Part . C .

SECRET

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Begins: 21/7/87.
Ends: 10/6/88.

PO -CH /NL/0327
PART C

Chancellor's (Lawson) Papers:

REFORM OF CAPITAL GAINS
TAX AND INHERITANCE TAX

DD's : 25 Years

[signature]
3/11/95.

PO -CH /NL/0327
PART C

SECRET AND PERSONAL

Inland Revenue

Policy Division
Somerset House

From: L E JAUNDOO
Ext: 7680
Date: 21 July 1987

1. MR HOUGHTON 21/7

2. CHANCELLOR

Thanks. Lasting for the time
Sorry, I should be
grateful if you would cost
this variant: 0–90 0
90–180 30
180–360 40
over 360 50

INHERITANCE TAX : SCALE OF RATES

1. The Chancellor enquired about the cost of abolishing the 60 per cent rate band (Mr Kuczys' note of 20 July).

2. If the change were to take effect from 1988/89, the cost in that year is estimated at £35m and in 1989/90 at £75m, building up over 5 years to a full year cost of £100m.

Ch
Now you have ruled out abolition of IHT in 1988, what about something more substantial than this, perhaps reducing the starting rate to 25%, and stretching out the middle of the rate schedule? See attached sheet
AWK

L E Jaundoo

L E JAUNDOO

---

cc: Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G Smith
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Beighton
Mr Houghton
Mr Cayley
Mr Gonzales
Mr Jaundoo
PS/IR

ps3/24K

SECRET AND PERSONAL

1987-88		Possible reform	
0 - £ 90,000	Nil	0 - £100,000	Nil
£ 90,000 - £140,000	30%	£100,000 - £200,000	25%
£140,000 - £220,000	40%	£200,000 - £300,000	40%
£220,000 - £330,000	50%	Over £300,000	50%
Over £330,000	60%		

AWK
21/7

0 - 90 0
90 - 180 30
180 - 360 40

4375/10

FINANCIAL SECRETARY TO THE TREASURY

AHSL
LA Sgstr.

FROM: J J HEYWOOD
DATE: 23 July 1987

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Cropper
Mr Tyrie
Mr Cayley IR
Mr Dyer

CGT ROLLOVER: SATELLITES AND SPACECRAFT

1. I attach for convenience a submission from Mr Cayley on this subject, together with letters from Viscount Blakenham and James Joll.

2. The Financial Secretary would be grateful for the urgent views of colleagues on whether:

(i) Rollover relief should be extended to satellites and spacecraft.

(ii) If so, the extension should be backdated to July 1987.

3. On (i), the Financial Secretary thinks that we should extend the relief. On (ii) the arguments are more finely balanced. Backdating the relief would be a great help to one particular company, and might be criticised as such. On the other hand, it would seem perverse not to give the relief to Pearsons if we concede the principle that rollover relief should be extended in the way they have suggested.

4. The Financial Secretary wanted to discuss this at Prayers tomorrow, but I note that the last day on which a PQ could be tabled for answer before the Recess is today.

J.H.

JEREMY HEYWOOD
Private Secretary

ENC

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY
DATE: 20 JULY 1987

Mr 20/7

1. MR HOUGHTON
2. FINANCIAL SECRETARY

CGT ROLLOVER: SATELLITES AND SPACECRAFT

1. The attached letter asks that rollover relief be extended to satellites immediately. As I said in my minute of 13 July, there is no policy reason to resist bringing satellites within rollover - and if this were done, we would recommend also including spacecraft. Investment by UK companies in these assets is likely to be fairly rare (though it will become more common, I suspect) - but in a year when it takes place the availability of rollover may cost the Exchequer some millions of pounds, while in other years the cost could be nil. The length of legislation involved is probably under a third of a page.

2. A satellite or spacecraft is almost certain to be a wasting asset, like a number of things on which rollover relief is currently given, including all fixed plant and machinery. This means broadly that, assuming no disposal in the interim, the gain will be brought into charge after ten years from the date the satellite or spacecraft was acquired. Pearsons will,

---

cc Chancellor
Chief Secretary
Economic Secretary
Mr Scholar
Mr Cropper
Mr Jenkins (Parliamentary Counsel)

Mr Isaac
Mr Houghton
Mr Cayley
Mr Hamilton
Mr C Gordon
PS/IR
Miss McFarlane

we think, be aware of this, though it would probably be sensible to mention it in the reply.

3. It would be perfectly possible to backdate such an extension to July 1987, though there would need to be an announcement, preferably by way of Parliamentary Question and Answer. I attach a draft of such an announcement.

4. We would be grateful for guidance as to whether you wish to extend rollover relief to satellites and spacecraft with immediate effect. If you do, are you content with the terms of the attached announcement? If so, we would be grateful if your Private Secretary could arrange for the question to be tabled.

5. In the light of your decision, I shall draft a reply to Mr Joll.

Michael Cayley

M F CAYLEY

Draft Question

To ask Mr Chancellor of the Exchequer, whether he proposes to extend capital gains rollover relief to satellites and spacecraft.

Draft Reply

We intend to include in next year's Finance Bill a provision bringing satellites and spacecraft within the scope of the capital gains rollover relief. This provision will apply from midnight tonight. It will enable rollover to be claimed, subject to the normal conditions, where after midnight there is a disposal or acquisition of a satellite or spacecraft or of an interest in a satellite or spacecraft.

INLAND REVENUE

Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01-438 6692 OR 6706

[3x]

July 1987

CAPITAL GAINS ROLLOVER RELIEF

1. The Financial Secretary yesterday announced that the Government propose to extend capital gains rollover relief to satellites and spacecraft from midnight last night.

2. In response to a Parliamentary Question, he said yesterday:-

> "We intend to include in next year's Finance Bill a provision bringing satellites and spacecraft within the scope of the capital gains rollover relief. This provision will apply from midnight tonight. It will enable rollover to be claimed, subject to the normal conditions, where after midnight there is a disposal or acquisition of a satellite or spacecraft or of an interest in a satellite or spacecraft."

NOTES FOR EDITORS

1. Rollover relief allows tax on capital gains to be deferred where there is a disposal of certain types of business asset and a new business asset is acquired within a period running from twelve months before the disposal to three years after it.

2. At the moment the types of asset qualifying for the relief include ships, aircraft and hovercraft, but not satellites or spacecraft.

PEARSON

FINANCIAL SECRETARY	
REC.	20 JUL 1987
ACTION	~~MR CAYLEY~~ IR
COPIES TO	PS/Chancellor
	MR Scholar
	MR Cropper
	PS/IR

PRIVATE & CONFIDENTIAL

Rt. Hon. Norman Lamont MP,
Financial Secretary to the Treasury,
The Treasury,
Parliament Street,
London SW1P 3AG.

17th July 1987

Dear Norman,

I gather that you bumped into Michael Blakenham last night and had a brief word with him about our problem over expenditure on satellites. I am encouraged to hear that you are intellectually convinced of the merits of the case for specifically including satellites in the category of assets that would qualify for "roll-over" relief. We fully understand the time and procedural pressures that make it impossible to amend the Finance Bill at this stage to set matters right.

I am venturing to write to you because we have something of a real-time difficulty in that BSB has signed a contract with Hughes to purchase two in-orbit satellites and will thus start to incur expenditure at a steady rate (apart from one rather large payment on 1st September) from now on. If, therefore, you were to set matters right in the next Finance Bill we would, I believe, in the normal way forfeit all expenditure until that point and thus lose most of the benefits of the change in the legislation. I hope you will not think me too forward in asking you to consider, if you are willing to embrace satellites within the category of eligible expenditure, either giving advance notice, in what ever way is appropriate and as you think fit, or otherwise arranging matters (perhaps by Revenue concession or practice statement), so that the whole of BSB's expenditure will qualify. Otherwise, we would be at a competitive disadvantage to all subsequent commercial buyers of satellites when we are already taking huge commercial risks by taking on the UK DBS franchise.

It would be nice to see you, however briefly. Might you have a moment sometime during the summer recess?

Yours sincerely,

James

James Joll

Mr Graham

Let us have a word.

M A Cayley

20/7

PEARSON

FINANCIAL SECRETARY

REC.	20 JUL 1987
ACTION	MR CAYLEY IR
COPIES TO	PS/Chancellor
	MR Scholar
	MR Cropper
	PS/IR

PRIVATE & CONFIDENTIAL

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Financial Secretary to the Treasury,
The Treasury,
Parliament Street,
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17th July 1987

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It would be nice to see you, however briefly. Might you have a moment sometime during the summer recess?

Yours sincerely,

James

James Joll

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

·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. Cropper
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

SECRET

Inland Revenue

Policy Division
Somerset House

From: L E JAUNDOO
Ext: 7680
Date: 27 July 1987

Thanks.

Tony

1. MR HOUGHTON 27/7

2. CHANCELLOR

INHERITANCE TAX : SCALE OF RATES

1. The Chancellor has asked about the cost of varying the existing scale of rates as follows (Mr Kuczys' further note of 24 July):

0	- £90,000	=	NIL
£90,000	- £180,000	-	30 per cent
£180,000	- £360,000	-	40 per cent
	over £360,000	-	50 per cent

2. If the variations were implemented from 1988/89, the cost in that year is estimated at £55m and in 1989/90 at £115m, building up over 5 years to a full year cost of £160m.

3. These cost estimates are usually made on the assumption that the existing scale would continue to be revalorised. If that assumption were made, it would be necessary to make one small change to the above scale so that the nil rate band would become 0 - £94,000. The corresponding cost of the scale with such further change would be £70m for 1988/89, £150m for 1989/90 and a full year cost of £200m.

But then the logic of your scale wd mean the higher thresholds wd rise in proportion

AWK

L E Jaundoo

L E JAUNDOO

cc: Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G Smith
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Beighton
Mr Houghton
Mr Cayley
Mr Gonzales
Mr Jaundoo
PS/IR

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

BF ~~23/10~~ ~~30/10~~ 4/11

FROM: M F CAYLEY
DATE: 12 OCTOBER 1987

1. MR ISAAC 12.10

2. FINANCIAL SECRETARY

CAPITAL GAINS INDEXATION AND GROUPS

1. This minute is about arrangements by which company groups can use the capital gains indexation provisions to create large capital losses for taxation purposes, at no extra risk and minimal inconvenience to themselves. Potentially hundreds of millions of indexed losses could be created in this fashion. So far we have seen only a few cases, but in one the tax losses involved run to some 35 million pounds. There may be other existing cases which have not yet surfaced. And a recent article in Accountancy Age has drawn attention to the potential for creating capital losses.

2. Against this background, we think Ministers may well wish to consider introducing legislation in the 1988 Finance Bill.

---

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Cassell
Mr Jenkins (Parliamentary Counsel)
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Isaac
Mr Pitts
Mr Cayley
Mr Hamilton
Mr Creed
Mr C Gordon
Mr Lester
PS/IR

The Nature of the Arrangements

3. The arrangements are concerned with the way groups finance their members. There are two variations, which may be used by a group separately or in conjunction with each other: multiplying up indexation, and passing funds round in effectively a circle ("circularity"). The following paragraphs describe the two variants in their simple form: a range of complications can be built in.

(i) Multiplying up

4. An intra-group debt will not normally constitute a chargeable asset within the capital gains net. The exception is where the loan takes the legal form of a "debt on a security", in which event the debt itself is a chargeable asset and on repayment of that debt the lender has an indexed loss. A group can interpose a number of companies between the member company with the funds to lend and the member company which needs these funds, with each of those companies receiving and making a loan of the same amount. This means that where company A in a group lends money in the form of a debt on a security to company B and so on through C, D, to E, if the loan is subsequently repaid via D, C and B to A, four lots of indexation relief are given on what is in substance the same asset. If company E buys an asset with the money, that asset on disposal also qualifies for indexation relief.

(ii) Circularity

5. Here entitlement to indexation relief is created by passing funds round the group in a circle. We have very recently seen a case where a group of companies appears to have hit upon this arrangement - in its case purely by accident. At its simplest the device works like this:

(i) the group sets up an unlimited company and agrees to subscribe for shares in it to a considerable value;

(ii) the new company agrees to lend the money subscribed back to the group interest-free; the new company has no assets other than the debt from the group and the matching liabilities are netted off so that no money actually passes;

(iii) the value of the new unlimited company's shares thus corresponds to the value of the loan, and hence with the money originally subscribed for the shares;

(iv) when the group wishes to claim the indexation relief, the loans are repaid, the shares are cancelled and the capital subscribed returned to the subscriber. Here again there are matching liabilities which can be netted off so that no money need actually pass. Thus, a self-cancelling set of transactions culminates in a disposal of the shares for CGT purposes and generates an indexed loss.

6. In the particular case we have seen involving an indexed loss on shares in a subsidiary, the arrangements were set up before indexation relief was introduced. In the event indexed losses of around £35m appear to have been generated - a large windfall for the group. In this particular case it is just conceivable that we may be able to resist the claim to indexed losses on technical grounds; but even if we can, it would be easy for them to set up similar arrangements in ways which were not open to technical attack. The legal principles established by the Courts in Ramsay and Dawson would give protection only in the most artificial case.

Case for Action

7. Arrangements of these kinds can be set up very easily by groups, at minimal cost and inconvenience and no disruption to their normal commercial operations. With attention having been drawn in the accountancy press to the possible use of loans within a group to create indexed loss, there must be a

serious risk that groups will soon seize on the potential for tax savings. There is therefore in our view a strong case for legislative action.

Form of Legislation

8. In theory, one option would be to look at the use to which a group member put funds which were provided from within the group - the legislation would bite where these were passed on to another group member. But in practice any such approach would be impractical, because groups could readily dress up the arrangements in ways which made it impossible to link the provision of funds to a member company with finance provided by that company to another group member. This is the familiar problem of the impossibility of effectively linking a particular source of a company's funds with particular activities of the company.

9. We think therefore that the general approach would be to focus any legislation on identified forms of internal group finance. We now turn to what these might be.

(a) Loans

10. Most loans within a group do not take the form of a debt on a security and hence do not give rise to a potential for indexed losses. We would suggest that the legislation should cover all loans within a group which take the form of debts on a security. There seems no good reason why a group should benefit from one or more tranches of indexed loss simply because a loan is dressed up in a particular legal form.

11. There is in fact a precedent for acting in this way on intra-group debts. Where a loan to a trader which is not normally within the capital gains net has become irrecoverable, it is brought within the net so that the lender can establish a capital loss. But this relief is not

available if lender and borrower are companies in the same group.

12. It may be suggested that action of this kind would catch some commercial arrangements within the group. But it should not inhibit them. A straight loan within a group does not create potential for establishing capital losses, and in the normal course intra-group loans will - and do - take the form of straight loans.

(b) Redeemable Preference Shares

13. Holdings which one group member has of redeemable preference shares in another company in the group can be used to establish indexed losses in the same way as a debt on a security, again at no extra risk to the group and minimal cost. We would recommend that action should extend to redeemable preference shares held within the group.

(c) Other Shares

14. Most other shareholdings will put the shareholder, even within the same group, at real commercial risk, and in general we do not think it would be right to tighten up the rules for intra-group shareholdings. But, as the example of circularity in paragraph 5 illustrates, there can be exceptions, and these can give rise to substantial capital losses. And if action were taken against redeemable preference shares it would be fairly easy to devise classes of ordinary shares with similar characteristics.

15. It would not be practical to lay down rules to identify the circumstances where there was likelihood of exploitation, because the possibilities are too wide-ranging. What we therefore envisage is a motive test. This would trigger the counter-measures where the acquisition of shares was financed directly or indirectly by way of intra-group loan etc and it appeared that the obtaining of an indexation allowance was

the main object of the transaction. This is not always an easy test to apply, and some schemes would slip through the net, but our experience in other areas of tax law suggests that it would serve to deter the most artificial arrangements.

Form of counter-measure

16. There are three possible methods of counteraction:

(i) CGT exemption This was the solution adopted for gilts and qualifying corporate bonds. But in the present areas it would deny relief for real losses (eg where the debt could not be repaid) as well as for indexed losses; and it would present scope for realising tax free gains. We would recommend against this.

(ii) Taking the target asset outside indexation

This would maintain relief for cash losses. It would involve both disallowing indexed losses and taxing paper gains if such gains arose. It would be exactly the solution which is to be adopted in order to deal with the problem of losses arising on building society share accounts.

(iii) Preventing indexation from creating or augmenting a loss on the target assets

This would again maintain relief for cash losses, and - unlike (ii) - also for paper gains.

17. The choice thus seems to be between (ii) and (iii). Although option (ii) could be criticised on the basis that, conceivably, some of the target assets could show paper gains which ought to benefit from indexation relief, it would mean

simpler and shorter legislation than option (iii) - in the order of two pages - would fit in with what is being done for Building Society shares, and seems to us preferable.

Associated Companies

18. So far this minute has focused on companies within a group. But similar scope for creating indexed losses exists where companies are "associated" - that is, while not members of the same group, they are under the control of the same person. We would therefore recommend that any legislation extend to associated companies.

Should Action go wider than Intra-group Transactions?

19. Confining action to transactions within the group and to associated companies does carry the risk that arrangements may develop involving outsiders. Thus the group could lend money to an outside company which could lend the money back to the group with some of the resulting tax benefits - the indexed loss - being passed back to the group. But extending any new legislation to arrangements involving parties outside the group generally could be attacked as catching genuine commercial arrangements. At this stage, therefore, we would recommend that any legislation should be confined to intra-group arrangements, but that we should keep an eye on the position and report to Ministers if arrangements involving outside parties develop.

Commencement

20. At the moment, although we have seen one or two cases, we have no evidence of widespread exploitation of intra-group financing arrangements to create indexed losses. We think this is likely to change, but with present levels of inflation it will be a little while before groups can establish sizeable amounts of indexed losses. We doubt therefore that this is a situation where an early announcement is called for, with legislation

backdated to the date of announcement. Accordingly, we would propose that any legislation should be announced on, and effective from the start of, Budget Day 1988.

Pressure for Group Relief

21. Although the issues involved are totally separate and self-contained it may be that, if Ministers do decide to act as suggested, there will be increased pressure to extend the existing group relief provisions to include capital losses. However you decided last year that any legislation on group relief should be deferred pending the outcome of three cases in the House of Lords and of European Community discussions on a draft Directive on mergers and demergers: these will have implications for the form of any legislation. The representative bodies are aware of this, and we see no reason to accelerate work on group relief.

Length of Legislation and Staffing Implications

22. Legislation might run to up to two pages of the Bill. The effect on our staff need would be negligible.

Could Legislation be Deferred for Another Year?

23. Given the prospective pressures on Parliamentary Counsel (and ourselves), and the competition for space in the 1988 Bill, the question obviously arises as to whether action on this issue could be put off for another year. At present rates of inflation, the extra cost to the Exchequer of deferring legislation to 1989 is unlikely to be very great. On the other hand, although we think that up to now few groups have set up arrangements designed to exploit the present position, more groups are likely to do so if action is not taken in 1988, especially given the recent publicity on the possibilities. There would thus be advantages in legislating next year rather than in 1989.

Conclusion

24. We have on several occasions in the past mentioned to Ministers the problems that stem from a system of partial indexation - indexation for (most) capital gains but not for interest etc - and that these problems are increased by the fact that from 1985 indexation relief can create a loss. There will always be an incentive for people to devise arrangements which dress up financial transactions to take advantage of this and establish tax losses. The boundary between what qualifies for indexation relief and what does not is necessarily a pragmatic one, and it is important to keep watch for the development of arrangements designed to exploit the relief. In 1985, action had to be taken on gilts and qualifying corporate bonds, and Ministers have recently decided to act on Building and Co-operative Society shares. This minute has been concerned with exploitation within company groups. It will remain necessary to monitor the position carefully, and it may be appropriate to consider further legislation if new devices for exploiting indexation emerge.

25. We would be grateful to know if Ministers consider that action should be taken in the 1988 Finance Bill, with effect from next Budget Day, on intra-group financing arrangements. If so, do they agree with our proposed approach under which:-

(i) the measures would apply to intra-group debts and redeemable preference shares;

(ii) they would extend to other intra-group shareholdings where the main benefit of having the shares was to obtain indexation relief;

...

(iii) they would apply to arrangements between associated companies as well as companies in the same group; and

(iv) as with capital losses on Building Society shares, the form of counter-measure would be to take the assets concerned outside the indexation provisions.

Michael Cayley

M F CAYLEY

Accepting that CGT indexation relief is here to stay, we have (as Mr Cayley says) a logical discontinuity in the tax system and - inevitably - wherever the boundary posts are placed, there is scope to exploit the discontinuity at the margin. Mr Cayley's proposals are consistent with the now established policy of seeking to frame a pragmatic solution for each particular threat, as it arises. As he says, we shall continue to need to keep a close watch on future developments.

Paragraph 23 of Mr Cayley's note raises an important question: if you agree that there is a case on merits for countervailing legislation, is the case sufficiently pressing to command space in an already very heavy 1988 Finance Bill? The pressures here will obviously, to some extent, depend on whether you decide to go for one of the possible wider CGT packages and whether that would itself require longer - or alternatively shorter - legislation.

CJGI

A J G ISAAC

4308/013

(u)

FROM: S J FLANAGAN

DATE: 13 October 1987

CHANCELLOR

cc Financial Secretary
PS/Sir Peter Middleton
Mr Burgner
Mr Gray
Miss Hay
Mr Potter
Mr Wynn Owen

LUNCH WITH THE UNQUOTED COMPANIES' GROUP, ~~WEDNESDAY 14~~ THURSDAY 15 OCTOBER

You are lunching tomorrow, along with the Financial Secretary and Mr Forman, with the Unquoted Companies Group. Sir Emmanuel Kaye has already indicated to Sir Peter Middleton the points he wishes to discuss. These are:

Personal Tax Rates

Sir Emmanuel indicated that he was hoping to see a drastic reduction. He believes that a structure of 27 per cent/40 per cent could be paid for by restricting personal allowances and mortgage interest relief to the basic rate only. Ultimately, he would like to see a single uniform rate of 25 per cent;

Inheritance Tax

The Unquoted Companies Group have various proposals for reducing the impact of Inheritance Tax, including:

- increasing business relief
- making Inheritance Tax on illiquid assets due only on disposal;
- a half rate tax for lineal descendents or lower top rate generally.

If you have time you might like to look at the attached detailed briefing prepared by FP. In general, reliefs and exemptions in the areas of concern to the Unquoted Companies Group are already generous;

Community Charge/National Non-Domestic Rate

Sir Emmanuel Kaye is apparently in favour of the CBI scheme for rate reform proposed by John Banham. These involve a four way split between:

- "national" services, paid for from central taxation;

- business-related services, paid for by a local business rate;

- marketable services, charged at full cost;

- other services, paid for by a small Community Charge.

2. I understand that Evelyn de Rothschild will also be present at the lunch. He is particularly concerned about Employee Share Option Schemes, in particular the effect of Section 79 of the Finance Act 1972 which effectively disbars from approved status almost all cases involving shares in a subsidiary of an unquoted company. The Financial Secretary has approved certain relaxations of Section 79, but this decision has not yet been announced.

Steven Flanagan

S J FLANAGAN

INHERITANCE TAX: BUSINESS RELIEF

Point at Issue

Although the change to IHT in 1986 removed the immediate charge on unfettered lifetime transfers to individuals (a treatment extended this year to gifts made by individuals into and out of interest in possession trusts) the UCG have continued to pursue their long-standing demand for 100 per cent business relief. Latterly they have made proposals which would achieve this objective by making transfers of business property exempt providing certain tests relating to length of ownership (both pre and post transfer) are satisfied.

Background

Business relief reduces the value for tax purposes of relevant business property by either 50 or 30 per cent. The higher rate is available for the transfer of businesses, majority shareholdings or substantial (ie comprising more than 25 per cent) minority shareholdings in unquoted companies. (It was extended to the latter category this year.) The lower rate is available for smaller minority shareholdings in unquoted companies and assets used in a business but held outside it. In addition tax on qualifying property can be paid by interest-free instalments over ten years.

UCG were probably the most forceful and persistent critics of CTT among the representative bodies and their attitude has moderated little since the change to IHT. Although committed to total abolition of the tax, in practice they have placed more emphasis on a variety of limited measures designed to secure a de facto exemption for the unquoted sector rather than on the general burden of tax. But in the past they have also argued that rates are too high especially in comparison with overseas equivalents. (Briefing on this area can be found elsewhere.)

Ministers have not favoured granting 100 per cent business relief or measures designed to achieve the same result because it would remove the present incentive for passing on control of businesses during lifetime, provide a complete tax shelter and induce extensive and undesirable behavioural changes.

This year's increase from 30 to 50 per cent in the rate of relief for substantial minority shareholdings went a long way towards meeting the long-standing UCG demand for parity of treatment between minority and majority shareholdings. (It fell short because parity was not at 100 per cent and it was not extended to all minority shareholdings.) This years extension of PET treatment to lifetime transfers involving interest in possession trusts similarly met a demand the UCG had been pressing.

Line to take

Present arrangements are already generous. Since last year business property can be transferred in the owner's lifetime, free of tax, to the next generation. This year's extension of the regime to transfers involving interest in possession trusts and the increase in the rate of relief for substantial minority shareholdings provide a further boost for family businesses. However a balance must be maintained. 100 per cent relief could be severe discouragement to flotation and could thus negate the Government' of encouraging wider share ownership

INHERITANCE TAX: ILLIQUID ASSETS

Point at Issue

As a means of reducing the impact of IHT, Sir Emmanuel Kaye has suggested that tax on works of art and other illiquid assets should become due only on disposal.

Background

Principal among the heritage reliefs contained in the IHT code is the conditional exemption system. This provides that a chargeable transfer of any work of art etc (pictures, prints, books, manuscripts, works of art, scientific collections or other things not yielding income) which is of national scientific, historic or artistic interest can be wholly exempt from IHT provided that undertakings are given to keep the item permanently in the UK, to preserve it, and to secure reasonable public access to it. The exemption is forfeited if the undertakings are subsequently broken or if the item is sold (unless the sale is by private treaty to a national institution - when the douceur arrangements operate) and a recapture charge is imposed.

The instalment facility enables the payment of tax on a wide range of illiquid assets to be spread over 10 years. The types of property covered by this are:

(a) land and buildings;

(b) property qualifying for business or agricultural relief;

(c) control holdings in any company and certain minority holdings in unquoted companies; and

(d) woodlands.

Apart from those in respect of land and buildings, instalments are interest-free if paid on time.

Line to take

Complete exemption is already available for works of art, subject to the conditions indicated in paragraph 2 above. Sir Emmanuel Kaye might be asked to clarify what more he considers could be done in the circumstances. The instalment facility - interest free in many cases - considerably reduces the impact of IHT on other types of illiquid assets.

INHERITANCE TAX: EUROPEAN COMPARISONS

Point at issue

Sir Emmanuel Kaye suggests a top rate of tax of 30% which he considers would be more in line with other European countries.

Background

The top marginal rate of IHT is 60%. This applies to around 3,000 estates annually whose assets exceed £330,000.

However there are many valuable reliefs which considerably reduce the amount of tax payable. The first £90,000 of an estate is wholly exempt, as are all transfers between UK domiciled spouses. There are also annual, marriage and charitable gift exemptions - and, most importantly, agricultural and business reliefs. These latter can reduce the tax base by as much as 50 per cent so halving the tax due. Tax on such property can often be paid by tax free instalments spread over 10 years - a facility that further reduces the burden of tax in real terms by some 20 per cent.

When these reliefs and exemptions are taken into account the effective top rate of tax is less than half the top marginal rate.

Direct comparisons with other European countries is made difficult by these extensive UK reliefs which do not always have their counterparts elsewhere. Other countries have a variety of gift and death taxes, and tax rates often vary with the relationship between transferor and transferee. Most also tax lifetime gifts whereas such gifts are now generally exempt in the UK provided the donor survives the gift by seven years.

In general the UK range of reliefs and exemptions is very generous compared with European estate and inheritance taxes.

To reduce the top marginal rate by half, without making commensurate reductions in the reliefs and exemptions now available, would be costly in terms of revenue foregone. This shortfall could be made good only by increasing the burden on smaller estates. There would be no administrative savings since the number of estates liable to tax would remain the same.

Line to take

Direct comparisons with European countries are extremely difficult to make. Although the top marginal UK rate is 60 per cent, in practice the effective rate of tax is on average less than half this when reliefs and exemptions are taken into account. Further reliefs to top-rate taxpayers could only be given at the expense of smaller estates.

INHERITANCE TAX: RELIEF FOR LINEAL DESCENDANTS

Point at issue

Sir Emmanuel Kaye suggests there should be a "half" rate tax for lineal descendants.

Background

Broadly speaking IHT taxes transfers which reduce the value of the transferor's estate. Apart from the important spouse exemption and the minor marriage exemption the relationship between transferor and transferee does not affect the tax charge. Transfers between UK domiciled spouses are wholly exempt from IHT.

When consanguinity reliefs have been considered before it has been felt that to confine any such reliefs to lineal descendants alone would be too narrow. Such a test is likely to be attacked and to create pressure to extend it to other family members. The difficulty then is to decide where to draw the line.

Moreover such reliefs would complicate an already complex tax by focusing attention on both donor and donee. Additional complexities would result from the interaction between bequests to lineal and non-lineal beneficiaries and between assets based reliefs (agricultural and business) and donee related ones. [There are already problems with the interaction of spouse relief with agricultural and business reliefs.] This goes against the Government's aim of simplifying the taxation system.

A relief for lineal descendants would penalise people who have no lineal descendants, and might distort the present pattern of giving by making it comparatively expensive to make bequests outside the class of lineal descendants - to collaterals, friends or business associates.

Members of the family are already the chief beneficiaries of gifts and bequests. So a relief for lineal descendants is bound to be costly in terms of revenue foregone. There would also be additional administration costs.

Line to take

It is already possible to pass property completely free of IHT to any individual provided the donor survives seven years. Where he or she dies between three and seven years after the gift, the tax charge is tapered. Taxpayers who look ahead can therefore already benefit family members without need for a further specific relief.

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON
DATE: 20 OCTOBER 1987

Ch saw FAXED copy of this.
JT 20/10

CHANCELLOR

INHERITANCE TAX - RATES

1. You asked what would be the cost (as compared with indexation) of raising the IHT threshold to either £100,000 or £105,000 and having a single rate of 40 per cent thereafter (Mr Taylor's note of 13 October).

2. For the £100,000 threshold the full year cost would be £205m (£68m in the first and £105 in the second year).

3. For the £105,000 threshold the full year cost would be £225m (£86m in the first and £190m in the second year).

4. These thresholds are estimated to produce 28,000 and 25,000 taxpaying estates respectively, compared with 31,000 taxpaying estates on the indexed scale.

---

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Scholar
Mr G Smith
Miss Sinclair
Mr Cropper
Mr Battishill
Mr Isaac
Mr Beighton
Mr Houghton
Mr Pitts
Mr Gonzalez
Mr Jaundoo
Mr Pape
Mrs Evans
PS/IR

5. Since the present IHT rates begin at 30 per cent there will be losers from a scale starting at 40 per cent. These losers will be in the smaller taxpaying estates. We estimate that on a threshold of £100,000 some 15,000 estates (in the range £118,000-£255,000) will pay more tax than under indexation. On a £105,000 threshold some 10,000 estates (in the range £138,000-£235,000) will pay more. (We can do more work to illustrate the extent of these losses if your wish).

6. You also asked what would be the cost of abolishing the 60 per cent rate. If the change were to take effect from 1988/89 the cost in that year is estimated at £35m and in 1989.90 at £75m, building up over 5 years to a full year cost of £100m.

B T HOUGHTON

SECRET

PPS-PA.

Inland Revenue

Policy Division
Somerset House

Thanks. Option 2 (PSR now) as main option for scorecard(s): NL.

FROM: L E JAUNDOO
DATE: 26 OCTOBER 1987
EXT : 6459

1. MR ISAAC CE 26.10 As you expected, the cost comparisons are more encouraging

2. CHANCELLOR

CEI 26.10

INHERITANCE TAX - RATES

1. The Chancellor has asked for an analysis of the likely gainers and losers if the present IHT rates were amended by raising the threshold to either £100,000 (Option 1) or £105,000 (Option 2) and having a single rate of 40 per cent thereafter. He has asked also for advice on a further Option (Option 3) involving a single rate of 35 per cent and a threshold set at a level that would ensure no losers (Mr Taylor's note of 20 October).

2. The tables below illustrate the incidence and costs of each of these Options. Table 1 shows the tax payable on a number of specimen estates. The threshold which produces no losers with a 35 per cent rate (Option 3) is (rounded) £100,000. The comparisons in Table 1 are all against the 1987-88 rate bands. This basis therefore produces more gainers and fewer losers than comparisons with the present system after indexation to 1988-89 (mentioned in Mr Houghton's note of 20 October).

top copy below - you have FAXed copy

---

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Cassell
Mr Scholar
Mr Cropper
Mr Battishill
Mr Isaac
Mr Beighton
Mr Houghton
Mr Pitts
Mr Calder
Mr Gonzalez
Mr Jaundoo
PS/IR

TABLE 1 - TAX ON SPECIMEN ESTATES

Size of estate £000s	1987/88 Scale	Option 1	Option 2	Option 3
	£	£	£	£
100	3,000	NIL	NIL	NIL
200	39,000	40,000	38,000	35,000
300	87,000	80,000	78,000	70,000
400	144,000	120,000	118,000	105,000
500	204,000	160,000	158,000	140,000
1,000	504,000	360,000	358,000	315,000
2,000	1,104,000	760,000	758,000	665,000

Gains and losses

3. There are no losers under Options 2 and 3. Under Option 1, estates in the range £130,000 - 230,000 would lose. These 11,400 estates are 34 per cent of taxpaying estates in 1988/89 (under the 1987/88 rate scale). However, the losses would be small. 8,700 estates in the range £140,000 - £220,000 would each lose £1,000; the loss for each of the remaining 2,700 estates would be smaller.

4. We estimate that under the thresholds in Options 1-3, there would be 28,000, 25,000 and 28,000 taxpaying estates respectively, compared with 31,000 taxpaying estates on the indexed scale.

5. The estates taken out of tax by the threshold increase would each gain £3,000 (£4,500 under Option 2). However, significant gains accrue to the larger estates under all 3 Options. For example, on an estate of £300,000 the gain under each Option is £7,000, £9,000, and £17,000 respectively. These gains rise to £44,000, £46,000 and £64,000 respectively for a £½m estate.

Costs

TABLE 2

	Option 1	Option 2	Option 3
First year	£ 68m	£ 86m	£160m
Second year	£150m	£190m	£335m
Full year	£205m	£225m	£360m

6. The costs in Table 2 have been estimated on the usual assumption that the existing rates scales would continue to be revalorised. The figures therein therefore represent additional costs over statutory indexation.

7. It is possible to reduce the £100,000 threshold in Option 3 to £98,000 without creating losers. This variant would reduce the Option 3 costs in Table 2 by £10m in 1988/89, £20m in 1989/90 and £20m in a full year.

LE Jaundoo

L E JAUNDOO

FROM: A J BOLTON

Inland Revenue

Policy Division
Somerset House

12 November 1987

What is the rationale of the 45% charge? How long has it been 45%? What would be the cost of reducing it to say 30%? [How can it possibly stay @ 45% if the top rate of tax on investment income were to be reduced to 35%? – these questions look for full answers] M.

1. MR SPENCE
2. PS/FINANCIAL SECRETARY 12/11

AIR TRAVEL TRUST

1. Following the Financial Secretary's meeting with Sir Peter Lane on 28 September, the Financial Secretary asked us to look again - with a sympathetic eye - at the possibility of relieving the Air Travel Trust from the 45% income tax charge to which it is subject as a discretionary trust (your note of 28 September).

No note of this exists

2. We understand that the Financial Secretary has ruled out legislation on the point. Consequently, this note considers what extra-statutory action could be taken.

Summary

3. a. We have not found any other compensation funds which face the 45% charge;

b. however, the 45% charge has been applied without exception to a number of funds (notably disaster funds) established for purposes even more deserving than the Air Travel Reserve Fund;

c. furthermore, there are many private trusts bearing the 45% charge which have at least as good a case for relief as the Air Travel Trust.

cc Ms Sinclair
Mr Cropper

Mr McGivern
Mr Spence
Mr Marshall
Mr Golding
Mr Walker
Mrs Fletcher
Mr Bolton
PS/IR

4. So, we are clear that relieving the Air Travel Trust of the 45% charge would have wide ranging implications even though there are (so far as we are aware) no strictly analogous cases of compensation funds.

5. In any case, to grant the relief which ATT seeks would be to alter the basis upon which the 45% charge currently operates: a strict factual test (is the income arising to the trustees of an accumulation or discretionary trust?). Instead, there would have to be some kind of motive test or value judgement to identify the deserving cases. This would be difficult to frame and operate.

Is the Air Travel Trust uniquely deserving?

6. The Financial Secretary was particularly concerned to know whether the Air Travel Trust really is unique as Sir Peter Lane claims.

7. We have not been able to identify another compensation fund, analogous to the Air Travel Reserve Fund, which is constituted in such a form that it suffers the additional rate income tax charge. However, there has been no shortage of funds established for very laudable purposes which are subject to the additional rate charge. Several of these have appealed to Ministers for special exemptions but have consistently been refused relief however deserving they might appear to be.

8. A prime example is the Penlee disaster fund set up after the lifeboat tragedy. There was, of course, no income tax to pay on the donations to the fund but, pending distribution to the beneficiaries, the fund was invested and produced income upon which income tax was paid at 45%. A similar situation applied to the Bradford football fire disaster fund.

9. In fact, the natural place for disaster funds to look for tax relief is the general exemption for charities. However, as the law currently stands, charitable exemption only covers income which is applied for "charitable purposes" and that

does not extend to large payments far beyond the "needs" of the beneficiaries. So far, Ministers have not accepted the representations that charitable exemption should be extended to disaster funds. Neither have they accepted the argument which then follows that the additional rate charge at least should be removed.

10. The tax consequences depend, of course, on the precise legal structure employed. This is particularly true of compensation funds. All the cases we have looked at (other than the Air Travel Trust) are either constituted as corporate bodies (paying corporation tax at 35%) or in some other form which does not constitute a trust for the purposes of the 45% charge. Equally, disaster funds can avoid the 45% charge if they are established otherwise than as discretionary trusts. And to this end, the Attorney General has issued guidelines for the trustees of disaster funds.

11. Outside the field of disaster funds, we have identified that the recent Russian compensation fund also came within the scope of the 45% charge. Despite special pleading that it was a unique case, the Chancellor decided that it should not be exempted. Similarly, requests that small trusts, trusts for minors and the disabled, heritage trusts etc should be exempted from the additional rate have always been resisted on the grounds that any concession to a particular trust or to a particular class of trusts would lead to pressure from others for similar treatment.

12. In summary, we would say that, although there are apparently no compensation funds as such which share the Air Travel Trust's particular tax problems, there have been plenty of trusts established for very deserving causes but to which the 45% charge has uniformly been applied.

How could relief be given?

13. If Ministers were convinced that the Air Travel Trust was a special case deserving special treatment, the obvious way of

giving relief would be a special provision in a Finance Bill. However, we understand that the Financial Secretary rules out legislation on the point (maintaining the position taken by his predecessor). Consequently, relief could be given only by one of two routes:

a. a published Extra-Statutory Concession; and

b. the Revenue agreeing not to pursue the 45% charge in this particular case.

<u>A Published concession</u>

14. Extra-statutory concessions are granted in three types of cases:

a. where the concession is minor (ie small Exchequer cost and not involving large amounts in individual cases);

b. where the concession is transitory (meeting a passing set of circumstances); and

c. to meet cases of hardship at the margins of the tax code where a statutory remedy would be difficult to devise or be lengthy and out of proportion to the importance of the matter.

15. A published Extra-Statutory Concession could not be restricted to one taxpayer. It would have to be a general concession for a specified class of trusts of which the Air Travel Trust was one member. It seems certain that the class would have to be large including all the deserving cases already mentioned, not just compensation funds analogous to the Air Travel Trust. The disaster funds, for example, would seem to have an unanswerable claim to be covered as well as compensation funds for stranded holidaymakers. Accordingly, the Exchequer cost would be considerable.

16. A concession for such a large class of trusts could hardly be regarded as "minor" - criterion (a) for a published concession. Neither do we think it could be squared with the other criteria. Clearly, the problem is not "transitory" - category (b). And we do not see how it could be justified against the "hardship" condition in category (c). There is a clear difficulty in saying that an entity such as a trust suffers "hardship". In any event, it could not be said that a statutory remedy for the deserving class of trusts would be of a length and complexity which would be out of all proportion to the importance of the matter.

17. Quite apart from the difficulty of meeting the criteria for a published Extra-Statutory Concession, we see formidable difficulties in framing a general concession for deserving trusts and operating it sensibly. It is hard to see how the boundary line could be drawn in a factual way without calling on someone (? the Revenue) to make value judgements distinguishing the deserving from the undeserving. It would be hard enough to operate legislation containing that sort of test although there would then at least be the usual appeal rights. But trying to operate an Extra-Statutory Concession on that basis would be very difficult and leave us exposed to judicial review.

18. We are forced to the view that granting a concession to the Air Travel Trust (with all the consequences just mentioned) would be a response out of all proportion to the problem. It would amount to changing the basis upon which the 45% charge operates, replacing strict factual rules with some kind of motive test which we think is less satisfactory from everyone's point of view, including taxpayers. And the impact on the Air Travel Trust itself (about £200,000 per annum according to Sir Peter Lane) appears pretty marginal in terms of the financial problems of the trust.

Relief by administrative action

19. We do not think that the Board could legitimately decide under its administrative powers to forgo the additional rate tax in this one case. The position would be different if there was an arguable case in law that the additional rate did not apply to the Air Travel Trust. But there is none, as the Air Travel Trust themselves acknowledge. There has been an exhaustive search for such a case in which we have participated. (Indeed, this is the main reason why the Trust's tax affairs have taken so long to finalise.) However, the unanimous conclusion is that the Trust, as currently constituted, falls squarely into the ambit of the additional rate charge. It would be beyond the Board's discretion under its care and management of the taxes to ignore this clear liability. Neither should it be overlooked that the 45% charge forms part of the anti-avoidance measures to prevent loss of income tax through the exploitation of trusts. While no-one is saying that the Air Travel Trust is a tax avoidance vehicle, any suggestion that such legislation can be set aside at the discretion of the Board should be firmly rejected.

20. As the Financial Secretary may recall, we were able to assist over another problem the Trust had - with Capital Transfer Tax (as it then was). In that instance, there was a respectable case both ways. Consequently, in view of the nature of the Air Travel Trust, it was decided that the possible liability would not be pursued. However, there is no such scope for flexibility in relation to the additional rate income tax charge.

Conclusion

21. We are sorry that this note has taken so long to prepare but we have looked carefully at the wide range of trusts which could be affected. It has turned out to be negative. We recognise the Financial Secretary's desire to help the Air Travel Trust out of its difficulties but, with the best will in the world, we do not see any room for manoeuvre short of

special legislation. Assuming that the Financial Secretary still rules out that possibility (a view we strongly support), we recommend that Sir Peter Lane be told that the additional rate charge will have to stand.

22. We attach draft letters for the Financial Secretary to send to Sir Peter Lane and to Lord Brabazon of Tara who is responsible for aviation matters at the Department of Transport.

AJ Bolton

A J BOLTON

4374/26

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Sir Peter Lane
Chairman
Air Travel Trust
C/o Binder Hamlyn
8 St Bride's Street
LONDON
EC4A 4DA

November 1987

When we met on 28 September I said that I would have another look to see whether the Air Travel Trust could be relieved of the additional rate income tax charge. I explained that I saw no prospect of legislation on the point but that my officials would further explore the other possibilities.

I am sorry that this has taken a little time but we have carefully considered a number of options.

However, I have to tell you that this further work has not revealed any avenue of relief, short of legislation, which could be offered. The Trust appears to fall squarely within the additional rate charge. In these circumstances, it would not be right for the Inland Revenue to make an exception to the normal tax treatment for one particular trust. And I have concluded that it would not be appropriate to grant a general concession covering the many compensation funds and other trusts who would argue - with justification - that it would be inequitable to deny them any special tax treatment afforded to the Air Travel Trust.

I know that you will find this reply very disappointing. As you know, I have given your representations very careful consideration but I am unable to offer any concessions.

NORMAN LAMONT

4374/25

Treasury Chambers, Parliament Street, SW1P 3AG

Lord Brabazon of Tara
Parliamentary Under-Secretary of State
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

November 1987

AIR TRAVEL RESERVE FUND: AIR TRAVEL TRUST

Michael Spicer wrote to me several months ago, before the Election, in his former capacity of Minister for Aviation, in support of Sir Peter Lane's representations about the taxation of the Air Travel Trust.

Sir Peter and some of his colleagues from the Trust called on me on 28 September. While I explained to them that I could hold out no prospect of legislation on the point, I said that I would have another look to see whether the Air Travel Trust could be relieved of the additional rate income tax charge by some other means. However, it has not proved possible to do this for the reasons set out in my letter to Sir Peter of which I enclose a copy.

NORMAN LAMONT

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: C STEWART
DATE: 18 NOVEMBER 1987

Thanks. I will clear for weekend. I said the FST will consider the 3 options — (a), (b) + (c). There is clearly something to be said for (c). JT.

PS/CHANCELLOR

ADDITIONAL RATE TAX ON TRUSTS

1. I understand that the Chancellor has asked for note on the "additional rate" of tax on trusts, before his meeting with Sir Peter Lane tonight.

2. The additional rate is charged on the income of discretionary and accumulation trusts - ie broadly those where no particular beneficiary has a clear entitlement to the income as it arises. The income of these trusts is charged to basic rate (27%) plus additional rate (18%), making a total of 45%. When the income is paid to beneficiaries, the beneficiary gets credit for the 45% tax paid by the trustees, and part or all of it is repaid to him if his liability is below 45%.

3. The additional rate charge was introduced in 1973 as part of the reform of personal taxation which included the replacement of surtax by higher rates of income tax, and of earned income relief by the investment income surcharge. The additional rate charge on trusts broadly represents higher rate liability on the trust's undistributed income, so as to prevent the use of trusts by

cc PS/Financial Secretary
Mr Scholar
Mr Culpin
Mr Riley
Mr Isaac
Mr Corlett
Mr Beighton
Mr Calder
Mr Mace
Mr Stewart
PS/IR

wealthy taxpayers to avoid higher rate tax on investment income by accumulating it under the shelter of a trust. Where the trust is one in which beneficiaries have a fixed immediate entitlement to the income - such as a life interest - there is no need for an additional rate charge because the income will be taxed at the beneficiary's own personal rate.

4. Until the abolitaion of investment income surcharge, the additional rate was linked to the IIS rate (15%). On the abolition of IIS, the additional rate was re-defined as the difference between basic rate and the second higher rate (currently 45%). This meant that legislation would not be required each year to fix the rate again. When the basic rate was reduced from 30% to 29% and then to 27%, Ministers decided to leave the formula to apply automatically, so that the additional rate is now 18% and the total charge on discretionary trusts remains at 45% - ie about half way up the higher rate scale.

X 5. We have had in mind that the additional rate will need to be reviewed in the run up to the Budget. If there was to be a change in the higher rate structure the broad options would be -

a. to align the additional rate with the new top rate;

b. to align it at an intermediate point;

c. to abolish the charge, so that the trust income would bear basic rate tax only, unless and until it was distributed to a beneficiary who was liable at the higher rates.

Other changes which might affect the treatment of investment income could also be relevant to the decision, in particular, some ideas which we understand are being worked up in FP and to which the Chancellor referred at his most recent Budget meeting.

6. As a rough guide, the additional rate at present yields about £2m per percentage point - ie about £40m with the present rate.

7. The cost of changing the rate would depend on how the rate was fixed in relation to the basic rate for the year.

8. Presumably the Chancellor will not want to go into all this with Sir Peter Lane, but simply listen to his representations.

CS

C STEWART

3977/40

CONFIDENTIAL

FROM: P J CROPPER
DATE: 13 January 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Culpin
Mr Tyrie
Mr Call

Individuals wd sell shares to gross funds just before the dividend is paid, & buy them back afterwards. Thus no CGT wd mean not single taxation, but no taxation at all. However, from which the gross funds problem, using neither tax or the only way that the tax man whose asset can [illegible] transfer is

CGT

Judith Chaplin, as the PMG has recently implied in an admittedly different context, is a sensible girl. See attached.

2. Her point about CGT being a sort of double taxation is particularly important. The growth of a portfolio is already caught for tax purposes by the taxation of the growing income it yields. Furthermore, all of that income is likely to be taxed because personal allowances are nearly always absorbed by peoples' earned or pension incomes and income tax falls on their entire investment income. Unlike CGT, with its own threshold.

P J CROPPER

or essentially wd be a higher income. To make the case against CGT you need to have a tax on capital itself. As that wd hardly be desirable

~~[illegible]~~ of the wrong with a [illegible] the man with a wasting asset which, over the same period, provides [illegible]

Wednesday January 13 1988

THE TIMES

Timothy Yeo

An alternative to tax cuts

10=

If the Chancellor of the Exchequer wants to use his next Budget to give maximum relief to those earning less than £21,000 a year he should not cut the basic rate of income tax. More than 20 million people, over 96 per cent of the working population, fall into this category. Every single one would benefit more from reductions in employee insurance contributions than from income tax cuts.

While a switch of emphasis away from the basic rate of tax might seem to be abandoning one of the government's most cherished aims, it would in fact represent progress along a route pioneered by Nigel Lawson in 1985 when concessionary national insurance contribution rates were introduced for the lower paid.

Improved targeting of resources is another proclaimed government objective. The recent decision not to uprate child benefit fully was defended on the ground that social security expenditure should be concentrated more accurately on those in the greatest need. Why not apply the same approach to taxation policy?

The state of the economy makes this an exceptionally favourable time to reform the tax system. The previously elusive combination of rising public spending, falling government borrowing and further tax reductions is within the Chancellor's grasp for the second successive year. Changes in the tax treatment of married women are needed and should be initiated this year. Even more urgent consideration, however, should be given to phasing out employee national insurance contributions as a cost effective alternative to cutting income tax.

For while everyone would like to pay less tax, it is those on average earnings and below who are now most in need of relief. A married man on average earnings today pays about 20 per cent of his income in tax, compared with nothing before the war.

It would cost £3.2 billion to cut the basic rate to 25p. If this money was applied instead to reducing employee national insurance contributions, a married man on £200 a week would be £4.24 a week better off, compared with only £2.48 after the basic rate cut. Similar differentials apply at other earnings levels, although the disadvantage of the tax cut is less as income approaches £400 a week.

Cuts of this kind are so demonstrably fair that they would be hard to oppose, and the process could be carried much further once it was recognized that, from the wage-earner's viewpoint, the basic tax rate was not 27p but 36p, made up of 27p tax plus 9 per cent national insurance contributions.

Instead of aiming for a 25p basic tax rate, equivalent to an effective rate of 34p, the government should raise the income tax rate to 30p and abolish employee national insurance contributions altogether, at a net cost of £8.7 billion. This policy switch would not only achieve far better targeted tax relief but would also introduce a much simpler and more rational tax rate structure.

At present, taking into account income tax and national insurance, there are no fewer than 12 different marginal tax rates. In addition, those people whose earnings rise through the £41, £70 and £105 per week thresholds face marginal rates of over 100 per cent, which would be eliminated altogether by abolishing employee national insurance contributions.

At a time when the disincentive effect of the poverty trap rightly causes much concern, this opportunity of reform should not be wasted. The present irrational structure of marginal tax rates, rising in arbitrary jumps from 5 per cent at £43 a week to 36 per cent and rising again to 60 per cent at £868 a week would be replaced by six marginal rates, progressing logically from 30 to 60 per cent as incomes increase. This would still leave it open to the Chancellor to abolish or reduce the highest rates.

For employers there would also be a significant administrative saving in not having to make separate calculations and entries for employee national insurance contributions.

Pensioners who pay tax but not national insurance could be compensated by raising the married and single allowances by £1,385 each at a full-year cost of £775 million, thus ensuring that every pensioner with an income below £18,700 a year would be better off — substantially so for those with less than £10,000 a year. If the price of this protection was considered too high, the lower income pensioners could be helped much more cheaply.

The only slight losers would be those people whose income was exclusively derived from investments and who had no earnings or pension at all — a negligible group which has already benefited enormously from other tax changes since 1979.

A basic tax rate of 30p, coupled with abolition of employee national insurance contributions, would equate with a cut of 6p from the present 27p rate. The total cost, including full protection for pensioners, would be about £9.5 billion a year, achievable within the life of this Parliament if the growth and spending patterns of the past five years are sustained.

Eliminating employee national insurance contributions would be a fairer, simpler and more cost effective way of reducing tax than lowering the basic rate. For Mr Lawson it would have the further advantage of enabling him to retain the 25p basic rate as an objective for his second decade as Chancellor.

The author is Conservative MP for Suffolk South.

FINANCIAL TIMES

No case for leaving CGT

19=

From Mrs Judith Chaplin.

Sir, In your leader last Friday (January 8) you urged the Chancellor to be bold in his reform of taxation, but to ignore calls from the Institute of Directors and others for the abolition of inheritance tax and the scaling-back of tax on capital gains, in order to show "a commitment to fairness and efficiency."

Capital gains, you argue, should be taxed as far as possible like ordinary income, while inheritance tax should be designed to cause the break up of large fortunes, thereby encouraging the diffusion of capital and efficiency of its use.

In the 1970s, redistribution by taxation was a popular notion. But as Professor Sandford pointed out in his article the day after your leader appeared: "High marginal tax rates did not achieve the hoped-for reduction in inequality because they could be avoided and evaded – and the distortions they generated hindered economic growth." The notion is as erroneous when applied to capital taxation as it was when it was applied to income tax.

Inheritance tax may or may not be capable of breaking up large fortunes (probably not, for the owners of large fortunes are adept at avoiding such consequences), but it certainly does not achieve a diffusion of capital in private hands. Its main effect is to discourage the accumulation and passing on of modest sums which are required for private investment and the generation of new business, and which represent a genuinely wider distribution of the nation's wealth.

Capital gains which are, in effect, trading gains should be taxed accordingly, but is there really any case for taxing the growth in value of capital funds? Leaving aside the fact that three-fifths of the yield of CGT is not from an increase in real value, but from nominal gains arising from the inflation of 450 per cent between the introduction of CGT in 1965 and the indexation of gains in 1982, a capital gain is capitalisation of an increase in future (generally taxable) income.

If you tax the capitalised value as well as the income, there is double taxation. Nor is there clear evidence that the abolition of CGT will lead to income tax payers turning their taxable income into non-taxable gains, as you suggest; other developed countries manage satisfactorily without it.

The fair and efficient working of a capitalist society depends on the accumulation of capital in as many hands as possible. This will not be accomplished by high taxation, any more than high rates of marginal income tax led to greater equality of incomes.

And at a time when rates of personal tax are being reduced, there is no case for leaving CGT where it stood when it was introduced in 1965, when the basic rate of income tax was the equivalent of 41 pence in the pound.

Judith Chaplin,
Head of Policy Unit,
Institute of Directors,
116 Pall Mall, SW1

443/016/AC

Chancellor

ptp. 378/15

As I mentioned, this is rather a good read. R 17/2

Thanks. The Opposition gains!

FROM: D I SPARKES

DATE: 15 February 1988

MR CULPIN

MR LAWSON IN OPPOSITION : CAPITAL GAINS INDEXATION

I attach extracts from the Committee stage of the 1975, 1977 and 1978 Finance Bills.

2. As you will see, Mr Lawson preached indexation with missionary zeal. He cannot claim to have tabled the first-ever clause to index capital gains, although his 1975 effort was certainly the first that might have been remotely workable in practice.

3. There are also a couple of interesting remarks on why CGT should be indexed even though other parts of the tax system remain unindexed.

Ch

The Opposition would no doubt have had great fun if you had abolished indexation.

AA

Right!

D I SPARKES

[Mr. Davies.]

I take issue with my hon. Friend the Member for Goole and my hon. Friend the Member for Coventry, South-East (Mr. Wilson), who said that there is injustice to local government workers. There is no injustice. They have been treated in the same way as other employees who have similarly suffered.

The point was made that other employees also suffer. I remember the years between 1966 and 1970 when, as a result of Government policy, the coal mines in my constituency were closed. Miners had to travel longer distances to the remaining pits which were working. They had to bear the cost of travel. If they had been reimbursed for it they would have been taxed on the sums which they received. In the same way, factories can close as a result of rationalisation.

I do not think that a case has been made for this proposed change. If we give relief in this case, we must do the same in numerous others. I refer to people who live out of London, who cannot afford to live in the city, and who travel long distances. If we concede the one we must concede other cases.

I accept that there is a general problem here and that there are difficulties. However, when we look at the wider area we must try to frame legislation to mitigate some of the problems. In that case, we shall find ourselves in greater difficulties. We do not want to give relief to people who chose to live far away, who can afford to travel to work, and who do not need any assistance. I do not think that the discussion on this clause affords the right opportunity to alter the matter.

The original order introducing this concession for local authority employees was meant to last for three years. As a result of representations, I understand that the national joint council has now agreed that the payment of these expenses to employees by local authorities should be extended for a further year. I should not like to say in the presence of the Chief Secretary that that has anything to do with the taxation position. I am sure that it is coincidental. Although that concession has nothing to do with the tax position, there will be an additional benefit. The intention was that the order and the reimbursement should extend for three years.

Mr. Peter Rees: I should like to take the Minister back to the principle which he adumbrated. Under the German fiscal system relief is given for travel to work. Now that we have affirmed our adherence to the Common Market the Minister may feel that we might attempt the harmonisation of our tax systems.

Mr. Davies: The hon. and learned Gentleman is an expert on the English and German fiscal systems. I commend that. I know nothing about the German fiscal system. I concede that the cost of travelling to work is a substantial burden for thousands of people. However, if we tried to frame tax legislation to afford relief to those people we should find ourselves in considerable difficulties. Despite the fact that the Germans may in theory have found a way out, I think that if we tried to frame legislation we should encounter even more difficulties.

Mr. Graham Page: An exception was made for local government servants. The House passed an order saying that they should be reimbursed for these expenses. To that extent they have been recognised in law and by the House as being in an exceptional position. The hon. Member for Goole (Dr. Marshall) said that those people are losing as those expenses are taxed.

Mr. Davies: Those people are now receiving benefit which is often denied to other employees who suffer from acts over which they have no control. Those people receive a benefit. I find it extraordinary that we are now being asked to alter our taxation laws so that they receive an additional benefit. A case has not been made out for that additional benefit. I think that we would encounter other difficulties with other worthy groups if we did that.

I therefore ask my hon. Friend to withdraw his new clause as a result of listening to this debate, and to accept that the benefit will be extended for another year.

Question, That the clause be read a Second time, *put and negatived.*

New Clause 2

INDEXATION OF CAPITAL GAINS TAX

'(1) The sums allowable as a deduction from the consideration for the disposal of an asset pursuant to paragraph 4 of Schedule 6 'eter Rees: I should like to take ister back to the principle which ıbrated. Under the German fiscal relief is given for travel to work. ıt we have affirmed our adherence 'ommon Market the Minister may we might attempt the harmonisa- ɔur tax systems.

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New Clause 2

ːXATION OF CAPITAL GAINS TAX

he sums allowable as a deduction consideration for the disposal of an ·suant to paragraph 4 of Schedule 6

to the Finance Act 1965 shall be altered in accordance with the formula set out below, and any reference in the enactments relating to capital gains tax to any such sums shall be construed as a reference to such sum as altered in accordance with this section—

$$\frac{A \times B}{C} = D$$

where "A" is the sum allowable pursuant to the said paragraph 4;

"B" is the retail price index for the month in which the disposal takes place.

"C" is the retail price index for the month in which the sum allowable pursuant to the said paragraph 4 was expended.

"D" is the sum allowable as so adjusted.

(2) This section applies to disposals after 5th April 1975.

(3) In this section "the retail price index" means in relation to periods from 1st January 1962 the general index of retail prices and in relation to earlier periods an index which shall be published by the Board.'—[*Mr. Lawson.*]

Brought up, and read the First time.

Mr. Lawson: I beg to move, That the clause be read a Second time.

I apologise for the rather algebraic form in which the new clause is couched. I think, however, that it is fairly straightforward. That is why I should like it to be added to the Bill.

The purpose of the new clause is self-evident. I think that it is the most precise way of getting at the purpose. That purpose is to ensure that the gain which is liable to capital gains tax is a real gain and not a paper gain, reflecting a fall in the value of money and the rate of inflation. If, for example, over the period concerned the retail price index were to go up by 50 per cent., the amount that would be deducted from the sale price of the assets to compute the taxable gain would be not the original cost price but one and a half times the original cost price. In attempting to index tax, it is interesting to note that it is the general price index—here the retail price index—that has to be taken.

In Committee upstairs we had debates about the mortgage tax relief limit. I am sorry that the right hon. Member for Down, South (Mr. Powell) has left his place, because he was prominent—as was the Financial Secretary—among those who put forward the misguided argument that if there is indexation, for houses one uses the index of house prices and, presumably, for Stock Exchange securities one uses the Stock Exchange index, and so on. A moment's reflection in the context of capital gains tax will show that argument to be nonsense.

The real capital gain if a house or a security goes up in value is not measured against the index of house prices or the index of security prices but is registered against the cost of living generally—the price index generally. That is the only way to compute the true gain.

The argument that is likely to be put up against the clause might be couched in the form of a question: why single out capital gains tax for indexation and not other aspects of the tax system? I am sure that the Minister of State will put forward that argument but, as he well knows, there is one sense in which I am not singling out capital gains tax. I have argued for the indexation of all aspects of the income tax system—tax thresholds, tax brackets and so on. We have to deal with one matter at a time, and in this clause we are dealing with the indexation of a capital gains tax.

On the more general question of indexation, it may interest the Financial Secretary and the Minister of State to know that the General Sub-Committee of the Expenditure Committee, of which I have the honour to be a member, had before it as a witness on 20th June Sir Norman Price, Chairman of the Board of Inland Revenue. He gave evidence to the effect that there were no technical problems in the way of indexing the tax system and that it would not make any harder the job of estimating the tax yield or the yield of a particular tax in the year ahead. As some of these objections have been raised by right hon. and hon. Gentlemen when we have raised this matter in the past, I thought it might be useful to have on record the evidence given to the Select Committee by the Chairman of the Board of Inland Revenue.

As I say, why single out capital gains tax? In one sense we have not done so, but in another sense the Chancellor did it for us. I draw the attention of the Minister of State to the Chancellor's Budget Statement. The only reference to indexation in the Budget Statement as far as I can recall was when the Chancellor said:

"I know that some people take the view that with present rates of inflation the time has come to introduce indexation for capital gains

[Mr. Lawson.]

tax. I am not yet persuaded that this would be right."

At that time he was not yet persuaded that anything remotely resembling a statutory incomes policy was right. Now that he has been so persuaded, however, perhaps he may by now be persuaded of the rightness of indexing capital gains tax. He went on to say:

"There is, however, evidence that this tax is bearing unduly heavily on those who hold assets for long periods and is too lenient on those who hold for very short periods, and over the coming year I propose to review the incidence of capital gains tax"—[*Official Report*, 15th April 1975; Vol. 890, c. 311.]

That is all very well, but the only conceivable reason why capital gains tax bears hardly on those who hold assets for long periods is inflation and the absence of an allowance for inflation. If we lived in an era of totally stable prices, people who hold assets for a long period would not be at a disadvantage *vis-à-vis* capital gains tax. It seems to me that the Chancellor has agreed—to use a phrase of which we shall hear much more in future in a slightly different context—that capital gains tax is a special case.

6.45 p.m.

There is good reason why it is a special case. In the context of the indexation of income tax, the income is there. In real terms it may be slightly less than it appears to be and, therefore, the taxation is a little too high, but the income is there and it is being taxed. With capital gains, however, there are many cases where in real terms there is no capital gain but there is a loss. Something which is totally non-existent in reality is being subjected to a tax which is specifically meant to be confined to capital gains. That shows that the Chancellor was justified in considering capital gains tax to be a special case.

I am well aware that this point is not a new one. As long ago as the debates in Committee on the 1972 Finance Bill, my right hon. Friend the Member for Wanstead and Woodford (Mr. Jenkin), who was at that time Chief Secretary, said:

"it would be unjust to tax paper profits—profits that are not genuine because they are due to a rise in monetary not real value."—[*Official Report*, 10th July 1972; Vol. 840, c. 1354.]

It is worth bearing in mind why capital gains tax was introduced in the first instance. I quote from what the then Chancellor of the Exchequer—the present Foreign and Commonwealth Secretary—said in his Budget Statement in 1964:

"I intend to make a start next spring with two major tax reforms. The first will be a capital gains tax. The dividing line between capital and income has become blurred. The income tax system has been misused by some to avoid paying income tax by entering into arrangements which dress up income, which is taxable, to look like capital, which is mainly untaxed."—[*Official Report*, 11th November 1964; Vol. 701, c. 1039.]

What the then Chancellor of the Exchequer of the then Labour Government was trying to catch was a form of income dressed up as capital. It has turned into a totally different tax—a tax that is not a tax on income, however disguised, but a tax on capital, a form of wealth tax.

Again, I quote what was said by the Financial Secretary's immediate predecessor—now Minister of Transport—in Committee on the 1973 Finance Bill. Referring to one of my hon. Friends, he said:

"He sees this as a form of wealth tax"—

that is, capital gains tax—

"and I accept that. It is an arbitrary form of wealth tax, however, because it falls on those who have to realise their assets in certain circumstances . . . the way in which we tax capital gains at the moment is unfair, and I believe that we can remove the element of inequity, which is what the clause is attempting to do. In order to get an overall fairness into our tax system, however, as far as capital is concerned, we ought to have a wealth tax."—[*Official Report, Standing Committee H*, 23rd May 1973; c. 615.]

As right hon. and hon. Members will know, a Select Committee, of which I have the misfortune to be a member, is beavering away at the wealth tax. Indeed, I think that the Committee is sitting at this moment. Capital gains tax has turned into a totally arbitrary kind of wealth tax and it can no longer have any justification in anything like its present unindexed form. That is why last June, during the passage of the Finance Bill, we moved a similar clause to the one now before us. My right hon. Friend the Member for Carshalton (Mr. Carr), who was then Shadow Chancellor, said:

"We shall not get strength and confidence in investment if at one and the same time we have inflation at this rate and real capital losses and then insist on taxing not capital gains but capital losses."—[*Official Report*, 13th June 1974; Vol. 874, c. 1974.]

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ll not get strength and confidence nt if at one and the same time lation at this rate and real capital then insist on taxing not capital pital losses."—[*Official Report*, 13th Vol. 874, c. 1974.]

On that occasion we divided the Committee, but I am sorry to say that the Government had a majority of 18 votes. It is clear from what I have quoted that it is accepted on both sides of the House that the capital gains tax, which was originally introduced to deal with income dressed up as capital, has now become an arbitrary, unfair and capricious tax on wealth.

Indeed, it is a tax which is imposed at a very high rate. That is not fully realised. During the past year we have had inflation running at a rate of 25 per cent. Let us assume that an asset—it does not matter what it is; it can be any asset liable to capital gains tax which has increased in value but only in line with the rate of inflation, thereby producing no gain in real terms but merely holding its value—is subject to capital gains tax at 30 per cent. on a notional 25 per cent. appreciation. That is equivalent to a 6 per cent. wealth tax—namely, a 6 per cent. tax on the full capital value. I can see that the Financial Secretary is having difficulty so I shall explain the position to him. He will understand that 30 per cent. of 25 per cent. is 7½ per cent., and that 7½ as a percentage of 125 is 6 per cent. That is equivalent to a 6 per cent. wealth tax.

Let us consider the rate at which wealth tax is applied overseas. In Germany, for instance, the top rate is 0·7 per cent. In the country in Europe which has the highest wealth tax rate—namely, Sweden—the top rate is 2½ per cent. Even in the Green Paper issued by the present Government the two top rates chosen for the alternative systems are 2½ per cent. and 5 per cent. Those rates would not be brought into effect except for wealth amounting to £5 million. Here we have a 6 per cent. wealth tax on sums which, far from being in excess of £5 million, are probably so low that they would not be subject to wealth tax as proposed in the Green Paper. This is not only an arbitrary and unfair form of wealth tax but a swingeing wealth tax. It is being imposed at a time when our capital taxation is higher than in any other country in Western Europe as a proportion of GNP and as a proportion of total tax revenue.

It is true that the wealth tax as such has not yet been introduced. Having heard certain evidence, I hope that if it is introduced it will not be anything remotely resembling the form in which it is presented in the Green Paper. Further, if it is introduced I hope that there will be substantial offsets. Of course, since the various debates that I have mentioned we have had a further capital tax imposed—namely, capital transfer tax. The interaction of capital gains tax with capital transfer tax is of the utmost seriousness. The combined effect of those two taxes on transfers could be crippling to small businesses and farms.

We pressed very hard for a reduction in the severity of capital transfer tax, but the Chief Secreary and his colleagues took the view that it was not capital transfer tax we should be going for but capital gains tax. They conceded that the two taxes together were much more severe.

I shall quote what the Chief Secretary said on this matter in Standing Committee. After being tackled on this point—namely, the accumulation of capital gains tax and capital transfer tax—he said:

"I hasten to add that I accept that in certain instances it can be unfair. Where a man has been running his company from 1965 for 10 years a substantial liability to capital gains tax would accrue. The answer there lies more with a reform of the capital gains tax, whether it be by way of indexation, which the hon. Gentleman"—

that is, myself—

"is so fond of, or another way which others may prefer, a more progressive or different way of dealing with capital gains tax."—[*Official Report, Standing Committee A,* 11th February 1975; c. 1176.]

Perhaps we shall be told the nature of that different or more progressive approach. Thus it was conceded by the Chief Secretary that the accumulation of the two taxes was excessive in its effect and that we should deal with the problem of capital gains tax. That is what we seek to do by means of the clause.

The time has come for the talk to end and for the Government to act. As an Opposition we are in the inevitable difficulty that we can recommend only matters that would cut revenue; we cannot recommend any changes that would increase revenue. I hope the right hon. Gentleman will take it from me that we do not wish to do anything which would lead to an increased public sector borrowing requirement. Of course, we cannot cut Government expenditure as we would wish. We must remember that in the

[Mr. Lawson.]
White Paper it is made clear that the Government wish to increase subsidies.

I hope that in this debate we shall be told the total yield of capital gains tax. I understand that in the coming year it is expected to be £325 million. How much of that would be lost by acceptance of the new clause? Perhaps we shall be told what the rate of wealth tax already is in this country—namely, the wealth tax element in capital gains tax. These matters will be of considerable interest to the Select Committee.

Let us have no more prevarication. I hope we shall not hear the argument that this is not the time to act because we do not have a serious rate of inflation. That suggests that inflation is something evanescent and ephemeral in our society. I wish it were so. Given the Chancellor's target of a rate of inflation of 10 per cent. by September 1976, to talk about inflation as something ephemeral is an insult to the House.

Mr. Ridley: We should pay tribute to my hon. Friend the Member for Blaby (Mr. Lawson) for his assiduous pursuit of indexation on all occasions. I have always had some doubts about the argument for indexation of direct taxation. I believe that indexation of direct taxation would have great advantages if we were ever to have a Government who sought to reduce the rate of inflation. It is a necessary concomitant of a return to stable money. Since, instead, we have a Government who have just announced a packet which will put up the rate of inflation, based on seeking to increase the borrowing requirement, I am not so certain that indexation is appropriate in that respect. However, I entirely agree with my hon. Friend the hon. Member for Blaby that indexation of capital gains tax is highly desirable.

7.0 p.m.

If we go back through the history of this tax we can see how Governments change their objectives and how their aims become corruptive. You yourself, Mr. Speaker, in your wisdom and with the purity of your motives, introduced a short-term capital gains tax designed to tax speculators on quick profits. It was the mood of the day to hit those who go into a market and come out again within six months, so that they should pay some part of that profit to the community. I was not particularly enamoured of that proposal. I believe that the speculator plays an important part in society. Anybody who seeks to pursue commodity agreements and to stabilise prices of commodities is seeking to perform the function performed by speculators.

The Labour Party then introduced the long-term capital gains tax, and in due course my right hon. Friends recognised the situation by abolishing the short-term capital gains tax which you had introduced, Mr. Speaker, and they kept the long-term capital gains tax against which they voted when it was introduced. It is strange that that which we voted against we kept, and that that which we introduced we abolished. But that is history.

All those taxes were devised to catch the quick profit. What we now have is a permanent and swingeing levy on capital—and the steeper the rate of inflation the more punishing—and a charge upon the change from one asset to another. This is a capricious and arbitrary form of tax. It is particularly obnoxious because the higher the rate of inflation the more swingeing is the tax. It is a tax on those who have capital assets, and the rates are determined not by any sensible criterion but by the extent of the profligacy of the Government. The more profligate they are the more of the capital stock of individuals they seek to take.

I believe that the Chief Secretary is right to review this tax. I am astonished that he has gone that far. The Chief Secretary is such an attractive and charming man that one is inclined to be beguiled by him. I thought the right hon. Gentleman would have had nothing to do with the tax at all, but that was a wrong assumption. I believe that the right way to review the tax is to abolish it altogether. We have now the capital transfer tax and we are promised a wealth tax. Therefore, there is no need to have a capital gains as well, but if it is to stay, very much the second best course would be to index it.

What worries me is the Chief Secretary's use of the word "progressive" in the passage quoted by my hon. Friend the Member for Blaby. I have a suspicion that in the present context that

TELLERS FOR THE NOES:

Mr Joseph Harper and
Mr Joseph Ashton

New Clause 6

CAPITAL GAINS TAX INDEXATION

'(1) For the financial year 1977-78 and subsequent years the sums allowable as a deduction from the consideration for the disposal of an asset pursuant to paragraph 4 of Schedule 6 of the Finance Act 1965 shall be altered in accordance with the formula set out below, and any reference in the enactments relating to capital gains tax to any such sums shall be construed as a reference to such sums as altered in accordance with this section—

$$\frac{A \times B}{C} = D$$

When "A" is the sum allowable pursuant to the said paragraph 4;

"B" is the RPI for the month in which the disposal takes place;

"C" in the RPI for the month in which the sum allowable pursuant to the said paragraph 4 was expended.

"D" is the sum allowable so adjusted.

(2) This section applies to disposals so adjusted.

(3) In the section "the retail price index" means in relation to periods from 1st January 1962 the general index of retail prices and in relation to earlier periods an index which shall be calculated and published by the Board.'—[*Mr. Pardoe.*]

Brought up, and read the First time.

Mr. Pardoe: I beg to move, That the clause be read a Second time.

This clause concerns the indexation of capital gains. It will be familiar to the hon. Member for Blaby (Mr. Lawson), because it is the very clause that he tabled last year after great discussions with his various advisers. I make no apology for tabling the same clause. After going backwards and forwards with every conceivable piece of advice about how to draft an indexation to capital gains tax clause, we came to the conclusion that this was the only way to do it.

[Wrong: it was tabled in 1975]

The principle of capital gains tax is good. Where the possessor of capital enjoys a real gain, that gain is in a sense income. Indeed, if we had a sensible income tax structure, there would be much to be said for calling a spade a spade and including capital gains as income for tax purposes. I do not recommend that we should do that. I do not recommend it because our income tax structure is so unreasonable.

The principle that I support is that which involves tax on real capital gains. Gains on a capital asset which, because of inflation, are not capital gains at all merely enable the real value of an asset to be maintained.

10.15 p.m.

Let us suppose that a man bought an asset for £5,000 in 1972 and that that asset has increased in value to £10,000 since then. That man will be taxed at 30 per cent. on the alleged gain of £5,000. His tax will be £1,500. If he sells the asset he will receive £8,500 net after tax. The cost of living, measured by the retail price index, has doubled since that time. The sum of £8,500 will therefore be worth only that which £4,250 was worth in 1972. That man's original investment of £5,000 has become only £4,250 in real terms after five years. That is not a capital gains tax. It is a capital tax. It is a wealth tax.

I am in favour of a wealth tax as a replacement for investment income surcharge, the high rates of income tax and the general reform of our tax laws. I am not in favour of a wealth tax on top of our present tax structure. Let us not have a wealth tax by the back door. Let us do it by the front door. We should not tax a gain which merely compensates for the fall in the value of money.

The Government will say that this is an expensive clause. It may be. If the Government want to tax wealth they should bring forward a comprehensive and sensible wealth tax. They should not seek to tax wealth by this method because it taxes "phoney" gains which do not exist except in the imagination of the Inland Revenue and the Treasury.

Mr. Cope: On this occasion I am delighted to support the spokesman for the Liberal Party, the hon. Member for Cornwall, North (Mr. Pardoe). This is not a new issue. We have discussed it in successive Finance Bills for many years.

Capital gains tax is the wrong title for that tax. I was interested to notice that an amendment, which was not called suggested that capital gains tax should be called "inflation gains tax". It was a simple amendment. It was delightful in its neatness and simplicity.

Mr. Pardoe: It would not cost any money.

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capital gains. Many investors buy shares in building societies or put their money into building societies. They suffer from inflation. The value of their deposits, and, indeed, the value of the interest that they receive, is reduced by the effect of inflation. They are investors, but the clause would not help those investors. The hon. Gentleman refers to merely one kind of investor, but not all investors make capital gains.

Mr. MacGregor: If the Minister believes in the argument that he was using just before my hon. Friend the Member for Macclesfield (Mr. Winterton) intervened, why did the Government introduce index-linked savings bonds, and is that not an example of discrimination against the institutions and even individuals who are trying to attract savings?

Mr. Davies: I entirely accept that there is a certain amount of discrimination. But we are not living in a perfect world. There are certain areas in which it is believed that a certain group needs to be protected more than others against the ravages of inflation, which would seem quite different from saying that those who are able to make a capital gain should also get that benefit. However, I accept that there is a slight discrimination.

We should be wary of going along this road, otherwise we shall end up by thinking that we have solved the problem of inflation when, of course, we have not done so.

The clause calls for indexation on the basis of the retail price index. That is an unfair way of dealing with the problem. The hon. Member for Cornwall, North (Mr. Pardoe) looks surprised. I see RPI in several parts of the clause. I am right, am I not?

The hon. Member for Gloucestershire, West (Mr. Cope) gave a good example. He said "If I bought agricultural land at a low price and then found coal or oil under it and made a vast profit, why should I be allowed to index that profit to the retail price index? That gain might have nothing to do with the retail price index." Indeed, one might make a gain on property shares which had nothing to do with the RPI. The Sandilands Committee did not recommend that its form of indexation should be related to the retail price index. We cannot have one RPI for all the different sorts of asset. I suggest that is a major flaw in the clause. [*Interruption.*] It is suggested that it is a bad point. There are many reasons why a person makes a capital gain. A gain may have nothing to do with the retail price index. Why should someone get the benefit of an increase in the retail price index? I suggest that there must be different indices, to be fair, in deciding what part of a gain should be indexed.

Mr. Lawson: I am sure that the Minister does not want to display himself in public as an intellectual pigmy. He will surely appreciate that a capital gain is measured in terms of money. The retail price index measures the decline in the value of that money. We are talking about determining a true non-inflationary monetary gain. This has nothing to do with the particular price of coal, land or anything else.

Mr. Davies: The inflationary gain, according to the clause, is computed by reference to the retail price index. I suggest that might be unfair in relation to a particular asset. The RPI takes account of many factors. If the hon. Gentleman studies the Sandilands proposals, he will see no suggestion that the gains, profits or valuation of assets should be related to the retail price index.

It is interesting that the hon. Member for Norfolk, South and others suggested that if we were to go along this road we should have to look again at our capital gains tax system and provide a higher tax for a gain made over a short time, and that we should have to consider bringing back a short term gains tax to take account of speculative gains made over one or two years.

The main objection to the clause is that indexation is not the right way to deal with the problem. We should not index one form of taxation without looking at the whole area of taxation. Indeed, we should look at other areas of financial and commercial transactions.

I do not know whether the hon. Member for Cornwall, North will seek leave to withdraw the motion. If not, I ask the Committee to reject it.

Mr. Lawson: I have been silent up to now. Indeed, I have made no contribution at all during the whole of the Com-

[Mr. Lawson.]

mittee stage on this Finance Bill. It has been difficult for me to do that. Indeed, this would have been the first indexation deabte on any Finance Bill, since I have been a Member of Parliament, in which I had not taken part.

Mr. Budgen : My hon. Friend is taking part now.

Mr. Lawson : I was about to say that it would have been the first indexation debate in which I had not taken part, but the Minister's lamentable reply has prompted me to rise.

Mr. Robert Sheldon : The hon. Member for Blaby (Mr. Lawson) said the same thing last year, too.

Mr. Lawson : The Financial Secretary reminds me—I had forgotten—that he made a very bad reply last year, too. As a matter of fact, it was not last year. The hon. Member for Cornwall, North (Mr. Pardoe) had the courtesy to point out that this clause was the clause that I moved last year. To put the record straight, I tabled it originally the year before last. If the hon. Member for Cornwall, North cares to look at New Clause 2 which I moved on 16th July 1975 he will find that that is the *fons et origo* of the clause that we are debating tonight.

The clause has been criticised by the right hon. Member for Down, South (Mr. Powell) and the Minister. I shall deal with that in a moment with all the brevity that I can command. [*Interruption.*] It may not be a great deal because we have had the benefit of what the right hon. Gentleman called a seminar. We should debate the matter seriously and at some length.

One or two of my hon. Friends—the Minister hinted at this—said that they would be better disposed towards a tapering system rather than this explicit indexation. I do not have a copy of the amendments with me, but I believe that there is a new clause to taper capital gains on the Notice Paper for the Standing Committee. I hope that we shall repeat this debate even more fully upstairs. Hon. Members on all sides of the Committee will have the opportunity to discuss the question of tapering and perhaps vote on it.

My hon. Friend the Member for Gloucestershire, South (Mr. Cope)—or was it the hon. Member for Cornwall, North?—said that this might be an expensive clause. It is always important to discuss costs. It is right to bring that up. It was striking that the Minister at no time said what it would cost if the clause were to be accepted. That is strange, because Ministers invariably say what would be the cost of accepting a clause. On this occasion, the Minister said nothing at all. Yet the uncertainties about the cost are exactly the same as the uncertainties about the yield from capital gains tax. It is estimated that the yield for next year will be £330 million. Last year the estimate was £400 million but the yield was £320 million—a 20 per cent. error. It is surprising that the Government can give no estimate of the cost of the clause. It might not be great. Alternatively, it might be so great that it is horrific and they wish to suppress the amount that they are gaining from inflation. Whatever the reason, we should be told. [*Interruption.*] If the figure was in between, as the Minister suggests, I suspect that the estimate would be given with the alacrity with which such figures are usually provided.

The right hon. Member for Down, South said that he was against this, not because he felt that the inflationary element in a capital gain should be taxed. He did not think that any element of a capital gain should be taxed or that there should be any capital taxation at all.

That is a point of view for which there is a considerable argument. But if the right hon. Gentleman feels that way surely that is sufficient reason for him to go some of the way. I do not think that the whole should be the enemy of the part. I do not think that the best should be the enemy of the good. I should have thought that he would have supported something that goes part, or a large part, of the way towards what he wanted to do.

The right hon. Gentleman said that there were three kinds of capital gains—inflation, a relative gain and the other which is derived from income being transferred into capital through the mechanism of saving, and he said that if that is taxed in the form of capital, it is taxed twice, because it has already been taxed

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as income. That was what I understood him to be saying.

11.30 p.m.

Let us consider what might happen in a totally non-inflationary economy. Suppose that a painter got together certain pigments and used them to create a masterpiece of art. He would have created a capital asset of considerable value, but there would be no flow of income from it because a painting is not an income-producing asset.

Mr. Denzil Davies: Surely the hon. Gentleman must be aware that painters are subject to income tax just like everyone else. A painter would pay income tax on the profits of the disposal of the asset.

Mr. Lawson: That does not answer the point. A capital asset like a factory is valued by the multiple of its earnings and by the income that it produces. That is not so with a painting. I am surprised that Ministers should dispute that, because the whole of their case for recommending the introduction of a wealth tax is that there are assets which produce no income and that it is important somehow to tax them.

The economists have a term for that. They say that a painting creates psychic income, but there is no taxation of that. Unless the right hon. Member for Down, South, can weave that into his model, I cannot see that there are only three exclusive categories of capital gain.

My hon. Friend the Member for Wolverhampton, South-West (Mr. Budgen) also made a contribution—[*Interruption.*] Judging from the cheers from the Government Front Bench, it seems that Ministers agree with what my hon. Friend says. No doubt they will continue to take that view when he speaks in Standing Committee. My hon. Friend seemed to be advancing a strange theory on how to cure inflation. He must surely understand that the clause has nothing to do with curing inflation, however. The hon. Member for Cornwall, North did not advocate it as such, and I know of no one who does.

My hon. Friend said that inflation will be cured only by the infliction of pain. I should have thought that we had had enough of pain. Evidently he thinks that the answer to inflation is to have more and more of it, however. It seems that the cure also lies in the mechanism of the popular will. It is evidently not Governments that have a responsibility for the cure. It is the population, and until the populace is punished sufficiently the popular will will not provide a cure for inflation. I confess that I was not convinced by that thesis. Therefore, I was not convinced by my hon. Friend's opposition to the clause. I believe that the rest of my hon. Friends were in favour of the clause. I found their arguments more convincing.

The Minister, who could have done with some tuition from my hon. Friend the Member for Macclesfield (Mr. Winterton), made a lamentable speech. He seemed to think that the clause was being proposed as a cure for inflation. It was not proposed as a cure for inflation; therefore, to say that it was not a cure for inflation was no argument against it.

The Minister also said that the clause created a benefit for some people and not others. I have news for him; any tax change in any Finance Act creates a benefit for some—if it is a reduction in taxation—and not for others. That is no argument. The question is whether these people have been unfairly treated hitherto.

It has been pointed out cogently by the hon. Member for Cornwall, North and my hon. Friends that that is indeed the case. The Minister's speech was a marked retreat from the speeches of previous Ministers. This is rather worrying. Even the Chancellor of the Exchequer, when introducing the 1975 Budget, said, on the very question of capital gains tax:

"There is, however, evidence that this tax is bearing unduly heavily on those who hold assets for long periods and is too lenient on those who hold for very short periods, and over the coming year I propose to review the incidence of capital gains tax."—[*Official Report*, 15th April 1975; Vol. 890, c. 311.]

He admitted that there was a need for a review of the incidence of capital gains tax in the light of inflation, but nothing has happened since then. What is the result of that review? We have not been told. We should have been told what that review threw up, even if it led the Chancellor to believe that no action should be taken.

[Mr. Lawson.]

A previous Treasury Minister, in a previous Finance Bill Committee stage debate—this is the Minister whom we love so much and who changes from Department to Department so often that I forget which one he is in now; the hon. Member for Dudley, East (Dr. Gilbert)—said, about another hon. Member of the Committee, on the subject of capital gains tax:

"He sees this as a form of wealth tax and I accept that. It is an arbitrary form of wealth tax, however, because it falls on those who have to realise their assets in certain circumstances . . . the way in which we tax capital gains at the moment is unfair."—[*Official Report, Standing Committee II,* 23rd May 1973; c. 615.]

That was one of the Minister's predecessors. Yet we now have the Minister backsliding, with no admission of unfairness.

The Chief Secretary has also said that the capital gains tax was unfair. He said that we have to find

"a more progressive or different way of dealing with capital gains tax."—[*Official Report, Standing Committee A,* 11th February 1975; c. 1176.]

The Government have had two years now. What more progressive or different way of treating capital gains tax are they presenting to us? The Chief Secretary has been ready to admit that the interaction of capital gains tax in its present form—capital transfer tax—causes a heavy, severe, punishing and wholly unfair and unacceptable form of taxation in many circumstances. He has convinced us. If he wishes me to quote his exact words I shall do so. They come from last year's debate. In 1975 he said:

"Let me turn now to capital gains tax. The arguments about capital gains tax indicate a need for an examination of that tax. That I do not dispute."

He pointed out the problems of interaction, and then went on:

"The answer there lies more with a reform of the capital gains tax, whether it be by way of indexation which the hon. Gentleman is so fond of, or another way which others may prefer, a more progressive or different way of dealing with capital gains tax."—[*Official Report, Standing Committee A,* 11th February 1975; c. 1175-6.]

Yet now we have no admission at all from the Government, no news of a review or a more progressive or fairer means of levying capital gains tax.

There is one point that is worrying some of my hon. Friends and also seems to give some concern to the Minister. The right hon. Member for Down, South and some others have said that if one part of the system is indexed the lot must be indexed. This is manifest nonsense. The right hon. Member adduced no argument to suggest that this should be so.

Many parts of our system are already indexed. We have index-linked bonds, stock appreciation relief, inflation-proof pensions, and indexation in many other forms. Is the right hon. Member really saying that there should be no regular increase in pensions along with the cost of living because this is indexation? Is he saying that the threshold of taxation should not go up in line with inflation? This is a nonsensical proposition. But in any event capital gains tax is clearly a special case. The reason why capital gains tax is special is that other taxes, which relate to specified monetary sums, can be changed each year. In the words of the Financial Secretary—and I am glad to see him in his place—they can be revalorised. They are reviewed each year, and every so often the thresholds are put up and allowances raised. But capital gains tax, by its very nature, cannot be adjusted each year because it is not a tax relating to the events of one particular year, nor to any specified monetary sums. It relates to a period going back over a long time. There is no way in which capital gains tax can be annually reviewed. It can only be reconstructed—by indexation or by tapering, which is a rough and ready means.

The Government review every tax every year—even capital taxes such as capital transfer tax, where the limit of £15,000 could be put up next year by 10 per cent. or 15 per cent.—except capital gains tax. Because it is concerned with money at different times it cannot be revalorised or reviewed in this way. It is, therefore, uniquely necessary to reconstruct capital gains tax.

I urge the Minister to go back to those who provide his brief and ask them to provide him with a better brief so that when we come to discuss the new clause on tapering in Committee upstairs there will at least be arguments with a veneer of respectability about them.

The Minister of State gave us some indication of the severity of this tax, as one point that is worrying hon. Friends and also seems concern to the Minister. The ember for Down, South and have said that if one part is indexed the lot must be is is manifest nonsense. The Member adduced no argu- est that this should be so.

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Minister to go back to le his brief and ask them with a better brief so that o discuss the new clause Committee upstairs there arguments with a veneer about them.

of State gave us some severity of this tax, as

did the hon. Member for Cornwall, North. For the period this Government have been in office the rise in prices has been about 75 per cent. This means that if an asset maintained its real value and was worth £100 when the Government came to office it is now worth £175. That is a notional gain of 75 per cent. A figure of 30 per cent. capital gain (on that sum of £175 means a tax of £22·50, which is a tax of about 13 per cent. I hope that the Minister is with me so far. That is a wealth tax of 13 per cent. Admittedly, it is spread over a three-year period because this Government have been in office for three years. That represents a wealth tax of 4 per cent. a year. Yet the highest annual wealth tax in Europe is that imposed by the Swedish Government amounting to 2½ per cent. Our wealth tax of 4 per cent. a year is, therefore, a severe tax. This aspect of capital gains tax is no mere technicality. It is pre-eminently a wealth tax and a wealth tax of the utmost severity.

I hope that the Minister will try to reply more fully to these arguments when he deals with these matters upstairs. I hope that he will pay more attention than he is paying now while chatting to the Financial Secretary.

Mr. Robert Sheldon: We are checking the figures.

Mr. Lawson: The figures are right; do not worry about that. I hope that the Minister of State will remember the Chancellor's promise to review this matter and will come forward with something better upstairs or later on Report.

11.45 p.m.

Mr. David Howell: My hon. Friend the Member for Blaby (Mr. Lawson) is to be congratulated on the brevity of his speech, into which he was forced spontaneously and unwillingly by the provocative remarks of the Minister of State in summing up the earlier part of the debate.

There should be no apologies in respect of the right hon. Member for Down, South (Mr. Powell) for treating us to a seminar. As usual, his remarks provoked thought, and he was right to remind us of the nature and accumulation of capital and of the fact that capital itself is a simpler and more elusive concept than might be inferred from hearing the word "capital" as it drops from the lips of tax reformers or economists or as it is thrown about in debates in Parliament.

But when the right hon. Gentleman takes us on to his proposition that it is better that we do nothing in addressing ourselves to capital—because in principle he is against all taxation on capital—I do not think it follows that because we cannot do everything we can do nothing. I think that we should proceed on that path. There is progress to be made, and we should not let "ambition mock" our "useful toil" in this area.

There is progress to be made in this sphere. Two years ago we thought that the Government would make some progress, but the review has been lost in the spiral of reviews, there have been further delays and nothing much will happen on the Treasury Bench.

There are two aspects of the clause which have been discussed. There is the indexation aspect, and our position on indexation—obviously the word is elastic and can be stretched to mean many things—is that it should become the custom in this House that each year Chancellors of the Exchequer and Chief Secretaries should acknowledge the effect of inflation and rises in prices on the real impact of taxation. Money values should be appropriately adjusted and set before Parliament, and the Chancellor should explain clearly why he wishes to raise taxation if he does not want to make the full adjustment. That is what we mean by the principle of truth in taxation.

It is a principle which Labour Members should embrace with more vigour than happened in the run-up to this Budget when an absurd degree of pretence was mounted from December onwards that the Government would do wonderful things, that this would be the last Budget before the Chancellor went to the Foreign Office, and that there would be all sorts of tax concessions. By the time we reached it, the public had rumbled and had realised that what were being trumpeted as tax concessions were not tax concessions at all but temporary checks in the ever-rising level of real taxation. That is the indexation side.

[Sir G. Howe.]
of the calculation I was giving, they are the relevant figures. They represent the permanent growth in the size of the staff of these Departments as reported to the House in successive parliamentary answers.

Mr. Joel Barnett *rose*——

Mr. Stan Thorne (Preston, South): On a point of order, Sir Myer——

The First Deputy Chairman: Order. I confess that I find points of order one of the most difficult aspects of occupying the Chair. One is always told that one cannot say that anything is out of order until the point of order has been heard. But, having heard what I have just listened to from both sides, I think that the whole business is absolutely irregular. It has nothing whatever to do with the Chair. I am here to conduct the Finance Bill and to permit hon. Members to start discussing New Clause No. 1. Therefore, I do not propose to allow any further discussion on the point of order. There are other methods, well known to both sides, by which this matter can be raised. What has happened is irregular. I am therefore calling New Clause No. 1 —Sir Geoffrey Howe.

Mr. Joel Barnett: Further to that point of order, Sir Myer. A very serious accusation has been made against me personally as a Minister giving incorrect information to the Committee. The right hon. and learned Gentleman has once again misled the Committee. I ask him to withdraw his accusation. It is quite disgraceful.

Sir. G. Howe *rose*——

The First Deputy Chairman: Order. We are not going to carry on with this. We are here to discuss the Finance Bill.

Sir G. Howe: Further to that point of order, Sir Myer. I have quoted from the parliamentary answers given to Questions tabled by my hon. Friends. The figures that I quoted are founded on those parliamentary answers and on the figures quoted in the annual reports of the Commissioners of the Board of Inland Revenue, and the only figures quoted in those annual reports.

Mr. Joel Barnett: That is not true.

The First Deputy Chairman: Order. There are many methods whereby this matter can be pursued other than by addressing points of order to the Chair. I want to get on to the business that we have down for consideration.

Mr. Thorne: Further to that point of order, Sir Myer.

Mr. Nicholas Ridley (Cirencester and Tewkesbury) *rose*——

The First Deputy Chairman: I am not taking any more points of order. I have indicated that quite clearly. The whole thing is irregular.

Mr. Ridley: I beg to move, That the Chairman do report Progress and ask leave to sit again.

The First Deputy Chairman: I am not accepting the motion.

New Clause No. 1

INDEXATION OF CAPITAL GAINS TAX

'(1) At the end of section 20(4) of the Finance Act 1965 there shall be added the words "Provided that the said total amount shall be multiplied by the retail price index for March in the year of assessment and divided by 100."

(2) At the end of section 20(7) of the Finance Act 1965 there shall be added the words:

"(8) The amount of the chargeable gains shall be computed as provided in this Act subject to the amount of the consideration, the value at 6th April 1965, and the sums allowable under paragraph 4 of the Sixth Schedule to this Act, being adjusted by applying thereto the fraction $\frac{100}{Y}$, where Y is the retail price index at 6th April 1965 or for the month in which the acquisition for disposal is deemed under this Act to occur.

(9) In this section "the retail price index" means in relation to periods from 1st January 1962 the general index of retail prices and in relation to earlier periods an index which shall be, calculated and published by the Board."

(3) The provisions of this section shall apply for the year 1978-79 and subsequent years of assessment.'.—[*Mr. Lawson.*]

Brought up, and read the First time.

Mr. Nigel Lawson (Blaby): I beg to move, That the clause be read a Second time.

The new clause stands in the name of my right hon. and learned Friend the

› **First Deputy Chairman:** Order. are many methods whereby this : can be pursued other than by add- ; points of order to the Chair. I to get on to the business that we down for consideration.

Thorne: Further to that point of Sir Myer.

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Member for Surrey, East (Sir G. Howe), who I must say is owed an apology by the Chief Secretary——

Mr. Joel Barnett *rose*——

The First Deputy Chairman: Order. I think it is unfair of the hon. Member for Blaby (Mr. Lawson) to introduce a topic when I have said that it is out of order. I hope that he will conduct himself appropriately to the dignity of the Committee.

Mr. Lawson: This is a matter which is not new to the Committee, but I make no apology whatever for bringing it before the Committee again on this occasion. It is a new clause to index the capital gains tax—[*Interruption.*] May I have some protection, Sir Myer, from the non-stop chattering——

The First Deputy Chairman: Order. I think that the hon. Gentleman is getting more interference from right hon. and hon. Members on his own side of the Committee than he is geting from the other side.

Mr. Lawson: This is a matter which has been raised on a number of occasions, in previous Finance Bill Committees and in the House on Report, but I make no apology for again raising the matter, because we have had, since it was last debated on the Report stage of the Finance Bill last year, a very important document from the Inland Revenue on this subject. This carries the matter a little further, and in that sense it is a most helpful document. The fact that it does not carry it to a successful conclusion from the Opposition's point of view, and, I believe, from most of the Committee's point of view, is a matter which we hope can be put right even at this late stage.

Perhaps it might be as well to put the matter into perspective. The question has been raised in previous debates on this matter by, I believe, the right hon. Member for Down, South (Mr. Powell) about whether there should be any capital gains tax at all, or whether there should be any capital taxation at all. It is my view, and the view of my right hon. and hon. Friends, that there should be capital taxation. But it is not at all clear to us that there need be a whole battery of capital taxes in order to achieve the taxation of capital.

At present we have, at the very least, four major taxes on capital in one shape or form. We have a surcharge on investment income, capital transfer tax, stamp duty—one part of which we shall be coming to shortly—and we have capital gains tax. It seems dubious whether we need the last-named tax at all.

If the total amount of capital taxation is adequate—whatever is considered to be adequate, and there might be differences of opinion within the Committee on that—do we need four totally separate taxes on capital to achieve it?

If we are to have a tax on capital gains, it should be just that—a tax on genuine, real capital gains and not on paper gains. Yet it has been revealed in a recent speech by one of the Treasury Ministers that before the minor changes introduced in the Budget, of the total expected yield this year from capital gains tax of £390 million in a full year, no less than £350 million was the result of purely inflationary gains—paper gains —and only 10 per cent. of the yield was derived from genuine gains.

I have no idea whether that is right or wrong, and, no doubt, the Minister will confirm or deny it. All I know is that that is the figure that was thrown across the Chamber by Ministers in an earlier debate. But we are concerned about the principle of whether inflationary gains, which are only paper gains, should be taxed.

Mr. Ron Thomas (Bristol, North-West): Is the hon. Gentleman suggesting that his party wants to give another tax handout of £350 million to the wealthy section of our society?

Mr. Lawson: I thought I made quite clear that we are concerned here with justice. Despite the jeers of hon. Members below the Gangway, this is accepted by all those who have made a serious study of the matter and is, indeed, why the Inland Revenue, under instructions from the Treasury, produced the document of 5th October to which I have already referred.

While we are talking about the cost, another point is that, whatever the cost may be, no cost will fall on the borrowing requirement this year. It is clearly stated in the clause that it will come into effect only for gains made this year. Any

[Mr. Lawson.]

tax payable on gains made this year, whether at the present level or any diminished level, will not affect the revenue until next year, 1979-80. So it has no effect whatsoever on the borrowing requirement this year.

The capital gains tax covers two different types of gain—that is, genuine gains in the real value of the asset which has been disposed of, and gains which are not real gains at all—gains which arise on paper because the asset appears to have increased in value when disposed of although in fact, because prices generally have increased, the true value of the asset may not have increased at all.

What we have here is a substantial and capricious wealth tax. This has been admitted by Treasury Ministers in past debates, and those who have come lately into our debates should not attempt to contest it unless they have studied the matter rather more deeply than the hon. Member for Bristol, North-West (Mr. Thomas) has done.

As I say, this is a wealth tax of the most capricious kind, and that is why the Minister of State said what he said last year on Report. I quote from the Inland Revenue document:

> "In the course of a Finance Bill debate on 14th July 1977, the Minister of State to the Treasury, Mr. Denzil Davies, said that the Government would look sympathetically at the problem of the effect of inflation on capital gains."

It is to that point that I wish to devote myself in opening the debate. But for the benefit of hon. Members below the Gangway on the Government side who may have a misunderstanding of what is at issue, I shall read a letter from a constituent of my hon. Friend the Member for Bosworth (Mr. Butler). This is from a small shopkeeper:

> "I came to my business 7 years ago having experienced three jobs disappear, and bought a sub-post office and newsagency which had just had the delivery service abandoned. I paid £10,000 split as to £7,500 property and £2,500 goodwill. . .
>
> "Over my term of office my post office salary has increased from £1,000 to £3,150. Last year I realised that if I wanted a saleable business I had to resurrect the news delivery service so now in spite of sometimes feeling rather ill I opted to work a 13-hour day instead of merely 12. Just to show really willing, I also installed an automatic paraffin vending machine.
>
> "You must ask yourself whether we small shopkeepers really try. I must mention that over this period my rate of pay would not be much more than 50p an hour.
>
> "And now after 7 years I decide to sell up! We have now gone 7 years without a holiday and at last we are having to think in terms of appointing an assistant for whom I would have to allow £1·20 hourly plus and three weeks holiday. And this I will not do.
>
> "Over my 7 years, what we have not suffered to enhance the value of my business I cannot think. I always managed to save the post office salary and it seemed some consolation for working 6½ days a week. When the estate agent got me £34,000 for the business it seemed that at least I had balanced out inflation . . .
>
> "You have probably guessed—my accountant now tells me that I shall be liable to capital gains tax to the tune of £5,000.
>
> "I cannot describe the utter despair my wife and I feel. Everything we have done has been a waste of time and one of my tax inspector friends tells me how lucky we are that we didn't put our money in a building society as if there is something akin as between a stock exchange capital gains flutter and the service we have given the public.
>
> "I scarcely need to say, that I am having my rewards confiscated purely on a non-existent capital gain created by inflation. Is it any wonder that the unions, this Government and even some traders love inflation and will not consider indexation?"

Need I tell hon. Members that after paying the Chancellor his £5,000, the shopkeeper, possibly fatally ill, can receive neither dole nor sick pay? That is an example. of what is happening under the present regime of capital gains tax. I notice that Labour Members below the Gangway are no longer jeering or laughing. Quite right, too.

4.30 p.m.

This sort of problem is not in any way met by the mitigation for small gains introduced in Clause 35 of the Finance Bill. Nor is it met by any of the other provisions of the Bill. There is a genuine problem to which this Committee, should address itself. Indeed, the Inland Revenue note did its best to address itself to this problem. Hovever, the Inland Revenue——

Mr. Russell Johnston (Inverness): The hon. Gentleman said, after he had finished recounting the example of the shopkeeper, that Labour Members below the Gangway were, perhaps, taking a more solemn view of the matter. As far as I could see, they were not. It would be interesting to see whether they agree

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with what the hon. Gentleman said. Perhaps they might indicate that by some interjection.

Mr. Lawson: The hon. Gentleman is absolutely right. It will be interesting to see whether Labour Members agree. I hope that in particular the hon. Member for Liverpool, Walton (Mr. Heffer), who I know is concerned about small businesses, will make some contribution to the debate on this very matter and indicate his feelings.

Mr. Eric S. Heffer (Liverpool, Walton): The hon. Gentleman has read out a letter which quotes one side of the argument. We would need to examine it. I have learned in this world that one needs to examine the full details of any case that is put forward. I receive letters from constituents. The hon. Gentleman has a letter which puts one side of an argument.

In the past—I do not do it now—I have rushed in on the white horse, charging for this or that constituent and have discovered that there is another side of the argument as well, which had not been mentioned to me. Before I or anybody else rushes in to say that that is right or wrong, we would need to examine all the facts of the case.

If we are talking in general I agree that there is a case for small businesses, and that there is a need to look into the problems of small business men. But I wonder whether the hon. Gentleman is concerned only with the small business man——

Mr. Ron Thomas: Of course he is not ——

Mr. Heffer:—or whether he is concerned with all of those in business rather than one aspect of the problem.

Mr. Lawson: I admire the hon. Gentleman's insistence on studying this matter thoroughly before jumping to any conclusion. I and my hon. Friends have done so. Evidently he has not. I hope that he will not vote in any Division on this matter, on the ground that he has not had time to go into the matter with the thoroughness that he thinks necessary before reaching a conclusion.

The Revenue's note was interesting in one respect. It was looking at two different methods of dealing with this admitted problem of inflationary gains which ought not to be subject to tax but which are caught by the tax as it is at present constructed, and which would not be subjected to tax were this new clause, which indexes the gains, to be approved by the Committee.

One method of dealing with the problem was tapering, say over a period of 10 years, and the other was indexation. I know that a number of hon. Members have, until this Revenue document, thought that, possibly, tapering was a simpler solution and, therefore, to be preferred to indexation. The Revenue document makes two things absolutely clear. First, it makes clear that if the problem is inflation, the only logical solution is indexation. There is a case for tapering, but it is not the case which arises from inflation.

Before the hon. Member for Inverness (Mr. Johnston), the representative of the Liberal Party, leaves the Chamber, he should know that in our debates last year his hon. Friend the Member for Cornwall, North (Mr. Pardoe) stated clearly that he was in favour of indexation rather than tapering, because indexation directly concerned itself with the problem of rising prices and inflationary gains whereas tapering was something other than that. I refer to column 864 of the *Official Report* for 14th July 1977. I hope, therefore, that, with his usual consistency, the hon. Gentleman will be in the Lobby tonight with his hon. Friends.

Secondly, the Revenue document showed that the complications arising from tapering were every bit as great as those arising from indexation and that therefore the possible advantage of tapering—that it was a such simpler method—disappeared.

Logic and practicability go hand in hand to favour indexation as the method. There is only one respect in which tapering produces a simplification: the gains disappear altogether, for tax purposes, at the end of 10 years. But that can perfectly well be written into an indexation clause, as is done in some countries overseas, where gains over 10 years old are automatically exempt and there is indexation for those that are caught.

Three alleged practical disadvantages of indexation were produced by the

[Mr. Lawson.]

Revenue in paragraph 20 of the consultative document. The first is that

"a suitable index—or set of indices—would need to be prescribed."

There is no problem in prescribing a suitable index. In this clause we have suggested the retail price index, which is what is usually used where there are linkages to take account of inflation, whether in pensions or other aspects of our social security or tax system.

What is clearly wrong is the suggestion that there would have to be a set of indices. We are concerned with inflation, which means the changes arising in the general price level. Therefore, the only relevant index is one relating to the general price level. The argument of the Minister of State in our debates last year that there would have to be a separate index for every different type of asset was, therefore, bad. He now accepts that that was a bad point. That is made clear also in the Meade Report, which I have to hand. We need a general index of prices to establish how much is real and how much inflationary gain. That rules out the problem which might be introduced if there had to be a set of indices.

The second objection put forward by the Revenue was the "awkwardness", in the case of wasting assets such as leases, of both writing down the cost of the asset and adjusting it to take account of indexation. I think that by now the Inland Revenue will have received sufficient submissions to show that there is no such awkwardness. The existing system would be used for wasting assets such as leases. I do not wish to go into this matter in any more detail, but I have a note on it. If the right hon. Gentleman wishes me to——

The Minister of State, Treasury (Mr. Denzil Davies) *indicated dissent.*

Mr. Lawson: The right hon. Gentleman accepts that there is no problem there. Good. I shall not go into that.

The Revenue's third objection was about very long-term gains. If the Minister of State considers that this is the only problem, such gains could be exempted in an amendment to the new clause.

The Revenue put forward one other ironical objection—the compliance cost to taxpayers. Taxpayers pay a large sum of money on capital gains which are not true capital gains at all. All the taxpayers that I know would be happy to suffer the increased compliance cost in order to escape paying a tax which they should not pay in the first place.

Many other countries such as France, Sweden—for some gains—Ireland and so on index their gains for just this purpose. The Revenue is opposed to indexation. One knows that. I have a letter from a Revenue official. It is surprising to find Revenue officials having policy views, but evidently that is the situation we are in now. The Revenue official says:

"As you know, I hold no brief for indexation".

Therefore, the Revenue has been inclined to exaggerate the difficulties. There are some difficulties. For example, there are difficulties in the case of investment trusts and unit trusts, which, if there were indexation of gains, should be exempted altogether from capital gains tax. But the difficulties are not nearly as great as the Revenue has made them out to be. A number of submissions, copies of many of which I have, which were made to the Revenue in response to its consultative document have shown the way round these problems.

There was one curious matter in the Revenue document. The document claimed that when capital gains tax was orginally introduced in 1965 by the present Prime Minister, then Chancellor of the Exchequer, it was introduced at what was called "a relatively low flat rate" because it was specifically taken into account that it might contain an inflationary element.

Reading that document surpised me because it did not accord with my recollection, so I looked back to see what the then Chancellor of the Exchequer, the present Prime Minister, said on that occasion. He said:

"As for assets which are held for periods exceeding 12 months, I think that it would not be reasonable to subject a gain which may have accrued over a long period to the full rates of Income Tax and Surtax applicable to ordinary income for the year in which the gain is realised. I propose, therefore, that these long-term gains shall be taxed at a flat rate. Given a flat rate, I do not consider that there is any need to taper the rate according to the length of time for which the asset has been held, and the flat rate will, therefore, yers. Taxpayers pay a large sum y on capital gains which are not oital gains at all. All the tax-hat I know would be happy to he increased compliance cost in escape paying a tax which they not pay in the first place.

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apply irrespective of the period of ownership.—[*Official Report*, 6th April 1965; Vol. 710, c. 250.]

That was all he said on that point.

Therefore, the Revenue has it completely wrong. The 30 per cent. flat rate was specifically put as an alternative to a taper. It was not in any sense intended to take inflation into account because, of course, it was not envisaged at that time that we should have inflation at anything like the rates we now have.

We were then living in a different age. We were living in an age of what is now called the money illusion, when people who expected interest on money which they had lent thought of it in money terms, not taking inflation into account. People drawing up the profits of their companies were not concerned about inflation. Trade unions negotiating for wage increases in those days of 1965 did not really take inflation into account. Now everybody does. Now we are in a different era.

It is a very sad thing, and a damp squib, that the Treasury has come up with at present, because the relief that is included in the capital gains tax clauses, which we shall be dealing with in Standing Committee, is a relief which nowhere near meets—quite apart from the fact that it is different in form, size and scale—the amount of tax which is wrongfully extracted from taxpayers for gains which they have not in any genuine way been fortunate enough to acquire.

The Chancellor of the Exchequer, announcing the failure to introduce any form of indexation in his Budget Statement—this is the last quotation I shall read from a member of the Government —said this:

"I do not think that it would be right to give relief for inflation to investors in shares and land"—

If I may here interpolate, as we have seen, it is not simply a matter of shares and land. It is also a matter of the small shopkeeper and the sale of his shop. The Chancellor continued:

"while investors in building societies and other fixed-interest loans receive none—and while an investor can benefit from the decrease in the real value of his own borrowings."

That is an extraordinary statement. As to the first half of it, it is perfectly true at present that if somebody invests in a building society or some other fixed-interest security, a part of that which is taxed as income—and with the investment income surcharge, too—is merely replacement of the capital value which is otherwise deteriorating through inflation. That causes taxation to be too high.

4.45 p.m.

But the amount that that man suffers is not nearly as great as the suffering from capital gains tax—the inflationary gains being taxed at a real rate. That is a far greater injustice, and to say that the Government cannot remedy that glaring injustice because they have not seen a way of remedying the lesser—even though there are ways suggested in the Meade Report for doing that, but I leave them aside—really is a poor argument.

Mr. Heffer: I am following the hon. Gentleman's argument very closely, and up to a point I sympathise with some aspects of it. But would he not agree that if we are to have a system of indexation of the kind that he wants, he would also then have to apply indexation to wages and salaries? In fact, he would have to index all incomes of one kind or another. Is the hon. Gentleman in favour of indexing wages? Does he think that salaries also should be indexed? What is his view on that?

Mr. Lawson: The hon. Gentleman is on to an interesting point, but it is a completely different matter. He would be the first, I should have thought, to insist that wages and salaries are matters for negotiation freely between employers and employees and between employers and trade unions. If a trade union wishes to negotiate with an employer an index clause in a pay agreement, it is free to do so. There is no reason why it should not. But it is not a matter for negotiation or collective bargaining, even though perhaps the hon. Gentleman might like it to be, to decide how much tax should be paid. That is a matter laid down by law. It is a matter of the legal relationship between the State and the citizen and the obligations under law that the citizen has.

Mr. Denzil Davies *rose*——

Mr. Nick Budgen (Wolverhampton, South-West): I wonder whether my hon.

[Mr. Budgen.]
Friend would comment upon the relative attractiveness, in terms of employment in the private sector and the public sector, if all contrasts of service within the public sector were indexed. Would it not mean that labour would be sucked into the public sector, unless the private sector was prepared also to index all contracts of service?

Mr. Lawson: It might well do but, as I say, I do not accept the parallel of the indexation of wages.

Mr. Denzil Davies: Will the hon. Gentleman give way?

Mr. Lawson: In a moment, I shall. Where there is a parallel is in other aspects of the taxation system ; and it will be within the hon. Gentleman's recollection that last year, despite the Government's opposition, we insisted on indexing the personal allowances for income tax on precisely similar grounds.

Mr. Denzil Davies: In reply to my hon. Friend the Member for Liverpool, Walton (Mr. Heffer)—and I think it was a fair point—the hon. Member said that within private industry of course it was a matter of negotiation between the employer and the employee. However, if the Government accepted his view that indexation was a good idea, would he be in favour of indexing all contracts of employment between the Government and their employees, given that there was indexation?

Mr. Lawson: No. There really is no comparison with, say, the firemen, to take a recently topical case, who negotiate wages with the local authorities, and if they do not like the wages they can leave the fire service, as some of them may have done. That is quite different from a taxpayer who is legally obliged to pay a particular tax and cannot opt out of it. I think, therefore, that the Minister is on to a very bad point, and not for the first time.

Mr. David Price (Eastleigh): May I go back a number of years, as one who has had a lot of experience at negotiating in the private sectors with trade unions? It is implicit in the realm of contract that one tries to index. All that stops indexation is Government pay policy. In the real world, every trade union which is worth its salt expects the minimum of indexation, although the phrase is not used, and any sensible employer who can possibly afford it will accord it.

Mr. Lawson: There is implicit in what my hon. Friend said a very important point—that is, that matters which are reviewed every year, such as wages, can be, in a rough and ready way, adjusted for inflation. One of the reasons why the injustice is greatest in relation to capital gains tax is that this is not something which is adjusted every year, unlike even the income tax allowances. It is a tax concern with a period of years, when the pounds at the beginning of the period bear no relation in value to the pounds at the end of the period.

Let me remind the Committee of the final reason, as it was a few moments ago now, that the Chancellor gave for not moving on this matter, even though we were given to understand that there would indeed be legislation this year and the Inland Revenue document stated that the hope was that there would be legislation this year that a satisfactory form could be found.

The Chancellor said that he was not prepared to do this

"while an investor can benefit from the decrease in the real value of his own borrowings."—[*Official Report*, 11th April 1978 ; Vol. 947, c. 1202.]

Who is the investor who benefits most from the decrease in the real value of his own borrowings? It is the Government. It is the Government who are the biggest borrower of all. If anybody has benefited from the decrease in the real value of his borrowings, it is the Government. For the Government to say "Because we have had this great benefit, that is a reason why we cannot give any benefit to taxpayers whom we have been mulcting unfairly all these years" is a most monstrous and extraordinary argument. I am surprised that even the Chancellor, who, after all, had time to compose his Budget Statement as well as a long time to say it, should have used an argument of that kind. The fact that he did is, I think, some indication of the weak ground on which he found himself.

Mr. Ron Thomas: I thank the hon. Gentleman for giving way and will disregard the nasty comments he made earlier. Will he be good enough to tell th its salt expects the minimum of exation, although the phrase is not d, and any sensible employer who can sibly afford it will accord it.

Ir. Lawson: There is implicit in what hon. Friend said a very important t—that is, that matters which are ewed every year, such as wages, can in a rough and ready way, adjusted nflation. One of the reasons why the tice is greatest in relation to capital tax is that this is not something h is adjusted every year, unlike even ncome tax allowances. It is a tax ern with a period of years, when the ds at the beginning of the period no relation in value to the pounds end of the period.

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on Thomas: I thank the hon. n for giving way and will dis- he nasty comments he made Vill he be good enough to tell

the Committee how much he thinks the proposal will cost? We know that he had some trouble with the figures last time the Committee met, and perhaps he has had difficulty in getting it right, but could he give us some indication? Is it the £350 million of which we spoke earlier? If he would give just some indication, I at least should be grateful.

Mr. Lawson: The cost this year will be nothing at all, for the reason I have already given. The cost in a full year, next year, will in any case fall to be met by the incoming Conservative Government, so I think that the hon. Gentleman can leave that to us. I would judge that the order of magnitude—and it is possible to make only a guess at it, and that is the case with the Treasury, too, which is perhaps why it has produced a series of wrong answers in its Written Answers—is about £300 million of inflationary gain.

This, as I have said, is a matter of pure justice. That is why we have said in our policy document "The Right Approach to the Economy" that

"we shall adapt Capital Gains Tax so that only true profits (as opposed to inflationary gains) are subject to the tax."

We have an opportunity to embark on that course now. We have an opportunity to remove from the statute book in its present form a tax which is a wealth tax masquerading as a capital gains tax, a wealth tax of a higher incidence even than the Swedish wealth tax in a period of the sort of inflation that we have had in recent years, and a wealth tax which falls in a most capricious and undesirable way, which is contrary to any justice and contrary to the economic needs of the country.

I invite hon. Members on both sides of the Committee to give the new clause their support.

Mr. Denzil Davies: Perhaps I may come in at this stage and say a few words about the new clause, because the hon. Member for Blaby (Mr. Lawson) did not address his mind to it at all. He pretended that there were no real problems involved in indexation. Then he made a knock-about Second Reading speech which we have heard from him before.

Mr. Peter Rees (Dover and Deal): A very good speech.

Mr. Davies: It may have been a very good speech from the hon. and learned Gentleman's point of view, but the hon. Member did not really address his mind to the clause itself. He was asked, and he gave figures, about the cost of the new clause. He is quite right in saying that there is no cost this year because of the way the assessments are made. Our best estimate is that in a full year this new clause would cost about £350 million. I am not making an issue of the figures. I am just telling the Committee that our best estimate of the cost is £350 million.

The total yield from capital gains tax, if we include corporation tax on capital gains, is slightly greater than the hon. Gentleman seemed to think. It is about £480 million. But, as far as we can judge, the cost of this new clause in a full year is about £350 million.

Mr. John Cope (Gloucestershire, South): Will the right hon. Gentleman give way?

Mr. Davies: In a minute. The hon. Member for Blaby dismissed that. He said "Next year it will be a Conservative Government, and we will see about the cost." But he still has not told the Committee—indeed, we were not told on other amendments—from where this money is to come. We have had almost £700 million in a full year on other amendments, and here we have another £350 million, with very little indication from the Opposition where they will find the money.

Mr. Cope: What assumptions has the Minister made in arriving at the figure for the rate of inflation next year?

Mr. Davies: The assumptions are that the rate of inflation more or less will remain what it is now. I said that it was extremely difficult—the hon. Member for Blaby also mentioned this—to arrive at an accurate figure when estimating for a year ahead. But our best estimate is that the cost is around £350 million. I cannot pretend that it is an exact figure, but it is probably pretty close to what the actual cost will be if this new clause is accepted.

Mr. Ridley: Is it not a rather extraordinary admission by the Government that, if we take the £390 million figure of my hon. Friend the Member for Blaby (Mr. Lawson), 90 per cent. of capital gains

Inland Revenue

Policy Division
Somerset House

RESTRICTED

FROM: M F CAYLEY
DATE: 18 March 1988

1. MR PITTS

2. FINANCIAL SECRETARY

(as there is, of course, symmetry: you can't use unused CGT exemption against income. [illegible] [illegible] counterpart [illegible])

CGT: NON-TAXPAYERS

1. Your Private Secretary's note of 17 March 1988 asked about the rules for non-taxpayers.

2. As you said at the press conference, unused personal allowances will not be available against gains. We think only a small minority of CGT payers will be below the income tax threshold - mainly, we suspect, people with business losses.

3. Our Budget Day Press Release did not address this point as such, but in spelling out what was meant by taxing gains at the rates that would apply if they were the marginal slice of an individual's income (paragraph 7), it said that the CGT rate would be "either the basic rate of income tax, the higher rate of income tax, or partly one and partly the other". The implication is that the rate on gains above the exemption would always be at least the equal to basic rate and that the references to "income" are to what is commonly called taxable income, that is, income after reliefs and allowances.

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cc. Chancellor
Mr Culpin
Mrs Lomax
Mr Cropper
Mr Tyrie
Mr Isaac
Mr Beighton
Mr Pitts
Mr Cayley
Mr Hamilton
Mr Michael
PS/IR

4. How precisely accurate it is to state that gains will be treated as the marginal slice of income depends on what one means by income. If in context it means "taxable income", that is true - my first pound of taxable income is liable at the basic rate, and that is true even if my gross income is less than the tax threshold. If it refers to income before reliefs and allowances, then the statement is strictly inaccurate for people below the income tax threshold.

5. However this is not quite the formula used in the Budget speech - it talked in terms of applying a "tax rate" to indexed gains, and "taxing gains at income tax rates", and the personal allowance is not expressed as a "nil rate" band, and we took the view that the words in the speech were sufficiently accurate because applying a tax rate implies that tax will be charged and that when he referred to income the Chancellor meant taxable income after reliefs and allowances.

6. While we have had a few enquiries ourselves on the point, we have had no suggestion that the Budget material was misleading on the point.

7. We shall be proposing a more detailed press release on Finance Bill publication, and will be ensuring that it contains no ambiguity on this point.

Michael Cayley

M F CAYLEY

We have not merged gains and income. Each is calculated after its own reliefs and exemptions. Gains are then taxed at the appropriate income tax rate.
So while the drafting of the Press Release might have been a shade more secure, there is little room for real doubt to creep in. [initials]

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

Re para 14, (i) SEA — establish? 1 SLS to grateful for FST's views on 5(iii): we may need a small intg.

FROM: M F CAYLEY
DATE: 23 March 1988

1. MR PITTS

2. FINANCIAL SECRETARY

Now that circumvention of the higher rate charge has been canvassed so early in the game, I recommend you to introduce a countermeasure from the start.

DP 23/3

AVOIDANCE THROUGH TRUSTS OF CGT HIGHER RATE CHARGE

1. I am afraid that, following telephone calls after the Budget, a point has come up on which we would welcome Ministers' early guidance.

2. Inevitably, given a two-rate CGT structure, people will try to find ways of avoiding a higher rate charge on gains. The obvious route is to give an asset (with gifts relief) to someone (eg a spouse, son or daughter) who will be liable at the basic rate on any disposal. There is nothing we can readily do to stop this short of abolishing gifts relief - something Ministers decided last autumn not to do.

largely ~~only~~ because IR advised strongly against it!

---

cc.	Chancellor	Mr Isaac
	Chief Secretary	Mr Beighton
	Paymaster General	Mr Corlett
	Economic Secretary	Mr Pitts
	Mr Scholar	Mr Cayley
	Mr Culpin	Mr Davenport
	Miss Sinclair	Mr Hamilton
	Mr Cropper	Mr Stewart
	Mr Jenkins (Parliamentary Counsel)	Mr Thompson
		Mr Evans
		Miss McFarlane
		Mr Michael
		PS/IR

3. A slightly more sophisticated route, likely to be used if the intended recipient is a higher rate payer, is to transfer the asset (with gifts relief) to a trust set up for him or her. If the trust is a discretionary trust, then, as for income, any gain will be liable at the additional rate, so the total tax will be at 35%. There is thus a 5% advantage, but we are accepting this for income, and it would be difficult (even if rules could be devised) to be harder on gains. But if the trust is not a discretionary trust, the charge will be limited to the basic rate. (There is no equivalent advantage here for income, because the income must be paid out, and the recipient will be liable at the higher rate where appropriate.)

4. In theory one could extend the additional rate to gains made by any trust, but that would be seen as unreasonable, because a high proportion of non-discretionary trusts are set up for basic rate payers, and in a lot of cases a basic rate charge will give the right answer. An alternative approach, which would avoid that criticism, would be to treat non-discretionary trusts as more or less tax transparent for CGT, so that gains would be treated as apportioned between beneficiaries and taxed at the marginal rates that would apply if they had been made directly by the individuals concerned. But that would involve a complete rewrite of the CGT approach to trusts, and this would be a major (and complex) exercise on which consultation might well be desirable. We do not think we could undertake this in time for legislation this year. At least for the time being therefore, we think that, even if Ministers wished to change the rules for non-discretionary trusts at large, this would not be possible this year.

5. The calls we have had, though, have focussed on a much more narrow area, where we think it would be possible to act this year. And in dealing with the enquiries, we have told

people they will have to wait until the Finance Bill appears for details of what the rules will be.

6. Essentially the device is this. I set up a non-discretionary trust in which I or my spouse have a lifetime interest. I transfer assets (tax-free because of gifts relief) to it. The trust sells them. Instead of the gains being liable at the higher rate in my hands, they are liable at the basic rate in the hands of the trust. Variations would be to create a short-term interest in trust income for someone else (while retaining my interest in trust capital), to make the trust revocable, to set the trust up with a life of a few years, after which its assets revert to me or my spouse, and so forth. The common feature of all these arrangements is that I have escaped higher rate liability on gains realised while assets are held by the trust, even though I or my spouse have effectively retained an interest in the assets. By interposing the veil of the trust, I have confined gains liability to the basic rate. In the most crude and blatant cases, the Ramsay principle might give a little protection - but it would be easy to be safe from Ramsay attack.

7. It is clear from calls we have had that the tax planners have spotted the possibilities, and that, if nothing is done, such arrangements are likely to be set up on a wide scale to sidestep the higher rate. Our Budget Day Press Release said that "in general" trusts (other than discretionary trusts) would be liable at the basic rate, and we know that the outside world is waiting to see whether the inclusion of the words "in general" meant that there would be countermeasures in the Bill.

8. Without special provision, at least some of these arrangements would also work for sheltering income from the higher rate charge. But there are a series of provisions to stop avoidance of this kind. The one most relevant to the CGT problem says in effect that if I set up a trust in which

I or my spouse have a present or future interest, then the trust income is taxable at my tax rates.

9. It seems to us that, if Ministers wanted to do anything for capital gains, then the answer is to adapt this rule, so that the same principle applies for gains. We would envisage doing this for both discretionary and non-discretionary trusts (as is done for income already) - although for discretionary trusts it would be arguably a departure from the letter of the Budget Day Press Release.

10. The income tax provisions extend to settlements for one's own minor children. A parent cannot escape higher rate liability on income by transferring income-producing assets to his child. The income tax precedent would therefore suggest doing the same for capital gains so that gains on property transferred to a minor child by parents are taxable at the parent's marginal rate. Against this, for CGT purposes, minor children have always been regarded as independent taxpayers, each entitled to a separate annual exemption and so on, and it would be a major new departure to follow the income tax precedent. We would welcome Ministers' views on this.

11. We have not had time to work through the fine technical details. We would hope provisions of this kind would take up less than two pages of legislation but I cannot guarantee this. It is, though, too late now to have it drafted for the Bill as first published - we would need an amendment or a new Clause at Committee. But if Ministers wanted something of this kind, it could be announced in the Finance Bill Press Release on the main capital gains changes - and (as implied above) we think the outside world would see it as within the terms of the Budget Day Press Release, at least for non-discretionary trusts.

12. The argument for action is that, without it, the well-advised will step round the higher rate charge, at

least on larger gains, while still effectively retaining an interest in their assets. And such arrangements will almost certainly be widely used, and attract attention in accountancy and other journals. So the higher rate charge on gains would be largely ineffective, and seen to be so. Rules to counter this already exist for income and it would be natural, given the objectives of this year's reform, to extend the same principle to gains. A broadly similar problem is recognised for IHT, and countered by the "gift with reservation rules".

13. On the other hand, Ministers may be reluctant to introduce a new anti-avoidance measure in a year when, for income, the advantages of avoiding the higher rates are much reduced. And if we act on this loophole, people will still be able to avoid the higher rate charge - but only if they are prepared to divest themselves of all interest in an asset.

14. Against this background, we would welcome Ministers' guidance on

(i) whether they want to introduce at Committee stage a provision of the kind described in paragraphs 8 and 9 above;

(ii) if so, whether they agree that this should be announced in the Finance Bill Press Release on capital gains;

(iii) whether or not, if there is a rule of this kind, it should extend to gains on property settled by a parent on a minor child; and

(iv) whether, looking further ahead, Ministers would wish us, when Finance Bill priorities permit, to review the CGT treatment of trusts more generally in the light of the new two-rate structure (see paragraphs 3 and 4 above).

Michael Cayley

M F CAYLEY

42/2.BTW.4376/51 **CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 29 March 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Jenkins OPC
Mr Isaac IR
Mr Beighton IR
Mr Corlett IR
Mr Pitts IR
Mr Cayley IR

Thanks. 2. What is FST's view on the ~~[illegible]~~ of Mr Cayley's submission of 29/3?

AVOIDANCE THROUGH TRUSTS OF CGT HIGHER RATE CHARGE

The Financial Secretary has discussed Mr Cayley's minute of 23 March.

2. He agrees with the Chancellor that we should introduce at Committee Stage a provision which would prevent a higher rate taxpayer avoiding the 40% CGT rate by setting up a discretionary or non-discretionary trust in which he or his spouse had a present or future interest. He thinks this will need to be announced in the Finance Bill press release (Mr Michael's minute of 28 March presents the first draft). behind

3. On the question of gains made on property settled by a parent on a minor, the Financial Secretary has asked Mr Cayley to produce a further minute. If a decision is taken to tax such gains at the parent's CGT rate, this too will need to be covered in the Finance Bill press release. Therefore a decision is required by 12 April at the latest.

behind

JH

JEREMY HEYWOOD
Private Secretary

FROM MR. B. W. SUTHERLAND, C.B.E., F.C.A.

THE MANOR HOUSE
SHIPSTON-ON-STOUR
WARWICKSHIRE
SHIPSTON-ON-STOUR 61607

29th March, 1988

Dear Peter,

INHERITANCE TAX

Super Budget! But! I must tell you of my misgivings in one respect of it.

The new top rate of inheritance tax is fine as a top rate, but I am extremely concerned that there is a large band of estates, mainly belonging to Tory supporters, which are more heavily taxed on death now than they were on the introduction of the capital transfer tax in 1974, and indeed than they were in the last year of Atlee's government.

I enclose some tables I have prepared showing the comparisons. The following summary sets out the most significant figures, namely the amounts of tax payable on estates of the same real value on deaths in March 1971, March 1974 after the introduction of C.T.T. and after the Budget this year.

	Inheritance Tax Payable as % of	
Estate in 1988 £'s	Estate Duty March 1951	Capital Transfer Tax March 1974
	%	%
110,000	0	0
120,000	68	44
130,000	103	69
140,000	143	85
150,000	155	96
200,000	180	115
250,000	149	114
300,000	160	110
350,000	153	106
400,000	138	102
450,000	126	98
500,000	113	95
750,000	89	83
1,000,000	79	77

It is all very well to reduce the top rate to half of the top rate of estate duty and 53% of that of capital transfer tax, but we really ought to be seen to be doing more for our Constituency in the county. I realise that it is now late in the day but I really do think that we should introduce lower rate bands to at least restore the 1951 position and, preferably, to improve on it. I estimate that this would require bands of, say, £50,000 at 10% and 20% and one of £100,000 at 30%. You will no doubt be told that this would greatly reduce the yield of the tax. Since, however, the total yield is only £1 billion, or less than 0.6½% of total government receipts, this cannot be a major factor. It merely demonstrates what I have long maintained, that this tax should be high on Nigel's list for repeal.

I am also deeply concerned about the effect on the temporary emigration business of the capital gains tax changes but I will come and talk to you about this.

I am formally discharged from my I.O.D Tax Committee chairmanship when its Council meets on 7th April. I shall then be free of "sectional interests" in the tax world after some 25 years under various hats.

Yours

Bruce

P. J. Cropper, Esq., C.B.E.,
H. M. Treasury,
Parliament Street,
LONDON, SW1P 3AG.

Encs.

TAXES ON DEATH

ESTATE DUTY, CAPITAL TRANSFER TAX AND INHERITANCE TAX PAYABLE ON ESTATES OF THE SAME REAL VALUE IN THE LAST MARCH OF EACH GOVERNMENT SINCE 1945, ON THE INTRODUCTION OF CAPITAL TRANSFER TAX AND FROM 15TH MARCH, 1988

ESTATE ON DEATH IN 1988 £'S	LAB.	CONS.	LAB.	CONS.	LAB.	LAB.	CONS.
	ESTATE DUTY				CAPITAL TRANSFER TAX		I'TANCE TAX
	1951	1964	1970	1973	1974	1979	1988
£'000	£	£	£	£	£	£	£
110	4,400	8,800	13,720	14,939	7,087	13,153	-
120	5,907*	12,000	16,720	17,939	9,121	16,344	4,000
130	7,800	13,000	19,720	20,939	11,621	19,844	8,000
140	8,400	16,800	22,720	24,620	14,121	23,566	12,000
150	10,352*	19,073*	25,720	29,120	16,621	27,566	16,000
200	20,000	36,000	45,013	54,529	31,225	48,853	36,000
250	37,500	52,500	70,736	84,529	49,295	73,203	56,000
300	47,445*	73,860*	100,736	114,529	69,295	100,617	76,000
350	63,000	98,000	130,736	144,529	90,887	130,126	96,000
400	84,000	140,000	160,736	176,467	113,501	160,126	116,000
450	108,000	159,883*	190,736	208,967	138,502	190,126	136,000
500	137,510*	200,000	222,885	241,467	164,640	220,126	156,000
750	286,477*	340,863	385,385	407,604	309,813	370,126	256,000
1,000	450,000	500,000	555,038	582,604	459,813	520,750	356,000
1,250	596,321*	687,500	730,038	757,604	609,813	683,250	456,000
1,500	750,000	830,503	905,042	939,873	759,813	845,750	556,000
1,750	875,000	1,050,000	1,081,565	1,127,373	909,813	1,008,250	656,000
2,000	1,100,000	1,200,000	1,269,351	1,314,873	1,060,390	1,172,965	756,000
3,000	1,800,000	1,950,000	2,026,531	2,101,991	1,710,390	1,872,965	1,156,000
4,000	2,573,792*	2,698,204*	2,826,531	2,932,668	2,361,544	2,572,965	1,556,000
5,000	3,250,000	3,500,000	3,605,179	3,782,668	3,061,544	3,328,364	1,956,000
6,000	3,920,120*	4,326,256*	4,512,305	4,632,668	3,761,544	4,078,364	2,356,000
7,000	4,900,000	5,250,000	5,362,305	5,482,668	4,461,544	4,828,364	2,756,000
8,000	5,600,000	6,140,286*	6,212,305	6,332,668	5,163,852	5,578,364	3,156,000
9,000	6,325,857*	7,140,291*	7,062,305	7,182,668	5,913,852	6,328,364	3,556,000
10,000	7,500,000	8,000,000	7,912,305	8,000,000	6,663,852	7,678,364	3,956,000
12,500	9,528,738*	10,000,000	1,000,200	10,000,000	8,538,852	8,953,364	4,956,000
15,000	12,000,000	12,000,000	12,000,000	12,000,000	10,413,852	10,828,364	5,956,000
17,500	14,000,000	14,000,000	14,000,000	14,000,000	12,288,852	12,703,364	6,956,000
20,000	16,000,000	16,000,000	16,000,000	16,000,000	14,163,852	14,578,364	7,956,000

*Marginal relief applied

TAXES ON DEATH

COMPARISON OF THE BURDEN OF TAXES ON DEATH IN THE LAST MARCH OF EACH GOVERNMENT SINCE 1945, ON THE INTRODUCTION OF CAPITAL TRANSFER TAX AND FROM 15TH MARCH, 1988
1951 = 100

ESTATE ON DEATH IN 1988 £'S	LAB.	CONS.	LAB.	CONS.	LAB.	LAB.	CONS.
	ESTATE DUTY				CAPITAL TRANSFER TAX		INHERITANCE TAX
£'000	1951	1964	1970	1973	1974	1979	1988
110	100	200	312	333	161	299	0
120	100*	203	283	304	154	277	68
130	100	167	253	268	149	254	103
140	100	200	270	293	168	281	143
150	100*	184*	248	281	129	266	155
200	100	180	225	273	156	244	180
250	100	140	189	225	131	195	149
300	100*	156*	212	241	146	212	160
350	100	156	208	229	144	207	153
400	100	167	191	210	135	191	138
450	100	148*	177	193	128	176	126
500	100*	145	162	176	120	160	113
750	100*	119*	135	142	108	129	89
1,000	100	111	123	129	102	116	79
1,250	100*	115	122	127	102	115	76
1,500	100	111*	121	125	101	113	74
1,750	100	120	124	129	104	115	75
2,000	100	109	115	120	96	107	69
3,000	100	108	113	117	95	104	64
4,000	100*	105*	110	114	92	100	60
5,000	100	108	111	116	94	102	60
6,000	100*	110*	115	118	96	104	60
7,000	100	107	109	112	91	99	56
8,000	100	110*	111	113	92	100	56
9,000	100*	113*	112	114	93	100	56
10,000	100	107	100	107	89	94	53
12,500	100*	105	105	105	90	94	52
15,000	100	100	100	100	87	90	50
17,500	100	100	100	100	88	91	50
20,000	100	100	100	100	89	91	50

*Marginal relief applied

TAXES ON DEATH

EFFECTIVE RATES OF ESTATE DUTY, CAPITAL TRANSFER TAX OR INHERITANCE TAX ON ESTATES OF INDIVIDUALS DYING IN THE LAST MARCH OF EACH GOVERNMENT SINCE 1945, ON THE INTRODUCTION OF CAPITAL TRANSFER TAX AND FROM 15TH MARCH, 1988

ESTATE ON DEATH IN 1988 £'S	LAB.	CONS.	LAB.	CONS.	LAB.	LAB.	CONS.
	ESTATE DUTY				CAPITAL TRANSFER TAX		INHERITANCE TAX
	1951	1964	1970	1973	1974	1979	1988
£'000	%	%	%	%	%	%	%
110	4.00	8.00	12.47	13.58	6.44	11.96	0
120	4.92	10.00	13.93	14.95	7.60	13.62	3.33
130	6.00	10.00	15.17	16.11	8.94	15.26	6.15
140	6.00	12.00	16.23	17.59	10.08	16.83	8.57
150	6.90	12.72	17.15	19.41	11.08	18.38	10.67
200	10.00	18.00	22.51	27.26	15.61	24.43	18.00
250	15.00	21.00	28.29	33.81	19.72	29.28	22.40
300	15.81	24.62	33.58	38.18	23.10	35.39	25.33
350	18.00	28.00	37.35	41.29	25.97	37.18	27.43
400	20.00	35.00	40.18	44.12	28.38	40.04	29.00
450	24.00	35.53	42.39	46.44	30.78	42.25	30.22
500	27.50	40.00	44.58	48.29	32.93	44.03	31.20
750	38.20	45.45	51.38	54.35	41.08	49.35	34.13
1,000	45.00	50.00	55.50	58.26	45.98	52.07	35.60
1,250	47.71	55.00	58.40	60.61	48.79	54.66	36.48
1,500	50.00	55.37	60.34	62.66	50.65	56.38	37.07
1,750	50.00	60.00	61.80	64.42	51.99	57.61	37.49
2,000	55.00	60.00	63.47	65.74	53.02	58.65	37.80
3,000	60.00	65.00	67.55	70.07	57.01	62.43	38.53
4,000	64.34	67.46	70.66	73.32	59.04	64.32	38.90
5,000	65.00	70.00	72.10	75.65	61.23	66.57	39.12
6,000	65.34	72.10	75.21	77.21	62.69	67.97	39.27
7,000	70.00	75.00	76.60	78.32	63.74	68.98	39.37
8,000	70.00	76.75	77.65	79.16	64.55	69.73	39.45
9,000	70.29	79.34	78.47	79.81	65.71	70.32	39.51
10,000	75.00	80.00	79.12	80.00	66.64	70.78	39.56
12,500	76.23	80.00	80.00	80.00	68.31	71.63	39.65
15,000	80.00	80.00	80.00	80.00	69.43	72.19	39.71
17,500	80.00	80.00	80.00	80.00	70.22	72.59	39.75
20,000	80.00	80.00	80.00	80.00	70.82	72.89	39.78

3632/1

FROM: P J CROPPER
DATE: 31 March 1988

CHANCELLOR

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

BRUCE SUTHERLAND

Letter from Bruce, re Budget.

P J CROPPER

What Bruce fails to acknowledge is that the abolition of the tax on lifetime gifts makes IHT a different tax from CTT. Thus (tho' it wd be gratifying if IR wd check his figs, & ~~make~~ provide a draft reply) even if estates of between (say) £170,000 and £400,000 are on paper taxed more heavily in 1988 than in 1974, he is not comparing like with like. ~~[illegible]~~ Then if look to compare IHT with ED in 1973, IHT scores at all levels.

N

PS. On basis of current figs, what inc. in IHT threshold wd be needed to meet the Sutherland point?

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 11 April 1988

PS/CHANCELLOR

Ch/ Agree with FST's conclusions?
JS 11/4

OK -

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Jenkins OPC
Mr Isaac IR
Mr Beighton IR
Mr Corlett IR
Mr Pitts IR
Mr Cayley IR

AVOIDANCE THROUGH TRUSTS OF CGT HIGHER RATE CHARGE

The Chancellor asked for the Financial Secretary's views on Mr Cayley's submission of 29 March. The Financial Secretary has now discussed this with officials.

2. The Financial Secretary thinks that we should take no action on settlements for minor children this year. But he would agree with Mr Pitts' suggestion (his paragraph 10) that a few warning noises should be made at Committee Stage.

3. The Financial Secretary sees the case in principle for treating capital gains in broadly the same way as income in respect of settlements for minor children. However, he believes that a number of arguments point in the direction of leaving things alone at present.

4. Of the two main options presented by Mr Cayley, the Financial Secretary believes that option 1 is far too draconian compared with the income tax rules, and option 3 would be very complicated, involving two pages of legislation, and a significant compliance burden for taxpayers.

5. The Financial Secretary judges that although there would be scope for avoidance of the higher rate of CGT if nothing were done, in practice the Exchequer loss would probably be negligible. The vast majority of settlements at present are discretionary, and these trusts will therefore pay the additional rate of tax on any capital gains - an overall rate of tax of 35% only 5% lower than the top rate.

6. The Financial Secretary accepts that with no action taken, there might be a tax-driven burgeoning of non-discretionary settlements. However, the Revenue think it unlikely that this - even if it were to happen - would put great amounts of tax yield at risk.

7. Moreover, although the case for treating capital gains and income identically is stronger now that the rates have been assimilated, a lighter treatment of gains can in this area be justified on pragmatic grounds. Whilst income settled on a child by his parent is commonly used to maintain the child during his minority, capital is much less commonly paid out of trusts for minor children. Arguably, therefore capital gains which are generally not used as a substitute for parental income to support minors, do not need in practice to be taxed at the parent's marginal tax rate.

8. The Financial Secretary thinks that given the complexity of the option 3 solution proposed by Mr Cayley, given the small amount of revenue at stake, and given the fact that settlements of capital have in the past not generally been used to meet the expenses of maintaining minors, expenses which would otherwise have been met out of the parent's post-tax income/gains, there is no compelling case for (controversial) action this year.

J.H.

JEREMY HEYWOOD
Private Secretary

Inland Revenue

Policy Division
Somerset House

FST As you know, I was strongly in favour of proceeding as outlined on A

FROM: M F CAYLEY
DATE: 20 April 1988

1. MR PITTS DW 2/4 Please see my note at the end.

2. FINANCIAL SECRETARY

FST The proposal outlined in para 23 ('The Framlington amendment') goes a long way to the concern I expressed in my PPS minute of 18 April, and I accordingly support it. N

CAPITAL GAINS TAX

1. Mr Allan's minute of 18 April asked for a note on the sidelined part of the attached article. Mr Heywood's minute of 19 April asked for a paper reviewing our general approach in this area, and for comments on the particular suggestion from Framlington.

2. The Bill includes provision to ensure that rebasing does not lead to people being taxed on gains they have not made, or given relief for losses they have not incurred. They are a simpler version of equivalent rules in 1965 (simpler because we are building on an existing tax system).

3. There are four main circumstances in which these rules could apply (all figures are after indexation): Simple examples follow:-

(i) Restricted gain

Cost of asset	1,000
1982 value	100
Disposal value	1,200

---

cc. Chancellor
Mr Scholar
Mr Culpin
Mr Cropper
Mr Jenkins (OPC)
Mr Isaac
Mr Beighton
Mr Pitts
Mr Cayley
Mr Hamilton
Mr Michael
PS/IR

CAYLEY 20/4

The rules restrict the gain to 200: without them the taxpayer would be taxed on a further 900 of gain he had not made. An example might be shares in a company whose price had collapsed by 1982 but has since recovered.

(ii) Restricted loss

Cost of asset	1,000
1982 value	1,500
Disposal value	500

The rules restrict the loss to 500, rather than the 1,000 depreciation since 1982. Again, some shares might fall into this category.

(iii) Loss that would become a gain

Cost of asset	1,000
1982 value	100
Disposal value	800

The rules here give the taxpayer neither a gain nor a loss. Without them, he would be taxed on a 700 gain even though he had really had a 200 loss. Again some shares will be in this category.

(iv) Gain that would become a loss

Cost of asset	1,000
1982 value	7,000
Disposal value	6,000

Here too the rules give the taxpayer neither a gain nor a loss. Without them, a gain of 5,000 would be converted by rebasing into a loss of 1,000. Farmland will often be in this category, because over much of the country it peaked in value around 1981.

4. The rules thus work sometimes in taxpayer's favour, and sometimes against them. Because of the way asset prices (particularly shares) have moved over the years, the likelihood is that there will be more taxpayers who benefit from the rules than those who would be better off without them - though we cannot be absolutely certain of this.

5. The rules will apply in only a minority of cases. But it is not possible to predict with absolute certainty which those cases will be - even though it will be unlikely that eg most shareholdings will fall into any of these categories. So any rules of this kind mean that in principle taxpayers have to keep records of the actual cost of pre-82 assets. Very often they will want to do this (in order to make investment decisions). In computational terms, provided the records are kept, ~~they~~ the rules add only marginally to the burden of compliance: it will generally be possible to tell at a glance whether the rules apply: and for the great majority of disposals of pre-82 assets they will not. The burden is essentially one of record-keeping: of requiring people who feel they do not want records of actual cost of pre-82 assets to retain those records. The rules do not however involve people keeping <u>more</u> records than were needed for the pre-Budget regime: what they do is make it difficult for many people to keep <u>less</u>.

6. In practice it is for shares and securities that this record-keeping burden is most significant. (Acquisition costs of land and second homes, for examples will anyway be kept on the Land Register and so available if needed.)

<u>Can we dispense with the rules altogether?</u>

7. One option would be to dispense with the rules altogether. This would certainly be a simplification - in legislation and compliance terms, as well as for our own staff. And the effect on the tax yield of doing so would

probably be small, because the result would produce more tax on some disposals and less on others. The main beneficiaries would probably be people selling farmland, which generally showed large real gains in the 1970's and has over much of the country declined in value since 1982. The main losers would be people with shares whose values were depressed in 1982 but have since recovered. The losers' position would frequently be exacerbated by the other CGT changes - which would mean their being taxed on gains they had not had with a reduced annual exemption and, frequently, at a higher rate.

8. Malcolm Gammie's article recognises the fairness of the rules. We ourselves have had a number of contacts with the journalists and with taxpayers and their advisers about them. Our impression is that there was a general expectation that there would be rules of this kind. Some people indeed have expressed relief that they are being proposed. Malcolm Gammie himself (who spoke to me last week) has told me that, while people would prefer not to have to keep records of the actual cost of pre-82 assets, they generally regard this as a necessary evil: he (like other lawyers and accountants he has spoken to) thinks it would be hard to defend taxing some people on (in some cases large) gains they had not made. This is very much the flavour of the comments we have had from most other people who have telephoned us on this aspect.

9. In theory one possibility would be to have a one-way rule, which applied only where rebasing worked <u>against</u> taxpayers. This would add to the cost of rebasing - though probably by less than £m50. It would have no real practical advantages: taxpayers and their advisers would still need to keep records of the actual cost of pre-82 assets, because they could never be absolutely certain that the rule would not apply.

10. This would be so even if a one-way rule operated only on a claim by the taxpayer: professional advisers, stockbrokers etc would feel constrained to keep the records in order to protect themselves against actions for negligence if they failed to retain the information necessary to establish whether a claim would be to their clients' advantage. So in practice a one-way rule would not materially reduce the burden of compliance and record-keeping.

The Framlington suggestion

11. The only other option would be something on the lines suggested in Framlington's letter of 15 April (copy below).

12. When CGT was introduced in 1965, there were rules similar to those proposed in the Bill for 1982. But in the next two or three years it became apparent that for portfolio investments (where there were often frequent pre-65 transactions) many taxpayers - understandably not anticipating the introduction of CGT - had not kept records of acquisition costs. So the rules were often very difficult to apply to shares and securities because the necessary information was missing. The problem was fairly widespread because fluctuations in share prices at the time meant that the rules were potentially relevant in a lot of cases.

13. So in 1968, at the instigation of the accountancy bodies, we offered people a way out. What we said was that they could elect for 1965 market value to be used as the cost figure for their whole portfolio. They could elect separately for quoted preference shares and fixed interest securities on the one hand, and for other quoted shares and securities on the other. But within each of the two categories, an election applied to the whole portfolio. It had to be made within two years of the first disposal out of the portfolio concerned. So if the first disposal was of,

say, 100 ICI shares in 1969, the taxpayer had to decide then whether to make an election which would apply to later disposals of all his other ordinary shares in other companies. In the case of groups, the election was made by the top company on behalf of all the members of the group - and continued to apply to a company which subsequently left the group.

14. The problem which has been raised today is different: it is not the absence of records but the need to continue to keep records. But an election on these lines could go some way towards meeting complaints. In effect one would be telling people they have the choice - they can either have the fairness of the rules in the Bill - with the implied need to keep records of pre-82 actual costs - or they can elect to have 1982 values used for all their disposals.

15. The election for 1965 purposes applied only to quoted shares and securities. That was partly for technical reasons - because time-apportionment was often used to establish the 1965 value of other assets. Those technical reasons no longer apply: 1982 open market values are already built into the system and will be used universally. So if a similar election is made available now, there would be a good case for saying it should apply to <u>all</u> a taxpayer's assets and not just quoted shares and securities - and this would give a simpler rule and allow people to get rid of pre-82 records for all their assets.

16. If an election is made available it would - as for 1965 - have to be irrevocable (otherwise it is not worth having - it would just be a further complication for everyone), and it would need to be subject to a time limit. We would envisage that taxpayers would be able to make the election at any point during the next two years (to 6 April 1990) whether or not they made disposals. This would enable those who just did not want to be bothered with pre-82 costs to

dispense with them. Many people would in practice not bother to review their position until they made a disposal. So in addition, where people had not already made an election, we would suggest following the precedent in the rules for 1965 and allowing them to do so within two years of the first disposal after April 1988. As for 1965, we would propose that the top company in a group should elect on behalf of the whole group.

17. The obvious advantage of this is that it gives everyone a chance to opt out of having to keep pre-82 records, while still giving them the protection of the rules in the Bill if they prefer. And there would be unlikely to be any significant cost to the Exchequer.

18. Inevitably there are some disadvantages. First, the equivalent provisions for 1965 run to nearly two pages. This is because it is necessary to spell out who can make the election (eg for company groups or where people are acting as trustees), the technical interactions with the rules for transfers between husband and wife, and so on. We would need to do the same now. Parliamentary Counsel may find a shortcut to some of this - but if he does not, the necessary amendments or New Clause could well be approaching two pages.

19. Second, correspondence over the years with taxpayers about the corresponding provisions for 1965 suggests that in some cases their experience of the election was not entirely happy. Some did not understand the full implications of making the election - that they were committing themselves in relation to later disposals of other shares. Some subsequently regretted the election they had made, because on a later disposal it worked to their disadvantage.

20. Third, in order to decide whether to make the election, taxpayers and their advisers would need in principle to review all their assets, and form judgments about likely future movements in asset values. This could impose a

significant initial compliance burden, if it was done thoroughly.

Summary

21. It would be simpler for everyone not to have rules of this kind, and in particular would reduce the burden of record-keeping for taxpayers and their advisers. But the result could well be seen as unfair: and Ministers would be likely to receive complaints from people who had to pay tax on (possibly large) gains which they had not made, with a reduced annual exemption and, quite often, at a higher rate.

22. Having a one-way rule which applied only where it was to the taxpayer's advantage would not in practice materially reduce record-keeping, and would add to the cost of rebasing.

23. An alternative would be to give people an opportunity to elect, for all their assets, on a once-and-for-all basis, that gains and losses should always be computed by reference to 1982 market value. This would allow those who wanted the protection of the rules in the Bill to have it: while enabling others to be shot of pre-82 records. There were provisions of this kind for 1965 for quoted shares and securities. Experience with those provisions suggests that some taxpayers will have trouble understanding the implications of their election, while others may come to regret their decision. Unless Parliamentary Counsel finds a short cut, the provisions could run to approaching two pages. Despite these drawbacks, if Ministers want to do something, while giving people the chance of being protected from tax on gains they have not made, this seems to us the only serious candidate.

M F CAYLEY

1. If it is important that people should be able to get rid of their records, Mr Cayley's proposal of an option has much to commend it.

As regards the tax effect, options essentially work in the taxpayer's favour. Here, they won't pay tax on gains they never really had, but they <u>will</u> get relief for losses they never really incurred. Some Farmers in particular may get a windfall. But more generally this effect will be lessened by two aspects of the proposal - that the option be for <u>all</u> assets and for <u>all</u> (often mostly future) time.

2. If you decide you want the option, it will probably be achievable only by amendments to the Bill (not by a New Clause), which are most unlikely to be ready by Committee Stage of the Whole House. If the CGT Clauses are taken then, the amendments would therefore have to wait for Report Stage. But they could be announced in advance.

CAPITAL GAINS TAX

Lawson's final word on structure

THE BUDGET heralded a fundamental reform of Capital Gains Tax (CGT). The Finance Bill, coupled with Inland Revenue announcements yesterday, fleshes out the details.

Previously, Capital Gains Tax applied to gains arising since April 1965, when CGT was introduced. From April 6 1988 tax is charged only on gains accruing since April 1 1982. Assets held before that date will have to be valued as at March 31 1982 to eliminate from charge the pre-1982 gain. The indexation allowance will, however, always be based on the higher of the actual cost and the 1982 market value.

In the case of shares, identifying those held before April 1982 is simplified by the changes made in 1985, which introduced full indexation relief for post-March 1982 gains; indeed, the 1985 changes were designed with this development in mind. At present shares are divided into those acquired post-March 1982, and those owned at that date. Disposals from the second category will now be free of Capital Gains Tax.

The benefit of the pre-1982 exemption is not lost merely because new shares have been acquired on a takeover or other corporate reconstruction. In that case, the new shares are identified with the old. Similarly, where assets have been transferred between husband and wife or between group companies, the 1982 basis may continue to apply on an eventual sale by the transferee.

Where, however, between 1982 and 1988 a gain has arisen but has been postponed, the whole of the postponed gain remains potentially subject to tax even though it accrued in part before 1982. Three instances of this are those cases since 1984 where shares have been exchanged for a CGT-exempt corporate security; those where assets have been given away between 1982 and 1988 and the gain has been postponed until the donee sells the asset; and cases in which gains on business assets have been deferred upon reinvestment in new business assets. The difficulty of unscrambling the past in all such cases is one reason for leaving the gains fully taxable.

It may be that the gain or loss accruing since 1982 is greater than that arising since original acquisition. Alternatively, an overall loss since acquisition may show a gain since 1982, or vice versa. In the first case, the gain or loss will be limited to that arising since acquisition; in the second no gain and no loss will arise. While the fairness of this cannot be doubted, the added complexity it involves is regrettable; the old system cannot be discarded completely and pre-1982 records cannot automatically be destroyed.

Apart from rebasing the system, the bill provides for gains to be charged at income tax rates. This is not full integration with income tax, as personal allowances and other income tax reliefs cannot be deducted from gains. The annual exemption for gains is £5,000 in 1988/89. From 1990/91 a husband and wife will each be entitled to a separate exemption. Thereafter, the wife's gains will also be taxed separately rather than aggregated as at present.

To the extent that an individual's gains exceed £5,000, they will be added to his total income (after deductions and allowances) for the year and taxed at 25 or 40 per cent as appropriate. A basic rate taxpayer whose taxable gains take him over the basic rate limit will find those gains taxed at 25 per cent up to the limit and 40 per cent thereafter.

Gains of discretionary trusts will be taxed at 35 per cent and of other trusts and personal representatives at 25 per cent. The opportunity for higher rate taxpayers to reduce their tax by routing gains through trusts is to be countered by specific anti-avoidance provisions. These will be introduced to the bill later.

Whether this will apply to all trusts, or merely new trusts, is not clear. Higher rate taxpayers who set up trusts between Budget day and April 6 must now wait to see whether they will lose the 1982 exemption if they roll the gain into the trust even though the gain ultimately realised by the trust is still taxed at their full 40 per cent rate.

The bill implements a number of other changes announced on Budget day, including a CGT charge when a company ceases to be UK-resident and the abolition for the future of private residence relief for dependent relatives.

Much of the anti-avoidance legislation of the last 30 years has been designed to prevent income being converted into capital. Gains from land and the extraction of corporate profits in capital form have been two particular targets. Extracting dividends may now be better than selling the company with undistributed profits: the shareholder can credit part of the company's tax against his liability to tax on the dividend. Selling a company for a formula price based on future profits may also be less attractive. The scheme for the future may be to withdraw profits regularly as dividend and salary and lend the money back as necessary.

These changes must represent the Chancellor's final word on the structure of Capital Gains Tax. As a fully indexed system it sits somewhat oddly with the unindexed Corporation Tax system. While the distinction between income and gains is greatly reduced the two taxes are not fully integrated. In addition many types of gains remain outside the tax net altogether: for example, those in pension funds and Personal Equity Plans, or arising on Business Expansion schemes, gilts and quoted corporate securities.

While the exemption of pre-1982 gains will release many assets into the system, longer term the lock-in effect may remain. For example, the incentive for proprietors of family companies to hang on to their shares until retirement is significantly increased by retirement relief. This now exempts gains of up to £125,000 plus half the gain between that and £500,000. CGT is also not charged on death. Those who give away their assets and have the misfortune to die within seven years must face both CGT and inheritance tax charges. Death is perhaps one area to which the Chancellor should return in future years.

Malcolm Gammie

The author is a partner of Linklaters & Paines

Friday, April 15, 1988

18 APR 1988

FRAMLINGTON

Framlington Investment Management Limited

Royal London House 22-25 Finsbury Square London EC2A 1PJ Telephone 01-374 2931 Telex 915619 Fax 01-382 9116

DRC/SA

15th April 1988

FINANCIAL SECRETARY	
REC.	18 APR 1988
ACTION	Mr. Catley - IR
COPIES TO	PS/Chancellor
	PS/CST
	Mr. Culpin Mr. Lomax
	Ms. Sinclair Mr. Gray
	Mr. Tyrie Mr. Pitts - IR

PS/IR

The Rt.Hon. Norman Lamont, M.P.,
Finance Secretary,
Her Majesty's Treasury Chambers,
Parliament Street,
London SW1P 3AG.

Dear Mr. Lamont,

The decision to move the base date for Capital Gains Tax forward from 6th April 1965 to 31st March 1982, announced in the Budget, is to be welcomed. However, the special provision to ensure that the rebasing does not increase a gain or loss, as compared with the result that would be obtained under the present rules, gives some cause for concern.

If this provision is to be successfuly policed it would seem to the layman that it is necessary to carry out the long and detailed Capital Gains Tax calculations as now, possibly looking at the pre-1965 pool, the 1965/March 1982 pool, and then the current pool for the last-in first-out calculation prior to looking at the effect of rebasing cost on March 1982.

The administrative cost of these calculations will be substantial, as now, and growing. The complexities are already beyond the capabilities of most private investors.

Could not further thought be given to offering all investors the option to make an election for March 1982 values to be considered the acquisition date for all pool holdings held prior to that date? Investors were given the option of making an election for either equities and/or fixed interest investments when Capital Gains Tax was introduced in the late 1960s.

The majority of investors have seen the bulk of their gains rising from March 1982. The loss to the Revenue from rebasing to 31st March 1982 and doing away with the special provisions is likely therefore to be small against a background of a substantial saving in the administrative costs of monitoring acquisition dates prior to that date.

Could thought please be given to introducing some form of Election within the Finance Bill?

Yours sincerely,

D.R. CLARKE
Managing Director

PPS

Inland Revenue

Policy Division
Somerset House

From: Mrs C Evans

Date: 26 April 1988

1. MR JAUNDOO 26/4

2. APS/CHANCELLOR (MISS WALLACE)

really any / side
so I volunteer
again!
M.

Thanks

BRUCE SUTHERLAND'S LETTER OF 29 MARCH 1988

This note responds to your minute of 7 April 1988 addressed to Mr Cropper.

1. We have checked Mr Sutherland's figures and although we find some small discrepancies the general picture he gives is correct.

2. However Mr Sutherland's criticism is misconceived where he compares March 1974 "after the introduction of CTT" with March 1988 after the recent Budget.

---

cc	Chief Secretary	Mr Isaac
	Financial Secretary	Mr Pitts
	Paymaster General	Mr Beighton
	Economic Secretary	Mr Gonzalez
	Mr Cropper	Mr Jaundoo
	Mr Tyrie	Mrs Evans
	Mr Call	PS/IR

3. It is true that CTT was introduced in March 1974 but only for lifetime transfers. Transfers on death were not charged before March 1975. The Chancellor has already commented on the abolition of the immediate charge on the vast majority of lifetime transfers. This significant change makes it inappropriate to compare the March 1988 Budget rate scales with those for 1974.

4. The normal method is to compare the earlier Healey death scale, revalorised by the RPI with the current (1987-88) scale indexed to December 1987, and the Budget scale. So for the purpose of this comparison the Healey scale should be revalorised from December 1974 (since tax on death was first charged in 1975-76), to December 1987,

5. Although indexation alone would have compared unfavourably with the 1975-76 scale except for the smallest estates, the Budget scale improves on simple indexation as the table below demonstrates. The Budget scale only takes more tax than the 1975-76 scale from estates in the band £200,000 to £300,000 (precise figures are £196,000 to £292,000). All other estates pay less tax under the Budget scale.

6. Mr Cropper may like to remind Mr Sutherland of the improvements made to CTT/IHT since 1983, and a brief summary is attached.

7. Finally, in answer to the Chancellor's question (paragraph 2 of your minute) the table also confirms that a scale based on a threshold of £112,000 and with a single rate of 40 per cent would take less tax from all estates than the revalorised 1975-76 scale. The cost of this scale over and above the Budget scale would be £5 million in 1988-89, £15 million in 1989-90 and £15 million in 1990-91.

Specimen Estates £000s	1975-76 scale revalorised to December 1987	Indexed scale for 1988-89 ie threshold of £94,000	Budget scale ie threshold of £110,000 and single rate of 40%	Threshold of £112,000 and single rate of 40%
100	6,800	1,800	-	-
150	19,500	17,200	16,000	15,200
200	35,800	37,200	36,000	35,200
250	55,350	59,300	56,000	55,200
300	76,400	84,300	76,000	75,200
400	123,950	139,900	116,000	115,200
500	178,050	199,900	156,000	155,200
1,000	476,900	499,900	356,000	355,200
2,000	1,089,800	1,099,900	756,000	755,200

C Evans

MRS C EVANS

Main changes in CTT/IHT since 1983

1983 - Threshold increased to £60,000 and increased rate bands; broadly in line with indexation with some rounding up.

- Rate of business property relief for minority shareholdings in unquoted companies increased from 20 per cent to 30 per cent.

- Interest-free instalment facility extended from 8 to 10 years.

1984 - Threshold increased to £64,000. Top rate on death reduced from 75 per cent to 60 per cent and rate for lifetime transfers reduced to half death scale.

1985 - Threshold increased to £67,000 and increased rate bands in line with indexation.

1986 - CTT abolished and IHT introduced.

- Abolition of charge - provided donor surives 7 years - on outright lifetime transfers between individuals, on gifts into accumulation and maintenance fund trusts, and trusts for the disabled. Such gifts called PETs (potentially exempt transfers).

- Introduction of tapered reduction of tax on transfers made within 3 years of death.

- Cumulation period reduced from 10 to 7 years.

- Threshold and rate bands raised in line with RPI - new threshold £71,000.

1987 - Threshold increased to £90.000 (27 per cent increase on previous figure).

- PET treatment extended to trust property in which an individual has an interest in possession.

- Business property relief increased from 30 to 50 per cent for transfers out of large minority holdings (over 25 per cent) in unquoted companies.

- Shares dealt in on the USM to be treated like shares with full Stock Exchange listing (so business property relief on USM holdings available only on transfers out of control holdings).

- Further measures to help protect the national heritage (concerning maintenance funds and acceptance of property in lieu of tax).

42/2.BTW.4366/42

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 27 April 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
Mr Scholar
Mr Culpin
Mr Dyer
Mr Neilson
Mr Cropper
Mr Tyrie
Mr Pitts IR
Mr Cayley IR
PS/IR
Mr Jenkins OPC

Treat: Contra' throughout. Exception of X, where [illegible] 1st [illegible] [illegible] Revenue [illegible] [illegible] [illegible] lost [illegible] [illegible] (iii) [illegible] Mr Cayley's para 33.

CL Agree with FST's conclusions? JS 27/4

Contra'

CGT: GOVERNMENT AMENDMENTS

The Financial Secretary has read Mr Cayley's minutes of 18 April and 20 April and seen your minute of 25 April. He has also discussed these issues with officials.

The "Framlington Option" (Mr Cayley of 20 April)

2. The Financial Secretary agrees with the Chancellor that we should introduce an amendment to the Finance Bill at Report Stage which would give people the opportunity to make an irreversible election to have the gains/losses on all their assets computed by reference to 1982 market value. On the detail of this amendment, the Financial Secretary thinks that:

(i) the election should cover all the taxpayer's assets;

(ii) taxpayers should make the election either in the period up to 6 April 1990 or within two years of the first disposal made after April 1988.

3. It is for consideration whether the Paymaster General should announce this concession during Committee of the Whole House on 10 May.

4. The amendment will take up roughly two pages of legislation and will probably cost less than £10m although any estimate is fairly speculative.

Trusts (Mr Cayley of 18 April)

5. The Financial Secretary is anxious not to introduce further significant and potentially controversial amendments to the Bill. Therefore, he does not think we should pursue this year item (iii) in Mr Cayley's paragraph 33. Nor does he favour extending the new rules to non-resident trusts. The Revenue see no problem in leaving these matters for the time-being. The Financial Secretary has already asked for a paper in due course looking at CGT and trusts more generally.

6. The Financial Secretary is otherwise content with Mr Cayley's recommendations.

Letter from Mr MacGregor

7. The Financial Secretary has now received a letter from Mr MacGregor which draws attention to the interaction between rebasing and roll-over relief for assets disposed of prior to April 1982. Mr Cayley is providing urgent advice on this.

behind

JEREMY HEYWOOD
Private Secretary

PS/FST 6/5

42/2.BTW.4373/03

CONFIDENTIAL

FROM: J J HEYWOOD
DATE: 6 May 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Miss Hay
Mr Cropper
Mr Jenkins OPC
Mr Pitts IR
Mr Cayley IR
PS/IR

Ch, I think you already have Mr Cayley's minute of 5 May. (It covers the Winterton point.) But I attach a copy immediately behind. Content with FST's proposal? 6/5

OK -

CGT: POINTS RAISED BY MR MACGREGOR AND MR WINTERTON

The Financial Secretary has considered Mr Cayley's minutes of 27 April and 5 May, in advance of the debate on rebasing in CWH on 10 May.

Mr MacGregor's Point

2. Mr MacGregor raises the point, covered originally in Mr Cayley's submission of 29 October, that - as the Bill is drafted - rebasing gives no benefit where tax has been deferred on a variety of disposals made (normally) between 1982 and 1988. Typical cases would be where a person gave away assets (acquired before 1982) and claimed gifts relief, or where business assets acquired before 1982 were subsequently replaced, with tax deferred through roll-over relief.

3. When we considered this issue in the autumn, we recognised that a concession might prove necessary in due course. The Financial Secretary now believes that we ought to make a concession. The CLA are known to be concerned about the point, and both Tim Boswell and Sir William Clark have put down amendments (probably inspired by the NFU). The Revenue have received around 20 letters on the subject. The Financial Secretary has also been approached by Lord Weinstock in the 'gifts relief' angle.

4. Mr Cayley's latest note explains that in practice there are difficulties in making a concession. In many cases no record will have been kept of the proportion of any deferred taxable gain accounted for by pre-82 gains. In cases where records have been kept, the computation of the element of pre-82 gain may be highly complex - for example, where business assets have been rolled over into a large number of replacement assets, perhaps spread across a group of companies, and where many of the replacements assets themselves have been disposed of or replaced.

5. The Financial Secretary thinks that there are two possible concessions that can be made:

(i) For pre-82 assets which have been given away only once since 1982 and for business assets which were disposed of pre-82 and replaced after 1982 (the particular subset of roll-over relief cases which Mr MacGregor raises) we could introduce a 'precise' concession because in the case of the former the pre-82 gain should be easily computed, provided that the records have been kept and, in the case of the latter, all the gain will be pre-1982;

(ii) For all affected assets, we could introduce an arbitrary rule that half of any deferred gain element in the taxable gain would be exempt from CGT.

6. A further possibility would be to introduce both (i) and (ii). On balance the Financial Secretary thinks that (ii) is the best option. Just introducing (i) would increase the resentment of those benefitting neither from rebasing nor from the limited concession, which would itself affect only a small number of taxpayers. Introducing both (i) and (ii) would be the most complex legislatively and would again lead to some resentment since a few taxpayers with deferred gains would get the full benefit of rebasing whilst others would get less than they ought to (and, of course, others again would get more benefit than they ought to).

6A. Whatever solution we adopt, there will be some people who will not have the records to establish that there is a pre-82 element in their deferred gains. There is nothing we can do for these.

7. The Financial Secretary would propose, therefore, that we should bring forward an amendment at Report Stage to implement option (ii). During the debate on 10 May, he thinks the Paymaster should not announce this but agree to consider the point sympathetically and explain the practical difficulties. The letter to Mr MacGregor needs to be amended accordingly.

Mr Winterton's Point

8. The Financial Secretary intends to speak to Mr Winterton today to explain to him that the issue he has raised concerns the general question of how best to find an "open market value" for minority shareholding and has nothing to do with rebasing.

JH

JEREMY HEYWOOD
Private Secretary

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

9/6

BG 3/6

8/6

Ch. EST is looking into this, + then discussing with FST, who will report. This will be politically v. difficult — and provoke chorus of rage from the oil industry — but the risks in not taking action are very great. JF 26/5

(await FST's report)

FROM: A J G ISAAC
26 May 1988

FINANCIAL SECRETARY

CGT: PLANT, MACHINERY AND OIL LICENCES

1. Mr Johns' and Mr Cayley's notes below reports on some technical, but important, points arising from Ministers' decision during Committee Stage to introduce the "Framlington election" into the CGT rebasing provisions.

2. As we have all recognised, the "Framlington election" breaks the logical structure of the Finance Bill provisions. It necessarily follows - again as we all recognised - that it gives "uncovenanted" benefits to some individual taxpayers, and some such benefits will be very large.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Mr M Williams
Mr Cropper
Mr Tyrie
Mr Jenkins (Parl Counsel)

Mr Isaac
Mr Painter
Mr Beighton
Mr Calder
Mr Johns
Mr McGivern
Mr Pitts
Mr Cayley
Mr Elliss
Mr Hamilton
Miss Hill
Mr Beauchamp
Mr T R Evans
Mr Michael
PS/IR

3. Mr Cayley's note, accordingly, reviews some important points that have arisen in applying, and defining the scope of, the "Framlington election". (We do not think we need trouble you, unless you wish, with a number of other relatively low-level technical points).

4. The first major point concerns the interaction of the "Framlington election" with plant and machinery etc on which capital allowances were given before 1982. I imagine that you will, as Mr Cayley recommends, want technical amendments to ensure that the election does not give taxpayers the benefit of a "double dip".

5. The second major issue concerns rather wider interests in the North Sea. As Mr Johns reported in February, North Sea interests will in any event be among the major beneficiaries from 1982 rebasing. If widely applied, the Framlington election would give North Sea interests some further very large gains. It is very difficult to estimate costs in this area - if only because (under the special conventions applying to CGT) "unlocking" does not represent a "cost". But oil companies could have accrued losses running into 11 figures. They are likely to be able to realise only a small proportion of these, but even so could easily wipe out tax on tens of millions of pounds of gains a year and have an unhealthy loss overhang. In effect they would be an extreme example of the large "uncovenanted" benefits discussed at paragraph 2 above.

6. You will wish to consider whether it would be appropriate, as we tend to feel, if only on pragmatic grounds, to exclude these North Sea interests from the scope of the "Framlington election". If you do so, there is a choice - essentially presentational - between limiting this change to the North Sea and applying it generally to plant and machinery and mineral assets. The latter has the advantage of not singling out the North Sea or exposing the generosity of rebasing to the North Sea

so clearly; the former may be easier to present in terms of a definition of the scope of the "Framlington election".

7. Both these measures could (subject to the advice of Counsel) be included in the bundle of amendments which will in any event be necessary this year to legislate the "Framlington election" itself.

AJGI

A J G ISAAC

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM M A JOHNS

DATE 26 MAY 1988

1. MR ISAAC 26/5
2. FINANCIAL SECRETARY

CGT: PLANT, MACHINERY AND OIL LICENCES

Mr Cayley's note below raises some difficult questions about the way the Framlington election will affect assets qualifying for capital allowances, particularly in relation to the North Sea. We are still working on the details but we thought we should put the main issues to you now.

As I said in my note of 4 February to the Economic Secretary, rebasing to 1982 produces odd results in the North Sea anyway. In 1984 the Chancellor took steps to tighten up the ring fence to ensure that the Exchequer got its full share of gains on transfers of North Sea assets. Because 1982 was a peak year in the value of such assets, rebasing effectively took such assets back out of capital gains tax. And they are likely to remain so in perpetuity unless there is another dramatic surge in oil prices and except in cases of new substantial discoveries. But the kink test at that stage prevented artificial losses being generated. The Framlington election now removes this and the full 1982 value of North Sea assets (over £20 billion) will, over time, convert into allowable CGT losses. By the time the assets

cc	Chancellor	Mr Isaac
	Chief Secretary	Mr Painter
	Paymaster General	Mr Beighton
	Economic Secretary	Mr Calder
	Sir P Middleton	Mr Johns
	Mr Scholar	Mr McGivern
	Mr Culpin	Mr Pitts
	Miss Sinclair	Mr Cayley
	Mr M Williams	Mr Elliss
	Mr Cropper	Mr Hamilton
	Mr Tyrie	Miss Hill
	Mr Jenkins (OPC)	Mr Beauchamp
		Mr T R Evans
		Mr Michael
		PS/IR

are eventually abandoned in the next century the full amount will be converted into a loss. Large losses would in time have been generated anyway by indexation, but the election increases these and means that already there are accrued losses running into the billions. Before the election there were relatively small losses thinly spread or a no gain no loss position.

Does this matter, since gains will already effectively be exempt after the Budget? In my view it does, for three reasons:

a. Oil companies have other non-North Sea assets on which they would expect to make gains. We don't know how much they are likely to realise and when, but in any one year the tax lost could run into tens of millions of £ without any behavioural changes.

b. Companies could, over time, find tax advantages in buying up businesses which do generate capital gains (eg in the property sector). This will distort business and add to the cost above.

c. An overhang of artificial losses running to £billions is generally unhealthy even if most of the losses cannot be used. There will be a perpetual incentive for oil companies to convert income into gains (of the sort the last two Budgets have been intended to reduce) and continuing pressure to get effective relief for the losses. This would be reminiscent of the pre-1984 position on profits, though there is a key difference in that the losses cannot be used until they are realised which means a sale or other disposal of a North Sea interest which will not always be straightforward for companies.

Is it only a North Sea problem? The same effect in principle arises for all depreciating assets held in 1982 qualifying for capital allowances. Industrial buildings which are likely to appreciate from their 1982 value should be left out of any solution. But for assets where 1982 value is below acquisition cost the problem can be dealt with by a technical amendment which Mr Cayley suggests you should do anyway. The North Sea is likely to be the only area where assets qualifying for capital allowances stood significantly above acquisition cost in 1982 but are lower now. Whether or not you include non North Sea assets in any solution apart from the technical amendment is therefore a presentational question. From a North Sea angle I would recommend inclusion because it looks less as if you are singling the North Sea out for special treatment. (And you could get attacked from two sides on this account: the oil companies would complain that they were losing reliefs which others kept; but the Opposition could complain that the Budget taken as a whole was effectively, or actually, exempting North Sea profits from tax.) But my CGT colleagues rightly point out that inclusion of non North Sea assets could create more enemies and in particular could be difficult vis-a-vis the unincorporated sector.

Is the solution to exempt or take the assets outside the Framlington election? Exemption is actually likely to reduce the losses more. Ever since 1985 the companies have had the (highly generous in the oil context) option of indexation by reference to 1982 values even though indexation of acquisition cost would be much lower. Exemption would prevent that relief from generating losses whereas exclusion from the Framlington election would not - though the technical amendment on top of the Framlington election would considerably reduce the potential losses. On the other hand, exemption is much more visible and would appear a special privilege for the North Sea. And if oil prices were suddenly to rise substantially above their 1982 value you would be left without any tax on the gains. More generally, exemption would reduce the scope of business ability to defer tax on the replacement of business assets and the implications here would call for a lot more thought. Exemption would involve more complex Finance Bill drafting which would be difficult to do this year. So we favour exclusion from the election if action is to be taken.

Can the problem be left to next year? I would recommend against doing so. The only real case for deferment is if you think the problem may not ever materialise in unacceptable losses or market distortions. Alternatively you may feel that waiting will enable you to cite evidence of actual transactions/distortions to justify the action you are taking. This year, however action can be presented as a consequence of rebasing and the Framlington election and the debate will cover both the advantages of that and the disadvantages of effectively exempting oil from capital gains tax. Next year only the latter will come into the discussion. So far noone has spotted the effect of the 1982 rebasing on the oil sector; but sooner or later it seems to me someone will (the NAO?) and I would have thought it was better for the Government to face the argument at a time and on ground of its own choosing.

You will, no doubt, want to discuss this with the Economic Secretary in view of the substantial oil interest.

M.A. Johns

M A JOHNS

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY

DATE: 26 MAY 1988

1. MR JOHNS
2. MR ISAAC
3. FINANCIAL SECRETARY

CGT: PLANT, MACHINERY AND OIL LICENCES

1. Ministers announced in Whole House Committee that taxpayers should be allowed to make an election out of the "kink test", so that 1982 rebasing will apply to all their assets (the "Framlington election"). We have since been working through the full details and implications. Most of these are mechanical, and we do not need to bother Ministers with them. But there are two important areas on which we would be grateful for early guidance. These relate to the implications of the election for plant and machinery and for oil licences. Decisions here could have sizeable implications for the Exchequer, and for the cost of the Framlington election.

2. In previous papers we said that we doubted that the election would have a very high cost in total - though individual taxpayers could gain very substantially. Orally, I said that the cost was unquantifiable but might typically be around £m25 a

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		PS/IR

year. (This guess was on the same conventions as were used for the main CGT costings: ie that we allowed for behavioural changes; did not count against us tax given up on disposals that would not have taken place without the tax changes; and so on.) Most of this is likely to be in the corporate sector.

3. These costs will depend very much on the precise scope of the Framlington election, and precise detail of the legislation, with which this minute is concerned. Depending on decisions on the issues in this minute, the cost could be substantially increased. In particular, this is because on certain assumptions it could be possible, over a longish period of time, for the corporate sector to establish capital losses running well into the billions as a result of the Framlington election. Most of this would be in the North Sea sector. Onshore, the position could be safeguarded by technical amendments for which we would have been seeking Ministers' authority as consequential changes following the decision on the Framlington election: but those amendments would be of only limited relevance to the North Sea, and so we think Ministers may wish to consider wider options.

4. In terms of actual tax loss to the Exchequer in the near future, the implications may not be all that great. This is because there is no immediate effect on yield except to the extent that companies have - or can manufacture - gains on which they would otherwise be paying tax.

Background

(a) Plant and Machinery

5. In general disposals of plant and machinery take place at a loss. Under the CGT code, these losses are reduced to the extent that capital allowances have been given: this is to prevent the same cost being relieved twice - once against income and once for CGT.

6. Where rebasing applies, and gains or losses are computed by reference to 1982 value, the loss is reduced only to the extent that capital allowances have been given since 1982 and are not clawed back on the disposal by a balancing adjustment. This follows from the general approach that, with rebasing one ignores changes in value etc before 1982. Thus at the extreme, where 100 per cent first year allowances have been given for plant and machinery before 1982, and the asset is demolished at the end of its useful life (so that there is no balancing adjustment), no deduction is made for capital allowances, and so the loss is computed by reference to the unabated 1982 value. Typically this will be a lot less than the full cost of the asset (because for the 1982 valuation we will be looking at the secondhand value) but often more than the written down cost under the pre-Budget CGT code. So rebasing very substantially increases the capital losses, and results in double relief because expenditure on which capital allowances were given before 1982 can also give rise to a post-1982 capital loss. Where there are sale proceeds, there are likely to be balancing adjustments which offset this - though only to a limited extent in the case of assets which have been held for a significant part of their expected useful life.

7. For completeness we should mention that, both pre- and post-Budget, indexation itself would normally give rise to a loss computed by reference to the 1982 value unabated by pre-82 capital allowances. This followed from the 1985 changes to indexation, and the loss attributable to indexation is <u>not</u> increased by either rebasing or the Framlington election.

8. As long as the "Kink test" applies, the total loss will be restricted to any indexation loss available under the pre-Budget code and in the rare case there will be neither a gain nor a loss. But with the Framlington election, taxpayers can avoid the Kink test, and hence establish the much bigger loss that follows from rebasing. This loss will - as already explained - result in expenditure being doubly relieved and, even without the special oil dimension, we would have wanted to seek Ministers' authority, as a consequential on the Framlington election, for technical

amendments to remove the double relief. This would incidentally have the result of reducing the indexation loss described in the paragraph above. We return to that later on in the paper.

9. Those amendments would have removed any significant risk to the Exchequer on plant and machinery outside the North Sea sector But acting on the capital allowance front would still leave a large capacity for capital losses on North Sea plant and machinery as a result of the Framlington election. The reason is that in the early 1980's oil platforms were often worth a lot more than their original cost. So, even with the capital allowance point tidied up, there would still be potential for capital losses equal to the increases in value up to 1982. This is very much a North Sea phenomenon: outside the North Sea, the 1982 value of plant and machinery will almost always be less than cost.

10. These considerations have led us to consider that in addition to the technical amendments to remove double relief where capital allowances have been given before 1982 - we should try and find a solution which also removes the losses that can be generated where North Sea oil platforms increased in value before 1982.

(b) Oil Assets

11. The oil licence aspect is rather different. With oil licences, the main factor is not capital allowances; typically oil licences are granted for a nominal sum and capital allowances are then due on that nominal sum. Instead the possibility of large losses arise because the value of oil licences tends to track the oil price. Plant and machinery in the North Sea also reflects oil prices to some extent; this is the reason for the difference from the general pattern of plant and machinery discussed above.

12. 1982 thus represents a high for oil assets, with values then being considerably above their present levels. As a result there

are often large real gains pre 1982 but losses later. Mr Johns' minute of 4 February to the Economic Secretary on the North Sea Fiscal regime and CGT changes drew attention to the fact that as a result the North Sea sector stood to benefit substantially from rebasing.

13. Prior to the Framlington election announcement, this benefit was limited to excluding the pre-82 gains from tax and giving a loss equal to indexation on 1982 values. (Even this we reckoned would be sufficient more or less to wipe out any gains from North Sea assets, thus costing the Exchequer some £m30 a year.) This result reflected the operation of the Kink test: either the loss was restricted to the loss under the pre-Budget code, or there would be no gain, no loss.

14. Where a Framlington election applies, that benefit will be substantially increased. Subject to any adjustment in respect of any capital allowances which have been given after 1982, oil companies will be able to get a loss equal to the 1982 value of the assets in addition to the figure of indexation on the 1982 value.

15. Thus the total sum at stake in the oil sector is the aggregate value of North Sea assets at 31 March 1982, plus indexation on those values. Measured in terms of remaining NPV from existing and prospective fields the aggregate value of all North Sea assets in 1982, including North Sea plant and machinery, was around £20 billion. Indexation on that figure would add another £6 billion. (It is difficult to separate out how much of this sum is attributable to oil licences and how much to plant and machinery; normally the disposal will be interests in oil fields as a whole, with the attribution between the licence and plant and machinery element involving a large amount of judgement. It is possible however that oil licences themselves accounted for about half of the total.) So the total losses in the oil sector could, over a period of years, amount to something in the order of £20 billion, plus indexation;

and already, given the fall in the oil price, have accrued to around £16 billion.

16. The technical amendment described above would make no dent in the potential tax loss attributable to oil licences. In the case of North Sea plant and machinery it would reduce it to the increase in value between acquisition and 1982 plus indexation on that reduced sum.

(c) Other assets

17. In theory, the Framlington election could give an extra benefit on other assets on which capital allowances were given before 1982. In practice, here we are talking essentially of industrial buildings and hotels - which will frequently show real gains since 1982 and where, after capital allowance balancing charges, there generally will be a tax charge on disposals which will be unaffected by the election. We think therefore the issue is confined to plant and machinery and to licences, though if a change is made it should probably extend to all assets receiving plant and machinery or mineral extraction allowances (including the Mines and Oil Wells allowances).

Exchequer effects and other consequences of capital losses

18. Capital losses can be set only against gains made by the same company. But companies in groups can switch assets between themselves, so it would be easy for oil groups to transfer assets pregnant with gain to a North Sea member in order to utilise losses.

19. It is difficult to gauge the extent this could, and would, happen in practice. Virtually all North Sea assets are themselves likely to be showing a loss over the next few years; but many oil groups have substantial downstream interests as well, at least part of which - eg property - could now be sold at a gain. In addition there are a number of groups with substantial oil interests which are not predominantly oil groups,

including Thomson and British Gas. However insofar as such gains arise in respect of business assets and rollover relief is claimed, the utilisation of any capital losses will effectively be deferred - often indefinitely.

20. Within oil groups, more likely to affect Exchequer take over the next few years are gains on the sale of subsidiaries and of stakes in associate companies. In addition, depending on currency fluctuations since the dollars were acquired, a payment by an oil company of a dollar dividend to a US parent may give rise to a substantial gain. In both these cases the losses on North sea assets would be available to wipe out the tax that would otherwise have accrued to the Exchequer. It is impossible to quantify these effects; our best estimate is that they might easily run to £tens of millions a year, and could well be more. There was some incentive, anyway, before the Framlington election from the indexation losses on plant and machinery; but these would have been spread thinly across the Nort Sea, so we think the additional risk is significant.

21. Even taking into account all the potential gains within oil groups, there is likely still to be a large overhang of North Sea losses. To that extent there would an in-built inducement for oil groups effectively to buy in gains, in order to take early advantage of the losses available. An oil group could thus be moved to diversify, say, into property development. The existence of such tax driven options would inevitably favour the larger groups over the smaller independent oil companies. And utilising such options could mean diverting resources away from the North Sea itself.

Possible Solutions

22. There seem to us to be two possible solutions. Both could either be confined to the North Sea sector or extend to businesses generally. In addition, if Ministers preferred to act on the North Sea sector alone, there would within the special

North Sea rules be other ways of clawing back at least part of the benefit.

23. One general solution would be to exempt plant, machinery and oil licences from tax on capital gains. Since these assets will typically show capital losses, which are increased by indexation, whether acquired before or after 1982, there would be a (probably small) yield to the Exchequer.

24. One drawback to this is that, if at some point in the future oil prices rise substantially, there could be large real gains on oil licences which would be tax-free. There could exceptionally be gains before then in respect of North Sea assets acquired in the price trough of 1986, or where significant discoveries were made after 1982. But in general over at least the short and medium term we are likely to see mainly losses.

25. There is another, and major, drawback of exempting plant and machinery. This is that we would need to take plant and machinery outside the CGT rollover provisions - otherwise people could roll taxable gains into exempt assets. So a business selling eg land and buying plant and machinery would no longer be able to defer tax liability on any gain on the land, and some gains deferred on previous disposals would be brought into immediate tax liability when there was a disposal of plant and machinery even if new business assets were acquired. So there could well be a large lobby against exemption and there are issues here which would need careful study.

26. A particular awkwardness relates to provisions in this year's Bill. First plant and machinery includes satellites and spacecraft, to which rollover relief is being extended in this year's Bill. Second exemption would sit rather unhappily with clauses 60-62, which provide capital gains relief for certain early disposals of oil licence interests. It would not make these clauses redundant, as they apply to past as well as future disposals. But it would mean retaining them only for their

retrospective effect and for their, relatively small, impact on specific capital allowance provisions.

27. There are precedents for exempting assets from CGT where they are liable to generate only losses: for example, gilts and bonds. And irrespective of the Framlington election and rebasing, we had exemption of at least some plant and machinery in mind as a possible Starter for 1989.

28. The second option is to exclude plant, machinery and oil licences from the Framlington election. The obvious drawback of this is that it means pulling back the boundaries of the election, and going back a little on the statement that the election would apply to all assets. And - if one did this for all businesses - it would mean that for example small companies and unincorporated businesses would be unable to opt completely out of the complications of the Kink test.

29. On the other hand, one of the reasons for the election is to enable people to dispense with pre-82 records, and for the assets concerned those records will have to be retained anyway for capital allowances purposes, even where a Framlington election is made. And we are talking only of a very limited category of assets.

30. This second option would not produce any extra yield - it would merely restore the position to what it was after the original Budget decisions. And people would still generally be able to establish indexation losses on disposals of plant and machinery - though normally no bigger than the losses they could get pre-Budget.

Technical Amendments for Capital Allowances

31. I mentioned early in this note that, leaving aside the North Sea dimension, we would have been seeking ministerial authority to remove the scope for the Framlington election to create double relief where capital allowances have been given before 1982: once

under the capital allowance rules, and again - for the same amount - in arriving at the post-82 capital loss.

32. This would be done by amending the rules for reducing CGT base costs when computing losses where capital allowances have been given. Where rebasing applies, the reduction is only by reference to post-1982 allowances. The amendments would bring in pre-1982 allowances. And it would follow that the same thing would be done when arriving at the 1982 base for indexation, which would remove some scope for indexed losses on expenditure already achieved by capital allowances. This could be achieved by deleting about half a dozen words at two points in the Bill. It would be a consequential of the Framlington election (in the absence of which the scope for double relief would not have arisen because the kink test would have prevented it). It would be an appropriate solution outside the North Sea - but it would be of only limited help in the North Sea sector, where the potential for capital losses is only partly - and, in the case of oil licences, hardly at all - attributable to capital allowances.

33. We strongly advocate these amendments. If they were taken out of the Framlington election, there would still be advantage in doing so to reduce the indexation losses described in paragraph 7. These amendments would involve companies keeping pre-82 records of capital allowances. But those records will - as mentioned earlier - be needed anyway for capital allowances purposes.

Limited solutions

34. The Annex describes some limited solutions. None of them seem to us very attractive and none would remove the root of the problem.

Commencement

35. If any action takes the form of excluding some assets from the Framlington election, this would apply to disposals on or

after 6 April 1988. So would the technical amendments described in paragraphs 30 to 32. If it were to take the form of exempting particular types of assets, then under the normal retrospection rules the change would apply only to disposals after the date of announcement: this is because otherwise, in a minority of cases, one could be depriving people of losses on disposals they had already made in the first few months of the tax year.

Timing

36. We could in this year's Bill exclude from the Framlington election particular categories of assets or make the technical changes referred to in paragraphs 30 to 32 to remove the double dip on capital allowances. By contrast, we are doubtful whether it would be sensible to rush into immediate legislation to exempt particular assets from CGT, because we think the implications for rollover on the replacement of business assets need longer study, and for this we think that the prospect is of legislation having to wait until 1989. There could be an advance announcement at, or around the time of Report, but this does seem to us a substantive argument against the exemption options.

Should any wider action be confined to the North Sea?

37. Outside the North Sea, the position can be tidied up by the technical amendments we have described. So there is a possibility of making those amendments and then restricting wider action - exemption or taking assets outside the Framlington election - to the North Sea.

38. The arguments against restricting action to the North Sea sector are therefore largely presentational ones. First, if action applies generally, it can be defended on arguments of principle; whereas distinguishing the North Sea can really be justified only on pragmatic grounds. Beyond the money involved, there is no obvious defence for distinguishing between sectors of the economy in this way. It might be possible to present oil licences as a special kind of asset, ie given by the Government,

usually at little or no cost, to exploit a nationally-owned resource. But it would be less easy to explain why North Sea plant and machinery is being differentiated from plant and machinery generally. And there is also the practical point that Treasury Ministers would need at least to tell their Energy colleagues of any proposal to remove the benefits of rebasing the Framlington election from the oil industry alone. If the change applied generally, the need for such consultation would be less.

39. In addition it might seem harsh to single out the North Sea at a time when oil prices are still depressed. The oil industry themselves would no doubt complain vociferously at such "discrimination".

40. Another factor which needs to be considered in this context is the likely attitude of the Opposition. Both because of the large sums involved and because North Sea oil is a national resource, the Opposition are likely to be particularly worried about the implications of rebasing and the Framlington election for the North Sea sector. In that case the Government could be criticised as presenting the oil industry with an uncovenanted benefit, and as giving up some of that North Sea rent which should properly accrue to the nation at large. More specifically Ministers could, in this area, be open to charges of inconsistency. Why are they enabling real North Sea gains to result in large losses for tax purposes, when only 4 years ago they made considerable effort to ensure that the similar gains made on the occasion of the Forties farm-out were fully taxed?

41. If any wider action is confined to the oil industry, it may point up the fact that rebasing itself has already effectively removed capital gains tax on North Sea assets. Though this point has not yet been taken, Ministers could have to face the sort of arguments in the paragraph above anyway. But they are likely to be more potent if the change, and therefore the debate, is restricted to the North Sea.

42. The type of solution preferred could also have a bearing on whether or not it applied just to the North Sea sector. Obviously two of the approaches discussed in the Annex can only apply to that sector. Of the more complete solutions, exemption could more readily apply to business generally than the option of taking certain classes of assets out of the Framlington election. If applied across the board, the latter option would mean denying small onshore businesses some of the simplification of that election, and - given that the double dip provisions for capital allowances would solve any onshore problem - this might be a little awkward.

Should there be wider action at all?

43. The case for wider action for the North Sea (beyond just the technical amendments) is essentially pragmatic: that, unless something is done, the oil industry will have the ability to establish, over the long term, capital losses well into the billions; and will have immediately accrued losses of substantial size which it can use to neutralize the gains it makes outside the North Sea. As was so with gilts and corporate bonds - we are dealing with assets on which the Exchequer will on the whole be relieving losses rather than taxing gains.

We should seize on this aspect; it is more defensible than simply emphasising the size of the capital losses.

44. Against this, is the argument that the full benefit of rebasing and the Framlington election ought to be available on these as on other assets: and if this means oil companies get losses, that is something the Exchequer should be prepared to accept and defend if necessary. And there are - as we sought to bring out in our minutes on the Framlington election - other categories of taxpayer (eg owners of agricultural land) who will benefit significantly from the Framlington election because the value of their assets peaked in the early 1980's. Finally, as things now stand, although huge losses are potentially involved for the oil groups, the companies cannot use those losses unless they have gains. With rollover relief anyway available on disposals of business assets, it seems unlikely as things now stand that a significant proportion of these losses will be

crystallised in the foreseeable future. Even so the actual tax at stake could well run into £tens of millions. That tax loss would of course be more if companies went out of their way, eg by diversifying into non oil activity, to mop up the otherwise unused losses. And experience suggests that if companies can have large tax losses they will try - often successfully - to find ways to use them.

Conclusion

45. We recommend technical amendments to remove the "double dip" for capital allowances, under which the same expenditure can be relieved twice - once through the capital allowance system and again by contributing to a post-82 capital loss.

46. Looking wider, the options seem to us to be

(a) to exempt from tax on gains assets qualifying for plant and machinery allowances or mineral extraction allowances either;

(i) in the hands of North Sea companies, or

(ii) for businesses at large.

[This option has a number of awkward side effects and we do not think it a runner for report stage legislation]; or

(b) to exclude from the Framlington election assets qualifying for plant and machinery allowances or mineral extraction allowances either

(i) in the hands of North Sea companies, or

(ii) for businesses at large.

Either could be done at Report Stage as part of the Framlington election provisions. Going wider than the North Sea would mean hitting a target that would disappear onshore if these technical amendments for the double dip were made, but might have presentational advantages.

Michael Cayley

M F CAYLEY

ANNEX

LIMITED SOLUTIONS

An intermediate Course

1. An intermediate course between exemption and doing nothing would be to exempt plant and machinery from tax on gains for all businesses (not just North Sea) and do nothing about oil licences. As indicated in the main note, we already had something like this in mind as a possible starter for 1989. However, it is on plant and machinery that a significant part of the potential for oil groups to have losses arises; and it could be argued the position of oil licences is little different from that of eg farmland, which also widely peaked in value in the early 1980's; and by not exempting licences one would ensure that if, in the future, large real gains did emerge, they would be taxable.

A solution within the special North Sea tax rules?

2. If, by contrast, Ministers wished to take action on the North Sea alone, two further options seem feasible. Both would however be partial solutions only: neither would make much inroad into the losses oil companies would be able to establish under the Framlington election.

3. The first of these limited options would be to build some restriction into the clause of the present Finance Bill (clause 60) that provides a relief for certain oil licence disposals. But, even if it bit on all the disposals within the ambit of clause 60, this approach would have very limited application. Clause 60 extends only to disposals of undeveloped acreage where the consideration takes certain specific forms: it has no application to licences relating to developed fields, which is where all the really large windfall gains to the industry will arise.

4. In principle there seems no good reason for singling out these specialised disposals of undeveloped acreage for treatment harsher than all other licence disposals. In many senses they represent the most "deserving" case, often directly contributing to the North Sea exploration effort - which is why they were given the relief clause 60 provides in the first place.

5. Moreover in practice building any sort of restriction into clause 60, eg a deferral of the loss which would otherwise crystallise immediately on a licence swap, would probably be of cosmetic effect only. The basic purpose of clause 60 is to provide a relief, so it is in no way mandatory. If a company considered the unadulterated benefits of rebasing to be worth more to it than the clause 60 relief itself (which is likely to be the case in most circumstances), it would have no difficulty in so arranging its affairs to be outside the scope of that clause.

6. Another option within the special North Sea rules would be to prevent oil groups setting off North Sea losses against gains outside the North Sea. This would be a pragmatic solution to ensure that the losses arising on oil licences and North Sea plant and machinery could not result in tax loss until gains were made inside the North Sea ring fence itself. But it would have no justification in logic. The purpose of the present North Sea ring fence is to prevent North Sea income being eroded by extraneous losses: any attempt to ring-fence North Sea losses would mean turning this whole concept on its head. And such a move could have some very odd behavioural effects, distorting patterns of activity within the North Sea sector itself.

SECRET AND PERSONAL

BF 2/6

Inland Revenue

Policy Division
Somerset House

From: D Y Pitts

Date: 27 May 1988

1. Mr Isaac [initials] 27.5

2. Chancellor

Ch/ How would you like to take this forward? [initials] 27/5

Before responding to this v. negative note, I wd like a quick comment from Mr Culpin. At this stage I wd only wish to note that it is no part of our policy to consolidate the locking-in effect. NL.

CGT: MAIN RESIDENCE EXEMPTION

A. Introduction

1. You asked for a quick note, without wide consultation, on the possibility of limiting - rather than ending - the CGT exemption of an individual's main residence. It is often argued that owner occupiers are over-privileged, and the move to a community charge adds to this.

2. Since last considered, new background includes the general thrust for wealthier individuals of this year's Budget, including rebasing: per contra the charging of capital gains at marginal income tax rates (and 'lumpy' assets like house sales will sometimes push the gain into the higher rate): and severe staffing shortages in the Valuation Office.

---

c Mr Culpin

Mr Isaac
Mr Pitts
Mr Cayley
PS/IR.

PITTS → CH/EX 27/5

General

3. Two general factors. First, wider political considerations apart, a 'normal' CGT charge on the sale of a house (not least while house prices rise much faster than the general price level) would risk an unacceptable constraint on mobility. In principle, there are two main ways to mitigate that charge:

   (a) first, by deferring it (paragraphs 5 to 11 below)

   (b) by enforcing the charge at the time of disposal, but reducing the amount in one way or another (paragraphs 12 to 19).

4. Secondly, the CGT general exemption was introduced to keep the mass of small gains out of charge mainly for administrative reasons. With 1.3/4 million moves each year, any change to the residence exemption is in danger of reversing this - or even worse - at a stroke. Below, I consider which options are preferable in this regard.

B. The Options

Rollover

5. One reason for not ending main residence exemption is the locking-in effect that would have. A rollover relief - deferring a gain on the sale of one house by allowing it to reduce the cost of the new house - could reduce that effect. More precisely, the rule would be that the taxable gain (after rebasing) was not to exceed the amount by which proceeds are not reinvested in a replacement main residence in the UK. (The interaction with indexation would need further thought).

6. There are four main considersations. First, to make the charge effective and sufficiently reduce the locking-in effect you would need to reintroduce CGT on death disposals. Otherwise, because staying put until death would avoid tax, the new charge would enhance the reluctance many people already have to move.

?? (of all assets)

7. But a 'death' charge only for this asset would look arbitrary, and you may prefer to re-introduce it for all assets. We should need to consider the wider implications of reintroducing a 'death' CGT charge (on either basis), not least for inheritance tax.

8. Secondly, the main area of impact. The new CGT charge would apply most obviously to the elderly on trading down. For these there could be substantial tax to pay on the accumulated gains of a lifetime, and the liability could arise when resources were stretched. So you would certainly be pressed to exempt the elderly. That way, you could also avoid introducing a charge on death disposals. But exemption for the elderly would reintroduce the locking-in effect for those nearing the age threshold. And it is not clear that there would be many house moves left for the scheme to bite on. If you wish, we could see if an estimate can be made using historic data. The behavioural effect of the new rules would further reduce that number.

9. Thirdly, administration. Most of the 1.3/4 million moves each year would probably be covered by the new relief. That means that as with exemption, there would still be no tax. But, unlike with exemption, the house sales would have to be reported (and many sellers won't even get a tax return under present practice) and checked - a large administrative cost for no immediate yield. To reduce these costs, I would suggest you build in an exemption for smaller gains.

10. Even so, there could be a significant administrative cost, not least on vetting claims for improvements (something this year's MIR charge had got rid of). The cost of improvements to the old house (perhaps incurred long previously) would be added to the cost of its purchase price in determining the gain on selling it: and the cost of improvements to the new house would be taken into account in determining the extent of the 'rollover'.

11. Fourth, the law. When this option was last looked at, we advised that replacing the present exemption by a rollover relief would be a substantial legislative exercise.

Small gain exemption

12. If these considerations - not least, the 'elderly' dimension - rule out 'rollover', another option is to tax only gains above a (cumulative) threshold. Under this option (unlike rollover), the tax would apply whether the sale proceeds were reinvested in housing or not.

13. Both the points in 6/7 and in 8 above would apply, but with less force.

14. The main advantage of a quite high, cumulative threshold would be to reduce administrative costs. For that reduction to be effective, it would be necessary for the ordinary CGT exemption not to be available against house gains - they would have this new, separate threshold instead. Only the first 'improvement' complication (10 above) would exist, though this would entail house-owners keeping records, often for many years.

15. A variant on this option would be to tax a small percentage of the gain, or to tax the full gain at a reduced rate. But this would mean dealing with every house sold at a gain. On cost grounds, a threshold is preferable.

16. The threshold could be described either as £x thousand or as a percentage of costs - in each case per year of owner-occupancy of the house as the main residence. The former would cut out the small cases, but is rather inflexible - house inflation varies by year and by region - and so would have arbitrary effects. The latter would reflect regional differences better, in particular giving a higher threshold to more (than to less) expensive houses. To achieve the advantages of both, you could grant whichever of the two was greater.

17. We have not yet consulted widely to discover the underlying data needed to judge where to set the threshold (we might need to go to DoE for these). We would try to get it to fit your objectives. The lower the threshold, the greater the administrative cost: the higher, the lower the impact and the yield. The latter would be appropriate if your objective is to shift more of the tax burden on to higher price houses.

Small proceeds exemption

18. If that is your objective, an alternative approach might be to continue the present exemption for properties where the disposal proceeds were below a certain level, and to charge in full gains made on disposals above that amount. If the figure were pitched at a fairly high level - say £300,000 - only the more spectacular transactions would be caught (though no doubt it would cause some distortion in the market prices around the chosen figure and make valuations difficult). Measures would be necessary against the fragmentation of interests and sale proceeds in order to secure the maximum benefit. There would also need to be some form of marginal relief, to avoid a cliff-edge effect.

19. Because the number of cases would be relatively few, this would do most for the points in 6 to 10 above.

All options - general factors

20. Retrospection. Would you want to tax gains accrued before the date of change? CG changes generally apply in that way to existing chargeable assets, but here you would be bringing a new - and sensitive - class into charge.

21. Valuation Office implications. Either way, valuation would ordinarily be needed. If, as we assume, you did not want to bring into tax accrued gains, all houses sold would need to be valued as at the scheme's start-date: otherwise, the valuation - to give the benefit of rebasing - would be as at March 1982. We have not spoken to the Valuation Office but would expect much of the work to be done by non-professional staff. We doubt if even they could take it on before 1991, and would expect a significant call on valuer time as well - to deal with the more expensive houses and appeals generally - just when non-domestic revaluation is a priority and we are desperately seeking remedies for a large shortfall in recruitment.

22. To avoid valuations, the rules could be applied (more simply, but less fairly) only to houses acquired after a current date. But the new scheme would then not bite to any significant extent for a considerable time. There would also be some additional locking-in effect.

23. Independent taxation. We may need special rules to deal with jointly-owned houses.

24. Dependent relatives. In withdrawing the residence exemption this year from 'dependent relative' houses, you said it would continue in existing cases. It would seem sensible to exclude these from the new scheme.

25. There will be other technical areas, such as how the charge applies when people have two houses each of which has been used at different times as the main residence.

C. <u>Wider considerations</u>

26. If you want more work to be done on any of these options, you would presumably wish to consult more widely in Treasury (and later, if you decide these ideas are worth pursuing further, colleagues in Departments of Environment and Employment) on the wider implications for Government policies such as labour mobility, Right to Buy and home ownership encouragement generally, optimum use of housing stock, and the effect on house prices.

D. <u>Timing</u>

27. For this reason alone, we think it unlikely to be possible to introduce any option which could have major impacts in this year's Finance Bill. Similarly, if it had significant staffing effects, we should need extra funding and time to recruit and train. These considerations (and the Valuation Office position if the rule in 22 above is not acceptable) point to legislating not before 1989.

28. Our resources for devising further legislation on CGT this year are also pretty stretched. Unless a very simple option can be found, there will be a limit to how much we can do in time even for Report Stage.

E. <u>Conclusion</u>

29. We seek your guidance on whether further work is to be done, and if so on which options and on what timescale.

DP

D Y PITTS

NH3/42AL

NMR
[illegible]

FROM: A C S ALLAN

DATE: 3 June 1988

CHANCELLOR

CGT: MAIN RESIDENCE EXEMPTION

Now attached behind.

It looks like I will be off this evening before Robert's note arrives. I have discussed some of the points with him, so there maybe some overlap with his note.

2. If we do this, I would go for a scheme with a £X,000 per year cumulative threshold. I see no advantage in setting the threshold as a percentage of the cost, which means a larger annual exemption for expensive houses.

3. Nor do I like the alternative approach of charging gains in full if proceeds are above a £300,000 threshold. Set this high, it seems to be trying to take the wrong political trick: it looks like a belated attempt to clobber the rich after you have already weathered that storm; or ditto for offsetting the abolition of domestic rates. There could be some attraction in following this route but with a much lower threshold - say £100,000 - but I prefer the cleaner scheme of a cumulative annual exemption.

ACSA → CH/EX 3/6

4. I can't see you succeeding in introducing this with a base date earlier than the date you announce it: taxing gains made since 1982 would undoubtedly be seen as retrospective (though I accept that no-one has complained that raising the CGT rate to 40 per cent is retrospective).

5. One thought about the timing. It will clearly be very tight to get legislation drafted in time for Report Stage. If that is impossible, you could announce now that you are going to introduce CGT on main residences, with a base date on the day when you made the announcement, with legislation in next year's Finance Bill, but implemented only on sales after Royal Assent next year. This is a

bit odd - why didn't you do it in the Budget this year? and it gives a full year for adverse lobbying - but it does have the advantage of an early psychological/behavioural impact, which is a major objective. The revenue loss would be pretty small.

A C S ALLAN

AA

Most advantageous is both yours + Robin's. Pls minute John Isaac along the lines suggested by Robin, but without Option (1), & with my strong comments.

NL

2714/24

SECRET

FROM: ROBERT CULPIN
DATE: 3 June 1988

CHANCELLOR

CGT ON HOUSES

1 am afraid the Pitts paper (27 May) just won't do. We know the general arguments. What we want from the Revenue are worked up options.

2. I am pretty sure we shall decide against action this year; but we are not there yet. We still need to test the possibilities a bit further.

3. To narrow the field, I suggest you rule out three things:

- undiluted CGT, because that could seriously inhibit labour mobility

- full roll-over, because that would confine the charge (in effect) to equity withdrawal by elderly people trading down

- partial roll-over, because (I guess) that would be an administrative nightmare.

4. I suggest you ask the Revenue to work up as soon as possible ~~three overlapping~~ two options, to enable you to consider whether anything could be done in this year's Finance Bill.

CULPIN → CH/EX 3/6

Options

5. **Option 1:** insert thin end of wedge.

- Impose CGT on main residences sold for more than £300,000, or such other (preferably lower) figure as the Revenue may advise: Pitts para 18.

- Tax only real gains made from the time of announcement, or from Royal Assent of the Finance Bill, or such other date as the Revenue may suggest: Pitts para 20. Clearly, this could be shutting the stable door after the horse has bolted. But I doubt if retrospection would be reasonable.

- Limit the charge, either by taxing only a proportion of the real gain, or (possibly better to start with) by saying that tax will only be charged on real gains up to the (cash) difference between the £300,000 threshold and the sale price. Example: sale price £350,000; real gain £70,000; levy CGT only on the £50,000 excess over the threshold.

- Leave unchanged the CGT exemption at death.

- Keep other details as simple as possible.

- Aim, for the future, to lower the £300,000 threshold, while taxing only a proportion of the real gain.

6. The presentation of this would be that it should impose some direct check on the housing market at the top end; send a salutary shock through the market more generally;

and deal with the worst remaining unfairness of abolishing the rates, rebates having dealt with ability to pay at the lower end.

7. The counter-argument would be that it would be a lot of fiddle for little if any benefit: yet more pages of legislation, yet another job for the valuers, some locking in of higher paid executives, little yield, etc etc. These are perfectly reasonable points, but should be taken with a pinch of salt.

8. I was initially attracted by this option, for the simple reason that it has the feel of something we could just about get through quick. But on reflection, I do not really see why we should tax small gains on large houses, yet leave untouched large gains on smaller houses. Why, after all, _should_ capital gains on ordinary houses escape tax? And if that is the bullet we ought to be biting, might it not be a mistake to settle for second best simply in the interests of making a small start quick? It might not make enough impact on the housing market to be worth it.

9. So we need an **Option 2.** Option 1.

- Tax capital gains on main residences, regardless of their selling price, without roll-over relief.

- Tax only half the real gain, or such other proportion as the Revenue may advise.

- Tax only gains made from announcement, or Royal Assent of the Finance Bill, or some similarly appropriate date.

- Tax only gains above a small but cumulative exemption, set at whatever level it takes to keep the numbers manageable.

- If all this would push too many basic rate payers into the higher rate band (because houses are lumpy assets), consider taxing houses only at the basic rate.

10. It may be that there is, in practice, a knock-down objection to this: it would presumably require all owner occupiers, when they move,

    (a) to have a 1988 valuation put on their houses,

    (b) to go through elaborate calculations to compute their real gains, and

    (c) to file tax returns which would otherwise be unnecessary.

I can't judge how serious this would be, though we should clearly be extending what is now a minority tax to a substantial chunk of the population. We need to ask the Revenue how best to minimise the compliance burden.

11. If this poses an insuperable problem, we might have to fall back on an **Option** ~~**3**~~ 2, ~~which would be a compromise between the two~~. Roughly:

- Exempt altogether houses selling for less than (say) ~~£100,000~~. the Inheritance Tax threshold (at present £110,000).

- Tax half the real gain on the rest.

Timing

12. As I say, it seems to me just conceivable that, if you are prepared to confine the charge to expensive houses, we might be able to do Option 1 in this year's Finance Bill, though the Revenue would probably contest that. It would be a heck of a scramble, and there would be umpteen technical difficulties. But it would give us a foot in the door.

13. I think myself that I would not do that, because it would be too modest a measure; and I doubt if the wider ranging options are practical possibilities for this year, though I am all for pressing the Revenue.

14. If that is right, the question arises whether, as a fall back, you could make a statement now threatening action next year. All my instincts are against this: we should be setting ourselves up for a full year of lobbying, encouraging people to move houses before the next Budget, getting drawn prematurely into the details of a particular scheme, etc etc. But if you want to administer a shock to the housing market, it is only sensible to consider it.

15. As I am finishing dictating this (amid many distractions), Mr Allan has suggested that if you were to announce somthing, it might possibly take this form:

(a) you will definitely impose CGT next year;

(b) the base date for all calculations will be 1988; but

(c) transactions concluded before the next Budget will be exempt.

We should still, of course, have to say roughly what the CGT rules would be.

Conclusion

16. It may be that all this is becoming slightly less pressing if we are returning to a period of rising interest rates. And I do not pretend that any of the options here are easy, whenever we tackle them. But it comes back to the old story: CGT on houses is far from ideal, but there is nothing else on offer.

17. I see from today's Independent, incidentally, that it is the answer to all ills in Japan.

Rc

ROBERT CULPIN

SECRET AND PERSONAL

Regs

Inland Revenue

Policy Division
Somerset House

FROM: D Y PITTS

DATE: 8 JUNE 1988

PS/CHANCELLOR (MR ALLAN)

CGT: MAIN RESIDENCE EXEMPTION

Your minute of today.

I will now work this up consulting in the Revenue - including someone in the Valuation Office - on a named need-to-know basis.

D.

D Y PITTS

PITTS → ACSA 8/6

c Mr Culpin

Mr Isaac
PS/IR

53/2/LPD/3769/67

CONFIDENTIAL

FROM: P D P BARNES
DATE: 10 June 1988

PS/FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Mr Scholar
Mr Culpin
Mr M Williams
Ms Goodman
Ms Hay
Mr Cropper
Mr Tyrie
Mr Isaac IR
Mr Johns IR
Mr Cayley IR
Miss Hill IR
Mr Beauchamp OTO
PS IR

Content - but I v. much hope we shall not have to fall back on 46(i). ✓

Ch/ FST's view (to which this is a reply) behind. Agree we should go ahead on lines of 46(b) ii? With 46(b) i as a fallback? 14/6

CGT: PLANT, MACHINERY AND OIL LICENCES

The Economic Secretary has discussed with officials the oil aspects of the submissions from Messrs Johns, Isaac and Cayley of 26 May.

2. Against the possibility of a general solution proving <u>not</u> to be feasible, the Economic Secretary considered the option of ringfencing North Sea CGT so that capital losses in the North Sea could not be offset against capital gains elsewhere. But in discussion it was pointed out that this option would bite not just on potential beneficiaries of Framlington but also on those who would normally have wished to offset North Sea losses against gains elsewhere. There seemed no reason in logic to deny them this facility and to do so could have an adverse effect on activity in the North Sea. In addition, this change was likely to generate as much opposition from the oil industry as the more complete solution of denying the Framilington election simply on all oil assets. Given the unattractiveness of the ring fence option, the Economic Secretary agreed with the Financial Secretary that the option in paragraph 46b(ii) of Mr Cayley's minute was the one to pursue, with the 46(b)(i) option as the fall back.

3. On presentation, the Economic Secretary thought that we should deploy two main arguments; first, the reason for the introduction of the Framlington election was to ease pressures on record keeping. So there was no reason to extend Framlington to plant and machinery, as records of the acquisition and disposal of plant and machinery would need to be kept in any case. Second, it was not the intention that the change should allow people to make uncovenanted gains from tax losses. Extending Framlington to plant and machinery would simply give rise to tax-induced transactions, particularly in the oil industry.

4. In addition, we could argue that, as oil companies had been one of the principal beneficiaries of rebasing, there could be no justification for giving them a further unnecessary advantage.

5. The Economic Secretary thought that in any event we ought to make the two technical changes refered to in paragraph 45 of Mr Cayley's note.

PB

P D P BARNES
Private Secretary

SECRET AND PERSONAL

Copy 1 of 10

Inland Revenue

Policy Division
Somerset House

FROM: D Y PITTS

DATE: 10 JUNE 1988

Alex
pse regularise
pse ASAP.

Ch
Points for decision summarised in para "E1", at end

PITTS → CH/EX 10/6

1. MR ISAAC 10.6

2. CHANCELLOR

10/6

For the present, I do wish to keep open the option of legislation @ Report stage. But we will clearly need an early mtg. In the meantime, if helpful, I am inclined to accept the recommendations in B3, B5, B6, B11 & C2-10, but no drafting at once. We can discuss the general authority at the mtg to work. (urgent draft)

CGT: MAIN RESIDENCE EXEMPTION

A. Timing of legislation

A1. Mr Allan's minute of 8 June outlining the options you have chosen asked me a) to work up a scheme and b) for further advice on the timing of legislation. Although I realise b) may depend on a) - which is not fully ready - if we are to keep the option of this year's Finance Bill open, I need to seek your guidance on b) now. If we can instruct Counsel by the end of next week, and no new major snags come to light, we are hopeful we could have legislation ready for Report Stage. Decisions on the precise level of exemptions can be left for slightly longer.

---

cc Mr Culpin

Chairman
Mr Isaac
Mr Pitts
Mr Cayley
Mr Garrett (Valuation Office)
Mr Gonzalez (Statistics Divn)
Mr Boyce (M2/3
PS/IR

A2. But this means

a) a decision on the main details early next week, and on which option to go for the following week,

b) relatively straightforward legislation (eg no 'Kink' test, no CGT on death and the same rules for homes for dependant relatives),

c) introducing a major new measure - needing a Resolution - at Report Stage, and so too with little chance for amendment,

d) completing within this time scale any further work you may want from Treasury (and OGDs?) on such matters as labour mobility (paragraph 26 of my 27 May note),

e) haste increases the risk that we get things wrong,

f) less time for attention to any other new CGT developments (eg amendments to the Bill) which may arise before Report,

g) no time to work properly through staffing implications and procedures.

A3. You also need to consider:

h) making provisions for the resources needed,

i) aggravation (see B 7 and 8 below) of the Valuation Office problems.

A4. Not knowing your objective, I cannot judge how this weighs against these considerations - nor what scheme would best meet it. From here, legislation this year looks an unattractively high risk unless the economic arguments are sure and overriding.

A5. But deferral until next year would probably have to be of announcement as well as legislation. There could be unpredictable effects in the market if news broke that exemption has a year to run..

B. Which option?

B1. I do not yet have the figuring needed to assess more fully the impact of each option. One thing clear is that the number of cases could alter significantly with shifts in the rate of change in house prices (and the latest NIF, for example, sees rises after this year falling close to the rate of inflation for two years, but taking off again after that).

B2. And the figuring is important for assessing the options. So work is continuing on that. What follows is therefore an interim report only. I give it now both for its relevance to the decision in A above and to set out some policy questions on which early decisions are needed if the Report Stage Option is to be kept open.

a. The main option

B3. To allow time for people nearing the starting-gate of a house move, I suggest the charge apply only to disposals from contracts signed after (say) 30 September 1988, with that date also as the base for determining gains or losses.

B4. I have considered how the compliance burden of the main option might be minimised. But it is not clear that the results will be sufficient unless some way can be found to reduce the number of cases to manageable proportions.

B5. First, it will help if the special residence exemption is separate from the ordinary CGT exemption (14 of my 27/5 note).

B6. But for both taxpayer and tax office, giving relief for improvement expenditure, which may have been made many years before a sale, is a problem - record-keeping and distinguishing repairs long after the event. So secondly I suggest you disallow improvements (or all below a high-ish minimal annual threshold). Instead, the cumulative exemption - which is in addition to indexation and still leaves the general CGT exemption to offset any other gains - would count as a rough-and-ready proxy.

B7. We would not make a meal of examining the taxpayer's 30 September valuation for disposals soon after that date. But we have not so far thought of a way of short-circuiting the need to value every house sold thereafter. Even though most of the cheaper houses could be dealt with by non-professional staff, if the Valuation Office have to be involved - given their problems - this is a stopper. A first estimate is that over 500 valuers (apart from other staff) would be needed. The only way to avoid this would be to require the taxpayer (at his expense) to have valuations made by surveyors or estate agents, and for us to accept most (or all) without checking. But I would have no confidence that this would give consistent or reliable results. It could result in the scheme losing credibility.

B8. The extra demands, not least in the shorter term, to make 1988 valuations for some hundreds of thousands of cases could well lead to private firms poaching from the Valuation Office, if it proved practical at all. Valuation would be needed in nearly every case to establish whether or not there was a chargeable gain. The annual exemption does not avoid the need for this.

B9. Many who do not receive a tax return but sell their house would not themselves report it. We should need to set up machinery to chase up all potentially chargeable cases not reported. We get reports of all house sales as it is but they do not tell us the gain or say how long the house has been held, so again the exemption does not enable us to weed out cases.

B10. Both these considerations suggest the need for a threshold by reference to disposal proceeds to reduce the number of cases, as in the fallback option.

b. The fallback option

B11. The 'improvements' problem would remain (B6 above) unless, in addition to the £110,000 threshold, you added an annual exemption, as for the main option, in lieu of allowing the cost of improvements. I think you would have to. In effect, I think you need an amalgam of both the 'main' and 'fallback' options.

B12. While a final view must wait until I have the figures (B1 above), a preliminary assessment suggests that a threshold of £110,000 could still need 150 valuers or so.

C. Details of the options

There are some further points of detail we have identified so far needing your decision.

C1. You want to tax only a proportion of the gain. This does not reduce compliance costs. The purpose is presumably to reduce the impact of the tax. The criteria for deciding by how much presumably therefore depends on the effect on house prices - on moving house, people will be able to afford to pay less for the new house - and on mobility. Unless we can quantify these effects - which is doubtful - a half seems a reasonable fraction to go for.

C2. I take it that similarly only half of any loss would be allowable.

C3. Would you want to ring-fence house transactions so that losses/gains were not offsettable against other gains or losses? If not, you could stimulate more bed-and-breakfast sales of loss-bearing shares to reduce gains on selling houses; it might even be said that the new tax on houses was voluntary for some of the wealthier. But you may think a ring-fence would be going too far.

C4. The exemption from CGT on death would encourage some not to move, especially elderly people in over-large houses. But we could not, in the time, examine all the implications of reintroducing CGT on death.

C5. Because of the way the dependant relative rules intermesh with the general rules, I am now advised that we could probably not (this year) continue the complete exemption for existing dependant relative homes promised at the time of the Budget: instead they would become chargeable to the same extent as the taxpayer's own home.

C6. Similarly, a 'Kink test' - to prevent a charge arising because of an increase in value since the start-date where there is an overall loss since purchase - would probably be too difficult to legislate for this year. But (in present circumstancese) there should be few people with a loss one side of the start-date and a gain the other.

C7. It is not always clear - at any rate with married couples - how great the interests of each owner are where houses are jointly-owned. We recommend the solution already adopted for investment income in Clause 33 - gains to be divided equally unless the parties establish otherwise.

C8. But is each joint owner to have a separate cumulative exemption? Because for gains we have to look back over a number of years, we think it would be too complicated to follow this year's mortgage interest relief measure attaching the relief to the residence. So we conclude they would have to have a separate cumulative exemption so two joint owners would get double the exemption of a single sole owner in comparable circumstances. But I think the threshold should be divided between the joint owners in the ratio of their interests in the property at the time of any disposal.

C9. To avoid a penalty/advantage on marriage, the rules in C8 would apply to husbands and wives. And we suggest doing this from the start - not waiting for independent taxation.

C10. Would you want to exempt the elderly? For the reason discussed in paragraph 8 of my May note, I assume not.

D. Provision

D1. We have no PES provision for the cost of administering this new charge. We assume that you would be prepared in principle to agree an extra bid for the necessary resources, subject to agreement of the numbers. A preliminary estimate is that with an annual exemption of £5,000 and a threshold of £110,000, we should need some hundreds of staff.

!?

E. Conclusion

E1. In B above, although we still have more work to do, I show the way the two options are shaping up and apart from the level of exemption we have, we think, now identified all the policy issues that need to be decided. In the light of this and more especially of A, is the option of legislation at Report Stage to be kept open? If Yes, it would be helpful to have your decision on the points in B3, B5, B6, B11, C2 to 10 and D and early authority to start involving Parliamentary Counsel. You may want to discuss this with us.

DP

D Y PITTS