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Part. B.

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PO -CH /NL/0327

PART B

PO -CH /NL/0327
PART B

Chancellor's (Lawson) Papers:

REFORM OF CAPITAL GAINS TAX AND INHERITANCE TAX

DD's: 25 Years

3/11/95.

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON
20 JANUARY 1987

1. MR ISAAC

2. CHANCELLOR OF THE EXCHEQUER

CGT REFORM: FURTHER OPTIONS

1. Mr Cayley's submission below responds to the remits from your meeting of 15 January and brings together the main features of the reform and the means of achieving it.

2. The ultimate objective is a de-indexed and integrated tax on capital gains for the personal and corporate sectors. This should be simpler than the present system and should impose lighter burdens on taxpayer compliance and Revenue resources. De-indexation makes the tax simpler but increases the taxpayer population. A threshold increase is necessary to secure the maximum staff savings from the change.

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cc	Chief Secretary	Mr Battishill
	Financial Secretary	Mr Isaac
	Economic Secretary	Mr Painter
	Minister of State	Mr Houghton
	Sir P Middleton	Mr Calder
	Sir T Burns	Mr McGivern
	Mr Cassell	Mr Cayley
	Mr Scholar	Mr Gonzalez
	Miss Sinclair	Mr Hamilton
	Mr Cropper	Mr Spence
	Mr Ross Goobey	Mr Michael
	Mr Graham (Parliamentary Counsel)	Mr Cleave
		Mr Pinder
		Mr Keelty (M4)
		Mr Boyce (M2/3)
		PS/IR

3. The unresolved question is how to reach the new world. De-indexation produces losers. The problem is not simply the restoration of a tax on future paper gains; more specific are the effects of withdrawing the accrued indexation relief for the period 1982-1987.

The Options

4. Two methods of easing the transition are proposed:-

a. the 25 per cent rate cap

- simple for us and the taxpayer
- its cost would fall in the range £m100 - £m200
- as a top rate reduction in an integrated tax it could be "read across" to income tax
- it would be an across the board relief not targetted on de-indexation losers
- it would help top rate taxpayers, and others with large "lumpy" gains
- it would not be self extinguishing
- it would not run for companies.

b. the taper

- it would be self extinguishing (it could run for disposals within (say) three years from the date of change)
- the present indexation rules would have to be retained for that period - a compliance burden for taxpayers and Revenue
- interaction with half rate charge requires a significant (about 50 per cent) cut immediately in the

See para 17-18 A Michael Cayley's note

accrued indexation relief available to the taxpayer. In other words the taxpayer loses 50 per cent of his accrued indexation relief immediately. Without this a deep trough in liability is created.

ie v large gains for disposals in year 1 for basic rate & 45% taxpayers.

- incentive to accelerate realisation of gains and more particularly losses as soon as possible in the transitional period

- there could be a long term revenue cost, but there is uncertainty about the extent of this

- market, behavioural and revenue effects difficult to estimate

- companies could be included but this would add to the uncertainties about market etc effects of change. Exclusion would create a pressure point.

5. The choice between these options is not easy. Perhaps the key is to test them against their objective - to reduce the impact of the loss of indexation relief. The 25 per cent rate cap is targetted only on the top rate payers and those brought into the top rate by their gains. The taper applies across the board and has more of the structural characteristics of a transitional relief. The lesson of 1982, when the threshold was increased by £2,000 in recognition of pre-1982 inflation, is that the purpose of indirect compensation is quickly forgotten. Because it does not specifically address the problem (compensation for the accrued indexation relief), the 25 per cent rate cap may also suffer from this weakness. On the other hand, the taper requires taxpayers to forgo immediately one half of the relief that they thought they had. Losses may be tricky to deal with.

Losses

6. With a taper, where a loss exists in an asset which can be bed and breakfasted, the temptation to do so is almost irresistible when the alternative is the loss of all the indexation enhancement. There is not the deterrent, as with gains, that a tax liability is being accelerated. The justification for any counteraction would have to be

the protection of the yield against tax motivated realisations.

7. The options for counteraction are:-

a. reverting immediately on Budget Day to the 1982 regime where indexation cannot produce or add to a loss (this restriction was removed in 1985).

b. limiting the use of the indexed element in such losses against gains in the taper period. This would be an unwelcome complication and, if anything, would tend to add to the gains realised in that period - partly to get the accrued indexation, partly to offset indexed losses. We doubt we could legislate for it in the time available.

Of these, the former seems more appropriate for a short transitional period but would be vulnerable to criticism.

Life Assurance Companies

8. If anything is done for life assurance companies, the preferable option is probably to charge policyholders' gains at a pegged rate: with a 25 per cent rate cap, this might be either 30 per cent or 25 per cent; with a taper it might be 30 per cent or the new basic rate.

Fall Back —

9. As a fall back there is the option of simply charging corporate gains at CT rates or small company rates with ACT offset which would require no special action for life assurance companies.

NB Michael Cayley's note makes it clear this fallback is charging indexed corporate gains @ 35%.

Lw: yes?

B T HOUGHTON

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 20 JANUARY 1987

1. MR HOUGHTON ✓ Mr PI see accompanying note Mn 20/1
2. MR ISAAC
3. CHANCELLOR OF THE EXCHEQUER

CAYLEY → CH/EX 20/1

CGT REFORM

1. This note follows up the meeting in your office on 15 January. In view of the volume of past papers, it sets out not only to discuss the options we were specifically requested to examine further but also to summarise the present position.

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cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
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Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Graham (Parliamentary Counsel)
Mr Battishill
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Mr Houghton
Mr Calder
Mr McGivern
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Spence
Mr Michael
Mr Cleave
Mr Pinder
Mr Keelty (M4)
Mr Boyce (M2/3)
PS/IR

LONG TERM SHAPE OF REFORM

2. In summary the reform would result in this regime:-

i. indexation would be abolished;

ii. for individuals and trusts, half the excess unindexed gains over the threshold would be taxed at marginal income rates under a new Schedule G; the threshold might be increased;

iii. for companies unindexed gains would be taxed in full at mainstream rates (35%, or for small companies, the new basic rate) with ACT set-off.

3. There would be special measures to help particular hard cases. These are summarised in ~~the~~ Annex I. (In the light of the comments at the meeting on 15 January we have taken the scaled-down increases in the ceilings for CGT reliefs rather than the higher figures canvassed in my note of 17 December). There are two open questions on the Annex:-

i. should agricultural landlords get retirement relief in addition to rollover relief, or just rollover?

ii. should rollover relief extend to second homes?

The position of life assurance companies is considered below.

4. The reform, or transitional period if indexation relief is tapered out, would commence from midnight preceding Budget Day.

BUYING OUT INDEXATION

5. The biggest policy problem that is seen is how to buy out accrued indexation for individuals and for trusts for the period from 1982 to 1987. (The feeling at the 15 January meeting was that this was much less important for companies). We were asked to report further on two options:-

i. applying an effective rate cap of 25%;

ii. tapering out 1982-1987 indexation over a period.

It was considered that, without such general measures, the package for individuals and trusts might well not be viable.

6. An additional component of buying out indexation might be an increase in the threshold. The Table at the end of this note (which summarises key statistics) shows, that, on our now updated data, if the threshold were kept at £6,600* we might have another 60,000 or so taxpayers, as a result of the abolition of indexation. These would all be losers from the reform. To keep the taxpayer population at around its present level would necessitate an increase in the threshold to something over £9,000. Even with this, some people who would not pay tax now would be brought into liability (and conversely others liable now would be taken out). After allowing for the special reliefs in the Annex, the package for individuals and trusts might be broadly revenue neutral with a threshold of between £9,000 and £10,000 if the reform were introduced overnight without a rate cap or a transitional tapering out of indexation.

(i) A 25% RATE CAP

7. It is envisaged that the reform would be introduced in the context of an Option 2 income tax rate structure - ie. income tax rates of 27%, 45% and 60%. The effective rate on gains over the threshold would be half these figures. It would be possible to introduce a regime (in advance of any general cut in the top higher rate) under which the effective top rate on gains (but not income) would be limited to 25% (ie.50% on half the excess of gains over the threshold).

8. A 25% cap on the effective rate would be very much simpler than a taper for indexation and not affect the timing of staff savings. The Table at the end of this note illustrates yields at various thresholds. Depending on the threshold level, and allowing for the special measures in the

* Following publication of the December RPI, the £6,500 threshold quoted before for 1987-88 under present law becomes £6,600.

Annex, it would give the reform a revenue cost of between some £m100 and £m200 for individuals and trusts. When the extra tax from companies is brought into the picture, there would overall be a relatively small increase in yield.

9. The 25% cap could not be a full compensation for the loss of 1982-87 indexation, though, in conjunction with the special measures, a sizeable threshold increase and the cut in the rate on gains for basic rate and 45% taxpayers, it would go a long way. It means that <u>some</u> top rate taxpayers would be gainers from the reform - instead of all of those above the new threshold being losers. It would also ~~keep~~ help basic rate taxpayers with large lumpy gains which would pull them into the top rate. The main groups who would still feel a grievance would be those with accrued indexed losses and those with gains above the new threshold that would at present be wholly or very largely sheltered from tax by indexation (no rate cut can compensate those who pay no tax now but would be liable under the reform). The special measures in the Annex would help some of these. Many of the remainder would be able to arrange to stagger disposals - especially of shares and securities - so as not to emerge worse off. So the proportion of taxpayers with a real grievance would be limited. The cap, and a threshold increase, would also help to compensate for the loss of <u>future</u> indexation.

10. The Opposition would doubtless see the cap as a perk for the rich. It would benefit most those with large gains. There might be pressure for a firm statement as to whether the Government would cut the top rate on income to 50% after the election.

11. The cap would reduce somewhat the perceived degree of integration of the taxation of gains into that of income. It would also mean that the maximum effective tax rate on individuals was 10% less than the full mainstream rate for companies - though close to the 27% small companies rate.

12. To sum up, the cap would be simple for taxpayers and the Revenue and would not delay the timing of staff savings. In conjunction with a sizeable threshold increase and special measures for hard cases, it would mean that the number of people who were net losers on pre 1987 assets would be limited. And, again in conjunction with a threshold increase, it would help to compensate for the loss of future indexation. When the tax take from companies is brought into account, there might be an overall slight gain to the Exchequer. A cap has therefore a good deal to commend it.

"reduced" anyway. Mr 20/1

13. On the other hand, there would still be some people with a grievance over 1982-87 indexation, and the cap would reduce the perceived level of integration into income tax. And it might lead to pressure for a statement on future cuts in the top rate on income.

(ii) TAPERING OUT INDEXATION

14. The alternative option we were asked to consider further was to taper out indexation.

15. The scheme would work like this. Indexation would be computed for the period to March 1987. There would be no indexation for assets acquired on or after Budget Day, and no allowance for RPI increases after March 1987. The computation of this "frozen" indexation allowance would normally follow existing indexation rules except for the March 1987 cut-off. We do not think there would be a need for an additional share pool. So there would only be a relatively slight increase in complexity for the taper period.

16. A reducing proportion of this frozen indexation allowance would be available for disposals over the next few years. (It would be possible to give it in full for the whole of a transition period, but this would create the obvious problems of a sudden cliff face when the point of full switch to the new regime came). Half the excess of the resulting chargeable

gains over the threshold would be taxed at income rates under Schedule G.

17. A key question is the pattern of the taper. At the 15 January meeting we floated the idea of a three year taper, with a plateau for the first year, during which full indexation up to 1987 would be available. On reflection we think this has major drawbacks:-

i. those liable at marginal rate income tax rates of 45% and the basic rate would enjoy in the first year both a sizeable reduction in tax rate and full indexation. This would produce a major cut in their tax bill in this year. In some cases the bill would more than halve. Thereafter, as the taper bit, the liability would rise again fairly steeply. This picture, of a deep but temporary trough in the effective tax burden has clear difficulties. And it would be generous to the point where those concerned would be bound to dispose of, or bed and breakfast, everything they could in the first year with very major repercussions on the longer term yield.

ii. it would be open to exploitation, especially by higher rate taxpayers. For example, people would in the first year give assets to their families or place them in trust, claiming rollover relief. The rolled over gain might, it is true, be brought into tax on a later disposal, but it would then be reduced by indexation relief up to 1987. At the extreme, the asset could subsequently be given back to the original owner. People would thus be able to use the rollover provisions to preserve the full availability of 1982-87 indexation on disposals well beyond the transition period.

18. For these reasons we have concluded that an initial year with full 1982-87 indexation would not be a sensible answer. To some extent, similar problems would arise whatever the

pattern of taper, because there would be advantages in making disposals or gifting assets in the first year, to get more indexation relief. But the problems would be much reduced if very much less than full 1982-87 indexation were available in year one. If only half were available then, we think the level of exploitation of the rollover provisions would probably fall to the point where it could be tolerated, and the temporary trough in tax burden would be very much smaller.

19. The situation would be further helped if the threshold were increased in pre-set steps over the transition period: knowledge of the coming threshold increase would offset the tapering out of indexation, so that there would be swings and roundabouts for some people. For this to happen, it would be important to announce in advance how the threshold would move.

20. The sort of pattern that might, we think, largely avoid many of the potential drawbacks of a taper could be:-

Year	1	2	3	4
Percentage of 1982-87 indexation	50%	25%	15%	0%
Threshold	£7,500	£8,000	£8,500	£9,000

Examples illustrating the effect are in Annex Two.

If the percentage in the first year was more than 50%, we think the incentive for exploitation would be very considerable, With 50% or less in year one, for many disposals the problem of a trough, followed by an increase at least part of the way back, in tax burden would disappear.

Yield

21. The yield during the taper period is exceedingly difficult to predict. Were 1982-87 indexation to be preserved indefinitely in full we might expect (after allowing for the effect of the special measures in the Annex) the yield on

1987-88 disposals by individuals and trusts to be some £m140 to £m230 less than under the present system, depending on the threshold. This would be offset by an extra yield of perhaps £m70 from taxing companies at full mainstream rates with ACT set-off but with 1982-87 indexation preserved. The yield would gradually increase - still assuming no acceleration of disposals - until, after indexation allowance had worked out of the system, the package might roughly break even for individuals and trusts, and yield up to £m250 when companies are brought into the picture. If 50% of indexation relief were available in the first year, the reduction in yield would, after behavioural effects, more than halve.

from individuals and trusts

22. A major problem is to form a clear view on the likely extent of accelerated disposals. Here we can only use commonsense guesses. It seems likely that people would realise any indexed losses they could in 1987-88, so as to bank them at their maximum value. Other things being equal, this would

i. reduce the 1987-88 yield further, and

ii. to the (possibly considerable) extent that losses were not used in 1987-88 but were carried forward, reduce the yield in later years.

There would also be an acceleration in the realisation of real gains, as people sought to maximise the benefits of indexation. To the extent that losses (indexed or otherwise) were available to offset the gains this would generate no extra tax. But by no means everyone would have losses. So some extra tax payments would result.

23. Acceleration would be least marked where there were large real gains (so that the loss of indexation made relatively little difference) and for lumpy assets which cannot be bed-and-breakfasted (such as land, second houses, and unquoted shares). [Bed and breakfasting is effective for tax only for quoted shares and securities.] People who would keep below the threshold if they staggered their disposals would be less

likely to accelerate realisations of real gains. And some would prefer not to accelerate disposals, because they did not wish to accelerate payment of tax.

24. On balance - but this must be little more than an educated guess - we think the net result of all these factors might be to reduce significantly the cost of the first year of the taper for individuals and trusts., probably by at least half , and possibly enough to give revenue neutrality or even some extra yield. If the taper extended to companies, we think that acceleration of disposals would boost the yield on Company disposals in the first year, perhaps by as much as £m200. Thereafter, we think ~~they~~ the factors would probably pull down the yield - with, beyond the taper period, a sizeable long-term reduction, which could well be over £m200 a year if the taper were confined to individuals and trusts, and, if extended to companies, could also well eliminate the extra yield of the reform from companies. This long-term cost would reduce slowly over a long period of years.

Staffing and compliance costs

25. One obvious effect of the taper would be to defer the achievement of simplification - and hence of staff savings and reductions in compliance costs. Our staff requirement would increase during the taper period, because of the additional caseload from accelerated disposals, quite possibly by 100 or more a year from 1988-89. Taxpayers' compliance costs would also temporarily increase, as they made additional disposals or sought advice on whether to do so.

Market effects

26. Clearly there would be significant market effects. The Bank and Treasury will be better placed than us to advise on these.

Indexed losses

27. Much of the reduction in yield, and some potentially significant behavioural effects, stem from accelerated realisations of indexed losses.

28. We have therefore asked ourselves whether there is a case for restricting the use of indexed losses realised between Budget Day 1987 and the end of the taper period.

29. At one extreme, one might say that the taper would not apply to indexed losses: from Budget Day indexation relief would be confined to gains. But this would be regarded as harsh: indexed losses can reduce tax bills just as much as indexation relief on gains and people would argue that the taper should apply to indexed losses just as much as indexed gains.

30. An alternative approach might be to stipulate that the indexation element in losses on disposals from Budget Day to the end of the taper period could not be set against gains realised after the end of the period. This would not reduce the accelerated realisation of such losses, but it could prevent them sheltering gains after the end of the taper period and hence reduce somewhat the long-term yield reduction.

31. In practice however most of that reduction would result from the increased realisation of indexed gains in the next few years rather than of indexed losses. And a preliminary technical examination suggests that rules to restrict the use of indexed losses in this fashion would be complex and could significantly add to record-keeping and compliance costs. We doubt that at this late stage we could import this degree of sophistication into the legislation.

Conclusion

32. Tapering out indexation could ease acceptance of the new regime, though there would still be dissatisfied taxpayers. It would lead to an acceleration of disposals, most marked where there were indexed losses. There would be a sizeable long-term reduction in yield, and possibly a significant cost in the taper period as well.

33. The taper would be a temporary - though not, we think, excessive - complication of the existing system. It would defer simplification and savings in staffing and compliance costs. Our staff need over the next few years would rise because of the additional caseload from accelerated disposals.

34. As compared with a 25% cap, the taper would in the medium and long term be more costly and retain for a period the complexities of indexation. Against this, it would be more easily perceived as a measure to alleviate the disappearance of 1982-87 indexation.

COMPANIES

35. If the reform were introduced overnight for companies from the midnight preceding Budget Day, the yield might be £m150 in 1988-89 and £m250 in a full year. This leaves out of account any special relief for life assurance companies. These figures have been updated to take account of the latest data, but the updating reflects a quick provisional guesstimate and is subject to revision.

Life Assurance

36. The general consensus seems to be that something special would probably need to be done for the gains which life companies obtain for policyholders (any special measures would not extend to gains allocated to shareholders). The options have been discussed in my minutes of 16 December* and 8* and 13 January. As explained in the last of these, we doubt that

*On this folder, below the divider
AWK

confining any special relief to mutual companies would be a sensible option. Equally we could not confine relief to individual companies even if we were able to identify those which might conceivably be at risk. It follows that any relief would apply to the sector as a whole.

37. The choice of relief to some extent turns on

- i. whether there is a 25% cap or a taper for individuals, and
- ii. whether the full reform applied immediately to companies.

The position of life companies is therefore reviewed at the appropriate point in the following discussion of general options for companies.

<u>Implication for companies of 25% rate cap</u>

38. If there is a 25% cap for individuals, we see no strong reason to modify the company package: it could come into force in full from the midnight preceding Budget Day. Companies would initially press for a lower rate on gains - arguing that gains of all companies, large and small, should be liable at either the 27% small companies rate or 25%. However arguably in policy terms it is the comparison between small companies and individuals that is most important, and the differential between the small companies rate and the 25% cap would be small. Even so we would expect pressure from small companies for a rate of 25% or less, by analogy with individuals.

39. More generally, as you said at the 15 January meeting, the unincorporated sector on the whole emerged worse than companies from the 1984 CT reform since the withdrawal of high first year allowances was not accompanied by a major rate reduction. The CGT reform could be presented as to some extent redressing the balance.

- Life Companies

40. On this scenario, the choice of relief for life companies really turns on whether the objective is

i. to guarantee so far as we can that no company would be in real trouble, or

ii. to provide a general easement for the sector.

If it is the first, then , as explained in my 16 December minute*, bringing only half the gains allocated to policyholders into tax seems to us the only way consistent with the reform to meet the aim. This would be very expensive - we estimate that it would reduce the yield from the corporate sector by £m100 and make life companies gainers from the reform to the tune of £m50. Life assurance would be an attractive tax shelter for higher rate taxpayers. And there are obvious hesitations about giving so generous a relief to a sector that seems to be, looking at income and gains together, very substantially undertaxed.

*below the divider

41. There are less difficulties about the choice of a more general easement. Here, the answer seems to us to be to tax policyholders' gains at less than the full mainstream CT rate. One possibility might be to tax at 30%, the present effective rate. Another might be to charge at 25%, the new maximum effective rate for individuals. The cost might be respectively some £m20 and £m35 in a full year, leaving the sector paying additional tax of respectively some £m30 and £m15.

Taper

42. If indexation up to March 1987 were tapered out for individuals and trusts, the outside world would argue strongly that the same should apply for companies. There is a good deal of logic in this.

43. On the other hand, extending the taper to companies could well after an initial peak of yield from accelerated disposals, largely or wholly eliminate the extra yield from companies. And concern over the abolition of 1982-87 indexation was at the 15 January meeting concentrated on the position of individuals.

44. At the technical level, we think we could live with a taper for individuals and trusts but instant abolition of indexation for companies provided the taper period was reasonably short. The decision on whether any taper would extend to companies must be for Ministers' judgement.

- Life Companies

45. If the taper did not extend to companies, Ministers would probably wish to consider a special alleviation for life companies. If it did, but only, say, 50% of 1982-87 indexation was available in the first year, we think it unlikely that any life company would be in acute difficulty, but we cannot guarantee this: and in any event Ministers may still consider special measures appropriate. In either event the options are again

- taxing half the gains, or

- charging a lower rate (in this case 30% or the new basic rate).

Deferral of Full Reform

46. It was generally recognised at the 15 January meeting that there would be difficulty in implementing in full the package for companies while not doing so (at least at this stage) for individuals.

47. It would however be possible to take a significant step towards the long-term objective by

- charging indexed gains in full at normal CT rates (35% and the new small companies rate) and

- allowing ACT set-off.

Abolishing indexation would then wait until it could also be done for individuals.

48. The yield might be some £m40 in 1988-89 and £m70 in a full year.

- Life Companies

49. The rate increase to 35% should not present any great problem to life assurance companies. Consideration of special reliefs could therefore wait for the second stage of reform and the abolition of indexation. By then work might be further advanced on a general overhaul of the sector's taxation.

TIMETABLE FOR PREPARING LEGISLATION

50. As I mentioned, Parliamentary Counsel is - like ourselves - concerned about the short time left for preparing legislation if the reform goes ahead in 1987. He has told me that the introduction of Schedule G - as opposed to charging CGT at marginal income tax rates (to achieve the same final tax liability) - would make the task very substantially more difficult for him. Clearly the simpler we kept the reform, the more likelihood there would be of having legislation ready in time. We are already beyond the point at which we could add significant complications.

OPERATIONAL TIMETABLE

51. Operationally, we could, at some frictional cost, introduce the reform from Budget Day. But similar considerations arise. It would at this stage be important to avoid complications; and decisions on the detailed shape of

the reform it it were to go ahead ~~as~~ are urgently needed for contingency planning.

CONCLUSION

52. As a buyout for 1982-87 indexation, a 25% cap would be simple and, in conjunction with a sizeable increase in threshold and special measures for hard cases, would go ~~a~~ some way to meet complaints.

Whatever form it took, it could not appease everyone.

53. A taper would defer simplification, have a transitional staff and compliance cost, and a substantial long term revenue cost. It would however be more obviously addressed to the 1982-87 problem but it would of course continue the complexity of indexation for the transitional period. There would be strong pressure to extend it to companies, eliminating (after an initial peak of yield) most or all of the extra yield from the corporate sector.

54. If general reform did not proceed this year, it would be possible, for corporation tax, to apply normal mainstream rates to full indexed gains, with ACT set-off, this year, as a step towards the overall objective.

55. The need for, and form of, any special relief for life companies turn~~s~~ on the decisions on the general shape of the CGT reform.

56. Consideration would need to be given as to whether the special measures should include rollover for second homes and retirement relief for agricultural landlords.

M F CAYLEY

KEY STATISTICS

Notes:-

1. The revenue effects are the changes in liabilities for disposals in 1987-88 after adjustment for behavioural changes.

2. In the time available, we have not been able to attempt costings of a taper for 1982-87 indexation, and in any event (as explained in the main note) any such costings would be little more than educated guesses. But we have included estimates for the effect of preserving 1982-87 indexation permanently (the figures here do not allow for acceleration of disposals but with permanent preservation of 1982-87 indexation such acceleration would be unlikely). This gives a starting point, but no more than that, for considering the yield effects of a taper.

3. The staff effects include those from the change for companies In practice the latter are relatively small.

4. The revenue figures assume the minimum £m60 package of special measures in the Annex.

5. The figures take account of the updating of our data base, but are subject to revision as the forecasting assumptions change.

INDIVIDUALS AND TRUSTS

	Cost/Yield £m, (Full Year)	Change in taxpayer numbers	Likely staff effects April 1989	- Full Year
Option 2				
- £6,600 Threshold*	+30	+60,000	-115	-360
- £8,500 Threshold	-45	+10,000	-150	-410
- £10,000 Threshold	-75	-20,000	-170	-450
25% Cap				
- £6,600 Threshold*	-100	+70,000	-105	-340
- £8,500 Threshold	-160	+15,000	-145	-405
- £10,000 Threshold	-200	-15,000	-180	-445
Permanent Preservation of 1982-87 Indexation				
- £6,600 Threshold*	-140	+25,000	+25	+35
- £8,500 Threshold	-190	-20,000	-15	-25
- £10,000 Threshold	-230	-45,000	-35	-60

The 1987-88 threshold under current law

ANNEX ONE

CGT REFORM: SUMMARY OF SPECIAL MEASURES

	Full year cost	
	Minimum Package	Maximum Package
Rollover relief		
Extend to		
- Agricultural landlords, and	£m40	£m40
- (possibly) second homes	-	under £m5
Retirement relief		
Extend to		
- Agricultural landlords	-	£m10
Monetary limits		
Increase retirement relief ceiling from £100,000 to £125,000	£m5	£m5
Increase small part disposals relief from £20,000 to £25,000	£m15	£m15
Increase partially let exemption limit from £20,000 to £25,000	less than £m1	less than £m1
ROUNDED TOTAL COST*	£m60	£m75

*In practice, depending on threshold and means of buying out indexation the total cost might be slightly less.

ANNEX 2

EXAMPLES

Illustrating the effect of the taper in each of the years 1987-88 to 1990 - 91.

A

Individual realising a gain of £15,000 on shares acquired before 1982 - and with a market value of £13,000 in March 1982.

	1986-87	1987-88	1988-89	1989-90	1990-91
Gain before Indexation	15,000	15,000	15,000	15,000	15,000
Tapered Indexation	3,250	1,625	813	488	Nil
	11,750	13,375	14,187	14,512	15,000
Threshold	6,300	7,500	8,000	8,500	9,000
Excess over Threshold	5,450	5,875	6,187	6,012	6,000
x 1/2	-	2,937	3,093	3,006	3,000
Tax at 30%	1,635				
Tax at 27% All at basic rate		793	835	811	810

Note In 1983/4 35% of all gains were in the range £10,001 to £25,000.

B

Individual with income of £10,000 realising a gain of £100,000 on land acquired before 1982 and with a market value of £200,000 in March 1982.

	1986-87	1987-88	1988-89	1989-90	1990-91
Gains before Indexation	100,000	100,000	100,000	100,000	100,000
Tapered Indexation	50,000	25,000	12,500	7,500	Nil
Chargeable Gain	50,000	75,000	87,500	92,500	100,000
Threshold	6,300	7,500	8,000	8,500	9,000
Excess over Threshold	43,700	67,500	79,500	84,000	91,000
x 1/2	-	33,750	39,750	42,000	45,500
Tax at 30%	13,110				
Tax at basic and higher rates		15,006	18,606	19,956	22,056

Note In 1983/4, 14% of chargeable gains were in the range of £25,001 to £50,000.

ps3/84K

SECRET AND PERSONAL

RP

COPY NO. 7 OF 8

FROM: A W KUCZYS

DATE: 27 January 1987

MR CAYLEY - INLAND REVENUE

cc PS/Financial Secretary
Mr Scholar
Mr Battishill - IR
Mr Isaac - IR
Mr Houghton - IR

CGT REFORM

Since last Thursday's meeting, the Chancellor has had two further thoughts in connection with introducing a major reform in the next Parliament. Since these are not for 1987, he does not want to divert resources away from current work in order to answer the first point. But he would be grateful for a note in due course.

2. His first point is that it might be helpful to have a "sweetener" when introducing the reform for companies. One possibility would be a reduction in the main CT rates from its present 35 per cent. In order to decide what would be appropriate, can you quantify the cost to the corporate sector of the removal of indexation relief? And provide a ready-reckoner for reductions in the main CT rate?

3. The second point, which does not require any response, is that if, in the end, Ministers decide that removal of indexation relief is not on, then there is a fallback option. This would be directly analogous to what is proposed for companies this year. It would involve retaining indexation relief, but charging individuals' indexed gains in full at marginal income tax rates. It would be combined with a cut in the top rates. (Although this would mean retaining the complexity of indexation, Mr Michael has pointed out that it might make it possible to sweep away some anti-avoidance legislation in the field of dressing-up income as capital gains.)

A W KUCZYS

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 29.1.87.

Pl see note at end of text.
M 29/1

1. MR HOUGHTON
2. CHANCELLOR OF EXCHEQUER

Thanks. Nothing here to prevent us going ahead, but await Mr Scholar's overall analysis of company factors. N.

CGT REFORM: CORPORATION TAX CHANGES

1. At a meeting on 22 January, we were asked for a further note on the effect of possible changes in corporation tax on gains.

OUTLINE OF CHANGES

2. If the changes go ahead this year, they would take the following form:-

   i. gains would be subject in full to normal maintream rates (35% and the small companies rate) instead of, the present effective 30% rate;

---

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Battishill
Mr Isaac
Mr Painter
Mr Houghton
Mr Calder
Mr McGivern
Mr Cayley
Mr Gonzalez
Mr Greenslade
Mr Hamilton
Mr Spence
Mr Read
Mr Michael
PS/IR

ii. ACT set-off would be available against corporation tax on gains;

iii. the present rules on losses would continue, so that trading losses were available against gains of the same year but capital losses were not available against income;

iv. indexation would continue; and

v. the policyholders' gains of life asurance companies would be taxed at mainstream corporation tax rates.

The changes would - to prevent forestalling - apply from midnight preceding Budget Day.

Yield

3. Our latest estimate is that the extra yield (assuming a 27% small companies rate) would be some £m50 in 1988/89 rising to £m90 in a full year. The figures are higher than those we have quoted before: this reflects further updating of our data. Even so the estimate is still tentative: we have yet to complete our updating. And the figures may alter as the forecasting assumptions alter. We think it unlikely however that they will change dramatically. Without the ACT set-off against gains, the figure might be some £m30 higher in a full year.

SECTORAL EFFECTS

4. The number of companies with chargeable gains in any year is relatively small: about 30,000 (out of 700,000 companies). Only just over half of these pay tax on their gains - for the remainder the gains are sheltered from tax, for instance by group relief. Some 35,000 companies are taxed at the full mainstream rate: of these about a quarter have chargeable gains. Approaching 200,000 pay at the small companies rate: only some 7,000 have chargeable gains.

9,000

Small companies

5. Companies within the small companies rate (ie. small companies plus larger ones with relatively small profits) with gains would clearly ~~gain~~ benefit from the change, although (as the previous paragraph shows) they represent a small minority of small companies. (All small companies with income would of course benefit from the reduction in the small companies rate.) The ACT set-off is unlikely to be of much value to most small companies, as in general they do not have surplus ACT and would not wish to distribute gains. But it might assist the small company which was winding down and selling off some assets, or which had a one-off large gain, and wished to distribute the resulting gains as a qualifying distribution to its shareholders. The ACT set-off would thus help the proprietor(s) of a small company who wished to run it down (eg. prior to retirement) but keep it going on a smaller scale and have immediate access to the proceeds of the sale of company assets. This would meet a complaint which is put to us from time to time.

6. Many small unincorporated associations (eg. sports clubs) which make gains, for instance on the sale of a plot of land, would be within the small companies rates and hence benefit from the change. The sale of a very valuable development site might pull a sports club etc above the ceiling for the small companies rate relief - in which case the tax on the gain would rise.

Companies liable at full mainstream rates

7. Companies liable at 35% are more likely than small companies to have chargeable gains. Even so, only about a quarter of those paying 35% mainstream tax actually pay tax on gains.

8. Leaving ACT set-off on one side, these companies would all be disadvantaged by the change. The effect on their total corporation tax burden would be greater where gains regularly constitute a high proportion of profits. This means that, for instance, life assurance companies, property companies and investment companies would be likely to be especially affected. Some companies in the sectors would however largely or wholly escape the extra burden,

because they have group relief or other offsets, or because they have taken steps to shelter gains from tax (eg. by routing investments through unit trusts). Authorised unit trusts and approved investment trusts pay no tax on gains and would not be directly affected.

9. Even within the more heavily affected sectors, there will be companies for which the change would make minimal difference because they have few chargeable gains.

10. Our research suggests that companies in the distribution sector tend to have few chargeable gains and would be relatively little affected.

11. The impact on manufacturing and oil companies would often vary markedly from year to year. In most years many have few gains, but in occasional years (eg. when they sell a site for development) they may have very large gains.

12. We have little data on which to evaluate the incidence of the benefit of ACT set-off against tax on gains. Such information as we have suggests that the set-off would benefit only a small minority of companies.

13. It may well be that the main effect of the set-off will be behavioural: some companies with surplus ACT may decide to realise additional gains in the knowledge that most of the extra tax would be covered by the set-off. On the whole those companies which did benefit would probably tend to be singleton companies rather than members of groups: groups with both gains and surplus ACT frequently arrange for any group losses to be set off against the gains, thus extinguishing corporation tax liability on them. This maximises the income qualifying for ACT set-off and means that extending the set-off to gains would not increase the scope for set-off. The set-off is likely to be of more value where

   i. a lot of a company's or group's earnings derive from overseas and, after double taxation relief, bear little if any mainstream tax, or

ii. dividends have been maintained at a level which taxable income is insufficient to finance.

There may be one or two very large overseas earners from whom the set-off would be very valuable. The ACT set-off would be of no benefit to mutuals nor generally to foreign groups investing in the UK; and it would be of no advantage to non-mutual life assurance companies, which get all their ACT set-off one way or another under special provisions in existing law. And some companies - including some large unquoted companies - have a policy of making only minimal distributions and hence of course would not avail themselves of the ACT set-off.

Michael Cayley

M F CAYLEY

The changes proposed will benefit companies which:-

a. make capital gains which they distribute to shareholders;

b. pay corporation tax at the small company rate;

c. are high distributors (ie where the distributions are large enough to exhaust the mainstream liability on the income).

It will not be of much help to companies which:-

a. tend not to distribute gains they make;

b. are low distributors relative to profits;

c. are pushed out of the taper band of the small company rate and into the higher rate of tax (35%) by the gain itself;

d. where gains are exceptionally large relative to distributions.

Both sets of characteristics are scattered throughout the corporate sector and although we have some indications of the types of company where they may occur, their appearance seems likely to be pretty random and companies move from one category to the other from one year to the next.

BH

B T HOUGHTON

W. J. CALDER, SONS & CO.

CHARTERED ACCOUNTANTS

M. J. CALDER, M.A.

J. S. MOPPETT

R. C. I. GHEST

P. H. S. VON DER HEYDE

P. K. S. EWEN

25, LOWER BELGRAVE STREET,

LONDON, SW1W 0LS.

TELEPHONE: 01-730 8632

c
Treat official or do you wish to reply personally?

Our Ref: MJC/JEM

6th February 1987

9/2

I had better sign letter myself.

Dear Nigel,

We were at the House together in 1953/1954.

I have been in practice in my small family Firm, (103 years old) for the past thirty years and have just spent a total of three and a half hours on correspondence and computations and explanations relating to a Capital Gain realised by a Client at the end of last year on the part-disposal of one Stock Exchange Investment.

I am sure you have to consider numerous official representations on such matters, but thought that, perhaps, a personal letter from an old acquaintance inspired by common sense might help to persuade you to bring to an end the monstrously complicated legislation on Capital Gains which is accounting for an increasingly disproportionate amount of our working time and, I know, the time of the Inland Revenue.

I hope you remember me. I was the handsome one who lived in Meadows 4.

Yours sincerely,

Michael

MICHAEL CALDER

Rt. Hon. Nigel Lawson, P.C., M.P.,
11 Downing Street,
LONDON, S.W.1.

PLEASE SEE P.S. ON NEXT PAGE/.... 2

P.S.

Of course, if you could bring yourself to abolish the tax, that would be even better, or alternatively adopt something like the latest American model.

M.

W. J. CALDER, SONS & CO.
CHARTERED ACCOUNTANTS
M. J. CALDER, M.A.
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PLEASE SEE P.S. ON NEXT PAGE/.... 2

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M.

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY
DATE: 10.2.1987.

1. MR HOUGHTON Pl see accompanying note 10/2
2. CHANCELLOR OF THE EXCHEQUER

CGT ON DEATH IN PLACE OF IHT

1. You asked me to look at the possibility of replacing inheritance tax with capital gains tax charge on death. This note gives an overview of the main issues that would arise. There are a large number of other points to be considered if the possibility is to be pursued. And we have not diverted the statisticians from Budget work to provide estimates of the effects on yield or taxpayers numbers.

2. The Annex provides a broad tabular comparison of IHT with how the present CGT regime would look if it applied on death with no modification.

CAYLEY to CH/EX 10/2

General structure

3. The most obvious change is of course that the charge would be gains at the date of death instead of on asset values. There would thus be no tax on assets that had not increased in value, and the charge would be reduced to the extent that there were losses (including "indexation losses" on capital certain assets like building society share accounts).

cc Financial Secretary
Mr Scholar
Mr Cropper
Mr Isaac
Mr Houghton
Mr Battersby
Mr Cayley

4. The tax rate would be at a flat 30% instead of progressive from 30% to 60%. This would alter if marginal income tax rates in due course applied to gains, but if only half the gains were taxed as income the effective rate on gains would never exceed 30%.

5. Other things being equal, these two factors would lead to a major contraction in the tax base on death and a major fall in tax receipts (currently £m1,100) running to hundreds of millions of pounds.

6. Against this, the CGT threshold - £6,600 after 1987/88 revalorisation - would be very much lower than the proposed £90,000 IHT threshold (£74,000 with statutory indexation). This would help to offset the yield reduction. But it would also increase dramatically the number of estates liable to tax, by probably several hundred thousand (compared with numbers liable to IHT of around 26,000 with a £90,000 threshold and 38,000 with statutory indexation). This would impose a tax and compliance burden on small estates, and add hundreds to our staff requirement. If - as for CGT - there was tax deferral rather than IHT style exemption for bequests to spouses (see below), there would be a further major increase in compliance and administrative costs.

7. It is thus doubtful whether it would be sensible to apply the present CGT threshold on death. A very mugh higher figure might be appropriate. An additional justification for a much higher threshold might be that at death there is a concentration of disposals which might otherwise have been spread over a number of years and benefitted from several years' annual exemptions. But there would be an argument for setting the threshold on death somewhat below the IHT threshold as only gains were being brought into tax, instead of full asset values.

Gifts before death

8. A major issue would be the treatment of gifts. At present these qualify for CGT rollover. So someone could avoid the charge on death by giving assets away shortly before death. The IHT death charge is protected by the 7-year pre-death period in which transfers are chargeable, and also by the rules which tax gifts with reservation as effective only when the reservation ceases: some equivalent would be needed to protect a CGT death charge.

9. There is no CGT exemption for disposals to a spouse: instead, there is rollover. It would have to be decided whether bequests to a spouse should be exempt as they are generally for IHT.

Trusts

10. Trusts are liable to CGT only when they make disposals of assets. There is no CGT disposal when (eg. on the death of a life tenant) an interest in a trust passes from one person to another. When property passes into or out of a trust, there is a CGT charge but this can be deferred in the same way as a gift.

11. This contrasts with IHT. In order to protect a CGT death charge it would be necessary (as for IHT) to charge tax when property passes into or out of a trust, or when an interest in a non-discretionary trust changes hands.

12. As regards discretionary trusts, when (up to 1971) both CGT and estate duty applied on death, there was for CGT a deemed disposal of all assets every 15 years. It would have to be decided if this predecessor of the CTT/IHT periodic charge should be resurrected.

Principal Private Residence

13. The main home is exempt from CGT but not from IHT. If exemption is given on death, this would add to the Exchequer cost of the change (a main residence exemption within IHT would reduce the present yield by around a quarter); and it would discourage the elderly from moving to smaller accommodation: the more valuable the home at death, the more of the estate would be exempt. People would thus tend to be locked into accommodation bigger than they needed.

14. On the other hand, if homes are exempt in life but taxed at death, there would be an incentive to trade down to smaller, less valuable accommodation before death - or even to move to a residential hotel - and place the surplus proceeds in assets outside the CGT net, such as - under current rules - gilts, qualifying corporate bonds, and life assurance.

Assets outside CGT

15. This leads on to a more general issue. A number of assets liable to IHT are outside the CGT net. It would be hard to justify taxing gains on them at death but not have a lifetime gains charge on them. But if they are exempt at death there would be a major incentive for the wealthy elderly to switch into CGT-exempt assets - for instance out of shares into gilts. "Deathbed schemes" would be devised to facilitate this. There could be sizeable market implications, and such behavioural responses would be another factor pulling down the yield.

Pressure for best of both worlds

16. Generally there would be pressure for the best of both worlds: retaining all the CGT exemptions and adding on the equivalent of the IHT exemptions; combining CGT reliefs with those from IHT; and so forth. For example, with business and agricultural assets there might be pressure to combine CGT

rollover with total exemption of part of the gain (corresponding to the abated IHT charge).

Scope of charge

17. The IHT charge is based on UK domicile, but the normal meaning of the term is extended for IHT so that anyone resident here for 17 out of the last 20 years is deemed to have a UK domicile, and those who have had UK domicile remain within the scope of the charge for 3 years after they lose UK domicile. The charge to CGT on the other hand is based on the less stringent concepts of residence and ordinary residence. Accordingly, in order to protect the CGT yield on death it might be necessary to provide for a deemed disposal when someone left the country permanently (an emigration charge). Inevitably, this would lead to outside pressure for an immigration rule as well so that the tax charge was confined solely to gains accruing in the period of residence.

Compliance and administrative costs

18. Compliance costs and our staff need would rise substantially. One reason is that for IHT it is generally necessary to value assets only on the taxable occasion, whereas for CGT it would be necessary to establish a base cost as well, in order to compute the gain, and, in addition, under present rules there are the complexities of CGT indexation. The extent of the increase in costs would depend critically on

- the threshold at death

- what was done about bequests from one spouse to another, and

- the rules for lifetime gifts.

Other countries

19. We know of no major country which taxes gains on death but not the value of estates or inheritances. The nearest we have discovered is Australia, which has abolished its death duties, and for CGT gives universal rollover on death so that the heirs are treated as having acquired assets at the price paid by the deceased.

Evaluation

20. The change would be likely to have a heavy Exchequer cost and to lead to a substantial increase in compliance costs and our staffing need. There could be major market effects as, towards death, people sought to move into assets exempt from CGT. As with IHT, the death charge would possibly have to be protected by rules for gifts within a specified period of death; and the CGT regime for trusts would need major overhaul.

21. The change would however avoid the need for a comprehensive separate set of rules for tax on estates, though a number of IHT provisions would probably need to be imported for the CGT charge. There would thus be some legislative simplification. In practice however, for the reasons given in this note, the change would tend to complicate the winding up of estates.

Michael Cayley

M F CAYLEY

This Annex gives a broad tabular comparison of how a CGT regime on death under present CGT rules might compare with IHT. It covers only the straightforward case.

	CGT	IHT
A. GENERAL RULES		
Tax base	Indexed gains net of indexed losses.	Market value of assets.
Individuals liable	Generally those resident or ordinarily resident.	On worldwide assets if UK domiciled, on UK assets if not.
Threshold	£6,600 in 1987/8 assuming revalorisation.	£90,000 proposed for 1987/88 (£74,000 with revalorisation).
Rates	30%	30% to 60% on death, half death rates on chargeable lifetime transfers (eg. into discretionary trust).
Discretionary trusts	Taxed on disposals. Rollover when property passes into or out of trust.	Entry, periodic and and proportionate charges.
Other trusts.	Taxed on disposals. Rollover when property passes into or out of trust.	Tax when assets pass into or out of trusts and on changes in beneficial interests.
Gifts before death	Rollover.	Charge on gifts within 7 years of death, but taper relief for gifts between 3 and 7 years before death.
Bequests to spouse	Rollover.	Generally, complete exemption, but limited to £55,000 for transfers to spouse of non-UK domicile.

B. PARTICULAR ASSETS

Main Home	Exempt	Taxable
Business/ agricultural assets.	Rollover (but not for agricultural landlords).	Value reduced by 50% or 30% (includes tenanted agricultural land).
Life assurance proceeds.	Exempt.	Taxable.
Cash	Sterling exempt; other currency taxable.	Taxable.
Gilts/ qualifying corporate bonds.	Exempt.	Taxable.
Shares	Taxable.	Taxable, but could qualify for business relief.

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON
10 FEBRUARY 1987

Mr Romanski. I will come back to this in the course of looking again at CGT reform after the Budget.

HOUGHTON TO CH/EX 10/2

CHANCELLOR OF THE EXCHEQUER

CGT ON DEATH IN PLACE OF IHT

1. The attached paper will I hope serve to give you a "feel" for the questions which will have to be addressed if we were to substitute a CGT death charge for inheritance tax.

2. Death is a natural occasion of charge to CGT and was so until 1971 when it was removed because of the combined impact with estate duty at the very high rates then existing. When the death charge was removed it was estimated that the cost was equivalent to 15 per cent of the current yield of CGT.

3. But to rely only on a CGT charge on death opens up some big issues. You would be moving to a narrower base (gains rather than asset values). At present CGT is indexed and if indexation remained the pressure to give relief for pre-1982 inflation seems likely to be increased. It could be more difficult to remove indexation (or more expensive to buy it out) with a charge on death.

4. Then there is the question of the size of the threshold. A low threshold produces a large taxpaying population with the consequent compliance burden on both sides. A high threshold could narrow the base even further.

---

cc Financial Secretary
Mr Scholar
Mr Cropper

Mr Isaac
Mr Houghton
Mr Battersby
Mr Cayley
PS/IR

5. Particular classes of assets will throw up difficulties. The first of these would be the principal private residence. Would the lifetime exemption have to be replaced by roll-over if the principal private residence were not to be exempted on death? Something would have to be done about the present gifts roll-over on pre death gifts. Transfers between spouses would raise problems and the whole area of CGT exempt assets (sterling currency, gilts and qualifying corporate bonds, for example) would have to be reviewed.

6. A regime for charging trusts would have to be devised. We have a pre-1971 model but this might not prove acceptable in the world of 1988. The relationship between the CGT retirement relief and the charge on death would have to be established. Would the equivalent of business and agricultural relief have to be provided for CGT?

7. I fear that the answers to some of these questions may lead us to contemplate the possibility of a different CGT regime on death (threshold and even the rate of charge) as compared with the charge on disposals or deemed disposals in life. This could in turn create opportunities for arbitrage between life and death charges.

8. When we did some preliminary work on this possibility about a year ago, the estimate made at the time was that a CGT charge on death would yield between £250m and £300m on the assumption that the principal private residence would remain exempt, that CGT retirement relief would be given if it would have applied on a disposal immediately before death and assuming that gilts and corporate bonds would remain exempt. This has to be set against an IHT yield of almost £1b.

9. If the proposal is to be taken further we will need to provide you with a much more substantial examination of the possibilities. If it is to be a prospect for 1988, we shall also need to relate it to the major restructuring ideas already under consideration.

M

B T HOUGHTON

ps7/64L

UNCLASSIFIED

PBF 26/2

FROM: MRS D C LESTER
DATE: 11 February 1987

MR CAYLEY - INLAND REVENUE

cc PS/Inland Revenue
MCU

CAPITAL GAINS

I attach a copy of a letter which the Chancellor has received from an old acquaintance about Capital Gains Tax. He would be grateful if you could draft a reply for his signature, if at all possible by close of play on Thursday, 26 February, please.

Debbie Lester

MRS D C LESTER
Diary Secretary

W. J. CALDER, SONS & CO.
CHARTERED ACCOUNTANTS

M. J. CALDER, M.A.
J. S. MOPPETT
R. C. I. GHEST
P. H. S. VON DER HEYDE
P. K. S. EWEN

25, LOWER BELGRAVE STREET,
LONDON, SWIW OLS.
TELEPHONE: 01-730 8632

Our Ref: MJC/JEM

6th February 1987

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Yours sincerely,

Michael

MICHAEL CALDER

Rt. Hon. Nigel Lawson, P.C., M.P.,
11 Downing Street,
LONDON, S.W.1.

PLEASE SEE P.S. ON NEXT PAGE/.... 2

P.S.

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M.

ps7/64L

UNCLASSIFIED

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DATE: 11 February 1987

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Debbie Lester

MRS D C LESTER
Diary Secretary

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY
DATE: 12.2.1987.

MRS D C LESTER
CHANCELLOR'S OFFICE
HM TREASURY

CAPITAL GAINS

Thank you for your note of 11 February. Below is a draft reply to the letter from Michael Calder.

MFC

M F CAYLEY

---

cc Mr Houghton
Mr Cayley
PS/IR

M J Calder Esq
W J Calder, Sons and Co,
25 Lower Belgrave Street,
LONDON
SW1W OLS

Thank you for your letter of 6 February.

I think we all accept that the capital gains tax is not ~~will never be~~ a model of simplicity and I recognise that the indexation provisions in particular are complex. But the reality, as we both know, is that equity and simplicity rarely go hand in hand. Total abolition of the tax has its own problems - how to make good the loss to the Exchequer (perhaps around £m2,000 in 1987/88 if you include tax on companies' gains), what to do about tax avoidance through converting taxable income into untaxed gain, and so on.

I know you will appreciate that at this time of year - the run-up to the Budget - it is not possible for me to comment substantively on suggestions for possible tax changes. But I and my Ministerial colleagues do try to keep in touch with what practitioners like yourself are thinking.

I hope all goes well with you.

NIGEL LAWSON

*

AWK

I have asked Peter Cropper to ask IR to cost exemption from CGT of all pre-1982 gains. Pse make sure they do so ASAP.

Note that this is not the same as taking pre-1982 acquisitions out of the net. Indeed, it is possible that, in the short term, this proposal may cause the CGT yield to rise, as pre-1982 acquisitions are 'unlocked' and CGT is then levied on the appreciation since 1982.

NL.   PTO

Also, re the Barbary

Marl & General Trust

problem, have IR

looked @ the possibility of

repealing the provision that

requires IR/HMT consent to

emigration, & replacing it

with a provision that

emigration triggers CGT

liability?

M.

ps3/1K

SECRET AND PERSONAL

FROM: A W KUCZYS
DATE: 16 February 1987

MR B T HOUGHTON - INLAND REVENUE

cc PS/Financial Secretary
Mr Scholar
Mr Cropper
Mr Isaac - IR
Mr Battersby - IR
Mr Cayley - IR

CGT ON DEATH IN PLACE OF IHT

The Chancellor was most grateful for your and Mr Cayley's minutes of 10 February. He will come back to this in the course of looking again at CGT reform after the Budget.

2. Mr Michael also kindly provided some previous briefing on a taper for CGT in place of indexation. Here too, the Chancellor has asked for no further action for the time being, but will come back to it.

AWK

A W KUCZYS

RT4.43

SECRET AND PERSONAL

b/f with response (or 20/2)

FROM: A W KUCZYS

DATE: 16 February 1987

MR HOUGHTON - INLAND REVENUE

cc Mr Scholar
Mr Cropper
Mr Isaac - IR
Mr Cayley - IR

AWK to HOUGHTON 16/2

CGT

Immediately after the Budget, the Chancellor would like to press ahead with work on radical options for 1988, including tapering. Meanwhile, he would be grateful to know as soon as possible the cost of exempting from tax all pre-1982 unrealised gains. (NB. That is not the same as exempting pre-1982 acquisitions.) The Chancellor thinks it is possible that, in the short term, this proposal may cause the CGT yield to rise, as pre-1982 acquisitions are "unlocked" and CGT is then levied on the appreciation since 1982.

AWK

A W KUCZYS

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

CAYLEY to CAYLEY 25/2

FROM: M F CAYLEY
DATE: 25 FEBRUARY 1987

Many thanks. What wd the figs be if rebasing applied only to securities, & not to real estate? Wd it be possible to make this distinction? NL.

1. MR HOUGHTON [initialled] 25/2.

2. CHANCELLOR OF THE EXCHEQUER

CAPITAL GAINS TAX

1. This note is in response to your request (Mr Kuczys' note of 16 February) to consider the short and long-term revenue effects which would result from moving the base date forward to 1982. As a separate matter we also take the opportunity to answer two points raised in Mr Kuczys' note of 27 January.

Proposal

2. The proposal would consist of rebasing the tax at April 1982. This date is possible because indexation involves establishing market values at April 1982 and the share pooling arrangements have been devised to fit in with this. Because of these arrangements a different date would be impracticable.

3. The change could, of course, be made in conjunction with any one of a number of possibilities which would

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cc Mr Scholar
Mr Cropper
Mr Isaac
Mr Houghton
Mr Cayley

remain for restructuring the tax treatment of post-1982 gains. But for present purposes, and with a view to responding quickly, we assume throughout this note the continuance of CGT in its present form.

4. However, it might be worth noting now that although rebasing would meet a recurring fundamental criticism of the present CGT it would not, in itself, be a buy-out for the abolition of indexation. This is because, as we said during the Review, the people who get the most indexation relative to the size of their nominal gains are those who have acquired assets since 1982. Rebasing could not, therefore, compensate for the loss of indexation.

Assessment

5. Our best guess is that if the base date was moved forward to 1982 short-term receipts from CGT could well rise by less than £m200. This figure can be no more than a guess given the great uncertainty about the scale of short-term behavioural effects. In the longer-term the cost would be up to about half the present yield, or, say, £m1,000. We suspect that most of the additional short-term yield would come from the institutions. These figures include corporation tax on companies.

Effects

6. Moving the base date forward to 1982 would exempt all gains which had accrued prior to that time. Subsequent gains on assets acquired previously would remain chargeable in the normal way. Similarly, gains on post-1982 acquisitions would not be affected.

7. It follows from this that rebasing would have rather capricious effects. The principal beneficiaries would unquestionably be those who had invested many

years ago in land (including property investment and holding companies) and, in particular, those who mopped up the market in the immediate aftermath of the tertiary banking crisis. These investors would see the prospect of a potential tax charge on substantial real gains, and not just inflationary gains, disappear from sight. For shareholders in companies the story is rather different. During the greater part of the 1970's, share prices in general moved well below the RPI: a high proportion of gains in this period were, therefore, purely inflationary. These gains would be taken out of charge by rebasing: but in practice the bulk of gains on shares will be attributable to the post-82 period when share values spiralled upwards. However, because of the share identification rules (which match disposals with shares acquired post-1982 in priority to pre-1982 acquisitions) rebasing would not confer benefits until shareholders reduced their holdings in companies to below 1982 levels. The institutions might well not wish to do this (especially as by making early disposals they would accelerate their payments of tax - with obvious cashflow drawbacks) and might therefore see little benefit in practice from the rebasing.

<u>Behavioural implications</u>

8. We, and Ministers, are frequently told that the long-term revenue loss which would result from rebasing (and no-one has disputed this) would be more than offset by the increase in short-term receipts as people got out of old and unprofitable investments (the so called "unlocking effect"). Of course, it must be accepted that in unchartered waters such as these there are many uncertainties. However, we think that claims of this sort must be treated with a certain amount of caution.

9. In many cases pre-1982 inflationary gains are already effectively kept out of the system either completely or for long periods and this is an important consideration in estimating likely behavioural changes. In the corporate sector the rollover relief for the replacement of business assets will defer tax charges where trading assets are sold and the proceeds reinvested. There are similar deferral provisions for share exchanges in takeovers or mergers and these encompass transactions which are cash orientated, for example, shares exchanged for redeemable debentures.

10. We also formed the impression during the course of the Review that many gains realised by companies are being franked by trading and group losses (although it remains to be seen what the position will be once the full effects of the 1984 reforms feed through). In addition, until the 1985 legislation came into force the life companies largely shielded gains on equities by losses on gilts. And this will have accounted for some pre-1982 acquisitions. Revenue leakage through this activity is no longer possible but there remains scope for mitigation of liabilities if the life companies decide (which has not happened so far) to move out of gilts and into capital certain non-qualifying corporate bonds so as to create indexed losses.

11. The business assets relief is, of course, available to unincorporated businesses. Moreover, individuals can pass on assets to their children in their lifetime free of tax by use of the gifts rollover relief - a process now facilitated by the abolition of the CTT lifetime charge. This will benefit lumpy assets such as controlling interests in family companies and agricultural land. Where fungible assets such as shares are concerned, the annual exemption, coupled with fragmentation devices, goes some way towards compensating for the absence of total indexation.

12. The conclusion we would draw, therefore, is that any additional yield in the short-term arising from rebasing would come from those who wished to sell old assets for cash or who could not claim rollover relief. These would include:-

i. institutional investors;

ii. those with second homes;

iii. agricultural landlords;

iv. individuals with gains on business assets substantially above the retirement relief limit; and

v. individuals with large portfolio investments.

As we said earlier (paragraph 7), (i) and (v) would not benefit from the exemption of pre-1982 gains until shareholdings were reduced to below 1982 levels. And by accelerating disposals they would accelerate tax payments - which might well limit their enthusiasm.

Market effects

13. If you wish to pursue rebasing, we shall need to consult the Bank and Treasury on the market effects.

Other matters

14. In Mr Kuczys' minute of 27 January you asked two questions. First, an estimate of the additional yield if indexation was abolished for companies alone. Secondly, whether we could provide a ready-reckoner for reductions in the main corporation tax rate.

15. Abolishing indexation for companies would yield, after allowing for behavioural effects and the proposed Budget changes, rather over £m200 in a full year. Each one percentage point reduction in the full corporation tax rate costs about £m400 in a full year.

ie, abolition of indexation wd buy only ½% of the CT rate. But a package involving a cut in the CT rate wd be beneficial to the corporate sector overall.

AWK
26/2

P A Michael
for M F CAYLEY

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY
DATE: 6 APRIL 1987

1. MR HOUGHTON Pl see accompanying note
2. MR ISAAC

3. CHANCELLOR OF THE EXCHEQUER

CAYLEY to CH/EX 6/4

CAPITAL GAINS TAX

1. This note responds to your request for a paper on options for the reform of capital gains tax. It does not discuss the possibility of substituting a CGT charge for inheritance tax, on which Mr Houghton and I minuted you on 10 February.

General considerations

2. It may be helpful if I start by discussing some general considerations.

Should capital gains be taxed?

3. Economists and tax theorists generally accept that capital gains are a proper subject for taxation: gains are included in the conventional economic definition of income, and CGT is not in principle a tax on capital in the way that (say) IHT or Stamp Duty are "capital taxes".

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cc Financial Secretary
Mr Cassell
Mr Scholar
Mr Cropper
Mr George
(Bank of England)

Mr Battishill
Mr Isaac
Mr Houghton
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Michael
PS/IR

4. In practice to exempt capital gains would encourage conversion of (taxable) income into (exempt) gains. The conversion of income into gain is familiar territory in tax avoidance. The tax receipts at risk would thus be not only the present yield on gains but also the tax on income that might be transmuted into gain.

Simplification

5. Administrative costs (for the Revenue) and compliance costs (for taxpayers) are important. Any capital gains tax is likely to be complex because of the need to relate disposals to acquisitions and so on. But there are widespread complaints that the complexity of the present regime has exceeded reasonable bounds. It is arguable that some of these complaints are exaggerated: but at the least it seems essential that any reform should not add to the present complexity. Preferably it should reduce it.

Inflation

6. Both these considerations arise in the present treatment of inflation.

7. Most economists would consider that a tax system should tax real income, excluding what the taxpayer (at a time of rising prices) needs to reinvest to maintain the real value of his capital. The argument applies equally to capital gains, interest, stock appreciation and depreciation.

8. In practice, UK (and foreign) governments have ruled out a "capital/income" adjustment for interest, because it appears intolerably complex; and the 1984 corporation tax reform eliminated the then-existing "capital/income" adjustments for stock appreciation and for depreciation. The sole remaining such adjustment in the UK is for capital gains and, in a situation where all other such adjustments have been withdrawn, there is room for argument about how far this

induces distortions in the system and creates anomalies at the borderline of capital gains tax. With low (if mildly fluctuating) inflation, the case for indexation - at least for the future - is much reduced.

9. Whatever the theoretical arguments, indexation is responsible for many of the complexities of the operation of the present capital gains tax regime. On the other hand, as work over the past autumm and winter has illustrated, to move from an indexed to an unindexed system raises obvious difficulties.

Main elements of possible reform

10. The attached note summarises the main building bricks out of which the components of a reform package could be chosen. There are three main elements.

11. The first is a greater degree of integration with income tax by taxing gains at income tax rates. This would be consistent with the theorists' concept of gains as income, and could ease somewhat the problem of capital/income conversion. It would however not of itself be a simplification. A main factor affecting the feasibility of integration is the shape of the income tax higher rate structure: marginal rates of up to 60% make it difficult, if not impossible, to charge income and gains in the same way.

12. The second is abolishing indexation. This would be a major simplifation - the only major simplification we can identify. The simplest course would be to abolish indexation with instant effect. If this were not felt feasible, abolition could be phased in. Even so, there might still be difficulties in finding a reasonably well-targeted buy-out for indexation on existing assets.

13. The third is rebasing to 1982. This is a frequent request in representations. Of itself it does nothing to simplify the continuing system and it could create pressure for further rebasing in the future - which would be an added complication. But it could be a useful large sweetener, especially for old "lumpy" assets, in a wider package.

14. There are a number of minor variables which can be included. In particular, there is the level of the threshold, and minor sweeteners of the kind we identified in December. For simplicity this note leaves these possibilities on one side for the time being.

Packages

15. One possible package is of course the one considered in January - taxing half unindexed gains at marginal rates. This minute does not repeat the issues - in particular the link with higher rate tax regime - with which you will be familiar.

16. A further and radical option would be to combine all the main elements of reform: to tax unindexed gains at (full) marginal income tax rates while rebasing to 1982. The effect on 1987/8 accruals might have been an increase of several hundred million pounds in the CGT yield (£m1,600 on an accruals basis) after allowing for behavioural effects (as ever, it should be stressed that the estimate of behavioural effects is highly tentative) and possibly, a small increase in the CT yield on gains (£m1,100 for 1987/8 on an accruals basis under the post-Budget regime).

17. The package would be a major simplification. As with the first option, the feasibility in large measure probably depends on the shape of the higher rate structure: the lower the top rates the more possible it may appear. But even with a substantial cut in top rates removing indexation would no doubt remain controversial.

18. Variations on this package would be to phase out indexation over a period (the note below outlines how this might be done) or to confine the tax charge to a specified proportion of gains, on the lines of the January package.

19. If abolishing indexation is not feasible, we have considered whether a less radical option might be to rebase to 1982 and charge indexed gains at income tax rates. The effect on CGT yield might, after behavioural effects, be not that far off break-even. There would be a substantial decrease (possibly approaching 50 per cent) in corporation tax receipts on gains. This would not be a simplification of the regime; and, as I have said, we fear that this could be seen as a precedent for further rebasing in the future. You might in effect create some expectations of a "cut-off" regime, which would reintroduce some of the complications in CGT which we sought to remove in the 1985 reform. Again, the shape of the higher rate structure would be important.

20. A third package would be simply to tax gains (as currently computed) at income rates. This could substantially increase the burden on old lumpy assets. It would probably be a feasible proposition only in the context of very major cuts in the higher rates and even then some sweeteners could well be needed for "lumpy" assets. Sweeteners aside, the yield might increase by something over a third with the present higher rate structure. (There would be no corporation tax yield because this year's Finance Bill will already propose taxing companies' gains at the rates applying to income).

Conclusion

21. This minute and the attached note identify a number of possibilties, and there are a very large number of possible permutations. In the time available we have not been able to complete fresh statistical work and the figures quoted above should be regarded as no more than best guesstimates. In order to make best use of the resources we have for this type of work (and over the next few months the people concerned will

have major commitments on the Finance Bill), we would welcome guidance as to what options you would wish us to pursue in more depth. It would also be helpful to have your views as to whether integration with income tax should be a fundamental objective and whether we should be aiming for something not too distant from revenue neutrality.

22. More generally, work over the past few months would suggest that CGT reform may make most sense in the context of a wider reform of the personal tax structure, and in particular of the higher rates. This minute has however restricted itself to the taxation of capital gains and has not considered that wider context

Michael Cayley

M F CAYLEY

MAIN POSSIBLE COMPONENTS OF POSSIBLE REFORMS

I. TAXING GAINS AT INCOME TAX RATES

Proposal

1. For individuals and trusts, the 30% charge to CGT could be replaced by a charge at income tax rates. This would parallel the corporation tax changes this year, under which from Budget Day indexed gains will be taxed in full at normal corporation tax rates.

Arguments in favour

2. It would reduce the economic and fiscal distortions created by the differential treatment of income and gains, and would lessen the incentive to convert income into capital gain. The extent of these effects would depend on what other changes were made, in particular on what was done about indexation. The change would be in line with the recent US tax reform and with the regime in many other countries.

Problems

3. The change may be difficult with the present higher rate structure and a 60% top rate. (In the USA the cut in top income tax rates from 50% to 28% made the reform of gains taxation much easier). The difficulty may be particularly acute with "lumpy" assets like real property.

4. Depending on the higher rate structure and the other components of the reform package, there could be a large

number of losers and substantial (though very difficult to predict) behavioural and market implications.

Administration and compliance

5. Taxing at income tax rates is not of itself a simplification and would not reduce administrative or compliance costs.

Revenue and market effects

6. If the level of disposals stayed constant and this was the only change, the tax yield would rise substantially: but in practice - and depending on the rates of tax - there could be a marked reduction in the volume of disposals, pulling down the yield appreciably.

Variant

7. If taxing the whole gain at marginal income tax rates is not regarded as feasible, it would be possible to confine the charge to half or some other proportion of the gain.

II. DEINDEXATION

Proposal

8. To abolish indexation.

Arguments in favour

9. This would be a major simplification, substantially reducing administration and compliance costs, with (depending on the threshold) possible Revenue staff savings of several hundred. It would remove the anomalies that arise where part of the tax system is indexed and part is not (eg. on "capital certain" assets). The case for indexation is less pressing now that the level of inflation

has been reduced - and all other capital/income adjustments have been abolished.

Problems

10. The main problem is one of transition. The loss of indexation would increase tax liabilities on existing assets, and bring into tax inflationary gains for a past period that the holder of those assets had assumed would be exempt. There would certainly be allegations of retrospection and possibly also charges that the Government was reneging on an implied commitment to give indexation up to at least a current date. Indexation may be seen by some as an insurance policy against the possibility of higher inflation at some point in the future, and people may react with anxiety to the removal of this safeguard. The removal of indexation, by increasing tax liabilities, could have substantial market effects. If the threshold stayed constant, there might be some 60,000 more taxpayers, all of whom would be losers.

Revenue and market effects

11. Depending on the behavioural response, the yield might increase by several hundred million. But, particularly in the short-term, there could be a marked drop in the volume of disposals.

Variants

12. If indexation cannot simply be abolished in its entirety for all assets, there are two possible ways of easing the transition to an unindexed system:-

i. to freeze the indexation adjustment and phase out the resulting allowance over a transitional period. For example, with a three-year transition, in year one three-quarters of the frozen adjustment might be available; in year two, one half; in year three, one quarter; and in year four, none.

ii. more generously, to allow indexation to continue but on a tapering out-basis. Thus if the change commenced on 6 April 1988, the full indexation might be given for inflation up to that date, 90% for inflation in 1988/89, 80% for 1989/90 inflation, and so forth. This would of course perpetuate the complexities of indexation for a very long time, and would in itself be a complication, particularly in relation to the arrangements for share pools.

III. TREATMENT OF OLD ASSETS

(i) REBASING TO 1982

Proposal

13. The base date for CGT would be moved forward to 1982 (a different date would be impracticable because of the way the share pooling operates.)

Arguments in favour

14. It would meet a frequent criticism of the present regime. At the same time it would leave CGT applying in full on post-82 gains, thus not adding to the incentive to convert income to capital gain. It would much alleviate the tax burden on large pre-1982 gains on eg. land and could "unlock" old assets. It would avoid the difficulties of having in some cases to value particularly land at dates going back to 1965. It might be a useful sweetener in a wider package.

Problems

15. It would exempt large real (not just inflationary) gains, including some substantial development gains (and there is no DLT). It would of itself not be a simplification nor a buyout for indexation (the disappearance of which would increase the tax on post-1982 gains). It could create expectations and pressure for further rebasing in the future: and keeping open the possibility of further rebasing would mean complicating the system (see the section on tapering/cut-off below).

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16. There would be a high Exchequer cost (see below).

17. Since 1979 CGT changes have been designed largely to reduce the burden on <u>future</u> gains, thus improving incentives and so on. The change would mean treating old gains more favourably than post-1982 gains - a major shift of emphasis.

Gainers

18. The main beneficiaries would be landowners (including agricultural landlords) and those with second homes, on whose real property there were generally substantial real gains in the period before 1982. By contrast, for shares a high proportion of pre-1982 gains are inflationary.

V. Sadly expressed - Shareowners [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

Revenue and market effects

19. In the long term the yield might be roughly halved. There might be an additional yield (of possibly well under £m200) in the short term, probably mainly from institutions. The short-term market effects are extremely uncertain.

NB. For more detail on this proposal see Mr Cayley's note of 25 February.

(ii) TAPERING/CUT-OFF

Proposal

a. Taper

20. The tax on gains would be reduced as the period in which the asset was held increased. No tax would be payable at the end of the taper period. Losses would be tapered in the same way. There are two variations:-

- reducing the tax rate and

- reducing the proportion of the gain that is taxed.

b. Cut-off.

21. Gains would be taxed in full if held less than a specified period, and exempt if held longer. Losses would be cut-off in the same way. There would thus be a cliff-face at the end of the specified period.

Arguments in favour

22. Some form of taper or cut-off is the subject of recurrent representations. In the longer term, it would be more generous than rebasing. It might help to "unlock" assets which had been held for many years.

23. Like rebasing, it would exempt large real gains from tax. There would be a substantial locking-in effect on appreciating assets, to get the benefit of the reduced or nil tax charge on assets held for some years. This could create sizeable distortions in the markets. At the same time there would be an increased incentive to bed-and-breakfast capital losses at the earliest oportunity in order to maximise their tax value. The Exchequer would thus tend to give early (and full or near full) relief for losses while forgoing a sizeable amount of tax on gains (in many ways a situation comparable - but on a much bigger scale - to the position on gilts and qualifying corporate bonds before the 1985 changes came into force). The incentive to convert income into gains would be much increased.

24. A taper or cut-off would substantially complicate the operation of the system and add to compliance costs. It would not be simpler than indexation. Acquisition dates would have to be known for each asset. The share pooling arrangements could not continue in their present form and there would be difficulty in establishing the acquisition dates of individual blocks of shares in current share pools. Rules would be needed to determine whether the annual exemption should be given against later gains before earlier ones or vice versa.

Revenue effects

25. Could cost well over half the yield even before behavioural effects are brought into account.

(iii) SHORT-TERM GAINS TAX

Proposal

26. Unindexed gains on assets acquired within a specified period (which might be 6 months, 1 year, or whatever) would be charged in full at income tax marginal rates. Longer- term gains would be exempt.

Argument in favour

27. This is a recurrent suggestion in representations. The argument of principle would be that short-term gains resemble income.

Problems

28. Actual experience, in the USA up to the 1986 reforms and in the UK between 1962 and 1971 (when such a tax existed - for part of the period in conjunction with CGT), suggests that

- a short term gains tax can be complex because of rules to relate disposals to acquisitions and so on;

- it is easily avoided as people hold on to assets until after the cut-off date. CGT was in fact introduced in 1965 partly to try to protect the tax yield on short-term gains; and the short-term tax was subsequently abolished, as an unproductive complication; and

- it would have severe short-term lock-in effects.

29. There would be a major incentive to convert income into capital gains.

Revenue and market effects

30. Allowing for the behavioural response, the yield would be very small. When the UK's short-term gains tax was abolished in 1970/71, the yield was under £m5.

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

Ch/
This can be on the agenda for your post-Easter meeting on Tax reform (we will have to circulate it a bit more widely in the Treasury) AWK 8/4

FROM: B T HOUGHTON
7 APRIL 1987

HOUGHTON to CH/EX 7/4

Thanks. A useful start, wh shd go to all those who will be attending the tax reform mtg. Meanwhile, I shd like a note on methods of simplifying the indexation calculation (if we're to retain indexation) with worked examples. N.

1. MR ~~ISAAC~~ Kerr

2. CHANCELLOR OF THE EXCHEQUER

CAPITAL GAINS TAX

1. Mr Cayley's note below (drafted in consultation with the Treasury and the Bank) outlines the main options for CGT reform. Various permutations can be made of the key elements (integration, de-indexation, rebasing and possibly threshold adjustments). Deciding on the particular combination desired is the first stage. The second is to consider how to move from the present CGT to the new model. The type of transition which a particular option requires is itself an important factor in assessing the merits of that option. The more complex a transition has to be, the more it will detract from the new arrangements even though they may ultimately prove simpler and less of a burden for the taxpayer.

2. Furthermore it is more difficult to reform CGT in isolation. CGT changes are easier, both technically and presentationally if

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cc Financial Secretary
Mr Cassell
Mr Scholar
Mr Cropper
Mr George (Bank of England)
Mr Battishill
Mr Isaac
Mr Houghton
Mr Cayley
Mr Gonzalez
Mr Hamilton
Mr Michael
PS/IR

they are part of a larger reform (including the higher rates of income tax and, possibly, of IHT). It is also arguable that a mixture of elements in a CGT change is helpful. A combination of changes which affects individual taxpayers in conflicting and somtimes compensatory ways may be easier to present and see through to completion. In this context, rebasing may have a part to play in complicating taxpayers' responses to other elements in the package (although rebasing cannot, for instance, be presented as a direct buy-out for de-indexation).

3. Among the criteria which Mr Cayley mentions for considering the merits of the changes discussed I would emphasise particularly -

first, simplification/reduction in the compliance burden. The main contributor is de-indexation but the transitional arrangements necessary to achieve it may take some of the gilt off the gingerbread.

Second, limiting the scope for income conversion. Integration helps here but the rates of tax and levels of threshold have to be accommodating.

Third, behavioural/market effects. Changes which increased locking-in effects would go in the wrong direction. Reforms which incorporate sharp cliff faces between liability and non-liability must be suspect.

4. On an assumption of Revenue neutrality (or on a given increase or decrease in the yield) we could devise combinations which scored a maximum rating under the various criteria. But if this is to be anything more than a theoretical exercise, it has to be conceived as one component in a larger package of change and while therefore, as Mr Cayley observes at the end of his note, he has not considered the wider context, unless an attempt is made to do so, further work on the CGT aspects may be of little more than academic interest. At some stage if a realistic blueprint for reform of CGT is to be prepared, we need to have some idea of this wider framework. This is not easy and it may be possible to do no more than relate the CGT changes to a series

of options for wider change (various levels for higher rate tax and possibly a reduction in the IHT top rate). If a sizeable reduction can be achieved in the top rate of income tax, then full integration could become the main element in the reform and any combinations produced would reflect that fact. On this approach guidance would be helpful both on the CGT options which are to be worked up and also the framework of wider change within which they would fit. This implies a range of IT options and any other changes which would help to create the diversity of effects and counter effects which are so important in assessing whether full integration and de-indexation are feasible either in combination or separately.

B T HOUGHTON

These notes summarise the conclusions of long debates here.

To me, these points stand out:

- c.g.t. is criticised on a number of ~~fl~~ counts: complexity, interface with income tax, 'locking in'.
- all our work suggests that we need to amend indexation, if we hope to simplify the tax in any significant way.
- integration could improve the interface with the taxes on other income gains
- but the reform would be controversial, it would mean eating some past words, and it would produce losers. I remain convinced that its future rests, to a very large degree, on whether it can be wrapped up in a wider package, including action on (or least the higher) income tax rates.

C.L.C. 7.4.

b/f with advice

DEPARTMENT OF TRADE AND INDUSTRY
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Secretary of State for Trade and Industry

7 May 1987

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1

CH/EXCHEQUER
REC. 11 MAY 1987 11/5
ACTION MR CAYLEY-IR
COPIES TO CST FST EST SIR P MIDDLETON MR CASSELL MR SCHOLAR MRS LOMAX MISS SINCLAIR MR CROPPER PS/IR

Dear Nigel,

Thank you for your letter of 21 April replying to mine of 31 March about the implications for life assurance of the Budget proposals for taxing companies capital gains.

I remain of the view that these proposals would add significantly to the existing fiscal distortion between life insurance and other investment products. I would suggest that in the particular case of life insurance it is more important to achieve fiscal neutrality at the level of the individual policyholder (ie looking through the life insurance company and comparing the position of the life insurance policyholder with other investors) than at the level of the company (ie comparing life insurance companies with companies generally). This reflects the fact that whilst the life policyholder funds of insurance companies are the assets of the company, virtually all the investment return (100 per cent for linked policies and typically 90 per cent for conventional business) goes to policyholders or to meet expenses.

I argued in my earlier letter, that, even before the proposed Budget change, the existing CGT regime seems somewhat slanted against the life insurance policyholder and I compared the position of unit trusts with single premium bonds. You point out in paragraph 7 of your letter that the advantage is not all one way and mention that higher rate liability of a bond holder is deferred and that the bond holder can switch between funds free of CGT liability. However, I suggest that for most investors these advantages are worth much less than the personal allowance in

DW4CEB

respect of CGT liability enjoyed by unit trust holders but not by bond holders (because the bond value is reduced to reflect the insurance company's CGT liability).

In my earlier letter, I also argued that the 1985 computations of CGT liability would not be a good guide to the effect of the change in future years. Your letter accepts that there is some substance in this point although you do not accept the ABI's estimate of £100m either for 1986 or for future years. As regards the impact in future years, I note that two of the reasons which you mention as being likely to increase CGT liability in 1986 as compared to 1985 are likely to persist : the increases in stock market prices in 1986 will, unless reversed, continue to be reflected in capital gains realised in future years until the increases are eroded by the effect of the indexation allowances; and the amended rules on losses on gilts will also, unless there is a further rule change, continue to push up companies' CGT liability.

However, it is the effect on the individual policyholder which is most relevant when considering the significance of the proposed change. In my previous letter I mentioned that as a direct result of the Budget proposal, M&G Life Assurance had reduced its unit prices by up to 3½ per cent. This can be regarded as a reasonable measure of the impact of the change on mature unit linked funds. Although 3½ per cent is not a large percentage of the unit price, it would certainly not be insignificant for the policyholder affected : for example, on a bond with a £10,000 surrender value, the policyholder would lose £350.

There seems to be some implication in paragraph 6 of your letter that companies need not reduce their unit prices in order to make provision for the extra CGT. You mention that a few companies make no provision at all and that the level of provision is a matter for each company to determine. However, if companies are to be in a position to meet the expectations of their policyholders, adequate provision must be made for the contingent liability for CGT in respect of unrealised capital appreciation in the fund. Our solvency regulations require such provision to be made. Although there have previously been a few companies which have claimed not to make any deduction for CGT, that position could only be sustained in the initial phase of launching a new fund. There is at present only one company which still makes such a claim and then only in relation to one of its internal linked funds. It is true that the level of provision varies reflecting the different circumstances of companies and differing degrees of prudence in the reserving basis. However, there are many cases of companies which make provision for future CGT with only a small discount. I hope you will agree that when considering the case for a change to the

DW4CEB

999-49

tax regime applying to life insurance companies generally, regard should be paid to the position of the majority of companies rather than to a small minority who, for special reasons, are temporarily in a particularly favourable tax position.

I would be grateful if you could look again at the suggestion of a concession for gains arising in the life policyholder funds of insurance companies in the light of the points I have made.

Yours,

PAUL CHANNON

Paul

DW4CEB

999-49

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 13 MAY 1987

1. MR HOUGHTON 13/5

2. CHANCELLOR OF THE EXCHEQUER

LIFE ASSURANCE COMPANIES

I attach a draft reply to Mr Channon's letter of 7 May, a copy of which is below. The letter itself raises no new points.

Michael Cayley

M F CAYLEY

---

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Cropper

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Houghton
Mr McGivern
Mr Cayley
Mr Hamilton
Mr Spence
Mr Greenslade
Mr Michael
PS/IR

Ch

Not seen in draft.

NB See also answers to your question in folder enclosed.

AK

Pl type for Chris sig

The Rt. Hon Paul Channon, MP.,
Secretary of State for
Trade and Industry,
1-19 Victoria Street,
LONDON
SW1H OET

May, 1987.

Thank you for your further letter of 7 May about life assurance and the proposed changes in the capital gains regime for companies.

Perhaps I should start by mentioning that the Inland Revenue have now reviewed the tax computations for 1985 of some 60 life assurance companies, large and small, representing around two-thirds of total policyholders' funds on all life assurance. The ~~Inland~~ Revenue cannot give me figures for individual companies, because of confidentiality, but they have told me that, of these 60, approaching two-thirds had no 1985 liability on policyholders' gains and, had the change been operative in 1985, would have been unaffected by it. This two-thirds incidentally includes some large and long-established companies. The one-third or so paying tax on policyholders' gains had a total liability of some £m50 at the 30% nominal rate then applying - an effective rate of very much less than 30%. These figures confirm the Revenue's estimate that, had the change applied in 1985, the extra tax on policyholders' gains would probably have been under £m20: indeed they suggest it might have been nearer £m10.

It is still, I am afraid, too early to know whether the 1985 pattern is a guide to the picture in 1986 or future years: the Revenue have so far received very few 1986 computations. But those they have received, coupled with the information available to them on the pattern of investments, expenses and so on, suggest that~~, to put it at the~~

~~lowest,~~ by no means all life assurance companies are likely to be paying tax on policyholders' gains in 1986 or subsequent years. Those that have no liability will of course not have to pay any more tax as a result of the change. And, as I explained in my letter of 21 April, for those that do pay tax on policyholders' gains, there are large tax deductions available and the effective tax rate on the gains is likely to be very much less than the nominal 35% rate - and in some cases will in practice be negligible.

How life companies translate all this into provisions for possible future tax on gains is entirely for each company to determine and it would be inappropriate for me to comment on the extent to which particular companies have adjusted their provision on account of the proposed corporation tax change. All I would say is that I understand that there are some companies which have been setting aside sizeable tax provisions but which for many years have paid no or very little tax on policyholders' gains and whose future liability (if any) on accrued gains could well be significantly below the level of provision they have made.

In the light of the information available, I remain of the view that the change need not have any substantial effect on the competitiveness of life assurance. But, as I said ~~stated~~ in my earlier letter, I shall be keeping under review the ~~relative~~ overall effect in practice of the tax regime on life assurance as compared with other investment media, and I shall be studying carefully the representations I have received.

NIGEL LAWSON

4470/71

SECRET

Thanks:

FROM: MISS C E C SINCLAIR
DATE: 15 May 1987

CHANCELLOR

Ch
We spoke.
No mention of policyholders' gains, because officials assume we will stand firm on that – ie no policy decision arises. Is that right?
AWK 15/5

I may well wish to stand firm. But we will need to see a paper setting out the options here, too. [For the [illegible] Scholar: [illegible] the need compatibility with poss. future tax reform.] NL

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Scholar
Mr Culpin
Miss Evans
Mr Dyer
Mr Tyrie
Mr Ross Goobey

Mr Johns - IR
Mr Wilmott - C&E
Mr Graham - Parly Counsel

FINANCE BILL (NEW PARLIAMENT)

Mrs Ryding's minute of 11 May to Mr Scholar said that you wanted to get all the clauses which had to be left out of the Finance Bill which has just been passed into a second Bill which you hoped could be rushed through by end July.

2. Work is proceedings on this basis, with a view to having a second Bill as advanced as possible by the time of the election. But you and other Ministers might like to be aware that there are some points on which policy decisions will be needed before drafting can be finalised. These are:

<u>Profit-related pay</u>

The Revenue will be reporting on some outstanding and new policy issues, such as whether anything needs to be done on special companies such as insurance companies.

<u>Banks double taxation relief</u>

The Economic Secretary has asked the Revenue to report on the possibility of amending the transitional period of grace for existing loans.

Lloyds

The Revenue will be reporting to Ministers on progress in discussions with Lloyds. Ministers may, as a result, wish to make amendments to the existing clauses.

Oil

V bad

The Revenue have recently become aware of some desirable technical amendments to clauses included in the Finance Bill which has just been passed (clauses 153-155 in the original numbering). They have also found a defect in the PRT safeguard. They will be approaching Ministers to ask whether they would want these points to be dealt with in a summer Finance Bill. Most could, if necessary, be deferred.

Stamp Duty

A minor amendment is needed to rectify a flaw in the clause on warrants to purchase Government stock (which has been passed). Ministers will be asked whether they want this and certain other minor amendments to stamp duty reserve tax to be included in the summer Bill.

Pensions

One or two relatively detailed new points will need to be put to Ministers.

3. Since the above was dictated your Private Secretary has told me that what you would like us to do is to have legislation drafted as far as possible for each of the policy options which will be put to Ministers on the above points. This will be set in hand.

Carolyn Sinclair

CAROLYN SINCLAIR

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON
15 JUNE 1987

1. MR ISAAC 15.11

2. CHANCELLOR OF THE EXCHEQUER

POLICYHOLDERS' GAINS OF LIFE COMPANIES

1. Mr Cayley's minute of 15 June below sets out the options for handling policyholders' gains. Pressure to maintain the rate at 30% has been strong and although the election gave us a breathing space it shows little sign of letting up. There is a connection between these options and the desirability of finding a place for the capital gains tax charging provisions in the Summer Finance Bill.

2. You will recall that the controversy about policyholders' gains was the reason for not pressing for a place for the capital gains tax charge in the pre-Election Bill. The expectation was that we would be able to pick up the clauses in the Summer Finance Bill when the question of policyholders' gains could be better handled. But if a place cannot be found in the Summer Finance Bill for the capital gains tax clauses, a number of awkwardnesses will arise.

cc Chief Secretary
Financial Secretary
Mr Scholar
Miss Sinclair

Mr Isaac
Mr Painter
Mr Houghton
Mr McGivern
Mr Cayley
Mr Spence
PS/IR

3. Putting off the legislation to 1988 would involve:-

a. maintaining the 1987 start date to prevent forestalling by those faced with a higher rate and to validate the position of those who have acted on the basis of a lower rate (the new small companies rate of 27%);

b. bringing into question our statutory capacity to make any assessments until after that retrospective rate had been validated in the 1988 Bill.

At present there is no specifically prescribed reducing fraction to apply to company gains. The 1984 Act set a fraction up to the end of financial year 1986 but not beyond. It is therefore likely that we have no power to make even provisional assessment on gains of the current financial year. This could result in a moratorium on tax payments for companies with year ends on or after 1 April 1987 until next year's Bill gave us the power to make assessments. The amounts of tax deferred would be small - probably well under £50m - but it would suggest administrative confusion and there could be some additional staffing costs. A Government announcement that the new regime would be introduced with retrospective effect next year would not provide adequate legal cover.

4. There is therefore a strong case for including the capital gains tax clauses in the Summer Bill to set the position to rights and avoid an appearance of disorderliness. But given the pressures to get the House up early, it would seem desirable to keep controversiality down to the minimum and you might for this reason find option 3 (to retain a 30% rate for policyholders' gains and make an early announcement of a general review - paragraph 6 of Mr Cayley's note indicates a possible timetable) that much more attractive. The countervailing consideration is that this option might be thought to imply a "soft" approach in

the review itself and might stiffen resistance to more thorough-going reforms in the taxation of life assurance companies. A further consideration is that if we move forward to an integrated capital gains tax for individuals, the disparity between the corporate regime (which is the source of the problems here) and the individual regime will be even greater for the majority of cases than now.

h

B T HOUGHTON

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 15 JUNE 1987

1. MR HOUGHTON Mr Pl. see covering note MH 15/6

2. MR ISAAC

3. CHANCELLOR

POLICYHOLDERS' GAINS OF LIFE COMPANIES

1. Mr Kuczys' note of 18 May to Mr Scholar asked for a paper, early after the election, on policyholders' gains. This minute has been seen by FP Division who are content with it.

Background

2. Up to Budget Day, gains earned for policyholders by life companies were taxed at 30%. The pre-election Finance Bill proposed that the rate increase to 35% as part of the general changes for companies' gains.

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cc	Chief Secretary	Mr Isaac
	Financial Secretary	Mr Painter
	Mr Scholar	Mr Houghton
	Miss Sinclair	Mr McGivern
		Mr Cayley
		Mr Spence
		PS/IR

3. You will be familiar with the arguments on this. Life companies complain that the effect is to penalise them relative to eg unit trusts. The information available to us suggests that in practice (partly because of heavy tax deductions for management expenses) had the change applied in 1985 the extra tax burden would probably have been less than £m 20 - and quite likely nearer £m 10. The effect is not evenly spread. A high proportion of life companies would have been totally unaffected by it. The figure is tiny in relation to total policyholders' funds. The figure overall is likely to have been somewhat higher for 1986, for a variety of reasons, but even so the information we have suggests that the effect on actual future tax payments will for some companies in at least some years be zero; for some others, often negligible; and even for the remainder, gains will be substantially sheltered from tax by management expenses etc.

4. Nevertheless the life companies are complaining loudly; and some have significantly increased the provisions they make for possible future tax on accruing gains. The level of such provisions is a matter for each life company. There are no DTI guidelines. DTI are concerned essentially with the overall solvency of companies. They would want to be sure that companies had taken account of likely actual tax payments but do not look much beyond this or attempt to check whether provisions are excessive. Some companies which have for many years paid no or little tax on gains have long been making large provisions.

Interaction with possible CGT changes

5. Mr Kuczys' note specifically asks us to bear in mind compatibility with possible changes in CGT. The work we are undertaking on these relates to the regime for individuals and trusts. Policyholders' gains are of course taxed as part of the company regime in the hands of the life assurance company. The life companies' complaint about a 35% rate on these gains

might be reinforced if there were a relaxation of the gains regime for most individuals but not for companies. A general change in the regime for individuals could have implications for the comparison between life companies and unit trusts.

General Review of Life Assurance

6. However, as you know, we have been looking at the overall regime for taxing life assurance companies on company profits and on policyholders' income and gains. We will shortly be reporting to Ministers on the case for taking the review forward to a consultative document on reform options, with a view to legislation. This possibility needs to be borne in mind in assessing the immediate options on policyholders' gains. And some members of the Association of British Insurers have indicated that they would welcome a review. But the issues are proving even more complex than when we began this work and radical reform options would be very controversial. Because of the complexity of the subject and the need to get any new system right from the start, we believe there is a compelling case for full consultation with the industry and other interested parties prior to legislation. Completing the analyses and working up proposals for consultation will be a major undertaking and legislation does not seem a realistic prospect until 1989.

Options

7. Against this background, it seems to us that there are four main options.

8. Option One is to stick with the proposal to tax policyholders' gains at 35% and make no immediate announcement of a general review of the tax regime for life companies.

- advantages: no climbdown, and does not close off possibility of general review

- disadvantages: life companies will continue to complain of unfairness. If (as is almost certain) pressed on this, Ministers could promise to consider a general review, or announce that such a review will take place.

9. Option Two is to stick with the proposal to tax policyholder's gains at 35% and make an early announcement of a general review.

- advantages: no climbdown, and announcement of general review might reduce complaints

- disadvantages: life companies would probably say that the rate increase to 35% should be deferred pending the review. Given the timescale of a summer Finance Bill, Ministers would have to be prepared to announce the review before they had had an opportunity to consider the detailed contents of a consultative document - though the announcement of a review need not commit Ministers to producing a consultative document.

10. Option Three is to retain a 30% rate for policyholders' gains and make an early announcement of a general review.

- advantages: probably acceptable to life assurance industry. The announcement of a general review would make it easier to present the decision to retain a 30% charge for the time being.

- disadvantages: failure to carry through the rate increase on policyholders' gains might strengthen the life companies' view that they could resist other changes which would increase tax liabilities. Ministers would, as with Option Two, have to commit themselves to the review before they had considered the detail of a consultative document.

11. Option Four is to retain a 30% rate for policyholders' gains and make no announcement of a review.

- advantages: would be welcomed by life assurance industry.

- disadvantages: a climbdown which could make it difficult to proceed with a general review and overhaul of the taxation of the sector.

Evaluation

12. We suspect that Ministers will find Option Four - just reverting to the 30% rate on gains - probably the least attractive. With Option One - maintaining the proposal to change the rate to 35% and no announcement of a review - Ministers may well be forced to say publicly that they will at least consider a general review. The choice between this Option and Options Two and Three turns essentially on

(i) whether Ministers are prepared to announce a general review before they have considered the contents of a consultative document, and

(ii) whether in the immediate future (pending any general review) they feel they can resist the continuing complaints about increasing the rate on policyholders' gains to 35%.

Michael Cayley

M F CAYLEY

2/4367

SECRET AND PERSONAL

FINANCIAL SECRETARY TO THE TREASURY

(We spoke.) On the clear understanding that the corporate gains clause not in a summer FB to receive Royal Assent before the recess, I am prepared to go along with option 3 as favoured by the FST. N.

FROM: J J HEYWOOD
DATE: 16 June 1987

PS/CHANCELLOR

cc PS/Chief Secretary
Mr Scholar
Mr Haigh
Mr Cropper
Mr Houghton - IR
Mr Cayley - IR
Mr Spence - IR
PS/IR

POLICYHOLDERS' GAINS OF LIFE COMPANIES

The Financial Secretary has read the minutes from Messrs Houghton and Cayley* on this matter and has reviewed the various options with officials this afternoon.

*Ch/With you AK

2. The Financial Secretary is sure that the only two realistic options are 2 and 3 in Mr Cayley's minute. Of these, the Financial Secretary marginally favours option 3, for two reasons.

3. First, given the difficulties we are facing in getting the second 1987 Finance Bill through Parliament before the summer recess, the Financial Secretary believes that a preservation of the status quo for policyholders' gains - and the announcement of a general review - would be a fairly inexpensive (perhaps £20 million) and very useful way of expediting the Bill's progress. Indeed, the Financial Secretary foresees sustained and vocal backbench opposition, if we stick to our original intentions. He notes that various backbenchers have seized that there is a clear difference - reflected in existing legislation - between the gains of policyholders and those of shareholders. The Financial Secretary thinks that this distinction makes it much more difficult to answer the opposition.

4. Second, on the merits of the case, the Financial Secretary does have some sympathy with the industry's view that a CGT rate of 35 percent would put them at an unfair disadvantage relative to the unit trust industry. Whatever their original functions may have been, the Financial Secretary believes that the life

assurance companies are now bona fide savings intermediaries, the vast bulk of their policyholders being long-term savers.

5. As to the "review", the Financial Secretary thinks that there will be no need to announce at this stage what its terms of reference will be: this can be settled later, in consultation with the industry. Nor does he see any reason why such a review should commit Ministers to producing a consultative document. The Financial Secretary does think, however, that we need to be sure in advance that any possible future action on the creation of a "level playing-field" for savings will not cut across the ongoing review of the taxation of the life assurance sector.

J.H.

JEREMY HEYWOOD

Private Secretary

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

Secretary of State for Trade and Industry

7 July 1987

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1

CH/EXCHEQUER
REC. 08 JUL 1987 8/7
ACTION MR BEIGHTON -IR
COPIES TO CST FST EST
SIR P MIDDLETON
MR CASSELL
MR SCHOLAR
MRS LOMAX
MISS SINCLAIR
MR CROPPER
PS/IR

Dear Nigel,

Thank you for your letter of 30 June about your conclusions on the tax regime for life insurance companies. I agree that the main aim of the review should be to level the playing field between life insurance and other savings mediums.

I am glad that DTI officials are to be kept fully in touch with the exercise. My officials will be contacting yours in the next few days about their participation.

Yours
David

LORD YOUNG OF GRAFFHAM

DW1DCI

C10/23

cc: PS/CST
PS/FST
Mr Scholar
Mr Haigh
Mr Cropper
Mr Houghton - IR
PS/IR

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

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
1-19 Victoria Street
LONDON SW1

30 June 1987

Dear David

Before the Election, Paul Channon and I exchanged views about the changes proposed in the capital gains tax regime for life assurance companies. In my letter of 14 May, I said that I would be keeping the position under review and studying carefully the representations I had received. I am writing now to let you know the conclusions I have reached.

Although the life insurance industry have put their case vocally, I am by no means persuaded by their arguments. I have, however, decided that it would not be right to increase the rate of tax on policyholders' gains at the moment, for two reasons. First, the very compressed Parliamentary timetable for the new Finance Bill (containing those provisions which had to be dropped before the Election) points to avoiding contentious legislation if possible. Second, the tax treatment of life companies more generally has developed in a rather piecemeal fashion, and the time is ripe for a more widespread review. The main problems are that the system is exceptionally complex, raises relatively little revenue, and produces a very uneven playing field between different forms of savings.

I have concluded, therefore, that it would be right to review the whole area. Naturally I shall ensure that your officials are kept fully in touch with this. My decision - both on the review, and on the rate of tax - will be announced in a press release to be issued on the publication of the Finance Bill on 3 July. I shall also be writing to Brian Corby at the same time.

Yours
Nigel

NIGEL LAWSON

PEARSON

CH/EXCHEQUER
REC. 13 JUL 1987 ✓13/7
ACTION FST
COPIES TO

13 July 1987

The Rt Hon Nigel Lawson MP
11 Downing Street
London SW1

Dear Chancellor,

As you may know, Pearson is one of the four Founder Members of the British Satellite Broadcasting consortium. It has been pointed out to me that there appears to be an anomaly in the rules relating to capital gains tax 'roll over' relief. It could be helpful to us, possibly to other members of the consortium and other comparable enterprises if an amendment were to be included in the current Finance Bill to remove this anomaly.

It is possible to 'roll over' capital gains on disposals of business assets and thus defer the tax liability where the proceeds are reinvested in certain specified classes of asets. One of those classes includes ships, aircraft and hovercraft - but not spacecraft or satellites. This exclusion is presumably attributable to the fact that commercial ownership and use of spacecraft had barely been conceived when capital gains tax was brought in in 1965.

Satellites may be expected to have comparable useful lives to ships, aircraft and hovercraft, and they seem to us to be equally deserving of support through the tax system. I am told that a simple additional clause to the Finance Bill would be all that would be necessary, and we would be most grateful if the Government could give sympathetic and urgent consideration to our request.

I have sent copies of this letter to the Secretaries of State at the Home Office and the Department of Trade and Industry - being the Ministers responsible for broadcasting and satellites respectively.

Yours sincerely

Michael Blakenham.

Viscount Blakenham

PEARSON PLC · MILLBANK TOWER · LONDON SW1P 4QZ · TELEPHONE 01-828 9020 · TELEX 8953869 · FAX 01-828 3342
Registered Office at the above address Registered in England No 53723

Inland Revenue

Policy Division
Somerset House

I hope this letter was acknowledged in a more civil fashion by you

FROM: M F CAYLEY

DATE: 13 JULY 1987

EXTN: 7427

PS/FINANCIAL SECRETARY

PS/FST now doing so
15/7

CGT ROLLOVER: SATELLITES

1. You telephoned today about Pearson's request for an urgent Finance Bill amendment to extend CGT rollover on business assets to satellites. I have since seen Viscount Blakenham's letter to the Chancellor (below)

2. The position is that rollover is available only on specified types of asset. They include ships, aircraft and hovercraft but not satellites or spacecraft. When the rules were drawn up, it was not envisaged that these would be owned by the private sector. The point has not been raised until now.

3. There is no policy reason that we can see to resist giving rollover relief on satellites and spacecraft - though if the rules were extended, Ministers would doubtless come under intensified pressure for other extensions. But it is, I think, too late to do anything in the Summer Bill - a new specific

---

cc PS/Chancellor
Mr Scholar
Mr Cropper

Mr Houghton
Mr Cayley
Mr Hamilton
Mr C Gordon
PS/IR

Resolution would have to be prepared, and even if you felt able to table this at this stage in proceedings, time for drafting even a simple New Clause is excessively short.

4. I suggest that the substantive point should be considered in the starters round for the 1988 Bill. A draft reply to Viscount Blackenham is attached. I have prepared this for the Financial Secretary's signature.

Michael Cayley

M F CAYLEY

Viscount Blakenham
Pearson PLC
Millbank Tower
LONDON
SW1P 4QZ

You wrote to Nigel Lawson on 13 July about capital gains tax rollover relief.

As you say, the relief is not available where the proceeds from the sale of business assets are reinvested in a spacecraft or satellite. I am afraid that, whatever the merits of your suggestion, given the timetable for Parliamentary consideration of the Summer Finance Bill, it would not be possible, at this late stage to include in it a New Clause to extend rollover relief: but I shall certainly bear the point in mind.

I am sorry I cannot send you a more welcome reply.

I am copying this letter to Douglas Hurd at the Home Office and David Young at DTI.

NORMAN LAMONT

RCV BY:XEROX TELECOPIER 7010 ;13- 7-87 11:09AM ; 01 630 6858→ 012705244;# 1

PEARSON PLC (2) LOND No. 01 630 6858 13.07.87 11:09 P.01

·PEARSON·

13 July 1987

13 JUL 1987

Mr. Cayley IR
PPS, PS/CST
PMG, EST
Sir. P. Middleton
Mr. Monck, Mr Burgner
Mr Scholar
Mr. Croppel
PS/IR

The Rt Hon Nigel Lawson MP
11 Downing Street
London SW1

Mr. Jenkins OPC

Dear Chancellor,

As you may know, Pearson is one of the four Founder Members of the British Satellite Broadcasting consortium. It has been pointed out to me that there appears to be an anomaly in the rules relating to capital gains tax 'roll over' relief. It could be helpful to us, possibly to other members of the consortium and other comparable enterprises if an amendment were to be included in the current Finance Bill to remove this anomaly.

It is possible to 'roll over' capital gains on disposals of business assets and thus defer the tax liability where the proceeds are reinvested in certain specified classes of asets. One of those classes includes ships, aircraft and hovercraft - but not spacecraft or satellites. This exclusion is presumably attributable to the fact that commercial ownership and use of spacecraft had barely been conceived when capital gains tax was brought in in 1965.

Satellites may be expected to have comparable useful lives to ships, aircraft and hovercraft, and they seem to us to be equally deserving of support through the tax system. I am told that a simple additional clause to the Finance Bill would be all that would be necessary, and we would be most grateful if the Government could give sympathetic and urgent consideration to our request.

I have sent copies of this letter to the Secretaries of State at the Home Office and the Department of Trade and Industry - being the Ministers responsible for broadcasting and satellites respectively.

Yours sincerely

Michael Blakenham

Viscount Blakenham

CONFIDENTIAL

FROM: P D P BARNES
DATE: 13 July 1987

PS/CHANCELLOR

cc Sir P Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Williams
Miss Leahy

Mr Pitts - IR
Miss Hill - IR
PS/IR

OK

FINANCE BILL CLAUSE 80 : ROLL-OVER RELIEF OIL LICENCES

Both Brindex and UKOITC have recently expressed their strong opposition to the principle of retrospection involved in Clause 80. They have indicated, however, that they would be mollified to some extent if the Government were prepared to indicate at Committee Stage that they would consider introducing roll-over relief for oil licences, at least in some circumstances, in the 1988 Finance Bill.

2. The Economic Secretary proposes to say that the Government will consider introducing roll-over relief for work programme farm-outs on exploration oil licences where no cash changes hands.

4. The Economic Secretary would be grateful to know whether the Chancellor would be content with this. In the meantime, he would be grateful if Miss Hill would provisionally draft a speaking note that he might use in Committee. (She has done so — below)

PB

P D P BARNES
Private Secretary

BUDGET SECRET

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY
DATE: 15 JULY 1987

1. MR HOUGHTON ✓ PL. see accompanying note. 15/7
2. MR ~~ISAAC~~
3. CHANCELLOR OF THE EXCHEQUER

GAINS CHARGE ON DEATH

1. You asked us to examine further the possibility of replacing Inheritance Tax with a gains charge on death.

2. We have assumed that the gains would be taxed at income tax rates, with an income tax basic rate of 25% and a single higher rate of 40%. For illustrative purposes, we have assumed that the higher rate threshhold would be £20,400. We have allowed for the possibility of rebasing to 1982. In

---

cc Financial Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Lawrance
Mr Beighton
Mr Houghton
Mr Calder
Mr Cayley
Mr Gonzalez
Mr H B Thompson
Mr Weeden
Mr Hamilton
Mr R H Allen
Mr Michael
PS/IR

practice many of the structural questions that need to be examined would arise equally with the present CGT structure and with a reformed gains tax. The possibility of taxing gains at income rates has relatively little impact on the picture: the main effect of rebasing to 1982 would be on the size of the tax base and the yield.

3. We have also assumed no change in the income tax arrangements for married couples. If, for example, they were able to elect for independent taxation of investment income, this would have implications for the taxation of gains. As far as the death charge in concerned, the yield figures would change - though not dramatically - but the structural issues would be much the same.

4. Overall our thinking and analysis has not substantially altered the general picture presented in Mr Houghton's and my notes of 10 February.

5. This paper concentrates on the main issues that would arise on the form and structure of a death charge on gains. Inevitably, if such a reform were to proceed, there would be a number of additional second and third order questions to consider. The main points can be summarised as follows:-

i. whatever the details of the change, there would be a major contraction in the tax base - and consequently a sizeable loss of revenue. This is inherent in the replacement of a charge on the market value of the full estate with one on accrued gains on classes of asset. Assuming an exemption several times the normal annual CGT exemption, the loss would be probably at least £m1,000 and, depending on detailed decisions, it could be substantially more. This compares with an estimate that deaths in 1988/89 would generate an IHT yield of ~~approaching~~ £m1,500. In the first year, because of the likelihood of different collection arrangements, there could be an additional cash flow loss to the Exchequer (see paragraph 50).

ii. there would be a strong case for having a much higher gains exemption on death than the normal annual exemption of £6,600: probably at least £30,000 would be appropriate;

iii. there would be pressure for reliefs for "lumpy" assets like land and businesses. Some equivalent of retirement relief would probably have to be given at death, and payment by instalments on business and agricultural assets might have to be considered;

iv. the general deferral of tax on gifts would need changing to protect the death charge; and there would have to be major changes in the gains regime for trusts;

v. whether homes should be exempt at death needs careful thought. The issues here are difficult and whatever the decision there could be major implications for the housing market;

vi. there must be strong arguments for introducing a domicile criterion on IHT lines into the basis of charge.

6. By way of background, Annex One gives a comparison of the main features of IHT and (as presently structured) CGT.

<u>Data problems</u>

7. Because there is currently no gains charge on death, we do not have information on the capital gain component in estates, and information is not available to enable us to undertake precise work on gainers and losers. It follows that any estimates we quote for possible impact on tax yields and

taxpayer numbers can be no more than broad educated guesses. It would be a major exercise and take a lot of time to improve on our data or firm up the figuring and even with extra resources and an immediate start we do not think we could get results through in time to help decision-making for 1988.

Contraction of Tax Base

8. The most obvious point is that there would be a substantial contraction of the tax base. Inheritance tax is a tax on asset values. By contrast, a gains charge would be, by definition, limited to the gains component in asset values, and some assets - cash, gilts, possibly the principal private residence, and so on - which are currently liable to IHT would be outside the gains charge unless the scope of the gains charge extended beyond that of the present CGT. And for those outside the UK there is no gains charge on UK assets in contrast to the IHT position. The extent of the contraction of the tax base would depend particularly on

- the gains exemption on death
- the regime for gifts and trusts
- whether the principal private residence exemption ran on death, and
- whether the gains charge was rebased to 1982.

Whatever the decisions on these issues, the contraction would be very substantial.

Revenue cost

9. There would be a corresponding reduction in tax yield, which would be compounded by lower rates: IHT starts at 30% and rises to 60%, the gains charge would be at 25% and 40%. The IHT yield from deaths etc in 1988/89 is expected to be ~~approaching~~ £m1,500. Again the extent of the reduction would depend on decisions on the structure of the gains charge, but assuming (see below) present CGT coverage and an exemption at death of the first £30,000 of gains the cost to the Exchequer is likely to be a minimum of £m1,000 without 1982 rebasing and £m1,200 with rebasing on an accruals basis. Bringing in homes would reduce these costs by £m350 and £m200 respectively.

Taxpayer numbers

10. Taxpayer numbers too would depend on detailed decisions. Here the critical ones would be on the level of the gains exemption on death, and on whether or not the principal private residence should be exempt at death. Our data is very uncertain but with a £30,000 gains exemption at death, and assuming that the range of taxable assets was the same as it now is in lifetime, there might be some 20,000 taxpayers without, and 15,000 with 1982 rebasing, compared with an estimate that 30,000 or so estates of people dying in 1988/89 would be liable to IHT.

Exemption limit

11. IHT has a threshold of £90,000 compared with the CGT annual exemption of £6,600. It is estimated that in 1988/89 there will be some 30,000 estates liable to IHT. If only the £6,600 annual gains exemption were available in the year of death, the impact of tax on many smaller estates would be greater than now. In particular a lot of estates below the IHT threshold would pay tax on gains while a significant proportion of estates a little above the IHT threshold would pay more tax than now. Our staff need and compliance costs

would increase substantially. To keep the number of taxpaying estates down to IHT level would mean a gains exemption in the year of death of perhaps £10,000 to £15,000 - and £35,000 to £40,000 if homes were taxable. Even then, a sizeable proportion of liable estates would be below the present IHT threshold, and these would all be ~~losses.~~ losers. This may point to a much higher threshold. A £30,000 exemption in the year of death would, assuming private residence exemption, mean perhaps around 15,000 liable estates with, and 20,000 without, rebasing - but even though the number of estates paying tax would be less than for IHT, a significant minority could still consist of estates not currently paying tax.

12. The main arguments for a higher year-of-death exemption are to avoid increasing the impact of tax on smaller estates (including bringing into tax a significant number of estates below the IHT threshold) and to prevent a large addition to administrative and compliance costs. But there are also some theoretical grounds. Essentially the point is that at death there is a concentration of disposals which might otherwise have been spread over a number of years and benefitted from several years' annual exemption.

13. For reasons such as these, when (prior to 1971) CGT was charged on death, instead of the normal annual exemption, a special exemption was available of £5,000 - half the then estate duty threshold - compared with the £50 normal annual exemption. Whether one would want the exemption to be as high as half the IHT threshold is for consideration, and might depend in part on other decisions on the structure of the death charge: but an exemption of at least £30,000 might well be appropriate.This exemption could cover both gains at death and other gains in the year of death.

Top slicing

14. Since death concentrates disposals at a single point of time, if the gains charge were at income tax rates there would be pressure for top-slicing relief. However, if the death exemption is relatively high, and if there are only two tax rates - 25% and 40% - we think there are good arguments for resisting this pressure.

Bequests to surviving spouse

15. CGT is deferred on lifetime gifts to a spouse. Bequests to a spouse are exempt from IHT.

16. Exemption would be the wrong answer for a gains charge on death. With the IHT exemption, when the surviving spouse dies IHT is charged on the full value of his or her assets: if inter-spouse bequests were exempt from the gains charge, any subsequent disposal by the husband or wife would be taxable only by reference to increases in value since the death of his or her spouse.

17. The principle underlying both the CGT deferral on lifetime gifts between spouses and the IHT exemption is that, as long as assets remain within the married unit, no tax should be payable, but that full tax should be chargeable when assets pass outside the married unit. For a death charge on gains - as now for lifetime gifts - this points strongly to giving tax deferral rather than exemption on bequests between spouses.

Lifetime gifts

18. The position of lifetime gifts other than between spouses is more problematic. Decisions here have important implications for the trusts regime and for the degree of complexity of the regime at death.

19. At the moment CGT is generally deferred - through rollover relief - on lifetime gifts and there are corresponding reliefs for trusts. Unless the death charge were to be largely ineffectual, the gifts rollover relief could not continue in its present form: the point being that it would be easy for people to sidestep the death charge by making gifts shortly before death.

20. Essentially, there are two broad options. The first is to revert to the pre-1980 position and abolish the gifts rollover relief (and the corresponding trust reliefs) except for gifts of business assets. This would be much the simpler course, and would be consistent with the logic of a death charge: if "gifts" at death attract an immediate tax liability, in principle so should gifts in lifetime. General gifts rollover was introduced to provide a simple solution to the problem of a double charge to CTT and CGT: with the total disappearance of IHT, no question of a double charge would arise. But we are conscious that, whatever the logic and the arguments of simplicity, it may be politically difficult to withdraw general gifts relief.

21. The alternative is to have a very much more complex regime, with, among other things,

- an equivalent of the IHT "potentially exempt transfer" regime, so that the death regime applied to gifts within, say, seven years of death with tax being charged on gains accrued up to the date of gift. If this approach were adopted, we would as for IHT, need power to collect the tax from the recipient of the gifts as there might not be enough assets in the remaining estate to meet the tax liability.

- corresponding rules to bring into charge gifts into trust within, say, seven years of death and the termination of an interest in possession in a trust within that period, with special provisions to give "no gain/no loss" treatment where a spouse became entitled to an interest in, or assets of, a non-discretionary trust.

- rules to prevent avoidance through exploitation of a combination of the "no gain/no loss" relief for bequests to spouses, deeds of family arrangement, and gifts rollover. The device would be that the heirs would redirect property to the surviving spouse under a deed of family arrangement. With present law, tax would be computed as if this redistribution of the estate had taken place on death, so there would be no immediate charge on property surrendered to the spouse. The spouse would then give the assets to the original heirs, with rollover relief being claimed. Payment of tax would thus easily be deferred indefinitely where there was a co-operative surviving spouse.

- rules on IHT lines to counter avoidance through gifts with reservation.

Annex two compares these alternative approaches as they would affect trusts.

22. This alternative approach would not only involve much more complex legislation but would also add significantly to compliance costs. In particular, the executors would need to ascertain whether rollover had been given within seven years of death, and if so quantify the amount of gain held over. In practice, because rollover depends on a claim being made, the Revenue would generally have relevant information and be able to assist: but there is bound to be extra work for all concerned. There would be particular difficulties if (see below) assets exempt from the lifetime CGT charge were taxable at death.

23. IHT experience - and for IHT the compliance burden is less because one is concerned with establishing market values at a single point of time rather than taxable gains - would suggest that the alternative approach would not be popular with those administering estates. Practicalities - as well as the logic of the system - point to the simpler course of abolishing general gifts rollover, but this may have political difficulties.

Periodic charge on Discretionary Trusts

24. The death charge would not apply to property held by a discretionary trust, because there is no beneficial owner on whose death the tax can focus. Such trusts would therefore become a ready way round the charge unless there were special provisions. It is essentially for this reason that there is a periodic charge to IHT on discretionary trusts; and a similar CGT charge existed when CGT was payable on death up to 1971. If the gains charge is to be effective, a periodic charge would have to be built into it. The charge would be on gains accrued since the last occasion of charge.

25. Assuming gains generally are taxed at the same rates as income, the rate of tax would be the same as for the trust's investment income. Thought would have to be given to the frequency of the charge. If the interval between charges is too long, they will cease to be an effective proxy for a death charge: if it is too short, the regime will be too tough. For IHT the interval is ten years, and something of the same order might seem a reasonable compromise.

26. Rules on IHT lines would be needed to prevent a discretionary trust circumventing the periodic charge by for example setting up a short-term interest in possession just before the periodic charge date.

Overseas Trusts

27. The CGT regime for overseas trusts would need to be reviewed and it might well be appropriate to import or adapt some IHT provisions.

Special Classes of Trust

28. IHT has special rules for some special classes of trust - eg accumulation and maintenance trusts, and trusts for the disabled and for maintenance of heritage property. Some of these have equivalents in CGT; others do not, and the regime for these would need to be looked at.

Assets outside CGT

29. There are a number of assets outside CGT. The most important are life assurance policies, gilts and qualifying corporate bonds, and the principal private residence. The question which arises is whether there should be a charge on these at death.

Life Assurance

30. The exclusion of life assurance proceeds from CGT at death would place life assurance at some advantage in this respect over eg unit trusts. The life assurance industry would probably argue that it merely helped to redress the balance which it sees as weighted at present in favour of unit trusts. It would be difficult to bring life assurance proceeds within the CGT net either at death or more generally in advance of the outcome of the review of life assurance that has now been announced.

Gilts and Bonds

31. Leaving aside the obvious difficulty of justifying a death charge in the absence of a lifetime one, we do not think

that in general it would be sensible to contemplate a death charge on gilts and qualifying corporate bonds:-

(i) the yield would be likely to be negligible, or even negative. This is because on average there are likely to be as many losses as gains before indexation relief over the life of the asset, with indexation relief often adding to any loss or creating one for tax purposes where it did not otherwise exist. It was arguments such as these which led to gilts and qualifying bonds being exempted from lifetime CGT.

(ii) there would be substantial additional record-keeping. Because no investor could be sure he would not die while still in possession of the gilt or bond, records would have to be maintained in case a liability arose. This burden would be compounded where the investor had not himself bought the asset but had been given it - in these circumstances it might be difficult to track down the date of acquisition and hence the base cost for CGT. It would be further compounded if general gifts rollover were retained and there was an equivalent of the "potentially exempt transfer rules": executors might well have difficulty in tracking down the necessary information where the gilt or bond had been given away within a few years of death. Finally, because the investor would be dead, it could be difficult to secure compliance where he had failed to keep the records requisite to establish the gain.

(iii) for gilts, there is the special problem that with at least some existing issues the prospectus precludes a CGT charge.

32. The arguments on low coupon gilts are a little different. These will normally show real appreciation over time so there would be a yield to the Exchequer from taxing gains at death. If they were outside the net, they could be an attractive investment for those wishing to avoid the gains charge on death. This would have market implications. (The present nominal value of low coupon gilts in issue is £m10,000) On the other hand, the difficulty of justifying a death charge in the absence of a lifetime one remains, as do the compliance problems and, for existing gilts issues, the terms of the prospectus.

Principal Private Residence

33. The most common asset outside CGT is of course the principal private residence. The decision on whether to tax or exempt it at death has major implications both for the housing market and for the impact and yield of the tax. About a quarter of the IHT yield comes from homes. If homes were taxable at death, with a £30,000 death exemption, the yield might increase by over a half (by some £m200 with and £m350 without rebasing), and the number of liable estates could more than double - to perhaps 40,000 with and 55,000 without rebasing.

34. If homes were taxed on death, there would also need to be a charge on disposals within a few years of death: otherwise

there would be deathbed sales to avoid tax. An equivalent of the "potentially exempt transfer" rules would be essential.

35. Exemption of the main home would clearly add to the Exchequer cost of the change. It would also discourage the elderly from moving to smaller accommodation: the higher the proportion of their assets the home represented, the more of the estate would be exempt. Indeed, there would be an incentive to move into <u>larger</u> accommodation in old age and out of other assets: homes would be a very attractive tax shelter. The extra tax privilege - total tax exemption at death - would increase the upward pressure on house prices.

36. On the other hand, if homes are exempt in life but taxed at death, there would be an incentive, even with a threshold of £30,000 or more, for those with large accrued gains on their homes to trade down to smaller, less valuable accommodation - or even to move to a residential hotel - and place the surplus proceeds in assets outside the CGT net, such as - under current rules - gilts, qualifying corporate bonds and life assurance. This would pull down the yield. The charge on disposals within a few years of death would reduce this effect, but not remove it. And in practice it might not be always effective because the deceased might have used the proceeds to meet living expenses - for instance the costs of a nursing home. Hard cases would be instanced where the only assets left to meet any tax liability were items of a personal nature such as jewellery with sentimental value and the family Bible and these had to be sold to pay tax instead of being kept within the family. Professional advisers would doubtless tell the elderly person selling a home to set aside some of the proceeds to meet the contingent future tax bill on death - but this would be represented as reducing people's ability to make ends meet in old age.

37. The market effects of a tax charge on gains on homes at death would be much eased if the charge were confined to gains

from the start date for the reform: but there are obvious difficulties about singling out houses in this way. Paragraph 65 mentions the possibility of confining the death charge on all assets to gains accruing after a future date.

38. The decision on homes involves difficult judgments. Whichever way it goes, there are likely to be distortions in the market.

Residence and Domicile

39. Another major issue is residence and domicile. The short point is that, unless the CGT rules are tightened up, people easily avoid a death charge either by going absent from the UK for a year, during which they would wash all their gains, or by leaving the UK shortly before death. (If consultation goes ahead on residence - Mr Taylor Thompson's minute of 7 July to the Financial Secretary - this may have implications for the rules for gains). (below)

40. The IHT charge is based on UK domicile, but the normal meaning of the term is specially extended so that anyone resident here for 17 out of the last 20 years is deemed to have a UK domicile, while those who have had a UK domicile remain within the scope of the charge for 3 years after they lose it. By contrast the CGT charge is based on the less stringent concepts of residence and ordinary residence. To protect a gains charge on death, there is a strong case for either

- importing a domicile criterion on IHT lines for the purposes of the scope of tax on death,

or

- providing for a deemed disposal when someone left the country permanently (an emigration charge) - but this would be bound to lead to pressure for an immigration rule confining the gains charge to gains after someone acquired UK residence.

Whatever was done would be controversial, but, given the existing IHT precedent, importing the domicile concept might be the easier course.

Business and Agricultural Relief

41. For IHT either 30% or 50% of the value of qualifying business and agricultural property is excluded from charge. There would undoubtedly be pressure for equivalent relief to be available for a gains charge at death, so that 30% or 50% of the gain was left out of account: and there would probably also be pressure for the boundaries of CGT retirement and rollover relief to be extended to cover everything that qualifies for the IHT reliefs. This would mean, for example, extending rollover relief to agricultural landlords and qualifying shareholdings, and to a wider range of business assets.

42. With the death charge, possibly rebased to 1982, confined to gains, we think the pressure for IHT-style reliefs and extending CGT reliefs to more assets could be resisted. But there would be a good argument for giving CGT retirement relief on death where a businessman dies in harness, on the grounds that had he retired on ill health grounds or from age 60 onwards and died shortly after he would have got the relief.

Heritage

43. In one or two detailed aspects, IHT reliefs for the heritage are more generous than CGT reliefs. Consideration would have to be given to extending the CGT reliefs.

Payment by instalments

44. There are provisions to enable IHT on land, business assets and certain shareholdings to be paid by instalments over ten years. There would be strong pressure to import similar provisions for the new gains charge, and, if this were conceded, it might be difficult to resist extending the facility to the lifetime gains charge. This would add to the staff costs and reduce the yield in the short term.

Interaction with retirement relief

45. When CGT applied on death prior to 1971, the £5,000 exemption at death was abated to the extent that retirement relief in excess of £5,000 had previously been given. The reasoning was largely that, to the extent that a large amount of gain had been exempted in the deceased's lifetime, there was less justification for a high threshold at death. And without such a restriction a businessman could make a disposal of business assets shortly before death, get the benefit of retirement relief (which currently exempts gains of up to £125,000), and then a few months later his estate would have in addition a high death exemption. There would be a case for a restriction of the death exemption where retirement relief had been given if gains once more became chargeable at death.

Losses

46. There may be capital losses at death. In lifetime losses could be carried forward to set against later gains but death rules this out. There is already a provision allowing losses

in the year of death to be carried back three years: this would need to be extended to losses at death itself.

Period of administration

47. We would need to look at the rules for gains and losses made by executors before the deceased's assets were distributed.

Foreign taxes

48. Double taxation relief would be given for foreign taxes on gains at death. Other foreign taxes (eg. estate and inheritance taxes) would be a deduction in the gains computation. It might be necessary to seek to modify some double tax agreements.

Transitional measures

49. A number of transitional issues would need to be considered. For example:-

(i) if gifts etc within a few years of death were brought into charge at death (withdrawing rollover relief) we think this would have to be confined to gifts etc made after the change was announced - otherwise one would retrospectively alter the basis on which people had decided whether or not to claim rollover.

(ii) decisions would be needed on what to do where conditional exemption from capital transfer tax or IHT had previously been given and the conditions for exemption were subsequently broken. When this happened, the IHT charge would have been resurrected. Would exemption previously given in effect be made unconditional? If not, how would tax be computed? An example of the situation would be where the public access condition for the heritage exemption is broken. This needs careful thought.

(iii) issues similar to (ii) arise from the CTT/IHT regime for woodlands, under which tax may be deferred till trees are felled.

Collection of tax

50. For IHT, tax is paid on account when applying for probate. It is doubtful if this arrangements could continue with a charge on gains without causing an unacceptable delay in the obtaining of probate. If it did not our cost of collection would increase and there would be an extra initial cash flow cost to the Exchequer, with little tax under the new regime being actually collected in the first year; while the length of time it takes to wind up estates could increase. We would need to discuss the issues here with the Lord Chancellor's Department.

Compliance and administration costs

51. The change would not be a simplification. Even if the number of estates and trusts liable to tax does not increase, there would almost certainly be a substantial increase of

compliance costs and our staff need: a gains charge would be much more complicated than IHT because not only would it be necessary (as for IHT) to establish asset values at death but also to determine acquisition costs amd calculate indexation relief to arrive at the taxable gain. And establishing non-liability would involve quite a bit more work than for IHT. The extent of the increase in costs would depend critically on

- the exemption limit at death
- the rules for lifetime gifts and trusts, and
- the treatment at death of the main home.

The cost/yield ratio would be bound to be significantly greater than for IHT.

Length of legislation

52. At this stage we have not formed any firm view of the likely length of legislation: much would depend on detailed decisions. Once through, the reform would involve some reduction in the amount of tax legislation - though some IHT rules would have to be imported or adapted for the tax on gains, and it will be many years before all work on IHT disappears. To effect the reform would almost certainly require well over 25 pages of Finance Bill - and possibly more than 50.

Evaluation

53. On first principles, death is a natural occasion for a charge on gains, and gains tax was charged up to 1971, in addition to Estate Duty, with the CGT being deductible from

the value of the estate for Estate Duty. If IHT is abolished, the arguments for a gains charge on death are much strengthened: in the absence of a charge, there would be very substantial lock-in effects - many people would hang on to assets until death "washed" the gains. This already happens to some extent now, but the prospect of an IHT charge sets some limits.

54. While the introduction of a gains charge on death might be a corollary of the abolition of IHT, it would not be a substitute. This is for two main reasons. First, the base for a tax relating to gains is inevitably very much narrower than that for one related to asset values. Secondly, the gains charge would not extend to all assets.

55. The death charge would be a mere facade if people could readily sidestep it. There are three obvious potential escape routes:-

i. giving assets away, or transferring them into trust, shortly before death, or exploiting gifts rollover in other ways,

ii. going absent from the UK for a period, in which gains would be washed, or leaving the UK shortly before death, and

iii. moving into exempt assets, including trading up in the housing market. Rules would be needed to counter (i) and (ii): the third is more difficult, and the position of the principal private residence in particular raises difficult issues with important implications for housing.

Losers

56. Even with a fairly high exemption for the year of death, there would be likely to be a significant minority of losers from the change. Some would consist of estates below the IHT threshold but with gains above the death exemption. Others -

mainly a little way above the IHT threshold - would be estates paying tax now but with sizeable accrued gains which would often be taxed at 40%.

Market implications

57. The reform would obviously have other major market implications. The Bank and Treasury would need to consider these. One likely outcome would be an increase in bed-and-breakfasting activity during lifetime to reduce gains at death, taking advantage of annual exemption.

Operational issues

58. For the Revenue, some major operational issues would arise.

59. First, should the charge be administered by the Capital Taxes Office (familiar with the law on estates) or by local Tax Offices (familiar with CGT/income tax interactions and often in possession of information relevant to the gains computation) or by a new specialised office which might also handle lifetime tax on gains, or by some combination of these? In reaching decisions on this, personnel issues (what to do with the CTO staff and how to recruit and train additional Inspectors) and accommodation constraints in our local offices would be relevant.

60. Second, a lot of procedural details - relating to payment of tax, form of returns, the Department's computerisation programme, and so on - would have to be thought through. Some of these would involve legislation.

61. Third, our staffing need - like taxpayers' compliance costs and for similar reasons - would be likely to increase: how much would largely depend on decisions on the threshold, the trust and gifts regimes, and other details. We would have

to give careful thought to our staff resource capacity against the background of other possible major changes in the tax system.

62. Fourth, we would need to start work on training material to enable people to cope with the new work: but training could not, for obvious reasons of Budget confidentiality, commence until after the change had been announced.

63. We have not at this stage brought in our colleagues on the personnel, manpower and organisation side who would need to look at these aspects, but it is clear that, were this possibility to become reality, there would be a lot of detailed planning to undertake.

Commencement

64. Legislating for this as well as other tax changes would impose a major burden on our Head Office resources and Parliamentary Counsel. If the option of 1988 legislation is to be kept open, we need to press ahead as soon as possible with detailed work and to start instructing Parliamentary Counsel in the early autumn.

65. However, even if we can get legislation ready for next year, organisationally it might be difficult to implement the change before 1989. Until we talk to our colleagues in Management Division, we cannot form any definitive view on this. The organisational issues might become less difficult if the gains charge were limited to gains accruing from 1988 (because the active caseload would then be low) - but the price of this would be a yield from the new regime close to nil in the initial years and complications in the share pooling regime.

66. Another option would be to legislate in 1988 with effect from 1989: but this would lead to substantial forestalling of

any changes in the regimes for gifts, trusts and so on, and it would probably be impossible to devise rules to counter this.

Conclusion

67. Against this background, we clearly need very early guidance as to whether you wish to keep this option open for 1988. If so, we shall urgently have to bring in our management colleagues (substantially increasing the circle of knowledge) and embark on work towards instructions for Counsel, and we shall need to seek early decisions on structural details.

Michael Cayley

M F CAYLEY

ANNEX ONE

COMPARISON OF CGT AND IHT

This annex provides a tabular comparison of the CGT regime with IHT: for convenience it assumes implementation of the Summer Finance Bill proposals.

	CGT	IHT
Tax base.	Indexed gains net of indexed losses.	Market value of assets.
Individuals liable.	Generally those resident or ordinarily resident assets in the UK.	On worldwide assets if UK domiciled: on only UK if not. For IHT purposes an individual is deemed to have a UK domicile if - i. in fact domiciled in UK within the 3 years immediately preceding the transfer, or ii. resident in UK in at least 17 of the last 20 income tax years of assessment.
Annual exemption and threshold.	For 1987/88 annual exempt amount is £6,600 and £3,300 for most trustees.	£90,000 plus £3,000 annual exemption for outright gifts.

	CGT	IHT
Rate(s)	30% for individuals and trustees.	i. 30% to 60% on death. ii. Lifetime transfers which are chargeable when made (eg into discretionary trust) taxed at half death rates: additional tax due (at difference between tax already paid and death rates) if transferor dies within 7 years. iii. If a potentially exempt transfer (PET) becomes chargeable because the transferor dies within 7 years it is taxed at death rates, but with a tax taper for transfers more than 3 years before death. iv. In all cases the rate of tax applicable is determined by the cumulation principle.
Gifts before death.	Tax charge deferred by gifts holdover relief.	Charge on gifts within 7 years of death. Some lifetime gifts (eg into discretionary trust) taxable when made.
Bequests to spouse.	Tax deferral.	Generally, complete exemption, but limited to £55,000 for transfers to non-UK spouse.

	CGT	IHT
Trusts where there is a life tenant.	i. On creation of settlement, tax charge deferred by gifts relief.	i. On creation of settlement, no charge if settlor or spouse entitled to life interest. In other cases charge only if settlor dies within 7 years.
	ii. No charge when life tenant disposes of interest under settlement.	ii. No charge on lifetime disposal by life tenant except in event of death within 7 years.
	iii. On termination of settlement, tax charge deferred by gifts relief.	iii. Charge on death of life tenant.
Discretionary trusts.	i. On creation of settlement, tax charge deferred by gifts relief.	i. Entry charge on creation of settlement.
	ii. No periodic charge.	ii. Periodic charge at each 10 year anniversary.
	iii. Charge on transfers out of settlement deferred by gifts relief.	iii. Proportionate charge on gifts out of trust between 10 year anniversaries.
		iv. Some special discretionary trusts not liable to either periodic or proportionate charge and may also be exempt from entry charge.

	CGT	IHT
Businesses/ business assets.	i. Rollover relief for replacement of specified business assets used in trade. ii. Retirement relief up to £125,000 on on disposal at 60 years of age or earlier on on ill health grounds	i. Business relief at 50% for - - a business or interest in a business. - controlling shareholdings. - a life tenant's business or interest in a business. - substantial minority holdings in unquoted companies. ii. Business relief at 30% for - - small minority holdings in unquoted companies. - certain assets owned outside the business and used in it. - certain assets used in a life tenant's business.
Agricultural property.	Rollover/retirement relief available, but not to agricultural landlords.	i. Agricultural relief at 50% for - - freehold land - some existing agricultural landlords. ii. Agricultural relief at 30% for all other landlords.

	CGT	IHT
Divergence in treatment of particular assets (except as previously noted and ignores numerous minor exemptions/reliefs etc).		
i. Main home.	Exempt.	Taxable.
ii. Gilts and qualifying corporate bonds.	Exempt.	Taxable
iii. Cash	Sterling exempt: foreign currency gains taxable.	Taxable.
iv. Shares	Taxable.	Taxable, but could qualify for business relief.
Payment of tax by instalments.	In general, no instalment facility. available.	Tax may be paid by instalments over 10 years. in respect of - - land and buildings. - certain shares securities. - a business or an interest in a business.

ANNEX TWO

TWO POSSIBLE TRUST REGIMES

1. This Annex gives a tabular comparison of two possible trust regimes. The choice between them would depend on whether gifts

- Scheme A: qualified for rollover relief unless made within seven years of death or

- Scheme B: did not generally qualify for rollover.

2. The Annex does not attempt to deal with special classes of trust like accumulation and maintenance trusts, trusts for the disabled, and heritage maintenance funds.

	Scheme A	Scheme B
Lifetime Gifts	Rollover unless within 7 years of death	Immediate tax charge
Interest in possession Trusts		
Transfer of assets into trust.	Rollover unless at or within 7 years of death of settlor.	Immediate charge unless trust is for settlor or his spouse, in which case tax deferred.
Disposals realised. by trust.	Immediate charge.	Immediate charge.
Interest in possession changes hands.	Rollover unless at or within 7 years of death of person with interest in possession.	Immediate charge unless interest passes to life tenant's spouse, in which case tax tax deferred.
Transfer of assets out of trust.	Rollover unless at or within 7 years of death of person with interest in possession.	Immediate charge unless assets pass to spouse of person with interest in possession in which case tax deferred.
DISCRETIONARY TRUSTS		
Transfer of assets into trust.	?Immediate tax charge.	Immediate tax tax charge.
Disposals realised by trust.	Immediate tax charge.	Immediate tax charge.
Transfer of assets out of trust.	Immediate tax charge.	Immediate tax charge.
Conversion into interest in possession trust.	Immediate tax charge.	Immediate tax charge.
Periodic charge.	Every,say,ten years on gains since previous charge.	Every, say, ten years on gain since previous charge.

BUDGET SECRET

Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON
DATE: 15 JULY 1987

1. MR ISAAC 15.7

2. CHANCELLOR OF THE EXCHEQUER

GAINS CHARGE ON DEATH

1. Capital gains tax without a charge on death is an obviously imperfect tax. The reason for removing the death charge in 1971 was the high rates of estate duty then prevailing. If IHT is abolished the theoretical case for a gains charge on death is re-established. And in practical terms, without it, the lock-in effect particularly if higher rates apply on integration would be irresistible.

2. The costs of this change alone are considerable. In terms of 1988/89 accruals as Mr Cayley's note shows the net cost could be some £1 billion. This assumes 1982 rebasing and a charge on the principal private residence. (1988 rebasing would add significantly to the cost but the case for it would be pressed hard on the retrospection arguments.) In receipts

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cc Financial Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

Mr Battishill
Mr Isaac
Mr Lawrance
Mr Beighton
Mr Houghton
Mr Calder
Mr Cayley
Mr Gonzalez
Mr H B Thompson
Mr Weeden
Mr Hamilton
Mr R H Allen
Mr Michael
PS/IR

terms the figures are not so substantial. The 1988/89 cost might be of the order of £500 million; 1989/90 £900 million; and 1990/91 £1,100 million, depending on the precise arrangements for the entry into effect of the new charge, threshold levels etc. (These estimates are highly sensitive to the assumptions on which they are based).

3. But this proposal does not stand alone. Its companion is the integration package considered in the submissions of (not attached) 1 July. The costs of this with rebasing are nearly £1 billion in terms of 1988/89 accruals. Much of this cost is attributable to rebasing. But without rebasing, integration has even sharper corners for some and may be unattractive overall.

4. Thus for the two packages the accrual cost rises to about £2 billion. In receipts terms the figures build up over three years or so (1988/89 £500 million; 1989/90 £1,500 million; 1990/91 £2,000 million.

5. It is, certainly, arguable that these figures do not take adequate account of the surge effects created by 1982 rebasing. The size of this is a matter for conjecture. It could obviously make good in cash flow terms some of the yield forgone - at least in the short term although it would be 1989/90 before there was any substantial effect on tax receipts. It seems doubtful whether it could restore as much as one half of the total £1 billion accruals cost of the lifetime charges. It might restore one quarter. It should however be borne in mind that with a charge on death the surge effect to some extent merely accelerates future yield. (Without a charge on death the surge effect

brings into charge some gains which would otherwise be washed on death. With a charge on death the surge effect advances some disposals which would otherwise be charged to the full extent on death).

A programme of Reform

6. The size of these revenue costs and the limited area of those who benefit suggest that there may be advantage in seeing these two packages as separable parts of a continuing programme of reform. The logical sequence would be for integration (with rebasing) in Year 1 followed by the replacement of IHT with a gains charge on death in Year 2. This could be seen as a means of sustaining the momentum of tax reform over time. Spreading the burden of the legislation and the operational planning of the change over from IHT would be greatly welcomed by tax practitioners and particularly by ourselves. For us if the two packages were taken together the combination of the legislative burden, the management and operational problems and analysing the evolving interactions between the two packages could be indigestible to say the least.

Principal Private Residence

7. When you looked at the replacement of IHT by CGT on death in 1986 your view was that there was no case for excluding the principal private residence from the death charge on the view that the logic of the present lifetime exemption was essentially that of a rollover relief. But it is difficult to see how the present exemption (whether it is a proxy for rollover or not) could continue if there were a death charge.

Taxpayers would simply trade down from houses into exempt assets (ultimately sterling) at the appropriate time. But the introduction of a rollover relief for lifetime disposals would be a major change which could have large market, social and financial effects. Given that the cost of excluding the principal private residence is not enormous (£200 million on 1988/89 accruals) it is for consideration whether this challenge is worth taking up. The caseload would also be much reduced. Without exemption it could be upwards of 50,000; with exemption it could be 15,000-20,000.

8. As a tailpiece you may be interested to know that in Washington the House Ways and Means Committee are looking actively at a proposal to reintroduce a tax on gains at death - a measure initially introduced in 1976 but which came under such intense pressure that having suspended the change for three years Congress finally repealed it in 1980. (The US have an Estate and Gifts Tax; the charge on gains on death would be additional).

B T HOUGHTON

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

FROM: A J G ISAAC
15 July 1987

CHANCELLOR OF THE EXCHEQUER

ABOLISHING IHT: CGT ON DEATH

1. The notes by Mr Houghton and Mr Cayley below report the outcome of our further work on the implications of abolishing IHT and reintroducing a tax on capital gains, at death. This note tries to pick out a few wider points.

The underlying approach

except Mr Cropper!

2. If I have understood it, this "package" would be part of a more general shift **from** taxes on capital **towards** taxes on income and expenditure. (I think we all now accept that even the present indexed capital gains tax is in strict intellectual analysis an income tax, not a capital tax; and this reality may become explicit as a result of the proposed wider changes).

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cc Financial Secretary
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3. It hardly needs saying that a tax on capital gains at death would not - for all the obvious reasons - be a proxy for a tax on transfers of wealth at death. But if inheritance tax is abolished, the analysis in these notes confirms that there **would** be strong arguments for a tax charge on capital gains at death. This is not just a matter of some "fiscal logic". In the absence of a tax charge on death, there would be a clear - inconsistent with your IHT reform in 1986 - and on the face of it damaging - incentive for people to "lock in" to their valuable assets - and not give them away during life - in order that the accrued tax charge should be "washed" by death (the Lethe effect?).

Policy aspects

4. There was a charge on capital gains at death before 1971; and this gives us some pointers to the issues that we need to consider with you. In other respects, however, subsequent changes and in particular the abolition of first CTT and then IHT would create a new world. We see four main sets of issues.

5. One bundle of questions arises on the range of **exempt assets:** in particular

a. the wide range of "capital certain" financial assets, up to and including most gilt-edged and corporate bonds;

b. deep discount/low coupon gilts;

c. the owner-occupied home.

6. On the first category (a. above) no new problems may arise - provided that we can close the potential loopholes in the tax (paragraphs 7 and 8 below) - and in any event there are the prospectus commitments on at least some existing gilts. The second two categories (b. and c. above) are more troublesome, because they offer to the taxpayer a still greater degree of fiscal privilege for investment assets which could both show real

capital appreciation and be exempt (if you followed the lifetime CGT precedent) on death. Thus, there could be a risk of leakage of revenue and the distortion of private investment, away from productive assets. There are all the familiar difficulties in legislating in this area. As you yourself pointed out in 1986, however, there would be a serious case for considering a charge at death on capital gains arising on c. - even if the lifetime exemption is maintained - and similar arguments apply (at least for new issues) for b.. In the case of b., there is, of course, the wider question, whether there would be any justification under the new tax regime for issuing deep discount gilts at all.

7. Second, we should need to review with you the treatment of various disposals of assets which are in principle chargeable to tax, but on which tax can be **deferred** in various ways: gifts between spouses, other gifts between persons, the treatment of trusts and so forth. One approach would be to reintroduce an immediate charge to tax on such a disposal (with rollover on gifts between spouses), of the kind that existed when there was a CGT charge on death. The other approach looks much more complex, with a need for wide-ranging provisions analogous with the "provisionally exempt transfers" and "gifts with reservation" rules in the present IHT (though something of this kind might be needed in any event for the owner-occupied home).

8. The third main group of issues here concerns the scope for people to "wash" their gains, by going **offshore** and in other ways. There is every reason to believe that the risks here would be significant. Again, some new (and probably controversial) rules might be needed for capital gains, drawing on CTT and IHT experience and some concept of "domicile".

9. Fourth, there are the linked questions of the **threshold** and the **base date** for the new charge. Between them, these will greatly affect the yield of the tax (paras 15 to 18) and - critically - its operational impact (paras 22 to 25).

10. When there was previously a CGT on death, the **threshold** was very high - closer to the IHT threshold than to the threshold for CGT on lifetime disposals. Our current work suggests that you would need a similarly high threshold for charging capital gains on death in the present circumstances (perhaps £30,000) if you wanted to avoid a sharp increase in the impact of tax on small estates (and hence a lot of losers) Keeping down Revenue staff costs would also point to a threshold higher than the normal annual exemption.

11. With a £30,000 threshold the number of taxpaying estates would go down substantially, but you would still have losers among them. For the same purpose, you might want in addition a special threshold, to keep out of charge all gains on the great mass of owner-occupied homes.

12. In principle,it would be sufficient to offset the "locking-in" point (paragraph 3 above) if the **base date** for the new charge on death were to apply only to gains accruing after the Budget Day announcement. There would in any event be strong arguments (retrospection etc) for not taking an earlier date for any charge on "death" gains from owner-occupied homes. There are comparable arguments for making Budget Day the base date for the new death charge generally; but also arguments on the other side - cost, some additional complexity (separate share pools for post- and pre- Budget Day acquisitions of shares), a possible peg for pressure for a "1988" rebasing for the tax on lifetime as well as death gains.

13. There is, obviously, a potential trade-off between threshold and base date. For example, to achieve a target profile of cases over the early years of the new charge, you could have one threshold (say £30,000) and a Budget Day base, or a higher initial threshold, reducing thereafter, with a 1982 base (except for owner-occupied homes). Whichever method is adopted to keep down numbers there would be a~~n~~ ~~odd~~ discontinuity for estates of a given size and composition between the former IHT charge and the new CGT charge in the early years (see paragraph 17 below).

Losers

14. Even with a high threshold, there would be losers, though we cannot put numbers on them. Two particular groups would be:-

i. estates below the IHT threshold but with gains above the exemption and

ii. estates a little way above the IHT threshold with sizeable accrued gains. The losers would tend to be among smaller estates.

Timing and Exchequer cost

15. Experience suggests that there could be considerable difficulty in announcing in advance a change of this kind to the tax treatment of giving: risk of substantial forestalling, or else a "tax blight", as people delay giving and wait for the tax system to change. If this is correct, and if you decide to go forward with this package in the 1988 Budget, you may wish to consider whether it should take immediate effect, influencing revenue from 1988 onwards.

16. In terms of 1988/89 **accruals**, the paper suggests that the change could mean a net revenue loss of about £1 billion (on a 1982 base for capital gains) and about £1.5 billion (on a Budget Day base).

17. The effects on **cash flow/PSBR** would be rather different.

- Over the short term, receipts of IHT would continue to come in after the tax was abolished, so that total receipts of IHT might still be at something approaching two-thirds of their former level in the first year, then drop off sharply over the next couple of years, with a long but thin residual tail thereafter.

- We cannot at this stage paint a clear picture of the likely flow of receipts from the new regime for charging capital gains at death. In particular, it is not clear whether it would be reasonable to expect executors to self-assess and pay a capital gains charge, when applying for probate. If not, there might be virtually no receipts from the new charge in the first year or so. thereafter, the flow would depend very much on the basis of the new charge. With a Budget Day base, the flow would of course be very small in the early years, building up only gradually thereafter.

18. We have considered whether it would be possible to smooth these revenue effects, by a **phased abolition** of IHT. For example, it might be possible to raise the IHT threshold to (say) £142,000 for 1988/89 (roughly halving the present number of cases) and to £210,000 in 1989/90 (halving the number again). On this approach, the cash flow effects for IHT might be broadly as follows:

	£m
1988-89	-150
1989-90	-400
1990-91	-550

The possible attractions of this approach are that, as well as phasing the loss of revenue, it might make it easier to bring about the necessary run-down in the Capital Taxes Offices (paragraph 22 below). The obvious disadvantages are that it would achieve less than the clear-cut abolition of IHT and (if we are not going to introduce formidable new complications) estates above the (newly increased) IHT threshold would in a transitional period suffer two taxes, with all their respective complexities, as compared with the present single IHT charge.

19. There are important management implications here, to which I now turn.

Management implications

- Planning

20. Mr Houghton notes there would be a formidable amount of work to do, if you see this as a runner for your 1988 Budget. We should need to have in place not only the legislation, but also the nucleus of the operational staff, shortly after Budget Day.

21. As Mr Houghton says, the timetable would be a good deal easier if you saw this as part of a phased reform, with implementation of this part in a 1989 Budget announcement - though even for that it would be most helpful to have a clear steer by the autumn. If your conclusion is in favour of a 1988 start, we shall need to seek your authority to set up before the Summer Recess planning teams, both to handle the legislation and the management implications.

- Operational

22. Other things being equal, we would have three main options for handling the work of taxing capital gains at death:

- In the Capital Taxes Offices, as IHT runs down.
- In the 600 or so Tax Districts which now handle the work of taxing capital gains during lifetime.
- In a small number of specialised offices, set up for the purpose.

In the case of the first two options, there would be the further question of whether the Capital Taxes Offices - or the new specialist offices - should also take on from local Tax Offices the lifetime CGT work; or whether the lifetime and death taxes should be kept separate. In either event, we should need to invest in a highly efficient system for transferring information between the offices dealing with the various aspects of an individual's income and chargeable gains.

23. For security reasons, we have not yet consulted (below Board level) our management colleagues on the choice between these options. The arguments are complex, and pull in different directions. Thus, for example:

- The Capital Taxes Offices already face a serious workstate problem, with pressures of work and losses of staff. There is little prospect that they could be trained from scratch for and take on any substantial volume of new capital gains work from the 1988 Budget (and we cannot at this stage say whether the position would be significantly easier for a 1989 Budget announcement). On the other hand, if they did not take on the work on capital gains at death, we should need to consider the implications of running down offices in London and Edinburgh with some 600 staff, where the people have no present training in our main taxes work, come from different Civil Service groups, and are represented by different Civil Service Unions, as compared with Taxes staff.

- On the face of it, an obvious alternative approach would be to put the work in the 600 local Tax Offices, alongside the existing work on capital gains tax and income tax - perhaps to be integrated under the overall package. However, that would significantly widen the scope and complexity of the work which people in Tax Offices - and their management - would have to be trained in and cope with, on top of the other major changes being introduced at the same time. There would also be the question of recruiting and finding accommodation for another 600 people in local offices - perhaps on top of a further 1,200 or so being recruited and trained at much the same time for independent taxation and the numbers we are seeking in PES for the growth in existing work. The conclusion - depending perhaps in part on the detailed policy decisions - might be that this has to be ruled out on practical grounds (as in the PRP decision).

- The third course would be to place the work in specialist tax offices away from London, on the analogy of PRP and other specialised tax work (insurance, claims, Lloyd's, subcontractors etc). In that case recruitment, training and retention should be easier (we would obviously locate the new offices with that in mind). However, we should have to build up the offices and (as with CTO) train the people from scratch. And this in turn would govern the speed at which they could take on large volumes of new work.

24. There is a lot of thinking that we should need to do, before asking you for even a provisional steer between these options. If you decide that the reform is a 1988 runner, we should now need to set this work in hand most urgently, and in great confidentiality; and come back to you in the autumn with considered advice.

25. Meanwhile, the work so far suggests that the practicalities of a 1988 Budget decision - or for that matter a 1989 Budget decision without prior public announcement - could depend significantly on both the amount and the speed of the new work which it would generate on capital gains at death. Thus, if you are prepared to contemplate a threshold (say) in the region of £30,000 and a Budget Day base - or an equivalent mix of threshold and base date (see para 13 above) - the implied initial caseload would be very small in 1988 and 1989; and it would be possible to build up a trained staff progressively, as the workload (and yield of tax) built up progressively thereafter. On other assumptions, the practicalities of a 1988 (or 1989) Budget announcement might be much more difficult.

A J G ISAAC

SECRET: AND MANAGEMENT IN CONFIDENCE

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

FROM: A J G ISAAC

15 July 1987

I am most grateful for these three papers. I have considered them carefully, as the matter is complex. I have concluded that to do this in 1988 as well as everything else would be to bite off more than we can chew. Please therefore cease all work on this, and I will review after the 1988 Budget.

2. PS let me know the cost of abolishing the 60% IHT rate. N.

CHANCELLOR OF THE EXCHEQUER

REFORM OF IHT

below

1. I think perhaps that you should know - in connection with the policy submission which I am sending you today - that we shall be losing in September Mr Battersby - the (very able) Assistant Secretary responsible for policy matters on inheritance tax (and also valuation matters). Like others before him, he will be joining a leading firm of chartered accountants.

2. We have made arrangements to ensure that Mr Battersby will not from now on be handling papers leading up to your 1988 Budget.

3. As you will understand, this is an additional reason - though not of course a primary reason - why we should be most grateful for early guidance, if you wish us to work up major legislation in this area for the 1988 Budget.

Ch/ You may remember that, at your request, John Battersby gave a talk on IHT to (?) Leicester Polytechnic students, which seemed well received.
AWK

C.T.C.

A J G ISAAC

---

cc Financial Secretary
Mr Scholar

Mr Battishill
Mr Isaac
Mr Painter
Mr Rogers
Mr Houghton