO -CH /NL/0208
PART A

Disposal Directions: 25 Years

12/9/95.

TAXATION OF WOODLANDS

CONFIDENTIAL

[illegible]

FROM: T J PAINTER

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

21 October 1986

RP

FINANCIAL SECRETARY

TAXATION OF WOODLANDS

1. We were asked at the Chancellor's strategy meeting on 22 September (paragraph 4 of the minutes) to take another look at the scope for reforming the present income tax regime for forestry with special emphasis on environmental policy objectives.

2. An additional background note by Mr Elliott is available if you would like it but I am conscious of the amount of paper we are sending you at the moment and I have not attached it at this stage.

PAINTER TO FST 21/10

3. We have not of course consulted outside the Chancellor's Departments for present purposes. Little has changed in our analysis since the former Chancellor's announcement in 1980 that he had concluded that there should be no change in the present tax arrangements. We are nearly 2 years or so further away from that announcement and Ministers' last consideration of the issues; my impression is, that if anything, the environmental

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cc Chancellor of the Exchequer
Chief Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Scholar
Mr Bonney
Mr Cropper
Mr Ross-Goobey
Mr Graham (Parly. Counsel)
Mr Battishill
Mr Isaac
Mr Painter
Mr McGivern
Mr Houghton
Mr Beighton
Mr Pattison
Mr Dearman
Mr Weeden
Mr Battersby
Mr Johns
Mr Elliott
Mr Streeter
Mr Lawrance
PS/IR

lobby has become rather more vocal (complementing the Chancellor's comments on what he found in his recent Scottish tour); and we have heard on the grapevine that the Department of Environment are looking again at the issues and Mr Ridley may well approach the Chancellor, perhaps in the context of his Budget representations.[1]

It might be helpful to summarise the present tax arrangements.

Income Tax

4. In theory, an occupier of woodlands is charged to income tax either under Schedule B, in which case there is a nominal charge every year based on one-third of the (1936) value of the land in its natural state (about 15p an acre on average), or he can elect to be charged under Schedule D, in which case the costs of planting and maintaining the woodland crop in its early years can be set off against income from other sources, while the proceeds from sales of thinning and eventually of mature timber are chargeable in the normal way.

5. In practice, occupiers elect for Schedule D treatment when woodland is planted, so that the losses arising from the planting and establishment costs can be set off sideways against their other income for the year in question. Later they arrange for a change of occupier, either by an arm's length disposal or by arranging a nominal change of occupier, eg substituting a company for an individual without changing the effective control, leaving the successor to be taxed under Schedule B.

6. The application of Schedule D would arguably produce a reasonable result if it were applied consistently over the life of a woodland (about 50 to 60 years in the case of softwoods and double that for hardwoods): while the consistent use of

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1

The attached extract from the Daily Telegraph (18 October) adds support to these impressions.

Schedule B would be tantamount to exemption. But the result of switching is that keeping woodlands within the income tax system actually costs the Exchequer money - probably around £10 million a year; and it would save that money by exempting them altogether.

Capital tax

7. The capital tax position is briefly this. There need only be one charge to CTT/IHT during the life cycle of any woodland, however many individuals may have owned it during that time. That is because tax on timber on an owner's death can be deferred until a subsequent disposal: it is then charged on the estate of the last owner to die by reference to the sale proceeds. Any gain made on a disposal of timber is exempt from capital gains tax. The land on which the trees grow is chargeable to both taxes in the normal way, but its value is small compared with that of the timber.

Direction of possible change

8. Any Revenue official returning to the vexed question of forestry does so with some diffidence; suggestions to change the status quo have always proved disproportionately contentious and the main judgments involved are so obviously political ones for Ministers.

9. But if Ministers consider reform may now be feasible, I take it as axiomatic that

(a) the present tax regime based on the Schedule D/Schedule B option is an absurdity. Whether viewed as a positive fiscal incentive or as a mechanism to take account of the long term nature of the crop it must be a nonsense that it depends either on an arm's length disposal of the land or on licensed avoidance - an artificial change of 'occupier' which leaves the real owner in effective control; and

(b) there is strictly no case for a fiscal incentive for forestry generally in the broader context of the Government's economic policy. The traditional argument - import substitution - conflicts with efficient resource allocation. And although commercial forestry provides some employment (in some particularly sensitive regions) it is not distinctive in this respect and is by any standards a labour unintensive industry;

(c) if nevertheless an incentive element is considered appropriate it should not perpetuate the present, bizarre, situation where the nominal inclusion of forestry in tax imposes a net cost on the Exchequer and the forestry interests accordingly blench at any suggestion they should be exempt and so lose their tax subsidy; but, self-evidently

(d) starting from where we are forestry is not a suitable case for an unduly purist approach.

10. If so much can be taken as axiomatic, I would go on to suggest that any reformed system should dispense altogether with Schedule B. As it stands, Schedule B:

- is based on an absurdly outdated valuation;

- much of the nominal liability is simply not worth pursuit;

- so the yield (some £5,000 a year) gives a special meaning to the conventional term "negligible";

- the Schedule B charge is of course based on the unimproved value of the land; it takes no direct account of the value of the crop at any given stage.

11. But even an updated Schedule B basis would, to say the least, sit oddly in a tax reform package;

- the notion of basing a tax on annual rental values has been dropped from other parts of the tax system (Schedule B for farming in, I think, the 1920s; Schedule A for owner-occupiers in 1963; and local domestic rates are to disappear after the Election);

- there must be scepticism about the practical likelihood of regular revaluations;

- the valuation would still bear no reference to the trees and although in principle the cumulative Schedule B charge would be intended to frank the, large and often lumpy, profits on felling, I doubt whether many people would see it that way;

- the updated system would almost certainly be perceived as still being out of touch with reality. If valuation were preserved as the basis of charge it would not be easy to explain why it was not based on capital values, taking direct account of the trees; in effect a wealth tax.

12. I suspect however that these detailed arguments reflect a tax administrator's gut reaction that a Schedule B basis does note 'feel right' as a reforming measure in the late 1980s, and, as I have said, a recognition that the essential judgment, particularly this last, is essentially a political one for Ministers.

A consistent Schedule D basis

13. Against this background the front runner if the tax system is to be changed still looks to be a scheme based on the proposals which the Chancellor floated with the former Secretary of State for Scotland in February 1985.

14. In essence this envisaged a phased transition to a consistent Schedule D basis for all woodlands but leaving the treatment of existing woodlands largely unaffected:-

a. all planting and replanting after the start date would be under Schedule D without any option to rever to Schedule B on a change of occupier;

b. woodlands currently on Schedule B should remain there until felled;

c. woodlands now on Schedule D should, on a change of occupation within (perhaps) 10 years of the start date, be allowed to rever to Schedule B until felled.

15. I have assumed that it would be very difficult to propose a tougher regime now than that floated in 1985. We have seen no signs that the sponsor Departments (still less the forestry interests themselves) have weakened their opposition to change and the value they attach to "stability". The possible charges of bad faith given the recent and, I think, continuing, disposals of Forestry Commission land are still a risk. The former Chancellor's 1980 statement, following the last big interdepartmental review, that he "had concluded that no change should be made to the present income tax arrangements" (Hansard, 9 December 1980, col 347WA) is still pretty recent in forestry terms. And there is the strategy meeting remit that the relief could not be abolished, though it should not be increased, and, if possible, reduced. The difficulty, which I come to below, is that if the reformed regime really cannot be somewhat tougher overall than the 1985 proposals,

It is not easy to see how it can be skewed to meet environmental objectives.

16. This does, of course, reflect my judgment, for what it is worth, that it is the front-end loaded Schedule D relief for planting and establishing rather than the prospect of an

effective tax charge exemption in 60 or 120 years after planting which matters in the case of new investment decisions. (And the substantial phasing under the 1985 proposal is of course directed at the problem for existing plantations.)

17. One way of looking at it, is that because of the uniquely long-term nature of the "crop" the forester is in reality getting relief under Schedule D for what is very much like a capital investment in a growing asset. Considerations of effective tax exemption for his successors in 60 or 100 years' time must surely be pretty heavily discounted and he has always, no doubt, the hope that opportunities will remain to secure that the crop is in tax exempt hands, eg an exempt institution, by the time it is felled.

Environmental considerations

18. What such a phased transition to a consistent Schedule D basis for commercial woodlands generally would not do by itself is to meet the second half of the new remit. That is to import a discrimination into any new system to buttress environmental policy. (Nor would it do anything for the rather different objective - and I am bound to say I see some conflict with environmental considerations here - of encouraging, at the margin, the substitution of woodland for agriculture.)

19. There are clearly differences of emphasis between the various environmental lobbies.

20. Some see the overriding requirement as a net reduction in the amount of land afforested so that there is more open space, particularly in areas like Breckland, the Yorkshire Moors, or fellsides in the Lake District. The substitution of broadleaves (where the environment would support them) for conifers would not meet their case though it would probably be better than nothing. It follows, too, that they would not want to see afforestation of existing, marginal, agricultural land on any significant scale.

21. Others put more emphasis on securing an increase in broad leaves, though most of them would, I suspect, also like to see a decrease in conifers.

22. The first line of thought points to a regime which would discourage planting and replanting generally to some extent: the second to a regime where more emphasis was placed on switching the balance between types of tree.

23. I have to say that we have not been able to see an effective way of helping either objective through the income tax, or indeed capital tax, system, in line with the strategy meeting discussion, <u>if</u> the present level of relief is to be substantially retained <u>and</u> there is to be no increase in the total cost of relief. In particular it is difficult to see a way forward unless Ministers thought it feasible to restrict the front-end relief for losses (paragraph 16 above) (over and above anything proposed in Mr Johns's separate paper on a minimum tax) for conifers.

24. In particular, I suggest that retaining the present Schedule D/Schedule B option indefinitely for hardwoods should not be regarded as a runner, for the general tax reform and presentational reasons I have outlined above. But, in any case, operating by way of continued exemption in the indefinite future would, I have suggested, largely be ineffective as an incentive. Getting rid of the spurious Schedule B charge for hardwoods but retaining for both hardwoods and conifers immediate relief for expenditure would seem likely to make little practical difference to planting decisions. Certainly it is not easy to see the place in a reformed tax system for continuing to give substantial tax relief for expenditure when the relevant profits are effectively exempt.

25. Within a new, consistent, Schedule D basis there could be <u>some</u> scope for restricting the up-front relief for conifers though if Ministers felt that were politically feasible, we would want to do more detailed work on the practicalities and the possible complications. One possibility might be a restriction on

Case VI lines: in other words, losses on planting and establishing conifers would be allowable only against profits from the same activity.

26. This would be uneven in its effects. For example, a "forester" with a substantial acreage and crops at various stages of rotation so that profits were arising fairly frequently would get fairly early relief for his expenditure. But someone, perhaps a working farmer (and he could be particularly relevant if one objective was encouraging a switch from agriculture to forestry), with a single plantation could have to wait many years to get relief. But it might make conifers distinctly less attractive than they are now.

27. Whether it would actively encourage the substitution of hardwoods is more difficult to judge. The commercial realities - the fact that the crop takes about twice as long to reach full maturity, that it is probably rather more expensive to establish (though this is something we would need to discuss with the forestry experts) and that you can grow conifers on land which is not suitable for broadleaves, might outweigh any attempt at fine tuning within the tax system. But a scheme of restriction for loss relief on conifers could certainly add a presentationally useful environmental component if an inevitably contentious change in the tax regime generally were thought to be on. Perhaps however I should emphasise that there would be a need for some form of certification of what should qualify as expenditure on broadleaves in those circumstanes: plantations are, for example, often mixed, often for good technical reasons eg broadleaf shelter belts for conifer plantations. We would need to discuss the practical aspects of all this with the Forestry Commission.

Capital taxes

28. Turning to the capital taxes, I do not think CGT would need to come into the picture in a changed system on these lines. If there were a Schedule D basis for forestry generally, the tax

charge on the trees would be an income tax one and a CGT charge would arise only on a disposal of the land as at present.

29. If it were thought appropriate to act on inheritance tax, it would, again, I think be necessary to look at restricting in some measure to hardwoods the present special relief if there were to be no increase in Exchequer cost and tax sheltering. The only option would, I think, be to restrict for conifers. The alternative, exemption for hardwoods, would of course involve some cost and run counter to the policy so far of containing the existing tax shelters for inheritance tax.

Conclusions

30. To sum up, importing an environmental bias into a reformed tax regime for forestry would, I think, mean being prepared to restrict significantly Schedule D loss relief for conifers. This would make the proposals for softwoods considerably tougher than those floated in 1985 with Mr Younger. And since the big money is in conifers, it would inevitably make the change much more contentious. It would also, I think, represent a considerable tightening up compared with what Ministers had in mind at the strategy meeting. And even then, the gains might be largely presentational.

31. If a significant restriction of existing relief were ruled out, then I am not sure that I can see the scope for any effective - or even perhaps presentationally convincing - fine tuning within a reformed income tax system.

A Broader Approach?

32. An alternative approach might be to broaden the coverage of review to bring in, once more, grants and the regulatory system to see whether a non-discriminatory tax reform package could be set in the broader context of Exchequer-neutral changes which would tilt the overall system towards an increase in broadleaves and some reduction, or at least containment, of conifer plantations. (I think that the difficult task of squaring an

incentive to substitute trees for agriculture consistently with the broader environmental objectives would in any case need to be based on a more comprehensive review.)

33. The track record of interdepartmental reviews is, of course, not only that they take time and to some extent put the Chancellor's Budgetary decisions in commission, but also provide yet again an opportunity for the forestry interests and their Whitehall sponsors to mobilise their opposition to any change which does not add to the Exchequer cost.

34. But if Ministers decided to pursue the possibility of a reform package, they would in any case, I imagine, wish as in 1985 to broach the issues first, and in confidence, with the Secretary of State for Scotland and, in the light of that, with the other Ministers with the most direct interest, including Mr Ridley.

Minimum Tax

35. Finally, there are the possible implications of a minimum tax, if Ministers go down that road.

36. If there is to be a minimum tax, the proposal (in paragraph 25 of Mr Johns' minute of 17 October) is that forestry losses should be brought within its scope.

37. I feel sure that is right. The proposed test for a minimum tax is not whether the losses in question are "genuine" or not, but their size in relation to gross income. Thus, in the case of farming, normal, but large, losses in any year would be included as well as artificial losses which get through the rather large-meshed net of the hobby farming provisions.

38. Including forestry would of course mean some, possibly very significant, reduction in its attractiveness for the small number of people within the scope of minimum tax. It would not, however, prima facie, offer a very broad fig-leaf for the nonsense of the present tax regime for forestry generally or

perhaps have much effect on the total investment in conifers. I imagine that Ministers would not want to contemplate leaving the basic regime for forestry untouched but discriminating in favour of particular types of tree within a new minimum tax system so as to provide a tax shelter (on environmental grounds) within a measure which is designed intrinsically to mitigate the effects of existing tax shelters.

39. I apologise for the length of this note but the tax regime for forestry has resisted reform for many years. And the specific examination question we were set at the strategy meeting is not an easy one. We would of course be very glad to discuss it with you if you would find that helpful.

T J PAINTER

Daily Telegraph 18/10/86.

Dodging through a forest

There are strong rumours that tax loopholes enabling investors to profit from planting huge areas with conifer trees are soon to be closed. Charles Clover reports

ASHSTEAD Fell lies just across the A6 road from the Lake District National Park. If it were not for the bureaucratic convenience of a red line on the map it might be in the National Park. Indeed, locals say it should be, because it has all the features of the bare, spectacular hillsides on the other side of the road which have hardly altered for thousands of years.

Yet Ashstead Fell could be changed dramatically after next week when a Forestry Commission committee decides whether to give a grant for planting 400 acres of conifers on the side of the fell.

The applicants, the Economic Forestry Group, also want to plant 500 acres of firs at Black Howe on Dent Fell, over on the west side of the National Park: this would make it the largest plantation in the heavily protected county of Cumbria for 20 years.

A row has been in progress between the foresters and the Council for the Protection of Rural England for, in the language of environmentalists, conifer has become a dirty word.

Opinion has been swinging fast against the tax incentives and subsidies which each year mean that thousands of acres of the best scenery in the country disappear under a thick blanket of alien conifers.

Vast areas of Scotland and Wales have already disappeared under American varieties of Sitka spruce and Lodgepole pine, altering the wild appearance of the landscape and displacing moorland wildlife. Pressure is now on the English uplands too.

REPORT after report—by the Countryside Commission, the Nature Conservancy Council, the Ramblers—has condemned the post—First World War tradition of encouraging forestry on the uplands. And there are now signs that a drastic Government rethink may be on the cards for economic as well as evironmental reasons.

The present Environment Secretary, Nicholas Ridley, is known to be no friend of subsidies or of the forestry industry, of which he is known to have said "we have been subsidising it for years and it is still uneconomic."

* Now in the pipeline is an internal report into forestry by his department, which is guarded by a deafening silence. Secrecy also surrounds a report being compiled by the National Audit Office for the Commons Public Accounts Committee, but leaks suggest that it attacks the economic logic of granting tax incentives to the rich to plant trees.

It may sound surprising that tree-planting arouses so much antipathy, when Britain is, after the Netherlands and the Republic of Ireland, the least wooded country in Europe. But the fuss revolves around the kind of tree and where it gets planted.

Only small remnants remain of the hardwood forests of oak, elm and beech which used to cover the lowland south, before prehistoric man began to cut them down. And the huge Caledonian forests of ancient Scots pine which used to cover the Highlands have almost disappeared.

But the 750 square miles of planting in the past 10 years has been with imported fast-growing softwoods. Where Scots pine has been planted, it has been planted insensitively, as in the Suffolk Brecklands.

The semi-wild landscape of the Scottish hills, with their purple heather in summer, orange deer sedge in autumn and white mat grass in winter, is destroyed by blanket planting. The character of a whole area can change in a few seasons.

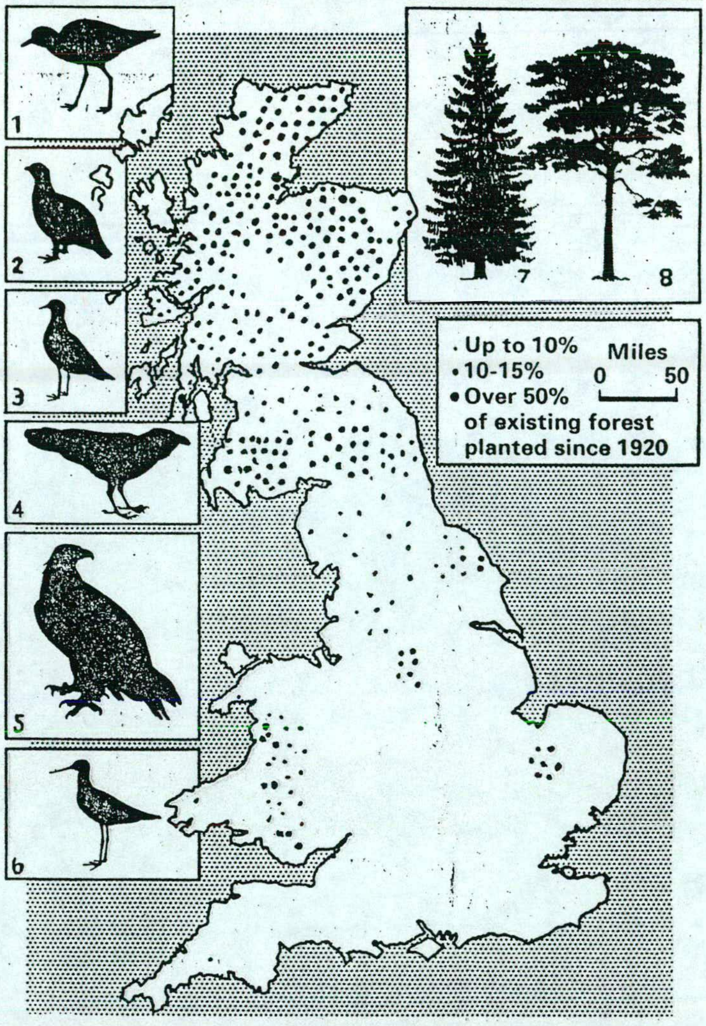
IN PINE forests birdlife is restricted to the top of the canopy. Common species like goldcrests, coal tits and chaffinches flourish. Rarer moorland birds like plover, greenshank and dunlin, together with such predators as ravens, golden eagles and buzzards, are pushed out.

The Nature Conservancy Council's report into afforestation in Britain points to an "unacceptable loss of habitats". Hill-walkers are unimpressed by walking along rural rides instead of open moorland. And the NCC and angling bodies are worried that pine forests tend to acidify the soil and poison the fish.

All this happened, first, because of a tradition started by the Forestry Commission—now trying hard to incorporate conservation measures into their planting policies. The Commission came into existence in 1919 because wartime experience had shown Britain was desperately short of timber as a strategic resource. To this day, Britain import around 90 per cent of its timber needs.

The strategic justification for the Commission's existence was abandoned in the 1950s and the argument became that forestry provided the best prospect of employment in certain rural areas. Since 1980, import-saving has been the main reason for a forestry policy.

NATURE UNDER THREAT



SPECIES displaced by new forests: 1 Stone curlew. 2 Red grouse. 3 Golden plover. 4 Raven. 5 Golden eagle. 6 Greenshank. Not illustrated: Emperor moth, large heath butterfly, bog moss, bog asphodel, bog rosemary, cottongrass, maiden pink. Plantation trees: 7 Sitka spruce. 8 Scots pine. (Source: Nature Conservancy Council.)

The Forestry Commission still runs at a heavy loss and relies on an annual subsidy.

Today the main thrust behind afforestation is private—because it is a perfectly legal tax-dodge. Today's investors are pop stars, snooker players, authors and successful businessmen who buy land and pay a forestry company to carry out the blanket afforestation which allows them to avoid income tax.

The tax dodge works like this. It costs £400 to plant an acre of trees. The Forestry Commission gives a grant of £100 for every acre planted. The purchaser then gets 60 per cent. tax relief on the other £300. He can also sell the forest after 10 years completely exempt from capital gains tax—although his asset may have doubled in value.

Demand for land for tax havens has inflated land prices above what many local sheep farmers could afford. The area most notoriously threatened is the "flow" country of Caithness and Sutherland, an open peat bog which supports populations of rare birds such as greenshank and merlin. The "flow" country is now one-third taken over by forestry interests.

In response to the whole disastrous history of forestry policy in this country, the Countryside Commission, the Government's own quango, now advocates imposing planning controls on forestry.

At present a landowner only has to consult with the Forestry Commission in order to get planting grants. But the Commission's Regional Advisory Committees, which arbitrate in difficult cases, tend to seek compromise, which assumes that some forestry is acceptable.

What is obviously crying out for review is the system of offering tax relief or subsidies for forestry at all.

There is an obvious need to promote forestry in the southern half of the country, where improving and extending derelict broadleaved woodland could both improve the landscape and offer a means of curtailing agricultural production.

As afforestation in the uplands is now greeted with a chorus of disapproval, there is one reassuring fact. Forestry subsidies and tax dodges are a purely national policy which could be thrown out without recourse to the rusty machinery of the EEC.

* Actually a draft report on the performance of the Forestry Commission

2812/37

CONFIDENTIAL

Pps (p)

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 4 November 1986

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Scholar
Mr Bonney
Mr Cropper
Mr Ross Goobey
Mr Graham OPC
Mr Painter IR
PS/IR

Rachel
Content with this approach.
M

TAXATION OF WOODLANDS

The Financial Secretary has had a quick word with Nicholas Ridley about this, after discussing with officials Mr Painter's submission of 21 October.

2. Mr Ridley is sympathetic to the general approach we favour, summarised in Mr Painter's paragraph 14 (ie a phased transition to a consistent Schedule D basis). He believes that the present tax position is absurd and environmentally damaging.

3. Mr Ridley would support action to cut tax relief for forestry, but believes that this could be combined with discrimination in favour of hard-woods (non-conifers). (He also believes that this might be economically sensible as over the longer-term there might be a world-wide scarcity of hard-woods.)

4. However he pointed out that we would need to take into account the objectives of the Prime Minister's Working Party on alternative land use.* He thought that the Revenue would be able to find some way of both reducing the cost of reliefs

*Ch/See separate folder on "ALURE". CST will be attending PM's meeting on Thursday AWK 7/11 and encouraging farmers to find non-farming uses (including hard-wood forestry) for agricultural land. He suggested that one way of proceeding might be to restrict reliefs to working farmers, excluding absentee investors.

5. Any relief would, of course, still have to be front-end-loaded, given the long-term nature of hard-wood forestry. The Financial Secretary believes that Mr Ridley's objectives could be met by a version of the proposed Schedule D changes. One way of doing this would be to move to the consistent Schedule D basis but to restrict the up-front relief for conifers by making losses on the planting and establishing of conifers allowable only against profits from the same activity while permitting losses on hard-woods to be allowable against profits from other income.

6. The Financial Secretary will now pursue with officials how we can best achieve the four basic aims:

(i) To reduce the costs of the current tax regime to the Exchequer;

? (ii) To discriminate against conifers and to encourage hardwoods;

(iii) To ensure that these measures do not conflict with any other decisions that may be made on how to help farmers to convert agricultural land into woodland.

(iv) To look again at the cash regime for forestry.

7. Mr Ridley mentioned that he would be submitting a paper* on the alternative uses of agricultural land to the PM's Group which would include recommendations on the Forestry Commission itself.

J.H.

JEREMY HEYWOOD
Private Secretary

*in "ALURE" folder
dsk

015/2762

PMP

CONFIDENTIAL

FROM: **JILL RUTTER**
DATE: **13 November 1986**

PS/FINANCIAL SECRETARY

cc:
Chancellor
Minister of State
Economic Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Monck
Mr Lavelle
Mr Burgner
Mr Edwards
Miss Peirson
Mr Scholar
Mrs Turnbull
Mr Bonney
Mr Instone
Mr Gray
Mr G White
Miss Sinclair
Mrs Imber
Mr Donovan
Mr Crawford
Mr Deaton
Mr Cropper
Mr Tyrie
Mr McGivern I/R

Ch
(1) I have spoken to PS/CST and made it clear you & CST wanted the 2 sets of issues on forestry (ALURE-type help + offsetting tax abuses) taken forward together.
(2) I spoke to David Norgrove who is firmly on-side on all this. He suggested best tactics were to liaise closely with DOE & I have spoken to Nick Ridley's office – who are all for that approach.
AA

Good –

but whereas depends on speed of progress on Alure

ALURE: TAX ASPECTS

At today's ALURE meeting the Prime Minister commissioned a great deal of extra work on a rapid timescale with a view to the publication of our document in the New Year. The Cabinet Office minutes will record this.

2 Two tax issues came up at that meeting, which the Chief Secretary will need to pursue. On the taxation of woodlands the Chief Secretary put on record the difficulty of doing anything in the 1987 Finance Bill. Nonetheless we may come under pressure to act quickly. I have asked the Chief Secretary if he wants any points, in addition to those recorded in your minute of 4 November, pursued by officials.

3 A separate point arose when Lord Whitelaw suggested to the Chief Secretary that there should be another look at the tax regime as it applied to holiday lettings. Could you arrange for the Chief Secretary to have a note, with the Financial Secretary's views, on the way in which this could interact with the ALURE exercise.

Jill Rutter

JILL RUTTER
Private Secretary

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: E McGIVERN

DATE: 20 NOVEMBER 1986

FINANCIAL SECRETARY

This seems sensible - & quite promising

TAXATION OF FORESTRY: THE ALURE REVIEW
FINANCE BILL STARTER NO 125

1. This paper sets out the position I believe we have reached on Ministers' proposals for a new regime for the taxation of forestry: and considers how best the further work which needs to be done can be progressed in parallel with the studies which the Prime Minister commissioned at last Thursday's meeting on the ALURE report.

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cc Chancellor
Minister of State
Economic Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Monck
Mr Lavelle
Mr Burgner
Mr Edwards
Miss Peirson
Mr Scholar
Mrs Turnbull
Mr Bonney
Mr Instone
Mr Gray
Mr G White
Miss Sinclair
Mrs Imber
Mr Donovan
Mr Crawford
Mr Deaton
Mr Cropper
Mr Tyrie
Mr Graham (Parliamentary Counsel)

Chairman
Mr Isaac
Mr Painter
Mr Houghton
Mr Beighton
Mr Pitts
Mr Cleave
Mr Lawrance
Mr McGivern
Mr Pattison
Mr Whitear
Mr Fitzpatrick
Mr Elliott
Mr Battersby
Mr Johns
Mr Streeter
PS/IR

2. We have noted the Chief Secretary's request - Miss Rutter's minute of 18 November - that we and Treasury officials should be closely involved in securing that the final draft of the paper which DOE is preparing on forestry is satisfactory. Officials of the three Departments are meeting on Friday (21 November) and we shall be discussing this and the general handling of the inputs to the paper on forestry generally (and not just the tax aspects) which the Prime Minister has commissioned and on which No 10 has now said MAFF are to be in the lead - Mr Norgrove's letter of 18 November.

A new tax regime

- Income Tax

3. Mr Heywood's minute of 4 November to the Chancellor's Private Secretary indicates that, following your discussions with Mr Ridley, you see the following as the main planks in a new tax regime for forestry which would be designed to include environmental aspects and reduce the cost of the present tax reliefs to the Exchequer:

a Schedule B would be abolished.

b Loss relief from planting conifers would no longer be available for use sideways against other income but would be restricted to set off against profits from conifers* of, broadly speaking, future years or of the same year if the individual has receipts from other conifer plantations. By contrast, loss relief would continue to be allowed sideways in respect of broadleaf planting.

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*At this stage we are using "conifers" (softwoods) and "broadleaf" (hardwoods) as shorthand for the distinction on environmental grounds. There will no doubt be an argument that in some circumstances Scots Pine, say, is the "right tree in the right place".

4. There would of course be transitional arrangements for existing plantations (hardwoods and softwoods) along the lines set out in paragraph 14 of Mr Painter's submission of 21 October.

- Capital Taxes

5. To reflect the income tax changes, the existing IHT regime could be amended to favour hardwoods:

a with effect from a specified date, an IHT death charge on woodlands could be deferred only for hardwoods (as defined) but not for softwoods, even if planted many years ago in the expectation of deferment; or

b with effect from that date, deferment claims could not be made on a death in respect of softwoods planted after that date, but could for those planted before.

6. IHT charges are unlikely to have a decisive impact on planting decisions. New conifers can take up to 50 years to come to maturity and the present relief is designed primarily to deal with the liquidity problem (the tax has to be paid on a death but the trees are not then ready for felling). Neither option is likely to have anything like the short-term effects on future planting of the income tax changes. Option (a) is more radical since it affects existing softwoods. It might be suggested that this would involve some element of retrospection in disappointing expectations of deferment claims on future deaths in respect of softwoods.

7. In addition, Option (a) would have no disincentive effect in relation to existing softwoods; and the loss of deferment would obviously be resented by the forestry lobby because of its impact on their financial commitments and plans for the future. So Ministers may feel Option (a) goes too far in making the point that conifers are no longer welcome in that it penalises those who planted many years ago. Option (b) delivers the same message but less forcibly.

8. We assume that no change is proposed in the existing arrangements which allow any woodlands, including softwoods, to qualify for heritage relief if they are of appropriate kinds.

"Working Farmers"

9. Mr Ridley has suggested that tax relief for forestry should be restricted to "working farmers excluding absentee investors". We interpret this to mean:

a On the income tax side, and within the discriminatory regime outlined above, sideways relief would only be available to "working farmers" who planted broadleaves. If they planted conifers relief would be available only against income from such plantings. Absentee investors who planted broadleaves or conifers would only get relief against income from such plantings. This of course goes much further (in denying sideways relief for broadleaves to absentee investors) than the scheme outlined in paragraph 3 above. We will clearly need to discuss with DOE officials whether the environmental and agricultural considerations require such a restrictive approach to broadleaf planting.

b On the capital taxes side, it would be possible to revive the working farmer definition from the 1975 CTT legislation (it would take up two or three pages). This would have the effect of limiting claims for deferment to those estates where the deceased qualified as a working farmer or the director of a farming company. But it will not be easy to mesh the IHT provisions in with those relating to income tax. There will be generation gaps, for instance; the IHT charge on the realisation of the timber may not relate to the working farmer who planted it. Given these difficulties, it is for consideration whether a working farmer restriction makes a great deal of sense in the IHT context. The message (hardwoods not conifers) would have been conveyed by the change discussed in paragraphs 5 - 7 above. The effect should be to encourage greater use of land (including marginal farmland) to grow hardwoods. The policy objective could, therefore, be achieved without the working farmer test.

10. We need to do further work in this area, for example we shall have to examine the position of close and other companies (and possibly trusts) carrying on farming on a commercial basis to ensure that sideways relief is available under the "working farmer" arrangements. At first glance we see no insuperable difficulties in achieving the desired objective. If it were decided that a "working farmer" test was not necessary in the IHT context, the definition would still need careful consideration for income tax and CT purposes.

11. However, a system of tax relief based on discrimination between different types of woodlands would certainly need some form of certification of "approved plantings" (particularly for mixed plantations) by whatever body was responsible for planting policy, at present presumably the Forestry Commission.

Taxation of holiday lettings

12. In her note of 13 November, Jill Rutter recorded Lord Whitelaw's request that there should be another look at the tax regime for holiday lettings. This would seem to be the same point recorded at item (v) on page 3 of the note of the Prime Minister's meeting, ie that in the context of encouraging tourism and other non-agricultural enterprises in rural areas, it would be worth reviewing the tax arrangements for, eg, the provision of accommodation on farms.

13. The attached annex sets out the present tax treatment which is already generous in comparison with the taxation of rental income from other property. It also indicates the further improvements which the representative bodies have sought in this area over the last few years. In essence there seems little scope for improving the reliefs themselves; and if the coverage was extended by reducing the qualifying periods, this would risk taking the scheme beyond its objective of providing relief for holiday lettings.

14. I understand we shall be meeting you shortly to discuss the possibility of more general and wide-ranging changes in the tax treatment of landlords' assets and income; there would clearly be repercussions in this wider area if more generous provisions for holiday lettings were introduced in isolation, but if you felt there was some scope for further relaxations in the context of the ALURE exercise, we would be happy to look at this area again.

<u>Timing</u>

15. The Prime Minister asked for the additional papers to be presented within a time limit which would enable Ministers to decide whether they wished "to publish a policy document before the end of January 1987". No 10 have now said that these papers are to be circulated by 10 December for consideration at a meeting in the week beginning 15 December.

16. Clearly the timetable for possible Finance Bill legislation on forestry remains very tight. We are pushing ahead with contingency planning as there is still a great deal of work to be done but provided we can have firm decisions on the final shape of the new scheme early in January, we should then be in a position to instruct Parliamentary Counsel by the beginning of February. However, this is on the assumption that there would be no major changes to the kind of tax regime outlined above which seems to be the kind of scheme Treasury Ministers are aiming for.

<u>Decisions required</u>

17. May we have your authority to take the following line in the further inter-departmental discussions:

a The existing tax regime for forestry no longer represents value for money, and produces results (excessive planting of conifers) which are environmentally damaging.

b There are no longer any compelling reasons for giving specially favourable tax treatment to forestry except on environmental grounds and as part of a scheme to encourage a switch in the use of agricultural land.

c Accordingly Treasury Ministers are proposing significant changes in the existing arrangements which would discriminate against conifers and, if this is what Treasury Ministers wish, would confine sideways relief for losses to "working farmers" (ie excluding absentee investors) who plant broadleaves. However, as mentioned above, we will discuss the broadleaves/absentee investor point with DOE and report the outcome in due course.

18. However, given the substantial ALURE discussions it would seem prudent at this stage to be establishing and attempting to reach agreement on the objectives Treasury Ministers are seeking rather than getting too bogged down on the precise tax route by which they might be secured. We seek your agreement that we should be reasonably flexible on the detail while of course keeping you informed as things progress. We are conscious of the need to avoid any changes on the tax side being used as a pretext to increase Exchequer costs through public expenditure and are in close touch with the Treasury on this aspect.

19. Furnished lettings - this too can be looked at as part of the further ALURE review (although it is not of course related to the forestry study). In this respect, it would be helpful to know whether you would wish to make improvements in the present tax regime and, if possible, what further relief you envisage might be allowed.

20. We are available if you feel a discussion would be helpful.

E McGivern

FURNISHED HOLIDAY LETTING RELIEFS - FACTUAL NOTE

Background

1. Special reliefs for furnished holiday lettings were introduced in 1984 (Section 50 and Schedule 11, Finance Act 1984).

2. The general tax rules are that furnished lettings - to which these reliefs provide an exception - are taxed under Case VI of Schedule D:

- expenses incurred wholly and exclusively on the lettings are deductible, e.g. maintenance, decoration, cleaning, insurance, interest on loans to acquire or improve the property, and management fees

- there is a flat rate allowance for wear and tear on furniture equal to 10 per cent of rental income; or actual renewal costs are deductible

- losses can be set against Case VI income of the same or future years, but not against any other kind of income

- reliefs available to traders - e.g. CGT retirement and roll-over relief, retirement annuity relief - are not available.

What do the special reliefs do?

3. Essentially they give furnished holiday landlords all the reliefs they would get if they were trading, i.e.-

- they can pay tax for each year in two equal instalments

- they can get wider relief for losses, e.g. sideways relief against other income, carry back of losses in the early years of a business and on termination

- their letting income is treated as relevant income for retirement annuity relief, and as earned income (relevant to wife's earned income allowance)

- they can get capital allowances on furniture and fittings

- they qualify for CGT reliefs, e.g. retirement and roll-over relief

- they can get a measure of relief for pre-trading expenditure.

What conditions have to be met to get the relief ?

4. The accommodation must be -

- available for commercial letting to the general public for not less than 140 days in the year

- actually let for not less than 70 days in the year

- not let to the same person for a continuous period of more than 31 days. This condition applies only for a period of 7 months, which need not be continuous but must include the months in which the 70 days actual letting occurs.

What representations have been made for widening the relief?

5. The NFU have asked for the test of availability to be reduced from 140 days in the year to 70 days, and for the actual letting test to be reduced from 70 days to 50.

6. Comment: The legislation as introduced provided for periods of 180 and 90 days respectively. Ministers reduced the periods in response to representations in Committee, but saw no case for going further than the present figures. On availability, it seems reasonable to expect commercial holiday lettings to be available for a period of four-and-a-half months of the year.

On actual letting, if the requirement were reduced further there would be a danger of allowing second home owners into the relief.

7. The Scottish Landowners Federation have asked for the seven month period to be reduced, so as not to discourage letting to students out of season.

8. Comment: The legislation was specifically designed to help people mainly engaged in holiday letting rather than any other kind.

9. Finally, the CLA, SLF and Law Society of Scotland have asked for CTT/IHT business relief to be available automatically to landlords of furnished holiday lettings. The point here, very briefly, is that IHT business relief is not available where the business activity consists wholly or mainly in the making or holding of investments. The relief therefore runs to furnished holiday lettings if the level of facilities and services provided are sufficient to make the business more than the simple letting of property.

10. Comment: Ministers have consistently resisted pressure for legislation on this point. It seems likely that the point will not be material in very many cases; and with this year's abolition of CTT on lifetime giving it seems likely to be of even smaller practical significance in future.

TAX TREATMENT OF FORESTRY

CONFIDENTIAL

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

[Mr Bradley v cmfn]

FROM: M A JOHNS
DATE: 6 MAY 1987

The C.G.T. option (para 23.) is a new idea. Mr. Johns has already identified in the paper some of the problems with it and it would look very different if there were a radical reform of C.G.T. itself. I have argued in earlier minutes that retention of Sch. B in a 'reformed' regime looks distinctly unattractive: that remains my view. JA 16-5

1. MR PAINTER ✓

2. CHIEF SECRETARY

THE TAX TREATMENT OF FORESTRY

1. In my note of 13 April I promised you a submission on the options for a radical change in the tax treatment of forestry. A provisional package had, as I explained, been agreed by Treasury Ministers as the objective to pursue in the inter-departmental ALURE discussions. But in the event, Ministers decided in ALURE that there was a strong case for a fundamental review of forestry policy including the tax incentives but that the time was not ripe. In this note we have gone back to first principles to consider the options which could be pursued rather than restrict our analysis to the package provisionally agreed last year.

2. This note does not address the possibility of Inheritance Tax changes. At present standing timber in a forest run on commercial lines is entitled to the IHT relief for business assets and there are in addition special rules to allow deferment

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cc Chancellor of the Exchequer
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Mr Burgner
Mr Scholar
Mr Bonney
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Chairman
Mr Isaac
Mr Painter
Mr McGivern
Mr Houghton
Mr Beighton
Mr Elliott
Mr Battersby
Mr Cayley
Mr Pattison
Mr Johns
Mr Streeter
PS/IR
Mr Lawrance

of the tax until the timber is cut down and sold. It would be possible to remove the special deferment rules and treat timber like any other illiquid asset (i.e. with tax payable in instalments over 10 years) or, indeed, to remove business relief as well and treat timber like passive investments such as shares which are subject to the tax in full. If you were interested in pursuing either option we could let you have a further note but you may prefer at this stage to concentrate on the major issue of the income tax treatment.

OBJECTIVES FOR CHANGE

3. There are three main issues about the objectives of any change which need to be settled before the options can be assessed.

Neutrality or support for forestry?

4. The first issue is whether forestry should be put on all fours with other industries and investments or whether there is a case for encouraging new planting of trees beyond what market forces would produce under a neutral tax regime. The arguments usually advanced for Government support for forestry are:

a) The UK imports over 90% of its timber and a subsidy is needed to build up a strategic reserve, especially in view of a likely worldwide shortage of timber in the next century as forests abroad are cut down. Timber is, however, no longer an obvious strategic material militarily. And as far as an economic reserve is concerned, if the private sector foresees a shortage it should be prepared to invest in the expectation of rising prices without Government support. And against the likelihood of reduced supply of timber has to be weighed the possibility of substitute materials for wood emerging especially if prices start to rise. Only if the Government believes that "short-termism" in what is inevitably a very long-term market is likely to lead to under-investment should it intervene.

b) Benefits to rural employment. Forests provide jobs in parts of the country where other work is scarce (both directly and through associated industries such as paper). A full scale study of cost per job would be necessary to assess whether assistance to forestry is the most cost-effective way of providing jobs but previous studies have tended to cast doubt on this.

c) Amenity benefits. Forestry enhances scenery and provides amenity to holiday makers and this justifies a subsidy. Again there is an issue of priority as opposed to other environmental expenditure on which other departments' views would have to be sought. Moreover, it is not all gain: there is widespread criticism from the environmental lobby that some forests detract from both scenery and ecology.

d) An argument that weighed quite heavily in the ALURE context was that the level of subsidy on woodlands was actually less than if the same land was used for agriculture so long as the Common Agricultural Policy remains unchanged. The correct solution is, of course, to reduce agricultural subsidies and not to increase forestry subsidies to compensate. However, the Government may be forced onto second best solutions by what is practical.

Should support be by tax break or grant?

5. If it is felt that some support is necessary the next question is whether it should be provided through the tax system or directly by grant (or, as at present, by a mixture of both).

6. The major disadvantage of giving support by tax relief is that it provides a disproportionate tax break for those with high incomes which can be criticised as inequitable. The general thrust of the Government's tax policy has been to get away from special tax reliefs for favoured activities and instead to reduce

rates of tax generally. Forestry reliefs have been widely criticised as providing unjustified tax shelters to City and entertainment personalities. Forestry did not show up as one of the most important shelters in our survey of high earners' tax shelters (my note of 17 October 1986 on Minimum Tax) but it is widely advertised as a medium for tax saving and, unlike many alternatives such as BES, there is no limit on the extent to which any one individual can take advantage of it. Tax reliefs also have the disadvantage of not being transparent: while the cost is published in the Public Expenditure White Paper, they are not subject to the same scrutiny and control as public expenditure support while being equally a drain on the Exchequer.

7. Against this, the main advantage of tax relief is that it involves less bureaucratic interference with individual investors' decisions than a typical grant system. With a grant the investor has to get individual decisions approved; with tax relief he merely has to satisfy general conditions set out in statute. It might be felt that another advantage of grants it that the cost of support does not add to public expenditure totals; but this is the other face of the lack of transparency mentioned above. Finally, it is easier potentially to defer the cost of tax relief to the Exchequer; tax reliefs can be concentrated at the end of a forest's life by reducing the tax on receipts from felling, whereas grants are more naturally given at the front-end when the decision to plant is taken. Again this is not all gain - the costs of tax relief are hidden by the deferment and are a substantial bill which will have to be met by the Exchequer in the next century.

Environmental considerations: the case for differentiating between woodlands?

8. The third issue, regardless of whether grants or tax reliefs are employed, is whether the regime should differentiate between different types of woodlands on environmental grounds.

9. The environmental lobbies are by no means united in their approach to forestry but there is a general thread of criticism of existing tax policy that it leads to afforestation of land which would otherwise be left bare with large blocks of conifer forests which are unsightly, discourage wild life and pollute water by acidification. In areas like the Scottish "flow country" they are criticised as spoiling a unique wilderness habitat. This is not because the tax system positively favours this sort of forestry: tax does not discriminate by type or location of forests. Rather, conifer forests in large blocks on poor land show the highest rates of return compared with alternative uses of the same land. They are more profitable than broadleaves because of their shorter life-cycle. So a tax system which encourages forests leads to conifers disproportionately being planted. There have been some suggestions that as the tax system encourages planting by top rate taxpayers it encourages planting by absentee landlords who are less sensitive to the environment than locals would be. We have, however, seen no firm evidence on the point and the Forestry Commission in discussions with us were sceptical.

10. If some differentiation were thought to be desirable, it would be necessary to decide whether it should be by a broad-brush approach of "conifers bad, broadleaves good" or by a more subtle approach of "the right tree in the right place". While generally there appears to be a predisposition to regard broadleaved woodlands more favourably than conifers on environmental grounds, it is arguable that the environmental problems are not caused by conifers as such but the wrong sort of conifers in the wrong places. In the right places conifers may be as deserving of support as broadleaves.

Conclusions on objectives

12. In the Revenue, we are not in a position to assess the weight of these arguments without the sort of inter-departmental consultations envisaged by ALURE and one approach would be to defer your final decision until this is possible. Alternatively

you may feel that a broadly neutral tax regime - consistent with the thrust of tax policy generally for neutrality - should be settled first and then the grant structure (if any) constructed to encourage whatever planting is desired over and above what market forces would produce. Certainly a clear view by Treasury Ministers on the proper tax system would help to focus the attention of other Departments on the need for achieving a more rational overall regime.

THE PRESENT REGIME

13. At present an occupier of woodlands managed on a commercial basis with a view to profit is taxed under Schedule B. This is in principle a tax on one-third of the value of the land in its natural state but, in practice, because the valuations on which it is based date back fifty years, it is a purely nominal charge (on average about 15p an acre). In addition the taxpayer has an option to elect for Schedule D. The normal practice is for an occupier in the early stages of a woodland when costs are heavy and there are no receipts to elect for Schedule D. He is then able to claim the expenditure as a loss and set it sideways against other income for tax purposes. An ordinary commercial firm would probably not show this as a loss in its accounts because it would carry forward the planting. Most probably the expenditure on planted trees would be shown as work in progress or stock in trade and be shown as an asset in the accounts at cost. However, under case law it has been held that for the purposes of the Schedule D option standing timber does not constitute stock in trade and so for tax purposes the forester is able to claim a loss.

14. An occupier cannot change his election so it is normal when a woodland reaches maturity and starts to produce receipts to engineer a change of occupation. (This can be an arm's length sale or just a transfer to a family trust or another member of the family). Consequently, although the expenses have received tax relief (at 60% if, as is usual, the first occupier is a top rate taxpayer), the receipts are effectively exempt. If timber

was treated as stock in trade, the old occupier would be liable to income tax at his marginal rate on the increase in value of his timber to the date of disposal. But because of the case law mentioned above he escapes income tax. The new occupier will be liable to Schedule B and effectively pay no tax on the receipts.

15. The Annex to this note sets out our understanding of the economics of a typical conifer plantation and a typical broadleaved plantation. The figures are derived from information provided by the Forestry Commission but the Commission have not vetted them in detail and they may well need considerable revision on discussion with other departments. Figures for individual plantations will in any case vary according to position, quality of soil, etc. It can be seen that the pre-tax internal rate of return on the conifer plantation is increased by tax from 4.9% to 6.7% and that on the broadleaved plantation from 2.7% to 3.7%.

16. In addition there are substantial grants available from the Forestry Commission provided they approve the plans for planting; these further increase the rates of return to the investor to 7.3% for conifers and 4.3% for broadleaves.

WHAT WOULD NEUTRALITY CONSIST OF?

17. So far I have spoken of a neutral tax system as if this were an unproblematic concept. However, even if it were agreed that no special support should be given for forestry there would be room for disagreement on what the proper tax treatment ought to be. Forestry is somewhat of a hybrid between a business activity and a passive investment (like investment in fine art or equity shares). It would in principle be possible to differentiate between investors for whom forestry was run on business lines (e.g. farmers who combined farming with growing trees) and those for whom it was an investment (e.g. entertainers or City businessmen). And some thought was given last year to distinguishing between working farmers and others. But in practice the dividing line would be arbitrary and contentious.

It would seem preferable for all commercial woodlands to be treated the same way. A decision has to be taken on whether to align it broadly with the Schedule D Case I rules for businesses or with one of the various regimes for passive investments.

18. Forestry is also unusual in its very long life cycle between initial expenditure and eventual receipts from felling. So, if it were regarded as a business, it would raise questions about whether initial expenditure should be allowed to create losses which can be carried sideways and set against other income or whether such expenditure should be carried forward treating the expenditure on the planting and maintenance of the trees as well as the expenditure on the trees themselves as being in the nature of stock in trade and work in progress. As explained above the Courts have held the former, but in economic and accountancy logic there is a lot to be said for the latter view. But if the latter view is taken, forestry would suffer compared with other businesses because of the very long time it would have to wait for relief for expenditure, during which time even modest inflation would substantially erode the value of the relief. There would be a case for special relief for forestry to compensate for this (at the risk of creating precedents for other businesses with fairly long life cycles such as whisky distilling). There is also a problem that receipts are lumpy and could push taxpayers into higher rates of tax without some measure of spreading.

19. If, by contrast, forestry is regarded as a passive investment there are a variety of different tax treatments for savings with which it can be aligned. The most obvious, probably would be to treat it like, say, fine art: to allow no relief on the initial expenditure but to treat any increase in value over cost as a capital gain. But an alternative would be to continue to regard the receipts from felling as income. If no privilege at all were given to forestry this would imply giving no income tax relief for the initial expenditure and charging receipts less expenditure in full to income tax. But there is a range of other investment media which receive some degree of privilege and an

alternative would be to align forestry broadly with one of these. There are two main models: the pensions fund type of treatment where relief is given on the initial investment but eventual receipts are charged in full and the PEP's type of treatment where no relief is given on the initial investment but the receipts are exempt.

20. This means that even within normal tax principles there are a variety of options which could be justified. Four are considered further here, in decreasing order of severity on the industry.

THE OPTIONS

Option 1 - Treatment as a Business on Normal Accountancy Principles

21. Schedule B would be abolished and the occupier of commercial woodlands would be taxed as a business under Schedule D Case I. In addition timber would be treated as stock in trade. This would mean that a forester no longer made large losses in the early years and so was unable to take advantage of sideways relief against other income. On selling the timber (either felled or standing) he would be taxed on the difference between receipts and expenditure during his occupation. (A broadly similar result could be achieved by continuing not to treat timber as stock in trade but legislating directly to stop sideways loss relief for woodlands and to charge disposals of standing timber to tax).

22. This would be the most onerous basis of taxing forestry (more onerous than has been proposed in previous reviews) but would put forestry on all fours with other business activities. However, as explained above, it could be argued that the special features of forestry would justify some amelioration. The lumpiness of receipts could be dealt with by some form of spreading provision. But the effect of inflation in eroding the real value of tax relief for expenditure could only be met within

this approach by the revival of some form of stock relief which would expose Ministers to claims for similar treatment by other industries adversely affected by inflation. (The whisky industry has been pressing strongly for the last 3 years). Another corollary of this option would be that tax exempt institutions such as pension funds would be liable tax on forestry (as trading activities are not exempt) so reducing its attractions for institutions compared with other investments. There could be a specific exemption for institutions if Ministers wished, though there is no particular need to extend the privileges of pension funds.

Ch
See Terry Painter's manuscript note at head of this minute
DWK

<u>Option 2 - Capital Gains Tax Treatment</u>

23. The commercial occupation of woodlands would be taken out of income tax completely and put within the capital gains tax regime (i.e. treating it as a passive investment). This would mean that there was no immediate relief on expenditure but when timber was sold (either standing or felled) the deduction for expenditure in the capital gains computation would be enhanced by indexation relief. And the problems of lumpiness of receipts would be less serious because capital gains tax is charged at a maximum flat rate of 30%. Special rules would need to be laid down for computing the eligible expenditure as the present CGT rules are not easily applicable to the sort of expenses incurred in forestry. These would be detailed and complex. And there might be problems over defining what the asset disposed of was. Moreover the difficult question would be raised of how far in principle the tax system should be indexed, in particular whether some sectors and not others should qualify for what would effectively be a form of stock relief. The charge would also be only partial in its impact. There is a large annual exemption, retirement relief and total exemption on death. The logic of this approach would also involve pension funds and similar bodies being exempt as they are on other passive investments (though again this could be explicitly overridden if so desired).

Option 3 - Tax on Profits but retaining Sideways Relief

24. Schedule B would be abolished and the occupier of commercial woodlands would be liable to Schedule D Case I as a business. Unlike Option 1, timber would not be treated as stock in trade, so the forester would have tax losses in the early years which he could set sideways against other income. It would, however, be most desirable to introduce a charge on the sale proceeds of standing timber when that timber was sold with the land. At present this escapes charge but when the trees are subsequently felled the purchaser (if liable to Schedule D - which he normally is not) is liable to tax on the full value of the timber without any deduction for the price he paid for it. Under this option the purchaser would not be able to opt for Schedule B and so long as institutions were also taxed on the profits from woodlands, the price the purchaser paid for standing timber would reflect the (discounted) cost of the tax which would eventually be due. The seller would therefore indirectly bear some tax on the increase in value of the woodlands. But the more direct and straightforward way of ensuring that tax was paid (rather than replicate the present position where relief is given on expenditure but no tax paid on receipts) would be to impose a charge on the value of standing timber disposed of.

25. This option would treat forestry more favourably than other businesses (but less favourably than at present). The privilege could be justified by reference to the special features of forestry in particular the long lead times. Sideways relief for initial expenditure (since it follows long-established case law) would probably expose you to less pressure for similar reliefs than indexation.

Option 4 - Exemption

26. Commercial woodlands would be completely exempt from tax. There would be no relief on initial expenditure and no charge on eventual receipts. If thought presentationally preferable, an equivalent effect could be achieved by withdrawing the Schedule D

option and taxing woodlands to Schedule B throughout their life. Because the present regime effectively subsidises forestry (see paras 13-16 above), exemption would paradoxically be more onerous than the present position. But it would be more favourable than that enjoyed by other industries and the privilege would be very apparent and difficult to defend.

EFFECT ON NEW PLANTING

27. The Annex sets out the effect of the various options for the tax regime on the expected rate of return for model conifer and broadleaved plantations. The cost of land is ignored and the price of timber is assured constant in real terms. In summary the position (ignoring inflation) is as follows:

Internal rate of return % (real)

	Conifers	Broadleaves
Pre tax	5.0	2.9
Present regime (without grants)	7.1	3.8
Present regime (without grants)	7.8	4.5
Option 1 (without grants)	4.2	2.1
Option 2 (without grants)	4.5	2.6
Option 3 (without grants)	5.0	2.9

Option 4 (without grants)	5.0	2.9

28. Under the present regime about 20,000 acres of new woodlands are planted a year, nearly all conifers. The Government's express target (reiterated in the recent ALURE consultative paper) is to increase this to 30,000. Any of the options discussed in this paper would be likely to lead to a substantial reduction in the area of new planting unless there was a compensating increase in grants. Option 1 would have the greatest effect: indeed it might well lead to very little new planting being undertaken as the rate of return on a typical conifer plantation (ignoring the cost of land) would be around 4% and that on broadleaves around 2% (if no grants at all were given). And even with the other Options the effect is likely to be significant: rates of return without grant would be 5% or less for conifers and below 3% for broadleaves. Quite apart from the effect on expected returns there could be damage to confidence merely in the fact that the Government was altering a regime which had been unchanged for 70 years. The forestry organisations could be expected to make a great point of this. But these effects are, of course, indicators that market forces unaided by government support would probably lead to very little planting. Whether there is a case for a higher level of planting depends on the arguments touched on in paragraph 4 above.

29. In principle, increases in grants could offset this effect within the total of support given by the Exchequer at present. But in practice two points need to be borne in mind. Much of the tax relief does not accrue until the final felling; the cost of grants to the Exchequer would typically arise much earlier (at present on planting, though they could be spread over the life of the woodlands). And because of the effect on confidence the new regime might have to be more generous than the old one to achieve the same level of investment to overcome the fear that if the Government had once changed the regime a future Government might make further adverse changes.

30. In considering the appropriate grant regime it would be necessary to consider also the tax regime to be applied to the grants.

EFFECT ON EXISTING FORESTS (THE TRANSITIONAL PROBLEM)

31. Because investors have made their decisions in the expectation that eventual receipts will only be charged to Schedule B, there would be strong pressure on Ministers to exempt existing woodlands from any change (except in the case of Option 4 where receipts would remain exempt). This would mean an enormously long transitional period (over a century in the case of broadleaves) and it would involve difficult problems of identification where parts of forests were felled and replanted at different times. There should, however, be no significant adverse effects on existing forests as their occupiers could continue to expect the same returns as at present. (There could be some adverse effects if the general contraction of new planting repercussed on the expertise available to service existing woodlands).

32. With shorter transitional periods, not only would there be criticisms of undermining the basis on which investments were made (investments which were in line with the then prevailing Government policy) but there would be risks of adverse effects on the management of existing woodlands depending on how the transition was implemented.

33. Taking first the options which withdraw or defer relief for expenditure (Options 1, 2 and 4), there would almost certainly need to be a let-out for the first two years of expenditure on woods already planted because expenditure is heavy over this period. Thereafter, if relief is removed there could in principle be some reduction in maintenance at the margin and a disincentive to incur heavy capital expenditure (though under Option 1 expenditure qualifying for capital allowances could continue to be carried sideways). But with the bulk of costs being sunk, there should be a continuing incentive to look after

the forests. It would be possible either to give expenditure relief for a fixed period of years or so long as the woodlands stayed under the same occupation.

34. On the options which impose a charge on receipts (Options 1, 2 and 3) a fixed period (or a period linked to occupation) would provide a strong incentive to fell trees before the period expired (or occupation was transferred) even if it was more economic pre-tax to let them grow longer. A limit linked to occupation would probably be less distortionary than one with a fixed time-limit. Occupiers liable under Schedule D would not be able to escape tax by felling before disposal because Schedule D imposes a charge on felling: so they would not have an incentive to fell early. Occupiers liable under Schedule B would have an incentive to fell before they disposed of the woodlands, but these woodlands would be mainly mature ones anyway.

35. Even if existing occupiers were allowed to retain the present rules they would not get effective protection from the tax change unless forests were exempt until felling. This is because the sale price of standing timber would immediately fall to reflect the increased tax charge on purchasers and this fall in the value of standing timber would be borne by existing occupiers. How large the reduction in wealth would be is hard to estimate but in principle imposition of full income tax rates could effectively cut the value of forests (apart from the land) by up to 60% or the imposition of CGT by up to 30% unless there were grants to compensate. In practice these would be very much upper limits but the effects would be severe and complaints could be expected. While no taxpayer can expect as of right that tax on his activities will be unchanged for a century or more, effects of this magnitude might be felt to be unacceptable.

36. An alternative approach would be to exempt from tax on eventual felling the value of woodlands accrued to the date of the change. This would involve applying some formula which approximated to the rate of growth of timber and charge only a fraction of final receipts which related to growth after the date

of change. This would be complex but would involve less criticism of retrospective confiscation of wealth.

ENVIRONMENTAL DIFFERENTIATION

37. If you wished (as discussed at paragraphs 8-10 above) to differentiate between forests on environmental grounds you would need to decide whether the differentiation should be through the tax system or by grant.

38. Under the present rules the Forestry Commission can exercise some influence on the location and type of planting through grants which depend on their detailed approval of plans. Very few planters in practice proceed with afforestation without a grant as well as tax relief (though there have been a couple of cases which caused considerable protests). However, the Commission have not succeeded in stemming the criticism from environmental bodies. If grants were made a larger feature of the new regime the Commission's influence would be greater but to achieve a change in the type of forests being planted it would be necessary to change their terms of reference to give greater weight to the factors which are bothering the environmental lobby.

39. Alternatively it would be possible to introduce a measure of discrimination within the tax system by giving a more generous regime to favoured woodlands rather than unfavoured ones. It would not be possible for the Revenue to operate a discretionary system so the discrimination would have to be very crude, e.g. one regime for broadleaves and a less favourable one for conifers. There would be considerable problems of definition at the margin for mixed forests (including cases where the bulk of the woods was of one type but a windbreak of a different sort was planted). And the discrimination would be very crude: it is arguable that the environmental problems are not caused by conifers as such but the wrong sort of conifers in the wrong places and that in the right places conifers are as deserving of support as broadleaves.

40. Another option would be for the tax treatment to depend on the discretion of the Forestry Commission or some other environmental body. At one time CTT relief was only available to woodlands dedicated under Forestry Commission schemes but in 1977 the condition was removed retrospectively after representations from the private forestry interests. It was felt that there was no fiscal case for retaining a link and that it was wrong to exclude large areas of forests outside the dedicated woodlands scheme. But these arguments are not necessarily decisive. On the whole Treasury Ministers have tried to avoid tax reliefs depending on discretion, especially by bodies outside the Revenue. But there are examples such as the Secretary for Trade and Industry's role as final arbiter on what constitutes scientific research for scientific research allowance. And if the object was to encourage particular types of woodlands it would be in the nature of things that woodlands which did not meet the criteria did not qualify for relief.

41. If the discrimination were through the tax system it would be necessary to adopt a fairly tough option like Option 1 for conifers (or woodlands not certified by the Forestry Commission) merely in order to provide sufficient differentiation between the favoured and the unfavoured regime to have any effect. It would probably be necessary to superimpose grants if either sort of forest were to be attractive financially (broadleaves look fairly unattractive whatever the tax regime and conifers do not look attractive under Option 1). That being so it is for consideration whether it would not be simpler and allow better targeting to employ a uniform tax regime and differentiate (as at present) through grants.

EFFECT ON TAX YIELD

42. We estimate the short-term yield at £10-15m a year from Options 1, 2 and 4 and nil from Option 3; the long term yield from Options 1 and 3 is around £100-£125m , while that from Option 2 would be some £10s of millions (particularly uncertain) and from Option 4 there would be no increase over and above the

short term yield. These figures are very approximate and ignore changes in behaviour. They are highly dependent on what people would do who at present invest in forests. If there was a compensating increase in grants so that existing planting volumes were maintained the yield in tax would correspond with those above but there would be a substantial increase in public expenditure (which we cannot cost) from extra grants. If there was no increase in grants (or a reduction) then the volume of planting would fall off steeply, and tax savings would depend on what people did with their money instead. If they invested the money in non tax privileged investments then the Exchequer would save the £10-15m short term cost of tax relief and would earn tax on the profits from the alternative investments in the long term. To the extent that the present tax system is encouraging sub-optimal investment in forestry the yield could well be more than the £100-£125m directly foregone on forestry and come earlier.

43. But the forestry lobby and the agricultural departments argue that in practice the sort of people who invest in forestry would find alternative tax shelters or would avoid or evade tax so the Exchequer would not benefit by anything like this amount. To the extent that they invested in alternative tax shelters like BES or enterprise zones Government policy in these areas would be correspondingly benefited. To the extent that they evaded or avoided tax (e.g. by shifting money offshore) there would be less gain or even a loss to the UK economy and the Exchequer.

44. It is not easy to tell where between these extremes the reality would lie. It is, however, rather pessimistic to assume that there is a fixed proportion of income that will be sheltered by fair means or foul whatever the tax law. If a strategy of lower tax rates and less tax shelters and reliefs is worthwhile one has to assume that a considerable proportion of the tax foregone on forestry would in fact be regained if the regime were rationalised.

EFFECT ON ADMINISTRATIVE AND COMPLIANCE COSTS

45. The present system of forestry taxation involves very little cost either to the Revenue or the taxpayer. Complete exemption (Option 4) would remove even that cost. But the other options would require taxpayers to submit computations of profit on felling and disposal of woodlands which are not at present necessary. Where disposals are not arm's length there would be valuations to be made of the arm's length value of the timber. This would cause both us and taxpayers some additional work. But the cost would be small and build up very slowly if there was a long transitional period and, for taxpayers, we assume that most of the necessary records are kept for their own purposes anyway.

HANDLING

46. In view of the gaps in the above analysis which can only be filled in through consultation with other departments and given the interaction with grants, it would not be possible to implement any of these Options in the 1988 Budget without Treasury Ministers consulting their colleagues. In the light of the ALURE discussions other departments will be expecting no proposals for change in advance of an interdepartmental review. But you indicated that you might want to negotiate for tax changes as a quid pro quo for agreeing to legislation to implement the farm woodlands scheme as published in the ALURE Consultation Document. In any case you had in mind inter-Ministerial soundings well in advance of next year's Finance Bill.

47. If you want to keep open the possibility of legislation in the 1988 Finance Bill we need to work out a scheme over the summer which would not be radically changed in consultations with other departments. It would not, for example, be possible to start discussions in November, obtain by February a consensus in favour of a scheme which we had not worked up and hope to have workable legislation in next year's Finance Act. On the other hand, there is a limit to the number of different options which

we could fully work up on a contingency basis. One possibility would be for Ministers to indicate now which option they prefer, for us to work it up and attempt to agree it with other departments in the Autumn. If we were successful it could be introduced in the 1988 Budget though this would give very little time for departments to agree a common line on grants which would need to be announced at the same time. If we were unsuccessful and Ministers collectively decided on a totally different approach it would be necessary to defer legislation to 1989. Alternatively, Ministers could set that as their target in any event and press for a review immediately after the election which could be followed by a consultation document on both grants and tax together. In this case we need a Ministerial steer on their preferred outcome from the review but it does not have to be worked up in so much detail.

POINTS FOR DECISION

48. There are two main objectives of Government policy which are to some extent in conflict:

i) the agricultural departments' objective of encouraging diversification from agricultural production and, as part of that objective, to increase the amount of new forestry from 20,000 to 30,000 acres a year; and

ii) your own objective of putting the present antiquated tax regime on a more rational basis for the future which necessarily involves a restriction in the existing reliefs (though these could be matched by an improvement in grants).

Against this background, the points for decision are:

a) Do Ministers want to keep open the possibility of legislation in Finance Bill 1988?

If so

b) Which of the options 1-4 would they like worked up?

c) Would they like a further paper on the transitional problems?

d) Do they want a paper on possible inheritance tax changes or should this be put on one side for the time being.

e) Do they agree that consultation with other Departments is necessary and when do they see that being set in hand?

If not

f) Do they agree we should press for an interdepartmental review immediately after the election?

g) Do they want further work done on any of the Options in advance of the review to enable them to give us a steer on their preferences?

49. We are ready to discuss this with you and/or the Financial Secretary if you wish.

M. A. Johns

M A JOHNS

ANNEX

BASIC FORESTRY ECONOMICS

In 1984 the Treasury and Forestry Commission agreed figures for a typical hectare of Sitka spruce, as a benchmark case for calculating the effects of the tax and grant regimes.

These figures have been updated to 1986 prices, with revised estimates of initial costs (agreed with Forestry Commission in January 1987) assuming good quality land. At current prices (before taking account of future inflation) they are:

SITKA SPRUCE - 54 year cycle

Costs			Returns		
Annual	Maintenance	10	Year 29	Thinning	230
Year 1	Plough/scarify	80	Year 34	"	435
	Fence	120*	Year 39	"	550
	Plant	200	Year 44	"	645
Year 2	Beat up	50	Year 49	"	740
	Weed	80	Year 54	Felling	7925
Year 3	Weed	80			
Year 4	Weed	80			
Year 8	Clean	50			
Year 15	Fertilise	40			
Year 21	Brash	5			

* Agricultural buildings and works allowances are available on this item at a straight line rate of 4% in each of years 1 to 25.

The equivalent figures for a typical broadleaf wood, (on which the figures for returns are less reliable) are estimated as:

BROADLEAF - minimum 108 year cycle

Costs	Returns		
as above	Year 58	Thinning	390
	Year 68		740
	Year 78		940
	Year 88		1100
	Year 98		1260
	Year 108	Felling	13470

Grants are available on new planting at rates for 1986 of

£240 per hectare for conifers
£470 per hectare for broadleaves

where the area planted exceeds 10 hectares. 80% is paid in the first year and 20% four years later. A higher rate of £600 is paid for broadleaf plantations which meet special requirements as to nature conservation, recreation, sporting facilities, etc.

Effect of different tax regimes Ignoring the cost of land, the internal rates of return on the basis of these figures are shown in the table below.

		With grant	Without grant				
		Present tax regime	Present tax regime	Option 1	Option 2	Option 3	Option 4
ITKA SPRUCE	Zero inflation	7.8%	7.1%	4.2%	4.5%	5.0%	5.0%
	3% inflation	"	"	4.0%	"	"	"
	5% inflationn	"	"	3.9%	"	"	"
ROADLEAF	Zero inflation	4.5%	3.8%	2.1%	2.6%	2.9%	2.9%
	3% inflation	"	"	1.9%	"	"	"
	5% inflation	"	"	1.9%	"	"	"

NOTES ON TABLE

Effects of different tax regimes

Under option 1 for income tax considered in the paper, expenditure incurred in the early years could only be carried forward to set against later receipts from thinning and felling. Under option 3 the expenditure could be set sideways against other income of the year. In both cases receipts would be taxed under schedule D instead of schedule B.

A 60% tax rate is assumed throughout the cycle.

Option 2 would charge receipts to capital gains tax, with expenses offset in the year of receipts, after indexing for inflation.

Grants

Figures for the various options are shown without taking account of grants, because it is at present unclear what system of grants might be adopted in the face of these tax changes.

Effects of inflation

All the calculations so far are in real terms, that is, before taking account of inflation. Inflation affects the figures in two ways.

First, because capital allowances are given in nominal terms, their value is eroded by inflation over the 25 years for which 4% of the fencing costs is allowed. This affects all the income tax systems (the present regime and options 1 and 3) similarly, but is not significant.

Secondly, under income tax option 1, expenditure in the early years would have to be carried forward in nominal terms only, so that when the losses came to be offset against proceeds from thinning, they would have been eroded by inflation. Of course this problem does not arise under the present tax regime or option 3. Again the effect is not very significant.

The capital gains tax route, option 2, is completely unaffected by inflation, because all expenses are indexed.

4372/047 Note

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

NOTE OF A MEETING IN FINANCIAL SECRETARY'S OFFICE, HM TREASURY ON WEDNESDAY 1 JULY TO DISCUSS TAXATION OF FORESTRY

Those present:	**Mr Painter**	**IR**
	Mr Beighton	**IR**
	Mr Johns	**IR**
	Mr Burgner)	
	Mr Bonney)	**HMT**
	Mr Haigh)	
	Mr Cropper	
	Mr Tyrie	

The meeting discussed Mr John's notes of 29 June and 6 May and also had before it Mr Bonney's note of 30 June.

2. Mr Painter briefly outlined and expanded upon the various options that had been set out in Mr Johns' note, and set this against the background of a special forestry relief which was in place because of the uniquely long forestry cycle and also the 'lumpiness' of profits in the industry.

3. Option 1 involved the abolition of Schedule B and the taxation of the occupier of commercial woodlands as a business under Schedule D. This was the treatment comparable with other industries but would be severe in its effects. Option 2 (Capital Gains treatment) would undoubtedly be difficult to operate over a long time-span and if capital gains indexation were to be abolished there would be the difficulty of having a special regime for forests. There could also be a long-term compliance cost and it would be very difficult for the Revenue to police. Mr Painter did not see this as a very workable or attractive option since it would in effect mean being locked into an awkward indexation regime.

4. Option 3 involved the addition of Schedule B with sideways relief available on the Schedule D charge. This would probably be the strongest runner in Mr Painter's view. Mr Johns said that the addition of front-end relief made it less severe than Option 1.

On purely presentational grounds alone Mr Painter thought that Option 4 would have to be ruled out since it would be very difficult to explain to the outside world that exemption would actually make the forestry industry worse off than at present.

5. Discussion moved on to the transitional problems that would be experienced if Option 3 were to be pursued. If there were no transitional relief and there was an immediate imposition of full income tax rates on s ales of timber there would be an immediate fall in the value of woodland. If, on the other hand, one were to make the change applicable only to trees planted in the future there would be a 100 year transitional period. Mr Johns said that there was a possible middle route which could give relief on a straight line basis. Mr Painter said that a system could be operated which would, in effect, follow the normal tax procedure with the forest owner putting in a claim and only when it looked to be dubious would the Revenue challenge it. If Ministers were prepared to be fairly generous here in order to gain added simplicity it should be possible to work up some system of this nature.

6. Turning to the subject of environmental differentiation, Mr Haigh remarked that all the options here, taken in isolation, would be detrimental to forestry. Mr Johns said that the present tax regime increased the rate of return on forestry by 50%. If Option 3 were pursued it would reduce the rate of return to 5% (the same as the pre-tax return) rather than the current 7.8%.

Mr Painter said that we must start from the basic premise that reform would be on the basis of a stiffer tax regime. If there were therefore to be a big tax differential to encourage broadleaves it would be necessary to penalise conifers excessively. The Financial Secretary said that he was reluctantly convinced that this would not be realistic.

7. Mr Painter said that the Chancellor had said that he wanted to look at the tax treatment of forestry on three grounds; its place in an overall tax reform strategy, the creation of a level playing field and the environmental angle. If we were to encourage broadleaved planting and also to achieve the Chancellor's first two objectives it would have to be done by way of differentially large grants. Mr Bonney said that this was already the case - in fact grants were twice as much for broadleaved trees.

8. As to the various options for future action, Mr Painter said that one route would be to impose a virtual 'fait accompli' on other departments while another would be to accept the need for an inter-departmental review. This could not start until the early autumn. Mr Burgner said that other Departments would be pressing on other grounds for the inter-departmental review to start in the Autumn and it should therefore not be difficult for tax to become a part of that review.

Mr Painter thought that this was the best route to follow. He also raised as a point for consideration the possibility of the Chancellor referring to forestry reform as part of a broader tax reform package in next year's Budget.

N Williams

NIGEL WILLIAMS
(Assistant Private Secretary)

3 July 1987

cc: PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Burgner
Mr Scholar
Mr Bonney
Miss Sinclair
Mr Haigh
Mr Cropper
Mr Tyrie
Mr Painter/IR
Mr Beighton/IR
Mr Johns/IR
PS/IR

CONFIDENTIAL

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

RP

FROM: M A JOHNS
DATE: 2 JULY 1987

PS/CHANCELLOR

(Done
AJK)

THE TAX TREATMENT OF FORESTRY

I am afraid I have discovered that a couple of misleading errors have crept into my note of 6 May which is being discussed at the Chancellor's meeting on Monday 6 July. Could you make the following corrections to my note?

Paragraph 27, Table. The second line is correctly described as Present regime (without grants); the third line should read "Present regime (with grants)".

Paragraph 42, line 2 should read "the long-term yield from Options 1 and 3 is around £100 - £125m, while that from Option 2 would be some £10s of millions (particularly uncertain)".

I am sorry for any confusion caused.

M. A. Johns

M A JOHNS

---

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Sir Peter Middleton
Mr Burgner
Mr Scholar
Mr Bonney
Miss Sinclair
Mr Cropper
Mr Tyrie

Chairman
Mr Isaac
Mr Painter
Mr McGivern
Mr Houghton
Mr Beighton
Mr Lawrance
Mr Elliott
Mr Battersby
Mr Cayley
Mr Pattison
Mr Johns
Mr Streeter
PS/IR

4372/034 Forestry

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FST
Ch/x
3 July

FROM: FINANCIAL SECRETARY

DATE: 3 July 1987

CHANCELLOR

cc: Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Burgner
Mr Scholar
Mr Bonney
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Painter I/R
PS/IR

TAXATION OF FORESTRY

I have now had the opportunity of discussing with officials the various options outlined in Mr Johns' note of 29 June and explained more fully in his note of 6 May. Although it is not necessary to decide now, my preliminary view is that the Revenue's Option 3 (Tax on Profits with retention of Sideways Relief) is the best of those available.

2. I was somewhat concerned about the transitional problem where the choice seemed to lie between an immediate capital loss or an enormously long transitional period (perhaps over one hundred years in some cases). I was assured, however, that the problem ought to be superable, if relief were given on a straight line basis from the date of the change. However, in my view this is something which clearly needs further examination.

3. I think that there is a strong argument for taking action in this area, and I am personally convinced by the environmental arguments. There are too many conifers at present and not enough broadleaved trees. I am also of the view, that it would be hideously complicated to have two separate tax regimes, one for conifers and another for broadleaved trees. I accept the argument that one must therefore seek to encourage the planting of broadleaved trees through the use of grants rather than via the tax system, (indeed there are already differential grants in existence to do this.) I am sceptical whether farmers will plant broadleaved trees for commercial reasons.

4. It is worth noting that the short term yield from Option 3 would be nil, while the long term yield would be some £100-£125m. It is clearly not primarily for reasons of yield, therefore, that we would take action. The real argument for action is to remove the present distortion in the tax system. (It is, of course, ironic that exempting commercial woodlands completely from tax would actually increase the tax charge).

5. I do not think that it would be politically realistic to take action unilaterally on this matter, since the Scots dimension alone would prevent us from doing that. It does seem sensible to me, however, to press for the inter-departmental review agreed by ALURE to start soon, probably in the early Autumn. The aim would therefore be to take action in the 1989 Budget. If we were to proceed on this basis, it was suggested you might announce your intentions in the Budget Speech of 1988. I think, however, that this would seem rather odd given that the final outcome would at that stage still be uncertain, and I would recommend against that.

NWilliams

pp NORMAN LAMONT

FORESTRY

PERSONAL AND CONFIDENTIAL

Tony K

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 July 1987

Dear Tony,

FORESTRY COMMISSION

The Chancellor at his bilateral with the Prime Minister last week mentioned that he and the Minister for Agriculture were enthusiastic about the possibilities for privatising the Forestry Commission. Privatisation would be given a stronger impetus if lead responsibility for the Forestry Commission rested with the Minister for Agriculture.

The Prime Minister has considered carefully the organisation of Ministerial responsibilities for forestry and has decided that she does not at present want to make any change. She has noted that it is in any case open to the Chancellor and the Minister for Agriculture to work up proposals for privatisation of the Forestry Commission to be put to colleagues in due course. She would wish to be consulted about the timing of circulation of any such proposals in~~n~~ view of their sensitivity.

I am copying this letter to Sir Robert Armstrong.

Yours,

David

(DAVID NORGROVE)

Tony Kuczys, Esq.,
HM Treasury.

PERSONAL AND CONFIDENTIAL

RT4.83

FROM: A W KUCZYS

DATE: 8 July 1987

Which is Taylor's – option 3 or option 4?

AWK TO CH/EX 8/7

CHANCELLOR

TAX TREATMENT OF FORESTRY

You were prompted by Michael Johns' minute of 6 May to ask for a meeting after the Election. We had this arranged for Monday, but it had to be postponed.

2. Since May, we have had further papers, which you have not yet seen:

(a) Michael Johns' minute of 29 June;

(b) Bob Bonney's minute of 30 June.

The FST discussed these with officials on 1 July, and has now minuted you (3 July, below) with his conclusions. I do not think it is necessary at this stage to decide which option you want to pursue. (The FST recommends Option 3 - abolish Schedule B, and tax forestry like any other business, except that there would be sideways relief, which other trades ~~would~~ do not get.)

3. It would, however, be helpful now to decide two things:

(a) are we going for "unilateral action" in the 1988 Budget, or consulting colleagues and going for 1989? (The FST recommends the latter); and

(b) (on a more mundane level) given the intertwining of tax and public expenditure considerations, should FST or CST take the lead within the Treasury? (Probably FST).

4. On forestry more generally, you are seeing Mr Ridley at his request at 3.45 pm. And see also the letter, attached, from David Norgrove. (The background to this is that David feels passionately about the environmental aspects of forestry, and feels that either MAFF taking responsibility for forestry, or privatisation of the Forestry Commission, would be a recipe for covering the country side with hideous conifers. Evidentally he has had some influence on the Prime Minister.)

AWK

A W KUCZYS

PERSONAL AND CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 July 1987

Dear Tony,

NORGROVE TO AWK 8/7

FORESTRY COMMISSION

The Chancellor at his bilateral with the Prime Minister last week mentioned that he and the Minister for Agriculture were enthusiastic about the possibilities for privatising the Forestry Commission. Privatisation would be given a stronger impetus if lead responsibility for the Forestry Commission rested with the Minister for Agriculture.

The Prime Minister has considered carefully the organisation of Ministerial responsibilities for forestry and has decided that she does not at present want to make any change. She has noted that it is in any case open to the Chancellor and the Minister for Agriculture to work up proposals for privatisation of the Forestry Commission to be put to colleagues in due course. She would wish to be consulted about the timing of circulation of any such proposals in view of their sensitivity.

I am copying this letter to Sir Robert Armstrong.

Yours,

David.

(DAVID NORGROVE)

Tony Kuczys, Esq.,
HM Treasury.

PERSONAL AND CONFIDENTIAL

CONFIDENTIAL

BURGNER TO CH/EX 10/J

FROM: T U BURGNER
DATE: 10 July 1987

CHANCELLOR

Thanks. A fair pt. But it has to be borne in mind that the ALURES package is meant to be a counterpart of CAP reform, which will save money.

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Scholar
Mr Bonney
Mr Cropper
Mr Tyrie
Mr Painter - IR

TAXATION OF FORESTRY AND INTER-DEPARTMENTAL REVIEW

There is one additional point arising out of the conclusions of your meeting yesterday which you should have in mind when you see Mr Ridley and Mr MacGregor. At the meeting you expressed a wish to reduce the current distortions in the tax regime, even though this would involve additional public expenditure through larger planting grants. In fact in order to maintain the present rate of return (as would be necessary if people are to continue planting voluntarily) the level of planting grants would have to increase by a factor of 2 or 3 times. We assume, though this did not come up explicitly at the meeting, that you would be looking for a broadly Exchequer - neutral deal, ie an increase in public expenditure no greater than the additional tax collected by the Revenue. If a further environmental aim is added - namely to increase broadleaf planting at the expense of conifers, this will inevitably mean that the total area of new planting will fall and that the new target of 33,000 hectares a year announced as part of the Alure package will not be met. This is because the differential in the grant for broadleaf planting over conifers will have to be increased even further.

2. From the Treasury's point of view, a reduction in the total acreage of new plantings would not be a matter for concern. Forestry is basically an uneconomic activity subsidised by the Government and its wider benefits in terms of employment generation, public

recreation, tourism etc are questionable. But Mr Rifkind (once he is involved) will certainly challenge any reduction in forestry activity as a whole. Even Mr MacGregor may not want to act in a way which might be thought inconsistent with Alure. Treasury efforts to limit the increase in public expenditure could therefore have the effect of raising the question of the rationale for forestry in the inter-departmental review. That could lengthen the discussion in a way that would make the prospects of early action on the tax side unlikely.

3. Of course one could argue that any increase in public expenditure would be more than offset if at the same time the Forestry Enterprise were being privatised in whole or in part. But the Treasury does not normally accept privatisation proceeds as an argument for relaxing control over public expenditure: hence the proceeds are scored on a separate public expenditure programme. Moreover until more detailed work, including a merchant bank assessment, has been done, we cannot regard privatisation of forestry as being in the bag.

TUB

T U BURGNER

CONFIDENTIAL

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

FROM: M A JOHNS
DATE: 24 JULY 1987

Ch/ See also note from Tom Burgner (below) AWK

CHANCELLOR OF THE EXCHEQUER

FORESTRY

FORESTRY

1. I attach an aide memoire for your meeting with the Environment Secretary and Minister of Agriculture on Monday. Miss Long's note of 20 July refers. It has been agreed with Treasury officials who have contributed the line to take on grants and privatisation.

2. We suggest that your key objectives for the meeting should be as follows:

(i) acceptance of the need to reform the tax regime for forestry;

(ii) recognition that this is bound to involve general review of forestry policy (as envisaged by the Prime Minister's ALURE group earlier this year);

(iii) agreement that first step should be joint paper by Treasury, DOE and MAFF (not at this stage consulting the other agriculture and forestry Departments) which could be sent to the Prime Minister and others on the ALURE group this autumn;

---

cc Chief Secretary
Financial Secretary
Mr Burgner
Mr Scholar
Mr Bonney
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Painter
Mr Beighton
Mr McGivern
Mr Houghton
Mr Elliott
Mr Johns
Mr Pattison
Mr Streeter
PS/IR

(iv) paper should cover:

(a) tax reform;

(b) the consequentials for the grant regime and environmental objectives; and

(c) the scope for privatisation;

(v) the overall constraint should be no net increase in Exchequer costs and no hypothecation of putative privatisation receipts to the forestry programme.

This is spelled out more fully in Tom Burgner's note below AWK

3. As you know, the last objective is likely to be the most difficult to achieve because it implies that any increase in grants consequential on the tax changes should cost no more than £10 million a year. This could well not be enough to achieve the current planting target of 33,000 a year, particularly if the Government wishes to encourage a higher proportion of broadleaves (which already attract higher planting grants). We would not advise you to concede anything at this stage on the public expenditure figures until the implications of Exchequer neutral changes have been fully considered. In our view there is no need to feel particularly attached to the current planting target and the removal of tax reliefs could well have a significant effect on land prices which will need to be assessed. We recognise, however, that some concession in this area may be necessary at a later stage in the review process, particularly if the Scots are to be persuaded to accept tax reform.

M. A. Johns

M A JOHNS

FORESTRY

AIDE MEMOIRE FOR MEETING WITH SECRETARY OF STATE FOR THE ENVIRONMENT AND MINISTER OF AGRICULTURE

Why a review now?

1. Manifesto commitment to tax reform. Ideal is to reduce rates of tax and get rid of reliefs which distort market signals. Tax treatment of forestry clearly anomalous.

2. Environmental lobby getting increasingly vocal about environmental, scenic and ecological objections to some types of forestry.

3. Before election Mr Ridley proposed to ALURE group of Ministers a radical review covering objectives of forestry policy, tax, grants and privatisation of the Forestry Commission. Ministers decided in January that the time was not then appropriate for a general review of forestry policy (David Norgrove's letter of 14 January). Reviews of this type are easiest to conduct shortly after an election so the time seems ripe to revive idea.

The present regime

4. Tax. An occupier of woodlands can opt for Schedule D treatment so that the expenses of planting can be set against other income; by engineering a change of occupation before receipts come in from felling he can secure a purely nominal charge on the receipts through Schedule B, a unique tax schedule just for forestry.

5. Tax therefore provides a net subsidy to forestry. The present cost of tax relief on planting is around £10m; when present forests are eventually cut down the tax foregone through Schedule B will cost over £100m a year at today's prices.

6. Grants. The Forestry Commission provides grants at varying rate depending on the size of plantation and type of tree. (The lowest rates £240 per ha - about 25% of planting costs - are for large areas of conifers; the highest (£1200 per ha) for small areas of broadleaved trees). Planting is rarely carried out without grant aid but the grant represents a smaller proportion of total support than the tax reliefs.

? abolish grants for conifers

7. Public ownership. The Forestry Commission established in 1919 now owns some 43% of the forest area in Great Britain (down from about 50% in 1980). The net operating costs of the Commission's estate (the Forestry Enterprise) are running at £30-40 million a year and are likely to continue at about that level for another 15 years until a larger proportion of its plantations have matured. Since 1980 the Government's policy has been to

encourage further private sector planting; to reduce the Commission's new planting to around 5,000 ha a year and to encourage it to "rationalise" its estate: disposals since 1980 have virtually reached the original £100 million target and some £44 million are planned for 1987-88 and the Survey years. The proceeds are credited to the privatisation programme not to the Forestry Commission in PES. There has as yet been no detailed study of full scale privatisation, although Mr Jopling proposed this in 1985 (and we suspect that Mr MacGregor would now favour one).

Criticisms of present regime

8. These were spelt out in Cabinet Office note of 12 December to Prime Minister and ALURE as follows:

a) economic justification for subsidy to limit imports not easily reconcilable with general trade policy,

b) social value of forestry as creator of jobs doubtful: new employment not necessarily located in areas where needed (and cost per job high),

c) environmental criticisms of scenic monotony, diminished wildlife diversity and loss of other habitats from large scale coniferous planting,

d) institutional appropriateness of Forestry Commission with multiple role as policy advisor, regulator and commercial forestry enterprise questionable. Last role may not be necessary,

e) fiscal arrangements give questionable advantage to owners with high tax brackets (frequently absentees).

Objectives for changes

9. Treasury Ministers' objectives are:

a) An end to the subsidies and major distortions in the tax system and a simpler system (while recognising there are special features in forestry compared with other businesses).

b) No increase in total Exchequer cost, i.e. grants should not increase by more than the £10m saved in tax relief.

c) A system which (through grants) encourages environmentally desirable planting, i.e. more broadleaves, fewer conifers. (Though this is principally for other Ministers and is only an objective if there is no increase in overall Exchequer costs).

d) If practicable, clear way for privatising Forestry Enterprise (though this is probably a long term objective).

10. Other Ministers may see as objectives:

a) Sustaining published ALURE target of 33,000 hectares a year planting. Treasury Ministers sceptical about economic and employment case for this.

b) Encouraging farmers to plant trees as means of reducing surplus agricultural production. (Treasury position reserved: cost effectiveness not yet demonstrated. Premature to propose major extension until ALURE farm woodland scheme evaluated after 3 year review (in 1991?) but current scheme should not be very much affected by tax changes).

Tax options

11. Treasury Ministers have considered a number of options. Treating forestry on all fours with other businesses would be very harsh (costs of planting would not get relief against other income because planted trees would be valued as "work in progress" in accounts). Charging to Schedule D and allowing sideways relief has same effect on profitability as complete exemption. Ministers have concluded exemption is best: it abolishes subsidy element but still treats forestry more favourably than other businesses. Simple and yields £10 million fairly quickly. Effects on profitability shown in Annex.

(same)

12. Inheritance tax. There is a special relief for inheritance tax which enables tax on woodlands to be deferred. But this is second order issue, best left out of review.

13. Differentiation between conifers and broadleaves. Tax not a good instrument for differentiation. Rules would have to be crude. If discretion needed, best to use grants.

Grants

14. Grant consequentials will need careful thought. Should not simply assume that same level of incentives (or current 33,000 ha planting target) needs to be maintained (this would imply doubling or tripling current grant rates). Forestry undertaken solely for tax avoidance reasons likely to cease. No bad thing, as much of it damages environment for no economic benefit. Objectives for future forestry support will need careful definition. Economic case for supporting commercial forestry very weak. Could be case for more differentiated approach within overall expenditure constraint. DOE and MAFF should consider practical options and discuss costings with Treasury.

Privatisation

15. Right to consider privatisation of Forestry Enterprise as desirable long term objective. First step might be to separate commercial from regulatory functions of the Commission (i.e. split Forestry Enterprise from Forestry Authority). Then

commission merchant bank study of options for privatising Enterprise as going concern or piecemeal. Policy bound to be controversial (particularly in Scotland) and may not be achievable in short term given current operating losses and withdrawal of tax relief. No question of hypothecating any proceeds to increase forestry grants programme.

Handling of a review

16. Next step would be for three Ministers to agree a paper to put to Prime Minister and other Ministers in ALURE. If can't agree Treasury Ministers may need to put in such a paper anyway but more sensible to try and agree a joint line.

17. Accept that it will be difficult to have conclusions in time for 1988 Budget (but don't give up the possibility of an announcement of intention at this stage in order to keep pressure up). Must start soon if we are even to meet 1989 Budget.

18. Suggest officials of three departments try to work up a paper by mid-October.

ANNEX

EFFECT OF TAX OPTIONS ON RATES OF RETURN FROM PLANTING

The following figures should be regarded as broad approximations only (especially for broadleaves). They ignore the cost of land and assume the price of timber is constant in real terms:

Internal rate of return % (real)

	Conifers	Broadleaves
Before Tax (equal to return on forestry exempt from tax)	5.0	2.9
Present regime (without grants)	7.1	3.8
Present regime (with grants)	7.8	4.5

ps3/33K

CONFIDENTIAL

Alex
[illegible]

FROM: A W KUCZYS
DATE: 27 July 1987

MR T BURGNER

cc PS/Chief Secretary
PS/Financial Secretary
Mr Scholar
Mr Bonney
Mr Cropper
Mr Tyrie
Mr Painter - IR
Mr Beighton - IR

Ch
Re (x) you were going to speak to PEM about whether he or Alex should set up this group
AWK 29/7

FORESTRY

See my note of [illegible] paper.

The Chancellor was grateful for your minute of 10 July, and Mr Johns' aide memoire of 24 July.

2. On your minute, the Chancellor has commented:

"A fair point. But it has to be borne in mind that the ALURE package is meant to be a counterpart of CAP reform, which would save money."

3. The Chancellor met the Minister of Agriculture and the Environment Secretary this evening. I was not present, but I understand that the three Ministers agreed to the idea of a single paper from their Departments. In the first place, this should be put to the Prime Minister only, not to the whole ALURE Group. A small working group of officials should be set up, with representatives from Treasury, Revenue, Environment and MAFF. x We will be in touch further on this.

4. Mr Ridley handed the Chancellor, on a personal basis, a paper produced by DOE officials last November. DOE Ministers have by no means signed up to this - indeed the Secretary of State thinks it concentrates too much on environmental issues, and not enough on tax, or privatisation. But he thought it might make a useful starting point for producing the inter-departmental paper. I attach the paper (top copy only). X

*
Imp
Re x, not so.
It is a useful account of DOE officials thinking - no more.

AWK

A W KUCZYS

2183/019

SECRET AND PERSONAL

FROM: N MONCK

DATE: 1 October 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Scholar
Mr Bonney

PS/IR
Mr Beighton, IR
Mr Draper, IR

Ch/
1. We had already fixed a short meeting with Mr Monck tomorrow, following your chat with Mr MacGregor this morning. Should we now stand him down - or would you like to discuss this note?
2. Content with this draft, and with the suggestion that we now fix a meeting with Mr MacGregor + Mr Ridley (This will have to be after the Conference)?
25/10

REFORMING FORESTRY POLICY

I attach a report embodying the reform proposals you have broadly agreed on with Messrs Ridley and MacGregor: tax exemption, your preferred option for replacing the present reliefs; a new grant scheme producing more environmental benefits; and splitting the Forestry Commission followed by privatising the enterprise side. The report casts doubt on the economic rationale for the present degree of exchequer subsidy for forestry. But it recognises that political pressures mean that some subsidies will continue and proposes changes in the delivery mechanism which will make the policy more defensible, particularly to the environmental lobbies. A draft covering minute from you to the Prime Minister is also attached.

MONCK → CH/EX 1/10

2. The target timetable is for the reforms to be announced in the Budget and implemented in 1988. The Revenue say that the drafting of Finance Bill clauses for tax exemption (but perhaps not a more complicated option) can be done provided decisions are taken before Christmas. The main uncertainty, apart from getting the proposals collectively agreed, is whether the new grant scheme can be settled in time. To make sure of that we need decisions well before the Revenue's deadline. The outline grant scheme in the report has to be tentative because we cannot get up-to-date figures or advice from the Forestry Commission until Mr Rifkind is brought into this. (For the benefit of new readers perhaps I should stress the obvious point that these papers must not be mentioned to the Departments or Ministers who have not yet been consulted. You may incidentally be interested to see the attached Daily Telegraph story about the defeat of Mr Ridley's proposals by other Ministers.)

3. In order to save time the draft report is being submitted to their Ministers simultaneously by the MAFF and DOE officials, who have worked helpfully and indeed enthusiastically with us and the Revenue to produce the report.

Next Steps

4. A sequence of steps is now needed to get this moving:

(a) you meet Mr Ridley and Mr MacGregor (unless they will clear the report and the draft minute without a meeting);

(b) you minute the Prime Minister and, probably, have a meeting with her which Messrs Ridley and MacGregor might also attend;

(c) you minute Messrs Rifkind and Walker (who also has forestry responsibility), proposing

(d) a discussion of the paper under the Prime Minister's chairmanship.

I understand Mr Rifkind is planning to be out of the country for about two weeks after the Party Conference.

The Report

5. The report contains contributions from the Revenue, MAFF, DOE and Mr Burgner, who has also managed to do the editing in the middle of the public expenditure round.

6. I draw your attention to a few points only since you are familar with the broad content:

(a) MAFF and DOE officials think that if you are prepared to raise public expenditure on planting grants by £10 million a year, the reform package ought to win over the main environmental groups while still being presented as broadly consistent with the new planting target of 33,000 hectares announced earlier this year. The environmental benefits will be achieved by attaching conditions to grants as well as by somewhat increasing the incentive for planting broad leaved trees;

(b) if £10 million is spent, the new grants plus the tax exemptions will broadly maintain the present internal rate of return on conifers (typically over 7 per cent in real terms after tax and grant) while somewhat enhancing the rate of return on broad leaved trees. This will be an important part of the basis for the presentation in (a), but there is inevitably great uncertainty about take up and the scale of planting under the new regime;

(c) there would be a transition of a few years in which there would be a small annual net exchequer cost (see Annex C to the report) because it takes time for the revenue benefit to build up. The constraint that, after the transition, the extra public expenditure must be matched by extra revenue assuming there were no other major tax changes has been accepted by MAFF and DOE. Within that constraint it would be possible to raise the return on broad leaved trees further. But there would be disadvantages, eg lower incentives for conifers and a lower overall level of planting. We are looking further at the trade offs here. It is possible we may find a slightly changed grant proposal which would be worth substituting for the one in para 26A before the report goes to Mr Rifkind, but I decided not to hold up the report for that;

(d) we cannot know whether or how effectively Mr Rifkind and the Forestry Commission will attack the outline grant proposals technically or how long it will take to firm up the details of the grant regime. But we have built in some points designed to hinder Mr Rifkind from upping the ante.

Conclusion

7. If you are broadly content with the present draft, you could invite Mr Ridley and Mr MacGregor to a meeting as soon as possible, unless they will give clearance without a meeting. If you have a meeting, we will of course provide a separate brief.

NM

N MONCK

SECRET AND PERSONAL

REFORMING FORESTRY POLICY
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SECRET AND PERSONAL

REFORMING FORESTRY POLICY

I INTRODUCTION

1. The purpose of this paper is to outline a set of proposals for a major reform of forestry policy. The process of reform would not be painless and the result would not be perfect since there would still be a number of anomalous features. But the policy proposed would be based on more up-to-date objectives especially on taxation and reducing the State's direct participation in productive activities. There would still be subsidies for forestry but they would be better targeted.

2. When presenting these proposals publicly, the Government would need to explain the reasons for the proposed changes. Government policy towards forests appears to be inconsistent with general policy on industrial support. In particular, Exchequer assistance is difficult to justify in relation to a rationale for intervention based on market failure, although the long production cycle for timber arguably raises some special considerations. Nonetheless there remains strong regional interest in continued support for forestry and there is widespread concern about the role of forests in the general environment. Yet, the current support mechanisms involving heavy reliance on tax relief and favouring top rate tax payers, sit uneasily with the Government's general policy towards taxation and make privatisation difficult, while at the same time failing to satisfy these environmental concerns. It is at the latter issues that these proposals are aimed.

3. The **main proposals** are

(a) tax exemption for forestry, replacing the present regime;

(b) re-designing the grant schemes to increase the environmental benefits of the considerable exchequer costs incurred in present forestry policy;

(c) separating the Forestry Authority role of the Commission from the Forestry Enterprise which would be privatised as soon as practicable, probably on a piecemeal basis and over a period of years.

These are discussed in parts III-V of the paper.

4. This paper has been prepared without consultation with the Forestry Commission or the Scottish Office. Thus, although the quantification provided mostly derives from material provided by the Commission on earlier occasions, it may need to be refined and updated.

II OBJECTIVES

5. The current objectives of Government forestry policy stem from the Acland Committee report of 1917. They were restated in 1980 by the then Secretary of State for Scotland as "to reduce our dependence on imported wood" with a secondary objective of stimulating rural employment. In March 1986 a further statement set a general aim of planting 30,000 hectares (ha) a year against the 25,000 ha in the 1980 statement. This was raised to 33,000 ha following the ALURE group discussions earlier this year. On neither occasion was the figure presented as a firm commitment.

6. Forestry expansion has been promoted by the activities of the Forestry Commission itself and by grants and tax incentives to the private sector. The cost of these measures in 1987-88 is expected to amount to about £50 million: public expenditure of £32 million on the costs of the Forestry Enterprise, £14 million on the Forestry Authority, £8 million in grants to the private sector; receipts from planned disposals of £13 million; plus about £10 million in revenue currently foregone from tax concessions. The private sector now accounts for more than 80% of total new planting compared with 35% in 1980. The policy has undoubtedly been a success in terms of new planting: the woodland area of Britain has increased from 1.2m ha in 1974 to 2.2m ha now. Some key background facts are set out in Annex A.

7. The present policy is, however, open to a number of criticisms. It was against the background of these that the ALURE group recognised the desirability of pursuing a fundamental re-appraisal of forestry policy after the General Election.

(i) the historic economic justification for a subsidy aimed at limiting imports is not easily reconcilable with the Government's general trade policy; nor is there any clear justification for assistance in the context of the general market-failure rationale for Government intervention and industrial support;

(ii) the social value of forestry as a creator of jobs is doubtful: new employment is not necessarily located in areas where it is most needed, jobs only emerge to any significant degree fairly late in the forestry cycle, after a period of some 35-40 years at the earliest; and in the North of Scotland, where most planting occurs, costs per direct job are estimated at £8000 per year, which after appropriate adjustments yields a cost per job nearly double that achieved by the Highlands and Islands Development Board, the development agency for the area;

(iii) there is widespread criticism of new plantations on environmental grounds, because the losses of wildlife outweigh the gains, because they can damage water quality, and because of the scenic monotony of unrelieved masses of conifers;

(iv) the fiscal arrangements run counter to the Government's aim of removing from the tax system features which distort commercial judgements; present arrangements allow very high rates of subsidy to investors in the highest tax brackets who have no real link with the land; and they hinder privatisation;

(v) the institutional appropriateness of the Forestry Commission with its multiple role as policy adviser, regulator and commercial enterprise is questionable.

8. On the other hand there is a strong body of opinion in favour of Government support for forestry.

(i) It is argued that the very long life of forestry investment might discourage investors, who are often averse to the risk associated with waiting a long time for returns, and lead to under-investment. It is also argued that the benefits of tree planting for nature conservation, amenity, recreation, sporting and shelter justify a subsidy in appropriate cases;

(ii) More sensitive planting techniques are now being devised and adopted, and the considerable recreational potential of forests is being exploited. As a result of these trends forests can often be environmental assets;

(iii) As for employment creation, while it is difficult to make a case on cost-effectiveness grounds, it can be argued that the contribution of forestry to income and employment in many scarcely populated and fragile rural areas argues for some caution when considering withdrawing Exchequer support. In certain areas it may take a considerable time to offset the income and employment consequences of a halt to new planting.

(iv) While the present fiscal arrangements are anomalous, bringing them to an end will not necessarily result in higher revenue or more productive investment; some taxpayers will always seek to shelter their income from tax and ending this shelter may mean no more than a switch of resources from one shelter to another;

(v) There is also an "insurance" angle. Although there is no clear evidence about market trends there are longer term uncertainties about the availability of imported timber. Other Community countries apparently consider the possibility of a future world timber shortage sufficient to justify a considerable degree of support for domestic production anticipating an average level of self-sufficiency of some 50% by the turn of the century compared to 25% in prospect for the UK. Those supporting these European decisions consider that existing UK levels of subsidy can similarly be justified as an insurance premium against future world timber shortages. The House of Lords report on EEC Forestry Policy in the 1985/86 Session in supporting continued but carefully managed expansion of forestry emphasised balance of payments considerations.

III TAX REFORM

The present regime

9. The present income tax regime for forestry is unique and curious, not least because it provides a net Exchequer subsidy for investment in planting trees: foresters would be worse off than they are now if forestry were exempt from tax altogether. An occupier of woodlands managed on a commercial basis with a view to profit is taxed under Schedule B, an archaic income tax schedule now confined exclusively to forestry. This results in a purely nominal charge which works out on average at about 15p per acre per year. In addition the tax payer has an option to elect for Schedule D (the schedule under which businesses generally are taxed).

10. The normal practice is for people in the early stages of a woodland, when costs are heavy and there are no receipts, to elect for Schedule D so as to be able to claim the expenditure as a tax relief against their other income. Someone opting for Schedule D cannot subsequently revert to Schedule B. They can, however, contrive a change of occupation. This can be done by selling the woodlands or giving them away (often to a family trust or another member of the family). This has the result of returning the woodlands to Schedule B. There is no CGT charge on the sale of trees.

11. The result is that the expenses receive tax relief under Schedule D (at 60 per cent if, as is usual, the first occupier is a top rate taxpayer) while the receipts are effectively exempt. This regime appears to be more generous to forest owners than those applying in France, West Germany and the USA.

12. These arrangements provide an attractive tax shelter for higher rate tax payers particularly as there are also favourable inheritance tax rules for woodlands. A number of commercial forestry companies have been established to market these and to manage the woodlands on behalf of the investors who receive the tax reliefs and the Forestry Commission grants (see paragraph 21 below). The companies concerned do not themselves own the land or invest shareholders funds directly.

13. Annex B sets out the economics of a typical conifer plantation and a typical broadleaved plantation. The figures are derived from information provided by the Forestry Commission but should only be regarded as broad estimates of typical returns: figures for individual plantations will vary. The internal real rate of return on the conifer plantation is increased by tax from 5 per cent pre-tax to 7.1 per cent post-tax; comparable figures for the broadleaved plantation are 2.9 per cent and 3.8 per cent. In other words the tax system is actually providing a subsidy to planting. Grants further increase the internal rate of return to 7.8 per cent for conifers and 4.6 per cent for broadleaves.

14. The present cost of tax relief on planting is around £10 million a year.

15. Continuation of this regime sits uneasily with the Government's general position on taxation. The underlying direction has been to reduce rates of direct tax but also to reduce or eliminate special reliefs or shelters which distort economic decisions.

Options for reform

16. There are three options. The first is to put forestry on the same fiscal basis as other businesses. Income would be taxed and the expenses would be allowable but not until the income was received. Because of the long life cycle of the crop and the lumpiness of the receipts this option would create major problems for the industry. Woodland owners would have to wait 30 years or more for their relief and the income would almost invariably be taxed at the highest rate. Some arrangement would be necessary for spreading the income over a number of years. Moreover, as Annex B shows, the effect would be to reduce the rate of return on conifers from 5 per cent (pre-tax) to 4.2 per cent (after tax) with no inflation and to 3.9 per cent (after tax) with inflation at 5 per cent. The rate of return on broadleaves would fall from 2.9 per cent to 2.1 per cent with no inflation and 1.9 per cent with 5 per cent inflation. This option would be strongly criticised by forestry interests and looks the least attractive of the three.

17. The second would be to abolish Schedule B, to tax all receipts under Schedule D but to allow relief for planting expenditure to be set against other sources of income as and when the expenditure is incurred. Post-tax rates of return would be very close to pre-tax rates of return. The Exchequer would eventually receive an extra £100 million a year from the abolition of Schedule B but initially there would be no Exchequer saving. Moreover, as would also be the case with the first option, arrangements for spreading would be necessary.

18. The third and by far the simplest option would be to exempt forestry entirely from tax. Receipts from the sale or felling of timber would not be charged to tax and the costs would not be allowed. After a short transitional period there would be a tax saving of around £10 million a year. Tax considerations would no longer distort commercial judgements, though the regime would be more favourable than for business generally.

19. Under all three options transitional arrangements would be required. With the third option (the exemption option), for example, it would be difficult to defend cutting off relief for expenditure overnight. But because the bulk of expenditure takes place in the first 2 or 3 years the transitional period with this option could be quite short. A 4 year period might be sufficient. On this assumption the tax savings as they would be published on Budget Day might be of the order of:

	£m
Year 1	0
Year 2	+1
Year 3	+3
Year 4	+4.5
Year 5	+6
Year 6	+10

With both the other options it would be difficult to justify a charge to income tax on receipts from forests which have been planted in the expectation that the present regime would continuc. A very long transitional period stretching ahead for decades would therefore be required.

20. The present tax subsidy would be removed under both these options. The exemption option ie (option 3) would require careful presentation and would need to be firmly related to the peculiar features of forestry and the need for simplicity. But with that proviso it seems preferable to option 2 because it is simpler, yields savings quickly and avoids the need for long transitional arrangements. **It is the option we recommend.** Provided the grants are sufficient to enable plantings to be maintained at broadly their present levels, forestry management companies should still be able to operate successfully on much the same basis as now but with a wider range of investors. But forestry would no longer be seen as the preserve of top rate tax payers.

IV CHANGING THE GRANT REGIME

21. There are at present several schemes under which grants are paid for afforestation. The main one is the Forestry Grant Scheme under which grants are paid for conifer and mixed plantations. Almost all the major plantations which receive the special tax allowances qualify for grant under this scheme. There is also the Broadleaved Woodland Grant Scheme, introduced in 1985, undcr which higher rates of grant are paid for woodland comprising only broadleaved trees. Rates of grant for these two schemes are as follows:

RATES OF GRANT (£ per ha)

Area of Woodland ha	Forestry Grant Scheme[1] Conifers	Broadleaved	Broadleaved Woodland[2] Grant Scheme
0.25- 0.9	630	890	1,200
1.0 - 2.9	505	735	1,000
3.0 - 9.9	420	630	800
10 and over	240	470	600

NOTES (1) Grants are paid pro rata to the proportion of conifers and broadleaved trees. 80% is paid on completion of planting and 20% five years later subject to satisfactory establishment.

(2) 70% is paid on completion of planting and 15% each five and ten years later subject to satisfactory establishment and maintenance of tress.

In addition to these two schemes, a proposed Farm Woodland Scheme was announced in March this year. Under this scheme, to supplement the planting grants, there would be annual payments to compensate for loss of income from farm crops.

22. The new grants structure proposed in paragraph 26a is intended to replace the Forestry Grant Scheme. However, it would be sensible to subsume the Broadleaved Scheme in the new structure since the grant rates would be more favourable. The new planting grants would in principle also apply to the Farm Woodland Scheme although some adjustments might be necessary.

23. It is proposed that changes in the grant regime would be announced at the same time as the tax changes. The grant increases would apply immediately whereas the tax savings would not begin to accrue until the following year. However, it should be possible

over the transitional period as a whole for the increase in grants to no more than match the tax saving, by phasing in the increased grants and particularly by reducing the proportion of grant paid in the first year. However, in the first 5 years expenditure will exceed the tax saving (see Annex C).

24. As a result of switching from tax relief to grants, it will be possible to devise a regime which is much more effective in achieving environmental objectives, as set out in Annex D. It will also be easier to defend the new system if the grant structure is broadly consistent, subject to inevitable uncertainty about take-up, with the aim of 33,000 ha of new planting a year announced in March with the ALURE package. It would be important to formulate at the outset an evaluation plan for assessing the success of the revised grant scheme in achieving its specific objectives. The new grant rates should be cash limited and also subject to an early review, which could involve reductions in rates if demand turns out to be higher than anticipated.

25. For illustrative purposes, it is assumed initially that the £10m saved (after a transitional period) of several years (see paragraph 19) from the tax changes could all be used to increase grants. The possible effects of using only half this sum are also examined briefly. Several cautionary points need to be made. First, the figuring is based on partial information and must be regarded as tentative. The main data lacking are a size structure analysis of new plantings and figures such as cost per ha by size and type of plantation which are necessary in drawing up an appropriate scale of grants and would help in assessing possible response rates to grants at various levels. Second, while higher grants could increase incentives to non and low rate tax payers, many potential farming investors - unlike the current high tax paying investors whose primary aim is to save tax and convert that into a capital asset - may not be able to afford the loss of income from their land. The present analysis assumes that grants would contribute only to costs of planting and would not compensate for income foregone. Under this assumption, only a limited increase in investment by non and low rate tax payers could be expected.

26. The changes in grants would be designed to blend environmental needs and commercial considerations. The new regime would encourage smaller plantations and the planting of more broadleaved trees (either on their own or to break the monotony of conifer plantations) by:

i. increasing the existing grant differential for broadleaved trees, so as to bring their internal rate of return somewhat closer to that for conifers. Although the percentage increase in the broadleaves grant would be less than that for conifers, the cost (net of grant) to the investor is reduced by more in percentage terms so improving the rate of return on broadleaves relative to conifers.

ii. requiring all plantations above a certain size to contain at least a minimum proportion of broadleaved trees, except where climate and geography make this impossible. A reasonable threshold would be 3 ha and a reasonable proportion 15%. These broadleaved trees would of course attract the higher rate of grant

iii. extending the existing grant differential in favour of smaller and medium size plantations.

On the illustrative expenditure assumption in paragraph 25 the pattern of grants could be such as to sustain a high rate of new planting and thereby maintain steady growth in jobs in rural areas and, over future decades, enable the production of timber to expand.

26a. The following table illustrates how these principles might be embodied in a grant schedule. The figures are tentative at this stage because the choice of actual figures will require careful study in the light of more refined and up to date estimates of planting costs, and of the existing and expected size distribution of plantations. But preliminary calculations indicate that, following exemption from taxation, the internal rate of return from conifers could be maintained at around existing levels, if grant rate were increased by some £300-£350 ha. The existing broadleaved rate of return would be somewhat enhanced if grants were increased by between £350 and £400 ha. These are illustrative figures related to plantations in the medium-size range.

Possible pattern of Grant Rates

	Present Grants		New Grants	£
	Conifer	Broadleaved	Conifer	Broadleaved
0.25 - 0.9	630	890	800	1200
1.0 - 2.9	505	735	750	1100
3.0 - 9.9	420	630	700	1000
10 and over	240	470	600	900
50 - 100 ha			500	800
100 - 500 ha			450	700
500 and over			400	600

27. As in the present grant regime, grant would be refused if it was concluded, after consultation with the relevant statutory authorities, that a proposed plantation would not be environmentally acceptable. Refusal of grant would be a much more effective sanction in future because tax relief would no longer be available and the grant would represent a higher proportion of the costs of planting. It might also be desirable to widen the circumstances in which grant is refused, for example to protect moorland areas, (preferably without creating rights to compensation). Precise guidelines and how they would be implemented would require consultation with the Forestry Commission and other interests. Where grant was forthcoming, the condition about a minimum 15% of broadleaved trees would normally apply, as described

above, and the grant structure would provide financial incentives for more scenically attractive forms of planting, which would also safeguard wildlife. These features of the new regime would make it broadly acceptable to environmental bodies, and enable the Government to resist pressure to make afforestation subject to planning control or a new system of planting licences.

28. It would also be desirable to reduce the workload involved in examining and consulting about individual grant applications. One possibility would be to formulate a comprehensive code of practice containing clear criteria for the environmental impact of forestry operations and to require applicants for grant to certify that their proposed scheme complies with a code of practice. But this would similarly require extensive consultation and could not therefore be introduced at the outset.

29. The possibility of limiting the increase in cost of grants to £5m would not assume that the present degree of Exchequer subsidy should be maintained or improved. Halving the increases in the above schedule would be seen as producing incentives inadequate to achieve the aim of 33,000 ha of planting annually. Adjusting the rates for particular categories of woodland would enable environmental objectives to be achieved but only at the expense of bigger cuts in incentives to commercial forests. It is hard to say what could be achieved for £5m but if the above schedule were lowered by a little over £100 per ha, it might achieve planting of around 20,000 ha. (This is not much different from the current planting rate of 23,000 ha in 1986).

30. The tentative conclusion is that subject to a more detailed study it should be possible through additional spending of £10m to devise a system of grants resulting which would:

(a) achieve an environmentally more favourable pattern of afforestation which would be acceptable to the main environmental bodies;

(b) give a pattern of incentives which it could be demonstrated were only slightly below present levels for higher rate taxpayers (and to other than highest rate tax payers were higher).

Given the change in the form of the incentive, and particularly the differential effect on high and low tax payers, it is not possible to be certain how the level of planting would be affected.

31. The suggested grant scheme would initially involve some Exchequer cost, but this would be relatively small (£10.9m over 5 years - see Annex C). The use of a cash limit, in contrast to current demand led schemes, would also help to avoid additional costs. A more modest scheme, at around £5m a year, would probably achieve the environmental benefits described and would be more consistent with the Government's general approach to industrial support in other sectors. But it seems unlikely that any pattern of grants based on this figure could be presented as coming close to achieving planting of 33,000 ha a year, and to this extent a higher level of grants - up to £10m - maintaining or improving existing Exchequer subsidies - would clearly be easier to defend in these terms. There is certainly no case for raising the overall level of Exchequer support for commercial forestry above its current level.

V <u>ROLE OF FORESTRY COMMISSION AND PRIVATISATION</u>

32. At present the Forestry Commission combines two distinct roles: as Forestry Authority it advises Ministers on policy and carries out regulatory functions including the administration of grant schemes; as Forestry Enterprise it runs the Commission's forestry estate largely on commercial lines. In accounting terms the two functions have been distinct since 1965. However, the Commission is open to charges of conflict of interest because it appears to be responsible for regulating its own commercial activities and some of its staff are involved in both functions. Moreover, its mixture of objectives make it doubtful whether the Enterprise is organised in a way which maximises efficiency.

33. Whatever Ministers decide on the future of the Enterprise (see below) there is a case for a more formal separation of the two arms of the Commission. Such a separation would in any case be essential for large scale privatisation. The functions of the Forestry Authority, which would need to continue in the public sector, include:

- advice to the Government on forestry policy;

- implementation of policy through the administration of grant schemes, plant health and felling controls;

- research and advisory services (preferably funded as far as possible by the private sector);

- statistics and public information.

In 1985 the Commission calculated that these functions could be carried out by a staff of 450-500 (including about 200 inspectors), less than 10% of its present total, at an average cost of around £20m a year before assuming any increase in grant expenditure.

34. The Forestry Authority could be reconstituted as a separate small Government department to fulfil these functions, but it would probably make better sense and be more economical to integrate these functions into existing Departmental structures. The Authority's functions would fit naturally into the three Agricultural Departments (as in Northern Ireland at present), although on many matters the Departments would need to act in close consultation with the Department of the Environment. Under this arrangement the Secretary of State for Scotland would continue to be the lead Minister for forestry matters. Further consideration may be necessary on the most cost effective administrative arrangements.

Privatisation

35. The Forestry Enterprise runs the 43% of the national forestry estate in public ownership (nearly two-thirds of which is in Scotland) broadly on commercial lines: its principal objective is to achieve a prescribed (albeit low) financial rate of return (3% in real terms), although it has subsidiary objectives of preserving the environment, maintaining rural employment which a fully commercial company would not be obliged to pursue. The Enterprise also ensures public access and recreation. Because most of its forests have been planted since the second world war it requires a continuing subsidy towards net operating costs of around £30m a year and these costs are likely to continue to fall on the Exchequer for another ten to twenty years if there is no change in the status of the Commission.

36. Since 1980 the Government's policy has been to encourage private sector planting; the proportion of new planting by the private sector has risen from about 35% to 85% over the intervening years within a broadly similar total of some 24,000 ha a year. A disposals programme was introduced at the same time, initially to provide opportunities for private investment and reduce the Commission's net call on public expenditure. A subsequent statement in 1984 changed the objective to one of estate rationalisation. Under this programme the Commission has reduced its holdings by some 60,000 ha (5%) producing receipts of around £100m in the years up to 1986-87. Further disposals worth £42m are planned for the period 1987-88 to 1990-91 inclusive. Receipts are credited to the privatisation programme and are not available for redeployment by the Commission.

37. There was some preliminary consideration of the prospects for privatising the Enterprise in the autumn of 1985 following a paper which proposed its incorporation as a PLC by one of the independent Forestry Commissioners, Mr Ian Coutts. The issue was

discussed at a meeting between Forestry Ministers and the Financial Secretary in February 1986 but not pursued thereafter. More recently, the Secretary of State for the Environment proposed that the prospects for privatisation should be considered in the context of the ALURE group discussions. N M Rothschild and Sons have sent an informal paper to the Financial Secretary suggesting that privatisation could be achieved by a combination of piecemeal sales and the introduction of competitive tendering for the management of any residual estate. In the past a major objection to privatisation has been that it would amount to selling future tax breaks (ie the Schedule B/D option for which the private sector but not the Commission is eligible under the present arrangements) and the risk that despite the conventions that one Government cannot bind another successive Governments would effectively be obliged to maintain the present tax system unreformed after privatisation. The proposals for reforming the tax position earlier in this paper would remove that objection. The proposals for a reformed grant structure with much stronger environmental objectives together with other public interest safeguards (see below) should do much to overcome the objections of the forestry lobby to privatisation.

38. In determining the strategy for privatisation a number of political and technical issues would need to be resolved. These would include:

(i) public interest aspects, ie ensuring that privatised forests are managed in such a way as to protect flora and fauna and provide continued public access for recreation. It would have to be accepted that the relevant safeguards will reduce the proceeds from privatisation. The private companies would be subject to general legislation for the protection of water supplies and sites of special scientific interest, but it might be necessary to prevent them qualifying for compensation under the latter heading. Protection of the landscape would be secured by applying the new grant regime to restocking. To protect access, companies might be required to enter into satisfactory access agreements with the local authority prior to sale. It might also be necessary to consider giving statutory backing to the code of practice envisaged in paragraph 28 above. Excessive regulatory requirements would deter potential investors: for a limited number of "heritage forests", such as the New Forest, continued public ownership might be the best solution.

(ii) Profitability: the likely continuing cash deficit of the Enterprise for the next ten to twenty years suggests that early privatisation would mean splitting the Enterprise and selling the most mature forests first.

(iii) Industry structure and Competition: A progressive series of sales as in (ii) would probably fit better with the structure and scale of existing private forestry companies. The extent of competition would in practice be fairly limited - in the Commission's view competition tends to be highly localised within timber market catchments which typically have a radius of 100 miles or so.

(iv) Proceeds: merchant bank advice would need to be commissioned on the proceeds which might be achieved. In 1985 the Commission calculated that the proceeds might fall in the range £200m to £500m (compared with the book value of the assets of some £1.3 billion).

(v) Public Expenditure: Complete privatisation would initially relieve the Government of the net operating costs of the Enterprise of about £30-40m a year for ten to twenty years. (After that it would forego the expected cash inflow from increased felling). There would be a continued need to fund the Forestry Authority at some £20-30m a year. (A full assessment of public expenditure costs would need to include increased grant expenditure on restocking and new planting, for which the Enterprise is not currently eligible; and the operating costs of any residual parts of estate which may have to be retained (e.g. heritage forests).

(vi) Legislation: Selling off separate forests would not require primary legislation: the powers exist under the Forestry Act 1980. Legislation would only be required if the Enterprise were privatised as an entity or if major changes were made in the responsibilities of the Authority.

39. Once Ministers have announced their decisions on the future tax and grant regimes, it would be necessary to commission a merchant bank study of the best way of privatising the Enterprise. Draft terms of reference are at Annex E. Final decisions on how best to proceed with privatisation could be taken in the light of their report and further analysis of the other issues outlined above.

VI TIMING AND NEXT STEPS

40. If Ministers approve a reform package on the lines set out in this report, there would be a strong case for announcing it in the 1988 Budget and including the tax changes, which would take effect from Budget Day in the Finance Bill. If implementation were later, there would be a forestalling problem which would be difficult to solve. Early action is also desirable because of the strong pressure on the Government from the Nature Conservancy Council and environmental pressure groups, especially over the large-scale planting of conifers by high-rate tax payers in Caithness and Sutherland.

41. But to meet this timetable and in particular to ensure that the Finance Bill clauses can be drafted, decisions would have to be taken urgently. Further work would also be needed on the detailed design of the new grant regime to maximise the benefits within the upper limit of £10m a year or whatever lower figure Ministers decided on.

FORESTRY: BACKGROUND FACTS

	1987-88	1988-89	1989-90	£m 1990-91
1. PUBLIC EXPENDITURE				
Baseline	53.8	54.2	55.1	56.5
Of which				
Grants to private sector	8.3	8.8	9.6	9.8
Other Forestry Authority expenditure	13.7	14.6	15.2	15.6
Forestry Enterprise net expenditure	31.8	30.8	30.3	31.0
planned receipts from disposals	-13.0	-12.0	- 12.0	- 7.0
1987 Survey bids (related to ALURE proposals)				
Grants:				
traditional forestry		2.3	2.4	2.4
farm woodlands		2.2	4.6	4.8

2 FORESTRY AREA

	Conifers		Broadleaves and Coppice		Total	
	'000ha	% privately owned	'000ha	% privately owned	'000ha	% privately owned
England	395	50	461	91	856	72
Wales	175	26	61	90	236	43
Scotland	891	42	77	95	968	45
Great Britain	1461	43	599	91	2069	57

3 FORESTRY PLANTING

	England	Wales	Scotland	Great Britain	
	'000 ha	'000 ha	'000 ha	'000 ha	% privately owned
1978	2.1	1.4	17.1	20.6	32
1982	1.5	1.3	20.8	23.6	53
1986	1.2	0.8	21.3	23.3	82

4. FOREST EMPLOYMENT

Forestry Commission	8,000	6,000
Private Sector	11,000	12,000
related processing	33,000	27,000

5. RATE OF RETURN FROM FORESTRY

Forestry Commission
financial target (1982-87) 2.25%

expected outturn: 2.9% (average: rate of return on some new planting in remote areas estimated at 1.5%)

UNITED KINGDOM COMPARED WITH OTHER EC COUNTRIES

	Total forested area '000 ha	Forested area as % of total land area	% of area privately owned	Self Sawnwood	Sufficiency % Wood pulp
UK	2.2	9	57	21	14
France	15.2	28	74	79	54
Germany	7.3	30	44	69	46
Italy	8.1	27	60	32	28
EC(10)	55.5	25	54	51	39
Norway	8.6	28	85	Not available	
Sweden	27.9	68	73		
Finland	23.2	76	71		
USA	301.1	33	61		
Canada	440.0	48	6		

NOTE Figures in first three columns include unproductive woodland.

BASIC FORESTRY ECONOMICS

In 1984 the Treasury and Forestry Commission agreed figures for a typical hectare of Sitka spruce, as a benchmark case for calculating the effects of the tax and grant regimes.

These figures have been updated to 1986 prices, with revised estimates of initial costs (agreed with Forestry Commission in January 1987) assuming good quality land. At current prices (before taking account of future inflation) they are:

SITKA SPRUCE - 54 year cycle

Costs		£	Returns		£
Annual	Maintenance	10	Year 29	Thinning	230
Year 1	Plough/scarify	80	Year 34	"	435
	Fence	120*	Year 39	"	550
	Plant	200	Year 44	"	645
Year 2	Beat up	50	Year 49	"	740
	Weed	80	Year 54	Felling	7925
Year 3	Weed	80			
Year 4	Weed	80			
Year 8	Clean	50			
Year 15	Fertilise	40			
Year 21	Brash	5			

* Agricultural buildings and works allowances are available on this item at a straight line rate of 4% in each of years 1 to 25.

The equivalent figures for a typical broadleaf wood, (on which the figures for returns are less reliable) are estimated as:

BROADLEAF - minimum 108 year cycle

Costs	Returns		£
as above	Year 58	Thinning	390
	Year 68		740
	Year 78		940
	Year 88		1100
	Year 98		1260
	Year 108	Felling	13470

Grants are available on new planting at rates for 1986 of

£240 per hectare for conifers
£470 per hectare for broadleaves

where the area planted exceeds 10 hectares. 80% is paid in the first year and 20% four years later. A higher rate of £600 is paid for broadleaf plantations which meet special requirements as to nature conservation, recreation, sporting facilities, etc.

Effect of different tax regimes Ignoring the cost of land, the internal rates of return on the basis of these figures are shown in the table below.

		With grant	Without grant			
		Present tax regime	Present tax regime	Option 1	Option 2	Option 3
SITKA SPRUCE	Zero inflation	7.8%	7.1%	4.2%	5.0%	5.0%
	3% inflation	"	"	4.0%	"	"
	5% inflation	"	"	3.9%	"	"
BROADLEAF	Zero inflation	4.6%	3.8%	2.1%	2.9%	2.9%
	3% inflation	"	"	1.9%	"	"
	5% inflation	"	"	1.9%	"	"

Option 1 is the normal business basis (para 16 of the text)

Option 2 taxes receipts and relieves expenses as they arise (para 17 of the text)

Option 3 is tax exemption, the preferred option (para 18 et seq of the text)

ANNEX C

SECRET AND PERSONAL

PROFILE OF INCREASED GRANT EXPENDITURE

Assume grant of £500 per hectare half payable in first year and one quarter in second and again in fifth year; supplements of £50 in year 8 and again in year 15 as contribution to annual maintenance, clearing and fertilising. (Note: present grant is £240, 80% payable in year 1 and 20% in year 5). The calculations are based on annual planting of 30,000 ha.

	NOW		AFTER CHANGE		CHANGE IN EXPENDITURE	
	£ per ha	£m	£ per ha	£m	Gross	Net of tax saving
Year 1	240	7.2	298	8.9	+1.7	+1.7
2	As above		423	12.7	+5.5	+4.5
3			423	12.7	+5.5	+2.5
4			423	12.7	+5.5	+1.0
5			500	15.0	+7.8	+1.2
6						-2.2
7						-2.2
8-14			550	16.5	+9.3	-0.7
15+			600	18.0	+10.8	+0.8

NOTE: Increase in expenditure net of tax saving in years 1 to 7 totals to +£6.5m.

ANNEX D

ENVIRONMENTAL OBJECTIVES FOR FORESTRY

i. to prevent any afforestation in certain particularly sensitive areas. These might include sites of special scientific interest designated by the NCC; and archaeological sites which would either be physically destroyed by forestry or else seriously damaged in terms of visual impact and public appreciation

ii. to ensure that afforestation takes place in national parks or designated areas of outstanding natural beauty only if all the statutory bodies agree that it is environmentally acceptablein the proposed location

iii. to avoid encouragement to afforestation of areas which will give poor yields because of adverse geographical factors (very poor soil, high winds etc)

iv. to ensure that, wherever large-scale afforestation takes place, it is carried out in an environmentally sensitive way, is attractive visually, and avoids damage to water quality

v. to encourage environmentally more favourable forms of afforestation, involving smaller plantations, more diversity of species (especially the inclusion of native broadleaved trees), and multiple use, especially for recreation.

ANNEX E

FORESTRY ENTERPRISE PRIVATISATION - MERCHANT BANK REMIT

1. To consider the feasibility of privatisation of the Forestry Enterprise having regard particularly to:

   (i) the anticipated profile of cash and profitability over different time-scales (and the sensitivity of key assumptions such as demand for timber and price);

   (ii) the effect of overcoming any temporary cash deficit by commercial borrowing or sales of parcels of woodland;

   (iii) the tax regime currently in operation for private investment in woodland and its importance for potential investors in Forestry Enterprise;

   (iv) the effect on timing and proceeds of ensuring by legislation or alternative means appropriate standards for conservation, recreation and public access.

2. To estimate the likely proceeds of a sale under different timing options.

3. To consider how far the conclusions under 1 and 2 above concerning timing and proceeds of sale would be affected if the Forestry Enterprise were divided into separate units with the more profitable forests being sold earlier.

4. To advise generally on the form of privatisation (eg flotation, trade sale of individual forests etc) in the light of 1, 2 and 3 above.

[Note: Guidance would need to be given on the assumptions to be made about subsidies and about the regulatory regime following privatisation.]

2184/002

SECRET AND PERSONAL

DRAFT MINUTE FROM CHANCELLOR TO THE PRIME MINISTER

FORESTRY : TAX REFORM, THE ENVIRONMENT AND PRIVATISATION

The ALURE Group recognised the desirability of reappraising forestry policy after the election and I am in particular anxious to push ahead with reforming the present anomalous tax regime and with privatisation.

I have therefore arranged for the attached paper to be prepared. It outlines a set of reforms which we could announce and implement in the 1988 Budget. The main proposals are:

(a) tax exemption for forestry, replacing the present bizarre regime, which serves principally as a tax avoidance vehicle for top rate taxpayers and has become an obstacle to privatisation;

(b) re-designing the grant schemes to increase the environmental benefits of the considerable exchequer costs incurred in present forestry policy;

(c) separating the Forestry Authority role of the Commission from the Forestry Enterprise; and privatising the enterprise side probably over a period of years.

I believe these reforms would be a big step forward and politically attractive. They would be an answer to criticisms that the present regime gives too much to higher rate taxpayers and the strong pressure from the Nature Conservancy Council and environmental pressure groups against large scale planting of conifers. They would also help to speed up privatisation.

3. Nicholas Ridley, John MacGregor and I all favour moving quickly in this direction. The Treasury and Inland Revenue have drawn on advice from DOE and MAFF officials in preparing the report I commissioned, but I have not at this stage consulted Malcolm Rifkind or Peter Walker. Although the report's figuring is based on earlier Forestry Commission data, it may well need to be up-dated and refined.

4. If you would like a preliminary discussion about these proposals and handling them, I would of course welcome it. If you find the proposals attractive, I suggest the next step would be for me to send this paper to Malcolm Rifkind and Peter Walker proposing a discussion under your chairmanship of the attached paper (subject to any necessary up-dating). I hope that such a meeting can be held soon: we could announce the proposed tax changes in the Budget, and it should also be possible to announce the new grants, (which will need further detailed work), at the same time provided we take decisions rapidly.

5. I am sending copies to Nicholas Ridley and John MacGregor.

Ch.

Forestry.

You are planning to speak to Mr Ridley + Mr MacGregor about this at the Conference.

2. Mr Ridley's office have telephoned to say that he is in full agreement with your ppr. + proposals.

JS 6/10

I have now spoken to Mr R, & would like a discussion with Mr [illegible].
N

H 9.2

ps3/8T SECRET AND PERSONAL

Jonathan

FROM: J M G TAYLOR
DATE: 2 October 1987

MR MONCK

Ch
For Mr MacGregor
& Mr Ridley
AA

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Scholar
Mr Bonney
PS/IR
Mr Beighton - IR
Mr Draper - IR

REFORMING FORESTRY POLICY

The Chancellor discussed with you today your minute and enclosure of 1 October.

2. The Chancellor said that he considered this an excellent piece of work. He asked you to check the figures for the revenue benefit to the exchequer of the proposed tax reforms; you undertook to do this.

3. The Chancellor thought that when the proposals were eventually put to Mr Rifkind, they should be confined to changes to the tax and grant regime. No references to the possible privatisation of the Forestry Commission, or to its restructuring, should be made. This would make it less likely that the Commission would immediately leak the proposals, and begin hostile lobbying.

4. The report to the Prime Minister should, of course, include these references.

5. The Chancellor said he would speak to Mr Ridley and Mr MacGregor in this sense, probably in the margins of the Party Conference. Subject to their approval - and provided that they do not want a meeting - he will minute the Prime Minister. You undertook to revise your draft appropriately.

JMGT
→ MONCK
2/10

J M G TAYLOR

2184/004

SECRET AND PERSONAL

FROM: N MONCK

DATE: 12 October 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Scholar
Mr Bonney

PS/IR
Mr Painter, IR
Mr Beighton, IR

Thanks. I have a slight qualm: it might be safer to give IR + C&E an opportunity to comment on the draft cover letter before it goes off? 12/10

Ch / Content?

REFORMING FORESTRY POLICY

I attach a revised draft covering minute to the Prime Minister which reflects your talk in Blackpool with Mr Ridley and Mr MacGregor and your other comments.

2. I also attach a slightly revised version of the report submitted on 1 October. Apart from some revision of figures, the main change is that it no longer claims that the new tax and grant regime will somewhat raise the real return on broadleaved forestry. The claim is simply that the new regime would broadly maintain the present return (see Annex B) for both conifers and broadleaved trees. The environmental benefits come from attaching conditions to the grants. This will be a much stronger weapon than it is now because a larger proportion of the Exchequer subsidy will be delivered by the grant.

3. We have dropped the claims about improving the broadleaved return because it is likely to prove unrealistic. The reason is that if the timing of grant payments is such that cumulative grants exceed cumulative costs, there will be an incentive to fraud. This risk is greater for broadleaved because the grant needs to be higher than for conifers to reflect the more distant revenue prospect (see first page of Annex B). Our more modest claim that the return on broadleaved will be maintained is consistent with spreading the grants over time so that their cumulative value does not typically exceed cumulative costs. This has not at this stage been carried through to the public expenditure figuring, because the grant proposals will in any case need to be combed through and probably revised when the Forestry Commission is brought in to supplement MAFF's (limited) knowledge. Meanwhile it is best to be prudent about the claims made. We seem to be at or near the realistic limit for broadleaved grants.

NM

N MONCK

SECRET AND PERSONAL

DRAFT MINUTE FROM CHANCELLOR TO THE PRIME MINISTER

FORESTRY : TAX REFORM, THE ENVIRONMENT AND PRIVATISATION

The ALURE Group recognised the desirability of reappraising forestry policy after the election and I am anxious to push ahead with reforming the present forestry tax regime in time to include it in ~~the~~ next year's Budget.

2. I have therefore arranged for the attached paper to be prepared. It has been seen and agreed with Nicholas Ridley and John MacGregor. It outlines a comprehensive set of reforms which looks beyond the 1988 Budget. The main proposals in the report are:

(a) ending the present bizarre tax regime, which serves principally as an avoidance vehicle for top rate taxpayers and has also become an obstacle to privatisation; and instead exempting forestry from income tax completely, so that revenue would not be taxed and costs would not be allowed. Because the present tax regime provides a subsidy, the exchequer would benefit from this change;

(b) using the resulting revenue gain to finance increased and redesigned grants for forestry. The effect would be to get more environmental benefits for the considerable exchequer costs already incurred in existing forestry policy;

(c) separating, probably at a later stage, the Forestry Authority role of the Commission from the Forestry Enterprise; and privatising the enterprise side probably over a period of years.

3. I believe these reforms would be a big step forward and politically attractive. They would be an answer to criticisms that the present regime gives too much to higher rate taxpayers and also to the strong pressure from the Nature Conservancy Council and environmental pressure groups against large scale planting of conifers. But because (c) would be resisted by the Forestry Commission and its supporters, I propose that we should handle this in two stages. We would pursue (a) and (b), which are the urgent parts of the proposal, immediately; and come back to (c) after the Budget.

4. Nicholas Ridley, John MacGregor and I all favour moving quickly in this

direction. The Treasury and Inland Revenue have drawn on advice from DOE and MAFF officials in preparing the report I commissioned, but I have not at this stage consulted Malcolm Rifkind or Peter Walker. Although the report's figuring is based on earlier Forestry Commission data, it may well need to be up-dated and refined.

5. It would be helpful if you could discuss these proposals and their handling ~~them~~ with the three of us. If you find ~~the proposals~~ them attractive, I suggest the next step would be for me to send a paper covering the tax and grant proposals but not privatisation etc to Malcolm Rifkind and Peter Walker. If you agree, I would propose a discussion of ~~the~~ that paper under your chairmanship. I hope that the meeting can be held soon. If we are to announce the proposed tax changes in the Budget, we ought to announce a new grants regime (which will need further detailed work) at the same time. But this should be possible provided we take decisions rapidly.

6. I am sure the security classification of these papers will be self-explanatory.

7. I am sending copies to Nicholas Ridley and John MacGregor.

2184/011

SECRET AND PERSONAL

FROM: N MONCK
DATE: 22 October 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Scholar
Mr Bonney

Mr Beighton, IR

MONCK TO CH/EX BRIEF 22 OCT

REFORMING FORESTRY POLICY

You are meeting the Prime Minister with Messrs Ridley and MacGregor to discuss this subject tomorrow. Your objectives are:

(a) to get the Prime Minister's support for your proposals: a Budget announcement that income tax exemption will replace the present reliefs for new planting and that Forestry Commission grants will be increased and redesigned, using the extra tax revenue to finance this change;

(b) to get her agreement to the procedure you have proposed: you would send a shorter version of the paper (without the bits on the Forestry Commission and privatisation) to Messrs Rifkind and Walker, proposing a meeting under the Prime Minister's chairmanship; and

(c) to get any views she may have about handling those Ministers.

2. The rest of this brief lists some initial points to make in support of your proposals; and provides some possible answers to questions which I gather the Prime Minister might raise.

Arguments for your proposals:

3. (a) useful tax reform, replacing present regime much used - and criticised - as avoidance vehicle for top rate taxpayers; helpful component of next Budget;

(b) better environmental results, answer to pressure groups who dislike conifers;

(c) fits in well with immediate help on trees after last week's storms announced by Mr Ridley on Wednesday (see Hansard extract at Annex A to this brief). The Prime Minister prompted these;

(d) will continue expansion of woodland area in Britain and the switch of new planting to private sector (now over 80 per cent compared with about 30 per cent in 1978). Compatible with aim of planting 33,000 ha a year, announced with ALURE decisions earlier this year, since rates of return will be maintained;

(e) need to make rapid progress if new grant schemes as well as tax legislation to be ready for Budget. No legislation needed to change grants.

DEFENSIVE POINTS

Why switch from tax to public expenditure, better to leave people with their own money

4. Present income tax regime does more than leave people with their own money. Typically post-tax rate of return higher than pre-tax rate of return. A conifer plantation earning 5 per cent real pre-tax earns over 7 per cent post-tax. Wrong to use tax system in this way.

5. Secondly, if Exchequer subsidies are to continue, as I propose, they should produce politically popular results. Easier to attach environmental conditions to grants than to tax breaks.

Spend more to (a) create jobs and (b) to reduce imports

6. (a) Forestry Commission figures show that over 90 per cent of the jobs produced by forestry come 35 years after planting, even with conifers; (see Annex B to this brief).

7. These delayed jobs are expensive. In the north of Scotland subsidy per man year is about £8,000, ie more than typical earnings of £6,500 a year.

8. This is nearly double the subsidy per job needed for operations of Highlands and Islands Development Board.

9. (b) Import substitution needing subsidy on this scale impoverishes country. Our tax regime already appears more generous than those in France, West Germany and USA.

Transitional arrangements

10. Details not yet fixed. But broad proposal is that Schedule D relief for costs would continue for first four years after planting done [or perhaps committed] before Budget announcement. Most of the expenditure comes in these years (see Annex B to paper, page 1). Income tax exemption would leave the revenue from forestry untaxed. This is fair and defensible.

Mr Rifkind and Mr Walker

11. Knowledge of the proposed tax reform so far kept to a very narrow circle in London. But Malcolm Rifkind as the lead forestry Minister - nearly half of the GB forested area is in Scotland - clearly must be consulted. My officials also need to update facts and to refine the outline grant proposals in discussion with the Forestry Commission. Widening the circle inevitably involves security risk. But can limit this by omitting privatisation and reforms of the Forestry Commission itself from the paper I send him. We can return to it in a second stage after the tax and grant reforms are secured.

12. When we do so, Mr Rifkind can remain lead forestry Minister as part of his responsibilities for agriculture in Scotland.

13. Meanwhile increased grants should appeal to farmers in the less favoured areas in Scotland and Wales.

Next Steps

14. If this meeting goes well the next step will be for you to send a shortened report to Messrs Rifkind and Walker.

15. In parallel the Inland Revenue will want to seek your views on secondary tax matters on Capital Gains Tax and Inheritance Tax.

NM

N MONCK

Extract from Secretary of State for the Environment's statement on storm damage on 21 October 1987. (Hansard, col 732)

I recognise that, too, that the public feel deeply about the massive damage that has been done to mature trees. There is a strong feeling that we should replant for the benefit of future generations.

The royal parks are my direct responsibility, and we will press ahead with clearing and appropriate planting as fast as possible. There are already in existence for rural areas Countryside Commission schemes for grant assistance to local authorities and private owners for tree planting. I propose to extend these schemes in three ways to cope specifically with the loss of trees as a result of the hurricane force winds. First, for this temporary purpose, the rate of grant aid for local authority planting will be increased to 90 per cent. Secondly, and also temporarily, these schemes will be extended to cover London and other urban areas. Thirdly, the Countryside Commission will have discretion to grant-aid at a higher rate than under its present scheme historic landscapes of great value where the scale of tree loss justifies this. I shall make extra resources available in the current year for these schemes. These extensions will enable the taxpayer to contribute to restoring our heritage of fine trees for future generations. In addition, my Department will be issuing through the press to householders, guidance on the protection of surviving but damaged trees.

My right hon. Friend the Minister of Agriculture, Fisheries and Food is urgently consulting the European Commission with a view to increasing the rates of grant under the agriculture improvement scheme for shelter belts, hedges and traditional walls in the storm damage areas to 60 per cent., with conifer belts at 30 per cent., until the end of 1988-89. He will also be providing special additional help to Kew gardens and Wakehurst place which suffered severe damage of national and international significance. My right hon. Friend is also arranging for the farm and countryside initiative to provide help to some particularly hard hit rural communities both for tree clearing and tree planting.

The measures that I have announced today will provide both for the appropriate short-term assistance to local authorities in their emergency work, and for repairing, as soon as possible, the long-term damage to the environment

The House will wish to join me in thanking the local authorities and all the emergency services for their unstinting efforts, and in offering sympathy on the loss and suffering experienced by people in the areas affected.

ANNEX B

EMPLOYMENT IN FORESTRY

Trees take a long time to grow. Very little employment is generated for 20 years after planting. Unemployment is a pressing problem here and now. Investment in forestry cannot be an effective means of tackling current employment.

Forestry Employment

Period (Years)	Man Years per 100 Hectares	% of Total Labour Inputs	
-1 to 4	2.0	3.2	
5 to 10	.3	0.5	
11 to 16	.3	0.5	
17 to 22	.4	0.7	2.8
23 to 28	.3	0.5	
29 to 34	.3	0.5	
35 to 40	56.0	94.0	
	59.6		

Source: Forestry Commission

Bribing people to grow forests is also expensive. The Forestry Commission generally earn a return of less than 3 per cent and private growers are helped out by generous tax relief subsidies and grants. On average, each year a man is employed in forests, costs the Exchequer £8,000 - comparing with an average industrial employee wage in forestry of £6,500.

SECRET AND PERSONAL

CH/EXCHEQUER
REC. 23 OCT 1987
ACTION MR MONCK
COPIES TO CST, EST, SIR P MIDDLETON, MR FER BUTLER, MR BURGNER, MR SCHOLAR, MR BONNEY, PS/IR, MR PAINTER - I.R., MR BEIGHTON - I.R.

23/10

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 October 1987

Dear Jonathan,

FORESTRY: TAX REFORM, THE ENVIRONMENT AND PRIVATISATION

The Prime Minister this afternoon discussed with the Chancellor of the Exchequer his minute and paper of 19 October about forestry. The Secretary of State for the Environment and the Minister for Agriculture were also present, together with Professor Brian Griffiths of the No. 10 Policy Unit.

It was agreed after a brief discussion that the proposed four year transitional period under the third option would probably be adequate. However, it might perhaps be increased by a year or two if there were great pressure for this.

It was agreed that the Chancellor of the Exchequer should send a revised paper to the Prime Minister, copied to the Lord President, the Secretary of State for the Environment, the Minister for Agriculture and the Secretaries of State for Wales and Scotland, with a view to a meeting under the Prime Minister's chairmanship. The paper should not discuss the possibility of reforming and privatising the Forestry Commission. The Chancellor would consider how the new grants regime should be presented in the paper. He would also make contingency plans for an early announcement, before the Budget, to prevent forestalling if news of the discussions were to leak.

Yours,

David.

David Norgrove

Jonathan Taylor, Esq.,
H.M. Treasury.

NORGROVE TO TAYLOR 23 OCT

SECRET AND PERSONAL

2184/021

SECRET AND PERSONAL

FROM: N MONCK

DATE: 27 October 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Scholar
Mr Bonney

PS/IR
Mr Painter, IR
Mr Beighton, IR

Many thanks

Ch/ I think it would be wise (as well as courteous) to clear the draft minute in toto with MAFF + DoE ('x' in para. 3, below). Content for me to do this?

28/10 yes

REFORMING THE INCOME TAX REGIME FOR FORESTRY

I attach a draft minute for you to send the Prime Minister, covering a shortened version of the report designed to be acceptable to a wider group of Ministers. This version therefore excludes the "Stage 2" propositions about reforming and privatising the Forestry Commission itself.

2. It also, as you asked, expresses reluctance to use the revenue gain from the tax reform to increase public expenditure on forestry grants. The changes are sidelined. The perceptive reader may still be able to penetrate the show of decent reluctance. But we cannot go too far in the direction of disguise without removing the basis for agreement on a tax-and-grant package and some of the information relevant for decisions. If we spend less than the full revenue gain (after the transitional net Exchequer cost) we cannot argue that rates of return have bee[n] on average maintained and that the new regime can be presented as compatible wit[h] the planting aims announced earlier this year.

3. The draft minute would be copied to the Lord President, Mr Rifkind and Mr Walker as well as to Messrs Ridley and MacGregor. I have consulted MAFF about the draft minute to the Prime Minister in view of their sensitivity about referring to their co-operation. After your meeting at No 10 Mr MacGregor told his officials that it had been agreed that there would be no reference to this co-operation. My opposite number (Ted Smith) personally agrees with me that a denial of co-operation at official level will not achieve its purpose: it will simply not be credible to Mr Rifkind's and Forestry Commission officials that the Treasury would have produced the grant proposals the report contains unaided. He therefore agrees

that the best course is for the minute to refer to co-operation at official but not Ministerial level, as the draft does in para 4. But because of the instructions he has had from Mr MacGregor, he feels obliged to ask that your private office should get Mr MacGregor's agreement to the treatment in the draft minute. I should be grateful if Mr Taylor could get clearance for this by telephone from the Private Secretaries in MAFF and DOE.

X

4. Mr MacGregor also told his officials that definite agreement had been reached at No 10 on additional public expenditure of £10 million. He will argue for that sum at the wider meeting and expects to get it. He accepts it is an upper limit.

5. I have kept to the "secret and personal" classification although the circle is being widened, as the one most likely to succeed. Mr Scholar agrees.

6. The Revenue and we are working separately on a contingency statement that could be used in case of a leak. We hope to let you have it later this week.

N MONCK

2184/002

SECRET AND PERSONAL

DRAFT MINUTE FROM CHANCELLOR TO THE PRIME MINISTER

REFORMING THE INCOME TAX REGIME FOR FORESTRY

I am anxious to push ahead with reforming the present forestry tax regime for forestry in time to include it in next year's Budget. You may recall that the ALURE Group recognised the desirability of reappraising forestry policy after the election.

2. I have therefore arranged for the attached paper to be prepared. From my point of view the priority is to end the present bizarre and over-generous tax regime, which serves principally as an avoidance vehicle for top rate taxpayers. Instead the paper proposes exempting forestry completely from income tax. This would mean that revenue would not be taxed and costs would not be allowed. Because the present tax regime provides a subsidy, which makes the rate of return higher after tax than before tax, the Exchequer would actually benefit from this change.

3. One result of this tax reform, however, would be to reduce the rate of return on new planting. Whatever the merits of the tax reform, this might run into criticism on the grounds that it was inconsistent with the aim, announced earlier this year, of planting 33,000 hectares a year. There are arguments against maintaining the present level of Exchequer subsidies, but I recognise that there is a political case for drawing on the resulting revenue gain to finance increased grants for forestry. I would be reluctant to do this, especially as there would be a transitional net cost to the Exchequer. But if my colleagues think it politically necessary, I would prefer that course to leaving the present tax regime unreformed.

4. If we went down that road it would be sensible to redesign the grant scheme and the conditions attached to grants so as to get more environmental benefits. The report therefore outlines how this might be done, though my officials have as yet only been able to draw on the limited advice available in London from MAFF and DOE officials. This was based on earlier Forestry Commission papers, but the report's figuring may need to be up-dated and refined.

5. I believe that reform on these lines would be a big step forward and politically attractive. It would be an answer to criticisms that the present regime gives too much to higher rate taxpayers and also to the strong pressure from the Nature Conservancy Council and environmental pressure groups against large scale planting of conifers.

6. I would not normally propose such a procedure for an issue involving tax alone, but in this case there are a number of colleagues with responsibilities for forestry and for public spending on forestry grants. I suggest that the next step might be for you to chair a meeting to discuss my proposals. We need to take decisions quickly if the necessary preparatory work is to be ready in time for announcement in the Budget.

7. I am copying this minute and the attached report to Willie Whitelaw, Peter Walker, Nicholas Ridley, John MacGregor and Malcolm Rifkind.

[NL]

007/920

SECRET AND PERSONAL

REFORMING THE TAX REGIME FOR FORESTRY

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Annexes

REFORMING FORESTRY POLICY

I INTRODUCTION

1. The purpose of this paper is to outline a set of proposals for a major reform of forestry policy. The process of reform would not be painless and the result would not be perfect since there would still be a number of anomalous features. But the policy proposed would be based on more up-to-date objectives on taxation and the environment. There would still be subsidies for forestry but they would be better targeted.

2. When presenting these proposals publicly, the Government would need to explain the reasons for the proposed changes. Government policy towards forests appears to be inconsistent with general policy on industrial support. In particular, Exchequer assistance is difficult to justify in relation to a rationale for intervention based on market failure, although the long production cycle for timber arguably raises some special considerations. Nonetheless there remains strong regional interest in continued support for forestry and there is widespread concern about the role of forests in the general environment. Yet, the current support mechanisms involving heavy reliance on tax relief, and favouring top rate tax payers, sit uneasily with the Government's general policy towards taxation while at the same time failing to satisfy these environmental concerns. It is at the latter issues that these proposals are aimed.

3. The **main proposals** are

(a) income exemption for forestry, replacing the present regime;

(b) re-designing and, if necessary, enhancing the grant schemes to increase the environmental benefits of the considerable exchequer costs incurred in present forestry policy.

These are discussed in parts III-IV of the paper.

4. This paper has been prepared without consultation with the Forestry Commission or the Scottish Office. Thus, although the quantification provided mostly derives from material provided by the Commission on earlier occasions, it may need to be refined and updated.

OBJECTIVES

5. The current objectives of Government forestry policy stem from the Acland Committee report of 1917. They were restated in 1980 by the then Secretary of State for Scotland as "to reduce our dependence on imported wood" with a secondary objective of stimulating rural employment. In March 1986 a further statement set a general aim of planting 30,000 hectares (ha) a year against the 25,000 ha in the 1980 statement. This was raised to 33,000 ha following the ALURE group discussions earlier this year. On neither occasion was the figure presented as a firm commitment.

6. Forestry expansion has been promoted by the activities of the Forestry Commission itself and by grants and tax incentives to the private sector. The cost of these measures in 1987-88 is expected to amount to about £50 million: public expenditure of £32 million on the costs of the Forestry Enterprise, £14 million on the Forestry Authority, £8 million in grants to the private sector receipts from planned disposals of £13 million plus about £10 million in revenue currently foregone from tax concessions. The private sector now accounts for more than 80% of total new planting compared with 35% in 1980. The policy has undoubtedly been a success in terms of new planting: the woodland area of Britain has increased from 1.2m ha in 1924 to 2.2m ha now. Some key background facts are set out in Annex A.

7. The present policy is, however, open to a number of criticisms. It was against the background of these that the ALURE group recognised the desirability of pursuing a fundamental re-appraisal of forestry policy after the General Election.

(i) the historic <u>economic</u> justification for a subsidy aimed at limiting imports is not easily reconcilable with the Government's general trade policy; nor is there any clear justification for assistance in the context of the general market-failure rationale for Government intervention and industrial support;

(ii) the <u>social</u> value of forestry as a creator of jobs is doubtful: new employment is not necessarily located in areas where it is most needed, jobs only emerge to any significant degree fairly late in the forestry cycle, after a period of some 35-40 years at the earliest; and in the North of Scotland, where most planting occurs, costs per direct job are estimated at £8000 per year, which after appropriate adjustments yields a cost per job nearly double that achieved by the Highlands and Islands Development Board, the development agency for the area;

(iii) there is widespread criticism of new plantations on <u>environmental</u> grounds, because the losses of wildlife outweigh the gains, because they can damage water quality, and because of the scenic monotony of unrelieved masses of conifers;

(iv) the <u>fiscal</u> arrangements run counter to the Government's aim of removing from the tax system features which distort commercial judgements; present arrangements allow very high rates of subsidy to investors in the highest tax brackets who have no real link with the land;

8. On the other hand there is a strong body of opinion in favour of Government support for forestry.

(i) It is argued that the very long life of forestry investment might discourage investors, who are often averse to the risk associated with waiting a long time for returns, and lead to under-investment. It is also argued that the benefits of tree planting for nature conservation, amenity, recreation, sporting and shelter justify a subsidy in appropriate cases;

(ii) More sensitive planting techniques are now being devised and adopted, and the considerable recreational potential of forests is being exploited. As a result of these trends forests can often be environmental assets;

(iii) As for employment creation, while it is difficult to make a case on cost-effectiveness grounds, it can be argued that the contribution of forestry to income and employment in many scarcely populated and fragile rural areas argues for some caution when considering withdrawing Exchequer support. In certain areas it may take a considerable time to offset the income and employment consequences of a halt to new planting.

(iv) While the present fiscal arrangements are anomalous, bringing them to an end will not necessarily result in higher revenue or more productive investment; some taxpayers will always seek to shelter their income from tax and ending this shelter may mean no more than a switch of resources from one shelter to another;

(v) There is also an "insurance" angle. Although there is no clear evidence about market trends there are longer term uncertainties about the availability of imported timber. Other Community countries apparently consider the possibility of a future world timber shortage sufficient to justify a considerable degree of support for domestic production anticipating an average level of self-sufficiency of some 50% by the turn of the century compared to 25% in prospect for the UK. Those supporting these European decisions, consider that existing UK levels of subsidy can similarly be justified as an insurance premium against future world timber shortages. The House of Lords report on EEC Forestry Policy in the 1985/86 Session in supporting continued but carefully managed expansion of forestry emphasised balance of payments considerations.

III TAX REFORM

The present regime

9. The present income tax regime for forestry is unique and curious, not least because it provides a net Exchequer subsidy for investment in planting trees: foresters would be worse off than they are now if forestry were exempt from tax altogether. An occupier of woodlands managed on a commercial basis with a view to profit is taxed under Schedule B, an archaic income tax schedule now confined exclusively to forestry. This results in a purely nominal charge which works out on average at about 15p per acre per year. In addition the tax payer has an option to elect for Schedule D (the schedule under which businesses generally are taxed).

10. The normal practice is for people in the early stages of a woodland, when costs are heavy and there are no receipts, to elect for Schedule D so as to be able to claim the expenditure as a tax relief against their other income. Someone opting for Schedule D cannot subsequently revert to Schedule B. They can, however, contrive a change of occupation. This can be done by selling the woodlands or giving them away (often to a family trust or another member of the family). This has the result of returning the woodlands to Schedule B. There is no CGT charge on the sale of trees.

11. The result is that the expenses receive tax relief under Schedule D (at 60 per cent if, as is usual, the first occupier is a top rate taxpayer) while the receipts are effectively exempt. This regime appears to be more generous to forest owners than those applying in France, West Germany and the USA.

12. These arrangements provide an attractive tax shelter for higher rate tax payers particularly as there are also favourable inheritance tax rules for woodlands. A number of commercial forestry companies have been established to market these and to manage the woodlands on behalf of the investors who receive the tax reliefs and the Forestry Commission grants (see paragraph 21 below). The companies concerned do not themselves own the land or invest shareholders funds directly.

13. Annex B sets out the economics of a typical conifer plantation and a typical broadleaved plantation. The figures are derived from information provided by the Forestry Commission but should only be regarded as broad estimates of typical returns: figures for individual plantations will vary. The internal real rate of return on the conifer plantation is increased by tax from 5 per cent pre-tax to 7.1 per cent post-tax; comparable figures for the broadleaved plantation are 2.9 per cent and 3.8 per cent. In other words the tax system is actually providing a subsidy to planting. Grants further increase the internal rate of return to 7.8 per cent for conifers and 4.6 per cent for broadleaves.

14. The present cost of tax relief on planting is around £10 million a year.

15. Continuation of this regime sits uneasily with the Government's general position on taxation. The underlying direction has been to reduce rates of direct tax but also to reduce or eliminate special reliefs or shelters which distort economic decisions.

Options for reform

16. There are three options. The <u>first</u> is to put forestry on the same fiscal basis as other businesses. Income would be taxed and the expenses would be allowable but not until the income was received. Because of the long life cycle of the crop and the lumpiness of the receipts this option would create major problems for the industry. Woodland owners would have to wait 30 years or more for their relief and the income would almost invariably be taxed at the highest rate. Some arrangement would be necessary for spreading the income over a number of years. Moreover, as Annex B shows, the effect would be to reduce the rate of return on conifers from 5 per cent (pre-tax) to 4.2 per cent (after tax) with no inflation and to 3.9 per cent (after tax) with inflation at 5 per cent. The rate of return on broadleaves would fall from 2.9 per cent to 2.1 per cent with no inflation and 1.9 per cent with 5 per cent inflation. This option would be strongly criticised by forestry interests and looks the least attractive of the three.

17. The second would be to abolish Schedule B, to tax all receipts under Schedule D but to allow relief for planting expenditure to be set against other sources of income as and when the expenditure is incurred. Post-tax rates of return would be very close to pre-tax rates of return. The Exchequer would eventually receive an extra £100 million a year from the abolition of Schedule B but initially there would be no Exchequer saving. Moreover, as would also be the case with the first option, arrangements for spreading would be necessary.

18. The third and by far the simplest option would be to exempt forestry entirely from tax. Receipts from the sale or felling of timber would not be charged to tax and the costs would not be allowed. After a short transitional period there would be a tax saving of around £10 million a year. Tax considerations would no longer distort commercial judgements, though the regime would be more favourable than for business generally.

19. Under all three options transitional arrangements would be required. With the third option (the exemption option), for example, it would be difficult to defend cutting off relief for expenditure overnight. But because the bulk of expenditure takes place in the first 2 or 3 years the transitional period with this option could be quite short. A 4 year period might be sufficient. On this assumption the tax savings as they would be published on Budget Day might be of the order of:

	£m
Year 1	0
Year 2	+1.5
Year 3	+4
Year 4	+6
Year 5	+7.5
Year 6	+10

With both the other options it would be difficult to justify a charge to income tax on receipts from forests which have been planted in the expectation that the present regime would continue. A very long transitional period stretching ahead for decades would therefore be required.

20. The present tax subsidy would be removed under both these options. The exemption option ie (option 3) would require careful presentation and would need to be firmly related to the peculiar features of forestry and the need for simplicity. But with that proviso it seems preferable to option 2 because it is simpler, yields savings quickly and avoids the need for long transitional arrangements. **It is the option we recommend.** Forestry management companies should still be able to operate successfully on much the same basis as now but with a wider range of investors particularly if the grants payable were at the same time somewhat increased, (see below). But forestry would no longer be seen as the preserve of top rate tax payers.

IV CHANGING THE GRANT REGIME

21. Changing the tax regime as proposed above would reduce the rate of return on new planting and would therefore be likely to reduce the volume. This might be felt to be inconsistent with current forestry policy and hence to raise political difficulties despite the economic arguments for lowering the present degree of Exchequer subsidy. If so, it would be possible to finance a higher level of grants by using part or all of the exchequer savings resulting from the tax changes. At the same time it would make sense to try to achieve environmental aims.

21a. There are at present several schemes under which grants are paid for afforestation. The main one is the Forestry Grant Scheme under which grants are paid for conifer and mixed plantations. Almost all the major plantations which receive the special tax allowances qualify for grant under this scheme. There is also the Broadleaved Woodland Grant Scheme, introduced in 1985, under which higher rates of grant are paid for woodland comprising only broadleaved trees. Rates of grant for these two schemes are as follows:

RATES OF GRANT (£ per ha)

Area of Woodland ha	Forestry Grant Scheme[1] Conifers	Broadleaved	Broadleaved Woodland[2] Grant Scheme
0.25- 0.9	630	890	1,200
1.0 - 2.9	505	735	1,000
3.0 - 9.9	420	630	800
10 and over	240	470	600

NOTES (1) Grants are paid pro rata to the proportion of conifers and broadleaved trees. 80% is paid on completion of planting and 20% five years later subject to satisfactory establishment.

(2) 70% is paid on completion of planting and 15% each five and ten years later subject to satisfactory establishment and maintenance of trees.

In addition to these two schemes, a proposed Farm Woodland Scheme was announced in March this year. Under this scheme, to supplement the planting grants, there would be annual payments to compensate for loss of income from farm crops.

22. An illustrative grant scheme is set out in paragraph 26a. Any new grant structure would be intended to replace the Forestry Grant Scheme. However, it would be sensible also to subsume the Broadleaved Scheme in the new structure since the grant rates would be more favourable. The new planting grants would in principle also apply to the Farm Woodland Scheme although some adjustments might be necessary.

23. It is proposed that any changes it was decided to make in the grant regime would be announced at the same time as the tax changes. The grant increases would apply immediately whereas the tax savings would not begin to accrue until the following year. However, the aim must be

over the transitional period as a whole for the increase in grants to no more than match the tax saving and preferably to fall below it, by phasing in the increased grants and particularly by reducing the proportion of grant paid in the first year. However, in the first 5 years extra public expenditure will exceed the tax saving (see Annex C).

24. As a result of switching from tax relief to grants, it will be possible to devise a regime which is much more effective in achieving environmental objectives, as set out in Annex D. It would be important to formulate at the outset an evaluation plan for assessing the success of the revised grant scheme in achieving its specific objectives. The new grant rates should be cash limited and also subject to an early review, which could involve reductions in rates if demand turns out to be higher than anticipated.

25. For illustrative purposes, it is assumed initially (paragraph 26a) that the £10m saved (after a transitional period) of several years from the tax changes could <u>all</u> be used to increase grants. This is the most generous option and is thus the upper limit of what could be done on this approach. The Treasury would prefer an alternative option - of using only half this sum, which is examined briefly (paragraph 29). Several cautionary points need to be made. First, the figuring is based on partial information and must be regarded as tentative. The main data lacking are a size structure analysis of new plantings and figures such as cost per ha by size and type of plantation which are necessary in drawing up an appropriate scale of grants and would help in assessing possible response rates to grants at various levels. Second, while higher grants could increase incentives to non and low rate tax payers, many potential farming investors - unlike the current high tax paying investors whose primary aim is to save tax and convert that into a capital asset - may not be able to afford the loss of income from their land. The present analysis assumes that grants would contribute only to costs of planting and would not compensate for income forgone. Under this assumption, only a limited increase in investment by non and low rate tax payers could be expected.

26. The changes in grants would be designed to blend environmental needs and commercial considerations. The new regime would encourage smaller plantations and the planting of more broadleaved trees (either on their own or to break the monotony of conifer plantations) by:

i. requiring all plantations above a certain size to contain at least a minimum proportion of broadleaved trees, except where climate and geography make this impossible. A reasonable threshold would be 3 ha and a reasonable proportion 15%. These broadleaved trees would of course attract the higher rate of grant

ii. extending the existing grant differential in favour of smaller and medium size plantations.

On the illustrative expenditure assumption in paragraph 25 the pattern of grants could be such as to sustain a high rate of new planting and thereby maintain steady growth in jobs in rural areas and, over future decades, enable the production of timber to expand.

26a. The following table illustrates how these principles might be embodied in a grant schedule. It is based on the most generous option of using the whole of the £10m tax saved. The figures are tentative at this stage because the choice of actual figures will require careful study in the light of more refined and up to date estimates of planting costs, and of the existing and expected size distribution of plantations. But preliminary calculations indicate that, following exemption from taxation, the internal rate of return from both conifers and broadleaves could be maintained at around existing levels, if grant rate for conifers were increased by some £300-£350 per ha and for broadleaves by some £350 and £400 per ha. These are illustrative figures related to plantations in the medium-size range.

Possible pattern of Grant Rates

				£
	Present Grants		New Grants	
	Conifer	Broadleaved	Conifer	Broadleaved
0.25 - 0.9	630	890	800	1200
1.0 - 2.9	505	735	750	1100
3.0 - 9.9	420	630	700	1000
10 and over	240	470	600	900
50 - 100 ha			500	800
100 - 500 ha			450	700
500 and over			400	600

27. As in the present grant regime, grant would be refused if it was concluded, after consultation with the relevant statutory authorities, that a proposed plantation would not be environmentally acceptable. Refusal of grant would be a much more effective sanction in future because tax relief would no longer be available and the grant would represent a higher proportion of the costs of planting. It might also be desirable to widen the circumstances in which grant is refused, for example to protect moorland areas, (preferably, given the higher grant levels, without creating rights to compensation). Precise guidelines and how they would be implemented would require consultation with the Forestry Commission and other interests. Where grant was forthcoming, the condition about a minimum 15% of broadleaved trees would normally apply, as described above, and the grant structure would provide financial incentives for more scenically attractive forms of planting, which would also safeguard wildlife. These

features of the new regime would make it broadly acceptable to environmental bodies, and enable the Government to resist pressure to make afforestation subject to planning control or a new system of planting licences.

28. It would also be desirable to reduce the workload involved in examining and consulting about individual grant applications. One possibility would be to formulate a comprehensive code of practice containing clear criteria for the environmental impact of forestry operations and to require applicants for grant to certify that their proposed scheme complies with a code of practice. But this would similarly require extensive consultation and could not therefore be introduced at the outset.

29. An alternative approach, which the Treasury would prefer, would limit the increase in cost of grants to £5m. Adjusting the rates for particular categories of woodland would enable environmental objectives to be achieved but at the expense of bigger cuts in incentives to commercial forests. It is hard to say what could be achieved by spending £5m annually on higher grants; but if the above schedule were lowered by a little over £100 per ha, it might achieve planting of around 20,000 ha. This is not much different from the current planting rate of 23,000 ha in 1986.

30. The tentative conclusion is that subject to a more detailed study it should be possible through additional spending of £5-10m to devise a system of grants resulting which would:

(a) achieve an environmentally more favourable pattern of afforestation which would be acceptable to the main environmental bodies;

(b) give a pattern of incentives which it could be demonstrated were only slightly below present levels for higher rate taxpayers (and to other than highest rate tax payers were higher).

Given the change in the form of the incentive, and particularly the differential effect on high and low tax payers, it is not possible to be certain how the level of planting would be affected.

31. An improved grant scheme would initially involve some Exchequer cost, but this would be relatively small (in the example in Annex C £7.0m over 5 years). The use of a cash limit, in contrast to current demand led schemes, would also help to avoid additional costs. A more modest scheme, at around £5m a year, would probably achieve the environmental benefits described and would be more consistent with the Government's general approach to industrial support in other sectors. But it may be difficult to present it as coming close to achieving planting of 33,000 ha a year, and to this extent a higher level of grants - up to a maximum of £10m - may need to be considered. There is certainly no case at all for raising the overall level of Exchequer support for commercial forestry above its current level.

V TIMING AND NEXT STEPS

32. There is a strong case for announcing the reform of the tax regime in the 1988 Budget and including the changes, which would take effect from Budget Day, in the Finance Bill. If implementation were later, there would be a forestalling problem which would be difficult to solve. If Ministers decided that the tax change needed to be accompanied by changes in the grant schemes, early action would also be desirable. It would be a response to the strong pressure on the Government from the Nature Conservancy Council and environmental pressure groups, especially over the large-scale planting of conifers by high-rate tax payers in Caithness and Sutherland.

33. But to meet this timetable and in particular to ensure that the Finance Bill clauses and any changes in grants could be ready in time, decisions would have to be taken urgently. Further work would be needed on the detailed design of any new grant regime to maximise the benefits within the upper limit of £10m a year or whatever lower figure Ministers decided on.

28.10.87

ANNEX A

FORESTRY: BACKGROUND FACTS

1. PUBLIC EXPENDITURE

	1987-88	1988-89	1989-90	£m 1990-91
Baseline	53.8	54.2	55.1	56.5
Of which				
Grants to private sector	8.3	8.8	9.6	9.8
Other Forestry Authority expenditure	13.7	14.6	15.2	15.6
Forestry Enterprise net expenditure	31.8	30.8	30.3	31.0
planned receipts from disposals	-13.0	-12.0	- 12.0	- 7.0
1987 Survey bids (related to ALURE proposals)				
Grants:				
traditional forestry		2.3	2.4	2.4
farm woodlands		2.2	4.6	4.8

2 FORESTRY AREA

	Conifers		Broadleaves and Coppice		Total	
	'000ha	% privately owned	'000ha	% privately owned	'000ha	% privately owned
England	395	50	461	91	856	72
Wales	175	26	61	90	236	43
Scotland	891	42	77	95	968	45
Great Britain	1461	43	599	91	2069	57

3 FORESTRY PLANTING

	England	Wales	Scotland	Great Britain	
	'000 ha	'000 ha	'000 ha	'000 ha	% privately owned
1978	2.1	1.4	17.1	20.6	32
1982	1.5	1.3	20.8	23.6	53
1986	1.2	0.8	21.3	23.3	82

4. FOREST EMPLOYMENT

	End March 1980	End March 1986
Forestry Commission	8,000	6,000
Private Sector	11,000	12,000
related processing	33,000	27,000

5. RATE OF RETURN FROM FORESTRY

Forestry Commission
financial target (1982-87) 2.25%

expected outturn: 2.9% (Average: rate of return on some new planting in remote areas estimated at 1.5%)

6. UNITED KINGDOM COMPARED WITH OTHER EC COUNTRIES

	Total forested area '000 ha	Forested area as % of total land area	% of area privately owned	Self Sawnwood	Sufficiency % Wood pulp
UK	2.2	9	57	21	14
France	15.2	28	74	79	54
Germany	7.3	30	44	69	46
Italy	8.1	27	60	32	28
EC(10)	55.5	25	54	51	39
Norway	8.6	28	85	Not available	
Sweden	27.9	68	73		
Finland	23.2	76	71		
USA	301.1	33	61		
Canada	440.0	48	6		

NOTE Figures in first three columns include unproductive woodland.

BASIC FORESTRY ECONOMICS

In 1984 the Treasury and Forestry Commission agreed figures for a typical hectare of Sitka spruce, as a benchmark case for calculating the effects of the tax and grant regimes.

These figures have been updated to 1986 prices, with revised estimates of initial costs (agreed with Forestry Commission in January 1987) assuming good quality land. At current prices (before taking account of future inflation) they are:

SITKA SPRUCE - 54 year cycle

Costs

		£
Annual	Maintenance	10
Year 1	Plough/scarify	80
	Fence	120*
	Plant	200
Year 2	Beat up	50
	Weed	80
Year 3	Weed	80
Year 4	Weed	80
Year 8	Clean	50
Year 15	Fertilise	40
Year 21	Brash	5

Returns

		£
Year 29	Thinning	230
Year 34	"	435
Year 39	"	550
Year 44	"	645
Year 49	"	740
Year 54	Felling	7925

* Agricultural buildings and works allowances are available on this item at a straight line rate of 4% in each of years 1 to 25.

The equivalent figures for a typical broadleaf wood, (on which the figures for returns are less reliable) are estimated as:

BROADLEAF - minimum 108 year cycle

Costs

as above

Returns

		£
Year 58	Thinning	390
Year 68		740
Year 78		940
Year 88		1100
Year 98		1260
Year 108	Felling	13470

Grants are available on new planting at rates for 1986 of

£240 per hectare for conifers
£470 per hectare for broadleaves

where the area planted exceeds 10 hectares. 80% is paid in the first year and 20% four years later. A higher rate of £600 is paid for broadleaf plantations which meet special requirements as to nature conservation, recreation, sporting facilities, etc.

Effect of different tax regimes Ignoring the cost of land, the internal rates of return on the basis of these figures are shown in the table below.

		With grant	Without grant			
		Present tax regime	Present tax regime	Option 1	Option 2	Option 3
SITKA SPRUCE	Zero inflation	7.8%	7.1%	4.2%	5.0%	5.0%
	3% inflation	"	"	4.0%	"	"
	5% inflation	"	"	3.9%	"	"
BROADLEAF	Zero inflation	4.6%	3.8%	2.1%	2.9%	2.9%
	3% inflation	"	"	1.9%	"	"
	5% inflation	"	"	1.9%	"	"

Option 1 is the normal business basis (para 16 of the text)

Option 2 taxes receipts and relieves expenses as they arise (para 17 of the text)

Option 3 is tax exemption, the preferred option (para 18 et seq of the text)

ANNEX C

PROFILE OF INCREASED GRANT EXPENDITURE

Assume grant of £500 per hectare half payable in first year and one quarter in second and again in fifth year; supplements of £50 in year 8 and again in year 15 as contribution to annual maintenance, clearing and fertilising. (Note: present grant is £240, 80% payable in year 1 and 20% in year 5). The calculations are based on annual planting of 30,000 ha.

	NOW		AFTER CHANGE		CHANGE IN EXPENDITURE	
	£ per ha	£m	£ per ha	£	Gross	Net of tax saving
Year 1	240	7.2	298	8.9	+ 1.7	+1.7
2	As above		423	12.7	+ 5.5	+4.0
3			423	12.7	+ 5.5	+1.5
4			423	12.7	+ 5.5	-0.5
5			500	15.0	+ 7.8	+0.3
6						-2.2
7						-2.2
8-14			550	16.5	+ 9.3	-0.7
15+			600	18.0	+10.8	+0.8

NOTE: Increase in expenditure net of tax saving in years 1 to 7 totals to -£2.6m.

This annex illustrates the 'upper limit' option (see paragraph 25 of main report)

SECRET AND PERSONAL

ENVIRONMENTAL IMPACT

Adverse impact of current practices

1. At present, the dominant pattern of afforestation, which has been widely criticised on environmental grounds, is large plantations of a single species of conifer of a single age. Large-scale monoculture is the most profitable approach commercially because it utilises the species which will grow most rapidly in a particular location, and allows a plantation to be felled in one operation. The present tax concessions make it financially very attractive to use hill land for this kind of forestry: land sold with consent for afforestation commonly fetches three times or more the price it would fetch if sold for sheep-farming.

2. Large-scale afforestation, especially with conifers, can be seriously damaging to the landscape, especially where the scenic beauty of an area depends on its openness. It also destroys wildlife habitats on open ground and reduces the diversity of species. Although the Forestry Commission has done much to develop leisure opportunities on its own and, afforestation often reduces recreational opportunities by restricting public access. And it can damage water quality and aquatic flora and fauna over a much wider area by changing drainage patterns and causing alterations in soil chemistry which lead to acidification of streams. These impacts are matters of serious concern to the Nature Conservancy Council (NCC) the Countryside Commission, the water authorities and to DOE.

Environmental objectives

3. The aim must be to devise future arrangements for forestry which achieve the following environmental objectives:

i. to <u>prevent</u> any afforestation in certain particularly sensitive areas. These might include sites of special scientific interest designated by the NCC; and archaeological sites which would either be physically destroyed by forestry or else seriously damaged in terms of visual impact and public appreciation

ii. to <u>ensure</u> that afforestation takes place in national parks or designated areas of outstanding natural beauty only if all the statutory bodies agree that it is environmentally acceptablein the proposed location

iii. to <u>avoid</u> encouragement to afforestation of areas which will give poor yields because of adverse geographical factors (very poor soil, high winds etc)

iv. to <u>ensure</u> that, wherever large-scale afforestation takes place, it is carried out in an environmentally sensitive way, is attractive visually, and avoids damage to water quality

v. to <u>encourage</u> environmentally more favourable forms of afforestation, involving smaller plantations, more diversity of species (especially the inclusion of native broadleaved trees), and multiple use, especially for recreation.

SECRET AND PERSONAL

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Burgner
Mr Scholar
Mr Bonney
PS/IR
Mr Painter - IR
Mr Beighton - IR

Ch/ Note below. 2/11

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

30 October 1987

Mrs S Stagg
Private Secretary to the
Secretary of State for Agriculture, Fisheries and Food

Dear Shirley

REFORMING THE INCOME TAX REGIME FOR FORESTRY

... I attach a draft minute from the Chancellor to the Prime Minister. I should be most grateful if you could confirm that your Minister is content with it. (I understand that its contents have been agreed at official level.)

I am sending a copy of this letter to Robin Young (Environment), with a similar request.

Yours sincerely

J M G TAYLOR
Private Secretary

Ch/
Mr Ridley was content.
Mr Macgregor had a no. of suggestions, which I have marked on the enclosed text. He attaches particular importance to the proposed deletion at 'X'.
Content with his suggestions?
2/11

PSR discuss with Mr Monck, Mr Ritchie's proposed changes to para 4, & state his advice (otherwise OK [illegible]).

TAYLOR TO STAGG 30 OCT

2184/002

Re type [final

SECRET AND PERSONAL

in line with ~~as part of~~ the Manifesto's commitment to a ~~press~~ continuing programme of tax reform. ~~[illegible]~~

DRAFT MINUTE FROM CHANCELLOR TO THE PRIME MINISTER

REFORMING THE INCOME TAX REGIME FOR FORESTRY

I am anxious to push ahead with reforming the present forestry tax regime ~~for forestry~~ in time to include it in next year's Budget ~~[as part of my general tax reforms]~~. You ~~may~~ will of course recall that the ALURE Group also recognised the desirability of this ~~reappraising forestry policy~~ after the election.

2. I have therefore arranged for the attached paper to be prepared. From my point of view the priority is to end the present bizarre and over-generous tax regime, which serves principally as an avoidance vehicle for top rate taxpayers. Instead the paper proposes exempting forestry completely from income tax. This would mean that revenue would not be taxed and costs would not be allowed. Because the present tax regime provides a subsidy, which makes the rate of return higher after tax than before tax, the Exchequer would actually benefit from this change.

3. One result of this tax reform, however, would be to reduce the rate of return on new planting. Whatever the merits of the tax reform, this might run into criticism on the grounds that it was inconsistent with the aim, announced earlier this year, of planting 33,000 hectares a year. There are arguments against maintaining the present level of Exchequer subsidies, but I recognise that there is a political case for [drawing on] taking advantage of the resulting revenue gain to finance increased grants for forestry. I would be reluctant to do this, especially as there would be a transitional net cost to the Exchequer. But if my colleagues think it politically necessary, I would prefer that course to leaving the present tax regime unreformed.

4. If we went down that road it would be sensible to redesign the grant scheme and the conditions attached to grants so as to get more environmental benefits. The report therefore outlines how this might be done[, though my officials have X as yet only been able to draw on the limited advice available in London from MAFF and DOE officials.] The figuring was based on earlier Forestry Commission papers, but it ~~the report's figuring~~ may need to be up-dated and refined.

5. I believe that reform on these lines would be a big step forward and politically attractive. It would be an answer to criticisms that the present regime gives too much to higher rate taxpayers and also to the strong pressure from the Nature Conservancy Council and environmental pressure groups against large scale planting of conifers.

6. I would not normally propose such a procedure for an issue involving tax alone, but in this case there are a number of colleagues with responsibilities for forestry and for public spending on forestry grants. I suggest that the next step might be for you to chair a meeting to discuss my proposals. We need to take decisions quickly if the necessary preparatory work is to be ready in time for announcement in the Budget.

7. I am copying this minute and the attached report to Willie Whitelaw, Peter Walker, Nicholas Ridley, John MacGregor and Malcolm Rifkind.

[NL]

2184/032

PS. I ought to have a word with Mr R.

FROM: N MONCK

DATE: 5 November 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Scholar
Mr Bonney

PS/IR
Mr Painter, IR
Mr Beighton, IR

Ch/ Content with the general line here (and that Mr Monck shld not, at this stage, consult other Depts. beyond IR)? JF 5/11

Yes (subject to a few words).

FORESTRY

At the meeting on 23 October it was agreed that you would make "contingency plans for an early announcement, before the Budget, to prevent forestalling if news of the discussions were to leak".

2. Now that you have widened the circle of Ministers and Departments involved, you may like to see the attached draft, in the form of a press release, which is largely the work of the Inland Revenue.

3. The Inland Revenue draw attention to three tax points to note on the draft press release:

(a) the draft covers companies, partnerships and trusts as well as individuals. Although most of the investment is done by individuals there is no reason why any person who invests in trees should not be treated in the same way: in general companies make their money from managing woodlands or from the timber rather than from owning trees and the profit on these activities will of course continue to be taxable in the normal way;

(b) the draft assumes that the transitional rules will follow the usual pattern, eg on the introduction of the 1984 business tax reforms, and that relief will be given during the transitional period for any expenditure incurred by someone on land which he has already planted or where he has entered into a contract or binding commitment to incur

MONCK TO CX 5 NOV

expenditure. It will not, however, apply to anyone who has acquired land or recently felled trees if he has taken no binding step to plant or replant. One implication of the transition is that expenditure which would otherwise have been incurred after April 1992 will be brought backward and incurred before IT cut-off but there is no simple way of avoiding this effect and there should be a limit on the extent to which it can be done;

(c) the draft is silent on capital gains tax and inheritance tax. The former is de minimis in this context and it would not be necessary to announce an immediate decision on the latter if there were an early leak. The Revenue will however shortly be seeking your decision on these taxes and that can then be inserted into the draft.

4. The draft assumes that a leak occurs too early for us to be ready to announce the new grants. This is likely because we will need to go over the outline in the report in detail with the Forestry Commission etc.

5. If we get a little more time, we may be able to say in the statement that the intention will be to raise the grants sufficiently to ensure that the post-grant rate of return on new planting will be broadly maintained and preferably to say that grants at the new level will be available restrospectively for planting that does not benefit from the transitional arrangements for tax relief set out in the draft.

6. I have not so far consulted MAFF or DoE, let alone the Scots and the Forestry Commission, and am inclined not to do so at this stage.

NM

N MONCK

2184/031

SECRET AND PERSONAL

DRAFT PRESS RELEASE

Tax Treatment of Woodlands

In his statement [today] the Chancellor of the Exchequer proposed a ~~major~~ reform of the tax treatment of woodlands.

2. The present income tax rules provide substantial advantages, particularly to higher rate taxpayers, under which the costs of planting trees can be claimed as tax relief against other income while the proceeds from the sale of trees are effectively exempt from tax. So the result of the current rules is to provide a tax subsidy for investment in forestry.

3. The Chancellor proposed that, with effect from midnight tonight, and subject to transitional provisions, woodlands will be wholly removed from the scope of the income tax and corporation tax. In future expenditure on woodlands will not be allowed as a deduction against other income and the proceeds from the sale or felling of timber will not be charged to tax.

4. Under the transitional provisions, where an occupier of woodlands has begun preparatory work on the land for planting, or has started planting, or has entered into binding commitments in relation to such expenditure, or where a contract for the development of woodlands has already been entered into with a supplier of these services, tax relief under the existing rules will be available for qualifying expenditure incurred in the 4 year period to 5 April 1992. This transitional relief will not however be available in relation to contracts signed or binding commitments made after midnight tonight.

5. Under the Chancellor's proposals, expenditure incurred on agricultural buildings, and plant and machinery connected with woodlands will no longer qualify for agricultural building allowances or writing down allowances. Persons qualifying for the transitional relief set out above will however also be entitled to these allowances under the existing rules for the period to 5 April 1992.

6. Planting grants under the Forestry Commission grants schemes are currently under review. The revised rates of grant and the conditions attached to them will take account of the proposed changes in the tax treatment among other factors, and give greater weight to environmental objectives.

7. The Government considers that, ~~the changes in forestry taxation which it has proposed are a valuable contribution to tax reform.~~ Together with the changes to the Forestry grant schemes which will be announced in due course [OR: as soon as possible], ~~they~~ the proposed new tax regime will provide a sound basis for future forestry investment. It will be fairer than the present regime and achieve better environmental results for the considerable Exchequer cost already incurred in supporting forestry. The Chancellor will be putting forward the necessary legislation in the 1988 Finance Bill.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Ch.

Your marginal suggestion, that you should have a word with Mr R.

2. Mr R(idley) or Mr R(ifkind)? We are fixing up a bilateral with the former. Should we do something similar with the latter – or will you speak in the margins of Cabinet? (I understand from his PS that his first reaction, incidentally, is reasonably favourable to your proposals.)

JS
9/11

Mr Rifkind – 5 mins before Cabinet.

N

C1/2/mjd

SECRET AND PERSONAL

Pse put on next Cabinet folder (in front part).

FROM: J M G TAYLOR

DATE: 9 November 1987

MR MONCK

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Scholar
Mr Bonney

PS/IR
Mr Painter, IR
Mr Beighton, IR

FORESTRY

The Chancellor has seen your minute of 5 November. He is content with the draft press release (subject to a few small amendments, noted below), and that you should not at this stage consult other departments.

2. The amendments are:

Paragraph 1: delete 'major'

Paragraph 3: recast first sentence to read: '.... woodlands will be wholly removed from the scope of both income tax and corporation tax.'

Paragraph 7: recast to read: 'The Government considers that, together with the changes to the forestry grant schemes which will be announced in due course [or: as soon as possible], the proposed new tax regime will provide a sound basis for future forestry investment. It will be fairer .....'

JMGT TO MONCK 9 NOV

J M G TAYLOR

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON S.W.1

From the Minister

pup

SECRET AND PERSONAL

CHANCELLOR OF THE EXCHEQUER

REFORMING THE INCOME TAX REGIME FOR FORESTRY

Thank you for sending me a copy of your report on the forestry tax regime.

I am very sympathetic with the approach you outline. But I am sure that the proposed changes in the tax regime for forestry would be saleable only if the tax savings were used to improve the grant arrangements.

I am copying this minute to the Prime Minister, Willie Whitelaw, Peter Walker, Nicholas Ridley and Malcolm Rifkind.

JM

JM
10 November 1987

Ministry of Agriculture,
Fisheries and Food

CHANCELLOR OF THE EXCHEQUER

Note.

I spoke to Norgrove re suggestion. He agreed that we shld. consult re proposal, but thought that before doing so the Ch. shld. clear his lines with the PM at their next bilateral. (Told NM).

JT

29/12

45/B.rj.2186/026

BF to AJ for 12/11/2 (for bilateral with PM)

SECRET AND PERSONAL

FROM: N MONCK

DATE: 16 November 1987

Ch/ If you agree, I shall phone 'X' in the first instance with Mr Norgrove. AJ 16/11

PS/CHANCELLOR

cc Mr Beighton, IR

Draft/contingency UA OK as amended. 2. Re X, yes pse. N.

FORESTRY

You asked for a draft PQ.

2. This is based on the earlier draft press release and the Chancellor's comments with some up-dating to reflect the meeting at No 10.

3. If the Chancellor decides the ban on internal consultation should be lifted, it should probably be cleared with No 10. I suggest you could do this orally at private secretary level, perhaps followed by a letter.

NM

N MONCK

MONCK TO PS/CX 16 NOV

45/B.rj.2184/031

SECRET AND PERSONAL

DRAFT STATEMENT

Tax Treatment of Woodlands

Q. To ask the Chancellor of the Exchequer if he will make a statement on the tax treatment of woodlands.

A. ~~Yes.~~ I have decided to reform the tax treatment of woodlands. The present income tax rules provide substantial advantages, particularly to higher rate taxpayers, under which the costs of planting trees can be claimed as tax relief against other income while the proceeds from the sale of trees are effectively exempt from tax. So the result of the current rules is to provide ~~a~~ an indiscriminate tax subsidy for investment in forestry currently worth about £10 million a year.

2. I propose that, with effect from midnight tonight, and subject to transitional provisions, woodlands will be wholly removed from the scope of both income tax and corporation tax: in future expenditure on woodlands will not be allowed as a deduction against other income and the proceeds from the sale of timber, whether standing or felled, will not be charged to tax.

3. Under the transitional provisions, where an occupier of woodlands has begun preparatory work on the land for planting, or has started planting, or has entered into binding commitments in relation to such expenditure, or where a contract for the development of woodlands has already been entered into with a supplier of these services, tax relief under the existing rules will be available for qualifying expenditure incurred in the 4 year period to 5 April 1992. This transitional relief will not however be available in relation to contracts signed or binding commitments made after midnight tonight.

4. Expenditure incurred on agricultural buildings, and plant and machinery connected with woodlands will no longer qualify for agricultural building allowances or writing down allowances. Persons qualifying for the transitional relief set out above will however also be entitled to these allowances under the existing rules for the period to 5 April 1992.

5. Planting grants under the Forestry Commission grants schemes are currently under review. The revised rates of grant and the conditions attached to them will take account of the proposed changes in the tax treatment among other factors, and give greater weight to environmental objectives. In consultation with my Right Honourable Friends with forestry responsibilities I have decided to raise public expenditure on grants for private sector woodlands by up to £10 million a year. The Government will be consulting forestry and environmental interests about detailed proposals in order to identify the best way of spending this sum to advance the Government's objectives. [Detailed proposals will be published as soon as possible].

6. The Government considers that, together with the changes to the forestry grant schemes which I have mentioned, the proposed new tax regime will provide a sound basis for future forestry investment. It will be fairer than the present regime and achieve better environmental results for the considerable Exchequer cost already incurred in supporting forestry. I will be putting forward the necessary legislation in the 1988 Finance Bill.

2185/022

SECRET AND PERSONAL

Pmg

FROM: N MONCK

DATE: 24 November 1987

CHANCELLOR OF THE EXCHEQUER

CPRS Schedule B proposal.

Wogan / Sitka spruce / taxpayers

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Burgner
Mr Scholar
Mr Bonney
Mr M Hughes

Mr Beighton - IR

REFORMING THE INCOME TAX REGIME FOR FORESTRY

The Prime Minister is holding a meeting tomorrow to discuss your minute to her and the attached paper of 4 November. Other Ministers present will be Lord Whitelaw, the three forestry Ministers (Messrs Rifkind, MacGregor and Walker) and Mr Ridley.

2. Your objectives are:

(a) to get agreement to an announcement in the Budget that income tax exemption will replace the present reliefs for new planting; and

(b) to keep any increase in forestry grants within the upper limit for increased public expenditure the Report mentions of £10 million a year. (This is the estimated size of the annual revenue gain in year 6 resulting from your proposals at the end of a transitional period of 4 years. At that point the reforms should become Exchequer neutral, assuming present tax rates continue. Expenditure on these enhanced forestry grants would be cash limited, as the Report says.)

3. You will want to avoid agreement to your tax proposals becoming contingent on satisfying Mr Rifkind and/or Mr Walker that the proposed quantum of expenditure on enhancing the forestry grants is adequate (see para 6 below for counter arguments). But in order to get agreement at this first meeting to (a) and (b) above, you could concede:

(a) official discussions (chaired by the Treasury) with the Forestry Commission and other Departments about different ways of spending a given quantum, up to the upper limit of £10 million, though you and Mr Ridley would want to hang on to the environmental benefits; and

(b) an offer to consider extending the availability of Schedule D relief for 5 instead of 4 years after planting or replanting done or committed before the Budget announcement.

Position of other Departments

4. Most of the Ministers present should favour your proposals. Mr Rifkind has told you he is attracted by them. But we understand that he has been advised by the Forestry Commission that the upper limit for spending on enhanced grants in our Report is not high enough. They claim we have underestimated planting costs, although we have used figures that were agreed by the Forestry Commission during the ALURE discussions in 1986 and early 1987. We understand a draft paper was put to Mr Rifkind but he has decided not to circulate it. Possible explanations are that he takes a softer line himself than the Forestry Commission and/or that MAFF would not sign up on an agreed paper by the Forestry Departments.

LINE TO TAKE

Arguments for your proposals

5. (a) useful tax reform, replacing present regime much used - and criticised - as avoidance vehicle for top rate taxpayers; PAC has just criticised lack of information about cost of tax relief; helpful component of next Budget; helps get distortions out of the tax system so that investment decisions can be taken on commercial grounds after grants only;

(b) better environmental results, answer to pressure groups who dislike conifers;

(c) will continue expansion of woodland area in Britain and the switch of new planting to private sector (now over 80 per cent compared with about 30 per cent in 1978). Broadly compatible with aim of planting 33,000 ha a year, announced with ALURE decisions earlier this year, since rates of return should be similar after the reforms if grants are increased;

(d) increased grants should appeal to farmers in less favoured areas in Scotland and Wales;

(e) need to make rapid progress if new grant schemes as well as tax legislation to be ready for Budget. (No legislation needed to change grants.)

The arguments about planting costs and grant levels

6. It is true that some outside sources give higher cost figures and lower rates of return than we have used; and that if costs really are higher, the tax gain by the end of the transition would be similarly higher if tax rates do not change. But most of these sources have an axe to grind and it is difficult to know within the range of figures for different forests where the average level lies. But we think you should argue for sticking with the totals in the Report on the following grounds, even though you would be prepared to alter the pattern of grants within the upper limit quantum of £10 million:

(a) I have exceptionally decided to consult colleagues about a tax matter which is traditionally for the Chancellor to decide. Moreover I have reluctantly offered to consider some enhancement of grant levels subject to suitable environmental conditions and to an increase in public expenditure up to a maximum of £10 million a year. Colleagues should focus on whether and how to use this money, not on raising the stakes;

(b) there is no entitlement to compensation for tax changes. This general point is reinforced by the weak economic case for the present level of Exchequer subsidy to forestry. My upper limit on increased public expenditure is already generous. Moreover it involves a net Exchequer cost during the transition period;

(c) any substitution of increased grants for tax reliefs can only be done broadly, because taxpayers with different marginal rates are affected differently;

(d) it would, however, be possible to vary the proposed pattern of grants, eg in favour of smaller planting areas where costs are higher and perhaps more in favour of broadleaved trees. My officials could of course look at such proposals <u>provided</u> they were within the upper limit of £10 million a year. But I hope we can take the decision of principle now, subject to rapid official work on the details. With colleagues' help I need to get ahead with preparations for the Budget;

(e) <u>if pressed on length of transition</u>: a transitional period of four years would be sufficient to cover the bulk of the initial expenditure but I would be prepared to consider an additional year (or perhaps two) if it could be shown to be justified;

(f) if pressed on cost figures: the cost figures I have used were agreed by the Forestry Commission in the ALURE exercise and cross-checked against earlier 1984 calculations for new planting costs. [If the Forestry Commission figures have changed,] it is not clear why the changed policy context should produce different figures. The figures exclude the cost of land, as agreed in the ALURE exercise, because most planting will be done by owner occupiers. Sources of other figures nearly all have an axe to grind and do not provide any greater certainty.

7. The annex reproduces defensive points from my brief of 22 October.

NM

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ANNEX

2184/011

SECRET AND PERSONAL

ANNEX

DEFENSIVE POINTS

Why switch from tax to public expenditure, better to leave people with their own money

- Present income tax regime does more than leave people with their own money. Typically post-tax rate of return higher than pre-tax rate of return. A conifer plantation earning 5 per cent real pre-tax earns over 7 per cent post-tax and existing grants. Wrong to use tax system in this way.

- Secondly, if Exchequer subsidies are to continue, as I propose, they should produce politically popular results. Easier to attach environmental conditions to grants than to tax breaks.

Spend more to (a) create jobs and (b) to reduce imports

- (a) Forestry Commission figures show that over 90 per cent of the jobs produced by forestry come 35 years after planting, even with conifers.

- These delayed jobs are expensive. In the north of Scotland subsidy per man year is about £8,000, ie more than typical earnings of £6,500 a year.

- This is nearly double the subsidy per job needed for operations of Highlands and Islands Development Board.

- b) Import substitution needing subsidy on this scale impoverishes country. Our tax regime already appears more generous than those in France, West Germany and USA.