

PO-CH/NL/0386
PART A

SECRET

(Circulate under cover and
notify REGISTRY of movement)



PO -CH /NL/0386



PART A

BUDGET 1988 ADDITIONAL
RATE TAX ON TRUSTS

DD's 25 years NAGL 7-12-95.

19.2.88

PO -CH /NL/0386

PART A

PART A



Inland Revenue

Policy Division
Somerset HouseFROM: C W CORLETT
FAX No. 6766
EXTN. 6614
12 February 1988

1. MR ISAAC *del 122*
2. FINANCIAL SECRETARY

ADDITIONAL RATE TAX ON TRUSTS (STARTER 120)

1. This paper sets out the arguments for and against abolishing the 15 per cent additional rate on trusts. It recommends retention, though at a lower rate.
2. The crucial factor from our point of view is that, even with a reduced higher rate of tax, abolition would open up significant scope and temptation for the well-off to shelter income, especially now that -
 - i. the covenant tax-break is being stopped; and

cc Chancellor of the Exchequer
 Chief Secretary
 Paymaster General
 Economic Secretary
 Sir P Middleton
 Sir T Burns
 Sir G Littler
 Mr J Anson
 Sir A Wilson
 Mr Scholar
 Mr Byatt
 Mr Culpin
 Mr Sedgwick
 Mr Odling-Smee
 Miss C Evans
 Mr Hudson *(Not read Stewart paper)*
 Mr Cropper
 Mr Tyne
 Mr Call
 Miss Sinclair
 Mr Riley
 Mr Unwin - Customs & Excise
 Mr Knox - " "
 Mr Jenkins - Parliamentary
 Counsel

Mr Battishill
 Mr Isaac
 Mr Beighton
 Mr Cleave
 Mr McGivern
 Mr Deacon
 Mr Stewart
 Mr Davenport
 Mr Spence
 Mr Yard
 Mr Mace
 Mr R H Allen
 Mr Ko
 Mr Cayley
 Mr Boyce
 Mr H Thompson
 Mr Bryce
 Mr Reed
 Mr Skinner
 Mrs Fletcher
 PS/IR
 Mr Corlett

Mr Painter

- ii. there will probably be more top-rate taxpayers than at present who could gain an advantage.

3. The shelter is more awkward and less advantageous than the covenant route. It requires the settlor to divest himself of any interest in the capital and income. And the benefit is only the higher rate tax, not the basic rate. But the former reservation does not apply to gilt unit trusts, which would be particularly attractive. And our judgment is that there would be sufficient benefit to be gained in even the ordinary trust fund to make it attractive to a wide range of new people.

4. If the decision is to retain the additional rate, something could be done for disaster trust funds, if desired. For our part, we could certainly operate an exemption. But we could not determine what qualified as a "disaster": that would have to be done by some other, more expert, authority.

5. The Law Society, in particular, is likely to continue to press for some concession for very small trusts. Once the Finance Bill is out of the way, we could, if you agree, have talks with the lawyers to see if there is any way of providing some sort of easement in those circumstances, if only through streamlined procedures.


C W CORLETT



Inland Revenue

Policy Division
Somerset HouseFROM: C STEWART
DATE: 12 FEBRUARY 1988

1. MR CORLETT *656
12/2*
2. MR ISAAC
3. FINANCIAL SECRETARY

ADDITIONAL RATE TAX ON TRUSTS (STARTER 120)

1. This minute considers the future of the additional rate income tax charge on trust income.
2. The main questions to be considered are -
 - a. whether the additional rate charge should be abolished in the context of the Budget reforms;

cc Chancellor of the Exchequer	Mr Battishill
Chief Secretary	Mr Isaac
Paymaster General	Mr Beighton
Economic Secretary	Mr Cleave
Sir P Middleton	Mr McGivern
Sir T Burns	Mr Deacon
Sir G Littler	Mr Corlett
Mr J Anson	Mr Davenport
Sir A Wilson	Mr Spence
Mr Scholar	Mr Yard
Mr Byatt	Mr Mace
Mr Culpin	Mr R H Allen
Mr Sedgwick	Mr Ko
Mr Odling-Smee	Mr Cayley
Miss C Evans	Mr Boyce
Mr Hudson	Mr H Thompson
Mr Cropper	Mr Bryce
Mr Tyre	Mr Reed
Mr Call	Mr Skinner
Miss Sinclair	Mrs Fletcher
Mr Riley	PS/IR
Mr Unwin - Customs & Excise	Mr Stewart
Mr Knox - " "	
Mr Jenkins - Parliamentary Counsel	

b. if not, how the formula for fixing the rate should be adjusted, and at what level the rate should be pitched for the future.

3. Final decisions on b. will clearly depend on decisions on personal tax rates for the coming year.

4. Our recommendation is that the charge should remain for the reasons set out in paragraph 19.

5. If, however, you are attracted to the idea of abolishing the charge, paragraph 5 of the Annex suggests how this might be done. If that is your preferred option further work will need to be done on this and possible consequences.

How the additional rate works

6. The additional rate is charged on the income of discretionary and accumulation trusts. Broadly, these are trusts where no individual beneficiary has a clear entitlement to have the income paid to him as it arises. For example, under a discretionary trust, the trustees will have discretion over whether (and if so when) the trust income is paid out, and to which beneficiaries. So it does not immediately become part of anyone's personal income.

7. For the purposes of the accrued income scheme (AIS) the additional rate applies to a wider range of trusts. In particular, it applies to gilts unit trust so that they pay tax at 45 per cent on their accrued income charges.

8. The income of all these trusts is charged at 45 per cent (27 per cent basic rate, plus 18 per cent additional rate). When income is paid out of a discretionary trust to a beneficiary, the beneficiary gets credit for the basic and additional rate tax paid by the trustees. So if he is a non-taxpayer, or pays tax at less than 45 per cent, he can get all or part of the tax repaid

to him. If he is liable at more than 45 per cent, he will be charged the extra tax direct.

9. If the income is to be accumulated, it will become part of the capital of the trust and will eventually reach the beneficiaries as capital. In that case, the 45 per cent rate is effectively a flat rate charge on the income, and there is no repayment (or further liability) for the beneficiaries.

History of the additional rate

10. The additional rate was introduced in 1973 as part of the general reform of the structure of personal taxation (which abolished surtax and replaced earned income relief by investment income surcharge). It broadly represents higher rate liability on the trust's income. The aim is to restrict the use of discretionary trusts by wealthy taxpayers to avoid higher rate tax by accumulating income under the shelter of a trust, and to reduce the tax loss when they do so.

11. When AIS was introduced in 1985 the additional rate was applied to the accrued income of trusts. This was to deter the use of trusts as a medium for avoiding higher rate tax on accrued income (and thus frustrating the anti-bondwashing defences of AIS). The additional rate charge on accrued income covers most trusts, including gilts unit trusts (which had been one of the main avenues of bondwashing).

The level of the additional rate

12. The additional rate was originally linked to the investment income surcharge (IIS) rate of 15 per cent. When IIS was abolished in 1984, Ministers decided that the justification for the additional rate charge on trusts still stood. But clearly the rate could no longer be pegged to the IIS rate, and the legislation now fixes it automatically as the difference between basic rate and the second higher

rate. In 1984-85 this gave an additional rate of 15 per cent (45 less 30). When basic rate was reduced to 29 per cent and then 27 per cent, Ministers left the additional rate to go up automatically under the formula to 16 per cent and then 18 per cent. So the total tax payable by the trustees has remained at 45 per cent - roughly half way between the basic rate and the top personal rate.

Numbers of trusts

13. A recent survey of 55,000 discretionary trusts showed that less than 3 per cent of the total have income of more than £25,000, but the income of those 3 per cent is over half the total income. So there is a relatively small number (around 1,500) with a very substantial income. The great majority have income of £5,000 or less (but the same family may have more than one trust).

14. There are another 35,000 or so trusts which were not covered by the survey and about which we have no detailed information. In addition there is substantial investment by higher rate taxpayers in gilts unit trusts, and other trust which are liable to additional rate on their accrued income.

Yield of additional rate

15. The additional rate charge on trustees is estimated to yield about £m50 a year at 1988-89 income levels. Some of that tax will in due course be repaid to beneficiaries when the income is paid out to them; but the precise effect will depend on trustees' distribution policy and beneficiaries' personal tax rates. For example, the bigger trusts identified in paragraph 13 above pay out less than smaller income trusts, no doubt in order to shelter income from tax at higher rates.

16. The net yield is about £m30 a year. But to the extent that the additional rate deters the use of discretionary trusts and gilts unit trusts to avoid higher

rate personal tax, the cost of abolishing it could be considerably more than the current net yield of the charge (after allowing for repayments to beneficiaries).

Representations

17. Representations arguing for abolition of the additional rate are made from time to time by various interests. There has not been much complaint about the additional rate from the generality of trusts affected by it. But there have been a number of complaints that the additional rate bears too heavily on particular types of trust, and should be removed from them. As you know the Air Travel Trust have asked to be exempted. The heritage lobby have repeatedly asked for heritage maintenance funds to be exempted. The Law Society have made regular Budget representations that small trusts, and those which distribute most of their income, should be excluded (but we think they have accepted privately the case for having an additional rate charge; and there are practical and definitional problems about exempting "small" trusts). Representations are also made from time to time that children's trusts should be exempted. And there has in the last few days been a Press campaign on behalf of disaster funds, eg the Zeebrugge fund. We deal with this in paragraphs 31-35..

The case for abolition

18. The case for abolition is:

- a. it is arguable that there might be little increase in the number of trusts to exploit the tax gap, because since 1984 the gap between the combined rate on trusts (45 per cent) and the top rate (60 per cent) has been 15 percentage points. If the gap between basic and top rates was reduced to (say) 15 points the maximum tax saving in an individual case would be no greater - even without the additional rate - than it is at present.

b. there are other factors which may limit the incentive to set up discretionary trusts for income tax saving purposes:

- if a person sets up a trust but retains a right to benefit under the trust or a power to revoke the trust, the trust income remains his own for tax purposes in any event;
- a transfer of property into a discretionary trust may involve an inheritance tax charge (or at least use up part of the settlor's exempt slice). There will also be a periodic IHT charge (every 10 years) while the property remains in the discretionary trust regime, and a further charge when it leaves that regime. However, these charges may not apply - if, for example, the trust qualifies for the IHT exemptions for accumulation and maintenance trusts; and when they do apply they may be less burdensome than IHT charges on property not held in discretionary trusts;
- setting up and running the trust will involve some expenses - for example on preparation of trust accounts, dealing with the trustees' tax liabilities, and possibly separate management of the investments.

The case for retention

19.

a. The 15 per cent tax saving would be available to all higher rate taxpayers, not just those now in the 50/55/60 per cent bands. Although the maximum saving in individual cases may not be increased, the number of people whom it would pay to take advantage of the

saving would be substantially greater (about double under the income tax option 3).

b. This would be another (and unnecessary) concession for the better off who will be benefiting from the reductions in higher rates.

c. The wealthy might seek to get round the covenant reform by using trusts to channel funds to other individuals, including their own student children and other relatives.

d. following a recent Court of Appeal decision the scope for trustees to accumulate income in a trust and then pay out the accumulated income as capital is increased. Without the additional rate the income would be charged at basic rate only (with no repayment to the beneficiary, but no higher rate liability either).

e. There is a danger of avoidance of higher rate tax on accrued income. It is probable that gilts unit trusts would be used to avoid higher rate tax on accrued income on a large scale. Prior to AIS, bondwashing by gilts unit trusts was costing the Exchequer around £15 million (and was on a rising trend). The AIS, with the additional rate on accrued income, has reduced the tax loss, we think, to negligible dimensions. But if additional rate is removed, gilts unit trusts would be a convenient and attractive medium for avoidance of higher liability on accrued income. The Revenue cost could be substantial - quite possibly exceeding the £15 million tax loss prior to introduction of AIS. There could be criticism that Ministers were reopening a loophole which they had closed with AIS in 1985.

f. greater use of discretionary trusts may also lead to a decline in IHT revenue;

Administration costs

20. The additional rate charge is sometimes criticised, particularly by solicitors, on the grounds that it involves trustees in extra work, and that if the beneficiaries are non-taxpayers (eg children) the tax is likely to be repaid in due course anyway. There is something in this argument, because where the trust's income has suffered basic rate tax at source, an assessment will be needed for additional rate only. But the argument is sometimes overstated. Even if there was no additional rate, the trustees would still have to deal with basic rate tax liability in cases where the income is not taxed at source; and many beneficiaries might still have to claim repayment of basic rate tax anyway.

21. For the Revenue abolition of additional rate would undoubtedly be a simplification but any manpower saving might be more than off-set by the increase in number of new trusts.

Exchequer cost

22. As explained in paragraph 16, the net yield of the additional rate charge is about £m30 a year. The cost of abolishing it could be higher, depending on how many new trusts are set up to take advantage of the reduced trust rate (ie basic rate only) and the scale of higher rate payers' investment in gilts trusts.

Balance of argument

23. You will want to consider carefully the relative weight of the arguments for and against abolition. On balance, we would recommend retention, mainly because of the new shelter which abolition would open up for higher rate taxpayers, particularly under a system where there were only two rates, thereby undermining both this year's covenant reform and the accrued income scheme.

Fixing the rate

24. If the additional rate charge is to be retained, a decision will be required on how the rate should be fixed for the future. At present it is fixed automatically by reference to the second higher rate.

25. The choice is between linking it to -

a. the higher rate (ie 15 per cent if the basic rate is 25 per cent and the top rate 40 per cent). This gives maximum protection against the use of trusts as a shelter. On the other hand this may be criticised as unduly harsh, for example on small trusts; or

b. an intermediate point - eg half way (7.5 per cent), or a flat 10 per cent. We recommend 10 per cent, giving a total rate of 35 per cent (25 per cent basic plus 10 per cent additional).

26. Either way, you may wish to consider defining the rate by reference to the ordinary tax rates, so that (as now) legislation is not needed each year to fix the rate afresh.

Heritage Maintenance Funds

27. National heritage maintenance funds which qualify for the IHT exemptions also get special income tax treatment. These funds are discretionary trusts, and their income is therefore subject to basic and additional rate tax. In many cases the income may well be treated as the settlor's income under the ordinary rules whereby trust income is treated as the settlor's if he retains any benefit from the trust. But there is a special rule for heritage maintenance funds that if the income would, under the ordinary rules, be taxed at the settlor's rate (for example because he benefits from the fund as the owner or occupier of the house it maintains), the trustees can elect for the income to be charged at the basic and additional rate instead of the settlor's rate.

Clearly this is beneficial if the settlor's own marginal rate is above 45 per cent. If the additional rate was abolished, the effect of the election would be that the income of the fund would be taxed at basic rate only, instead of the settlor's rate. This would be welcomed by the heritage lobby, who have argued that these funds should be exempted from additional rate tax (and perhaps even from basic rate tax) to encourage historic house owners to set up maintenance funds.

28. There is also a 30 per cent charge on any accumulated income not already charged at the settlor's rate included in money taken out of a maintenance fund for non-heritage purposes. The aim of the charge was to remove any possible income tax advantage if income was taken out. But the heritage lobby have pointed out that the 30 per cent charge means that the total charge can be 75 per cent - ie more than the top personal rate.

29. The 30 per cent charge is very much a long-stop, and we are not aware of any case where a charge has actually been levied. It could be reduced to 15 per cent (or perhaps fixed automatically as the difference between basic and higher rates). Alternatively it could be left as it stands, on the grounds that it is essentially a deterrent to taking funds out for non-heritage purposes and that it removes any advantage from rolling up income in the fund in the meantime.

30. It is very much a matter of judgment whether you wish -

- a. to leave the 30 per cent rate as it stands, and consider the point if the heritage lobby raise it; or
- b. to reduce it to a level where the basic rate plus additional rate plus heritage rate equals the top rate of tax.

Either way the heritage lobby may take the opportunity to press for further tax concessions.

Disaster Funds

31. The possibility of exempting disaster funds from the additional rate has been raised. Though their reports are garbled, this is the thrust of the campaign in the Sun and Mirror.

32. Disaster fund are normally either charitable trusts or ordinary discretionary trusts.

- If they are charitable trusts, they get the same tax exemptions as other charities. But the trustees' freedom to make payments to beneficiaries is restricted to what is charitable in general law (eg relief of poverty).
- If they are non-charitable discretionary trusts, the trustees have greater freedom, but the ordinary tax regime for discretionary trusts applies.

Trustees can choose which form of trust to set up, and in some recent cases (eg Bradford), the trustees have deliberately chosen the non-charitable form.

33. It is not clear whether, in practice, the additional rate charge is a significant problem for trustees. The fund will earn interest (taxable), but normally the trustees will want to pay the money out pretty quickly, and when they distribute the income the beneficiaries will get credit for the tax (and obtain repayment where appropriate). Removing the additional rate charge on income would still leave the basic rate charge.

34. Disaster funds could be exempted from the additional rate (and the basic rate) without much practical difficulty. But two issues would have to be faced:

- i. Ministers would have to justify drawing a line between those trust funds and others established for other good causes - for example to help a disabled child.
- ii. There would need to be a decision on each occasion as on whether a particular tragedy qualified as a disaster for this purpose. It is difficult to see how that could be coped with legislatively. The alternative would be certification. The Revenue is not qualified to make that judgement; and the last thing we would want is the Department to be drawn into frequent public disputes over whether some event was sufficiently tragic or large-scale to qualify. This suggests that the certification should be done by a competent authority, such as the Home Secretary or the Home Office (or perhaps an appropriate Division of the Treasury).

Implications of abolition

35. If, on the other hand, the additional rate is to be abolished, it will be necessary to decide how to handle the transition - and in particular what if anything to do about accumulated tax deducted in past years. This is dealt with in more detail in the Annex.

Questions for decision

36. The questions for decision are:

1. Should the additional rate charge be retained or abolished (paragraphs 18 and 19)?

2. If the additional rate is retained, what should the rate be for 1988-89, and how should it be fixed in future (paragraph 25)?
3. Should anything special be done about disaster funds (paragraphs 31-34)?
4. Should the 30 per cent "long stop" charge when property is taken out of heritage maintenance fund for non-heritage purposes be reduced to 15 per cent (paragraph 30)?
5. If the additional rate is to be abolished, should the charge continue for 1988-89 only to allow trustees time to distribute income which has already borne additional rates in the past (paragraph 5 of Annex)?

CS

C STEWART

IMPLICATIONS OF ABOLITION

Credit for beneficiaries

1. If the additional rate charge is abolished, trust income assessable for 1988-89 and subsequent years would be charged at basic rate only. (There would still be some additional rate tax payable during 1988-89 on assessments for 1987-88.) But it would be necessary to consider whether beneficiaries should get any credit against income paid to them in 1988-89 and subsequently, for additional rate tax paid by the trustees in earlier years.
2. At present, trustees pay tax on the income at the rate for the year in which they receive it. They thus accumulate a "pool" of tax which is available for credit when the income is paid to the beneficiary. When the beneficiaries in due course receive income payments, these are treated as net sums which have suffered tax at the rate for the year in which the income is paid to them.
3. Thus if the trustees receive income in year 1 and pay 45 per cent tax on it, and then pay income out in year 3 when the combined basic and additional rate charge is 40 per cent, the beneficiary will get credit for 40 per cent tax. The remaining tax paid by the trustees remains in the pool for future use. Conversely, if the rate in year 3 is 50 per cent, the beneficiaries will get credit for 50 per cent tax and the trustees may then have to pay extra tax to the Revenue to cover the credit, unless they have sufficient tax already available in the pool to cover the full 50 per cent credit.
4. The credit was designed to work in this way for the sake of simplicity. Because the beneficiary gets credit at

whatever rate is in force in the year when the income is actually paid out, it is not necessary to try to identify particular payments to the beneficiary with particular items of income received by the trustees in earlier years. But if the additional rate is abolished from 1988-89, the effect of the present credit rules would be that on any income payments made to the beneficiaries from 6 April 1988 onwards, the beneficiary would get credit only for basic rate tax. Any additional rate tax paid in an earlier year by the trustees on the income out of which the payment to the beneficiary was made would remain in the "pool". It would thus be available for credit against future distributions. But in practice it would be likely to become stranded.

5. If you wanted to do something to enable beneficiaries to get credit for this "stranded" tax, one possibility might be to continue the additional rate charge for one more year to give trustees time to distribute past income with full credit for additional rate tax, if they wished. An announcement this year that trustees would not be charged additional rate on income arising after 5 April 1989 and beneficiaries would not be given credit of additional rate on payments made to them after 5 April 1989 would give trustees time to decide what they wanted to do about accumulated income. It also avoids some awkward administrative problems which would arise if we had to make special arrangements to allow beneficiaries credit for tax paid by trustees in past years. If you want us to explore this, or other, possibilities to unblock the "stranded" tax, we shall let you have a further paper.

Capital gains

6. If CGT reform goes ahead, with gains taxed at the rates that would apply were they the top slice of income, the decision on the additional rate will also affect gains. If the rate is kept, it will apply to gains of discretionary and accumulation trusts. If it is abolished, then these

gains will, like the income of the trusts concerned, be liable at the basic rate only. If the additional rate is kept for one year only, and then abolished, we would recommend against applying it for capital gains for that one year only.

Dividend stripping

7. There is a similar form of tax avoidance which could also be encouraged by abolition of the additional rate. This is "dividend stripping". This is potentially attractive when a company has profits which it wants to distribute and its shareholders are higher-rate taxpayers who wish to avoid an income tax charge. For example, what they could do is sell some shares to a pension fund (possibly the company's own pension fund). As part of this arrangement the company would then pay a large dividend to the pension fund, which would be able to reclaim the tax credit. The shares might subsequently be sold back to their original shareholders. Not only would they have avoided higher rate income tax but the pension fund would have received a payment of tax credit (the value of which would no doubt have been split between the parties). This is wrong in principle because the profits being distributed really belong to the former shareholders, and are simply being diverted to the pension fund.

8. In 1973 legislation was introduced to prevent this kind of abuse. Its effect is to deny a repayment of the tax credit and it also charges the pension fund at the additional rate. Without this additional rate charge, dividend stripping could still be attractive. (There might be some CGT liability on the sale of the shares but this could be a lot less than the income tax that would have been paid if the former shareholders had received the dividend.)

9 So the abolition of the additional rate would weaken the deterrent effect of the 1973 anti-avoidance provisions, although it is difficult to estimate how much avoidance would result.



10% allowances

married man, ave earnings

£1.19/wk vs indexation

£1.97 vs 87/88

42p vs Option 3

whole package

4.48 vs indexation

5.26 vs 87/88

man allowance of 78/9

29.7% higher, real terms (30)
(29.5% single person.)



wd make m. man's
allowances highest
real terms since 1939/40,
single person's highest
since 72/73

900,000 out of tax cf 87/8
580,000 out of indexation

produces no new bull
pts on international
comparisons.



Inland Revenue

Policy Division
Somerset HouseFROM: C W CORLETT
FAX No. 6766
EXTN. 6614
12 February 1988

1. MR ISAAC *122*
2. FINANCIAL SECRETARY

ADDITIONAL RATE TAX ON TRUSTS (STARTER 120)

1. This paper sets out the arguments for and against abolishing the 15 per cent additional rate on trusts. It recommends retention, though at a lower rate.
2. The crucial factor from our point of view is that, even with a reduced higher rate of tax, abolition would open up significant scope and temptation for the well-off to shelter income, especially now that -
 - i. the covenant tax-break is being stopped; and

cc Chancellor of the Exchequer	Mr Battishill
Chief Secretary	Mr Isaac
Paymaster General	Mr Beighton
Economic Secretary	Mr Cleave
Sir P Middleton	Mr McGivern
Sir T Burns	Mr Deacon
Sir G Littler	Mr Stewart
Mr J Anson	Mr Davenport
Sir A Wilson	Mr Spence
Mr Scholar	Mr Yard
Mr Byatt	Mr Mace
Mr Culpin	Mr R H Allen
Mr Sedgwick	Mr Ko
Mr Odling-Smee	Mr Cayley
Miss C Evans	Mr Boyce
Mr Hudson	Mr H Thompson
Mr Cropper	Mr Bryce
Mr Tyre	Mr Reed
Mr Call	Mr Skinner
Miss Sinclair	Mrs Fletcher
Mr Riley	PS/IR
Mr Unwin - Customs & Excise	Mr Corlett
Mr Knox - " "	
Mr Jenkins - Parliamentary Counsel	

CORLETT
TO
FST
12 FEB

- ii. there will probably be more top-rate taxpayers than at present who could gain an advantage.

3. The shelter is more awkward and less advantageous than the covenant route. It requires the settlor to divest himself of any interest in the capital and income. And the benefit is only the higher rate tax, not the basic rate. But the former reservation does not apply to gilt unit trusts, which would be particularly attractive. And our judgment is that there would be sufficient benefit to be gained in even the ordinary trust fund to make it attractive to a wide range of new people.

4. If the decision is to retain the additional rate, something could be done for disaster trust funds, if desired. For our part, we could certainly operate an exemption. But we could not determine what qualified as a "disaster": that would have to be done by some other, more expert, authority.

5. The Law Society, in particular, is likely to continue to press for some concession for very small trusts. Once the Finance Bill is out of the way, we could, if you agree, have talks with the lawyers to see if there is any way of providing some sort of easement in those circumstances, if only through streamlined procedures.


C W CORLETT



Inland Revenue

Policy Division
Somerset HouseFROM: C STEWART
DATE: 12 FEBRUARY 1988

1. MR CORLETT *by 12/2*
2. MR ISAAC
3. FINANCIAL SECRETARY

ADDITIONAL RATE TAX ON TRUSTS (STARTER 120)

1. This minute considers the future of the additional rate income tax charge on trust income.
2. The main questions to be considered are -
 - a. whether the additional rate charge should be abolished in the context of the Budget reforms;

cc Chancellor of the Exchequer	Mr Battishill
Chief Secretary	Mr Isaac
Paymaster General	Mr Beighton
Economic Secretary	Mr Cleave
Sir P Middleton	Mr McGivern
Sir T Burns	Mr Deacon
Sir G Littler	Mr Corlett
Mr J Anson	Mr Davenport
Sir A Wilson	Mr Spence
Mr Scholar	Mr Yard
Mr Byatt	Mr Mace
Mr Culpin	Mr R H Allen
Mr Sedgwick	Mr Ko
Mr Odling-Smee	Mr Cayley
Miss C Evans	Mr Boyce
Mr Hudson	Mr H Thompson
Mr Cropper	Mr Bryce
Mr Tyre	Mr Reed
Mr Call	Mr Skinner
Miss Sinclair	Mrs Fletcher
Mr Riley	PS/IR
Mr Unwin - Customs & Excise	Mr Stewart
Mr Knox - " "	
Mr Jenkins - Parliamentary Counsel	

- b. if not, how the formula for fixing the rate should be adjusted, and at what level the rate should be pitched for the future.
3. Final decisions on b. will clearly depend on decisions on personal tax rates for the coming year.
4. Our recommendation is that the charge should remain for the reasons set out in paragraph 19.
5. If, however, you are attracted to the idea of abolishing the charge, paragraph 5 of the Annex suggests how this might be done. If that is your preferred option further work will need to be done on this and possible consequences.

How the additional rate works

6. The additional rate is charged on the income of discretionary and accumulation trusts. Broadly, these are trusts where no individual beneficiary has a clear entitlement to have the income paid to him as it arises. For example, under a discretionary trust, the trustees will have discretion over whether (and if so when) the trust income is paid out, and to which beneficiaries. So it does not immediately become part of anyone's personal income.
7. For the purposes of the accrued income scheme (AIS) the additional rate applies to a wider range of trusts. In particular, it applies to gilts unit trust so that they pay tax at 45 per cent on their accrued income charges.
8. The income of all these trusts is charged at 45 per cent (27 per cent basic rate, plus 18 per cent additional rate). When income is paid out of a discretionary trust to a beneficiary, the beneficiary gets credit for the basic and additional rate tax paid by the trustees. So if he is a non-taxpayer, or pays tax at less than 45 per cent, he can get all or part of the tax repaid

to him. If he is liable at more than 45 per cent, he will be charged the extra tax direct.

9. If the income is to be accumulated, it will become part of the capital of the trust and will eventually reach the beneficiaries as capital. In that case, the 45 per cent rate is effectively a flat rate charge on the income, and there is no repayment (or further liability) for the beneficiaries.

History of the additional rate

10. The additional rate was introduced in 1973 as part of the general reform of the structure of personal taxation (which abolished surtax and replaced earned income relief by investment income surcharge). It broadly represents higher rate liability on the trust's income. The aim is to restrict the use of discretionary trusts by wealthy taxpayers to avoid higher rate tax by accumulating income under the shelter of a trust, and to reduce the tax loss when they do so.

11. When AIS was introduced in 1985 the additional rate was applied to the accrued income of trusts. This was to deter the use of trusts as a medium for avoiding higher rate tax on accrued income (and thus frustrating the anti-bondwashing defences of AIS). The additional rate charge on accrued income covers most trusts, including gilts unit trusts (which had been one of the main avenues of bondwashing).

The level of the additional rate

12. The additional rate was originally linked to the investment income surcharge (IIS) rate of 15 per cent. When IIS was abolished in 1984, Ministers decided that the justification for the additional rate charge on trusts still stood. But clearly the rate could no longer be pegged to the IIS rate, and the legislation now fixes it automatically as the difference between basic rate and the second higher

rate. In 1984-85 this gave an additional rate of 15 per cent (45 less 30). When basic rate was reduced to 29 per cent and then 27 per cent, Ministers left the additional rate to go up automatically under the formula to 16 per cent and then 18 per cent. So the total tax payable by the trustees has remained at 45 per cent - roughly half way between the basic rate and the top personal rate.

Numbers of trusts

13. A recent survey of 55,000 discretionary trusts showed that less than 3 per cent of the total have income of more than £25,000, but the income of those 3 per cent is over half the total income. So there is a relatively small number (around 1,500) with a very substantial income. The great majority have income of £5,000 or less (but the same family may have more than one trust).

14. There are another 35,000 or so trusts which were not covered by the survey and about which we have no detailed information. In addition there is substantial investment by higher rate taxpayers in gilts unit trusts, and other trust which are liable to additional rate on their accrued income.

Yield of additional rate

15. The additional rate charge on trustees is estimated to yield about £m50 a year at 1988-89 income levels. Some of that tax will in due course be repaid to beneficiaries when the income is paid out to them; but the precise effect will depend on trustees' distribution policy and beneficiaries' personal tax rates. For example, the bigger trusts identified in paragraph 13 above pay out less than smaller income trusts, no doubt in order to shelter income from tax at higher rates.

16. The net yield is about £m30 a year. But to the extent that the additional rate deters the use of discretionary trusts and gilts unit trusts to avoid higher

rate personal tax, the cost of abolishing it could be considerably more than the current net yield of the charge (after allowing for repayments to beneficiaries).

Representations

17. Representations arguing for abolition of the additional rate are made from time to time by various interests. There has not been much complaint about the additional rate from the generality of trusts affected by it. But there have been a number of complaints that the additional rate bears too heavily on particular types of trust, and should be removed from them. As you know the Air Travel Trust have asked to be exempted. The heritage lobby have repeatedly asked for heritage maintenance funds to be exempted. The Law Society have made regular Budget representations that small trusts, and those which distribute most of their income, should be excluded (but we think they have accepted privately the case for having an additional rate charge; and there are practical and definitional problems about exempting "small" trusts). Representations are also made from time to time that children's trusts should be exempted. And there has in the last few days been a Press campaign on behalf of disaster funds, eg the Zeebrugge fund. We deal with this in paragraphs 31-35..

The case for abolition

18. The case for abolition is:

- a. it is arguable that there might be little increase in the number of trusts to exploit the tax gap, because since 1984 the gap between the combined rate on trusts (45 per cent) and the top rate (60 per cent) has been 15 percentage points. If the gap between basic and top rates was reduced to (say) 15 points the maximum tax saving in an individual case would be no greater - even without the additional rate - than it is at present.

b. there are other factors which may limit the incentive to set up discretionary trusts for income tax saving purposes:

- if a person sets up a trust but retains a right to benefit under the trust or a power to revoke the trust, the trust income remains his own for tax purposes in any event;
- a transfer of property into a discretionary trust may involve an inheritance tax charge (or at least use up part of the settlor's exempt slice). There will also be a periodic IHT charge (every 10 years) while the property remains in the discretionary trust regime, and a further charge when it leaves that regime. However, these charges may not apply - if, for example, the trust qualifies for the IHT exemptions for accumulation and maintenance trusts; and when they do apply they may be less burdensome than IHT charges on property not held in discretionary trusts;
- setting up and running the trust will involve some expenses - for example on preparation of trust accounts, dealing with the trustees' tax liabilities, and possibly separate management of the investments.

The case for retention

19.

a. The 15 per cent tax saving would be available to all higher rate taxpayers, not just those now in the 50/55/60 per cent bands. Although the maximum saving in individual cases may not be increased, the number of people whom it would pay to take advantage of the

saving would be substantially greater (about double under the income tax option 3).

b. This would be another (and unnecessary) concession for the better off who will be benefiting from the reductions in higher rates.

c. The wealthy might seek to get round the covenant reform by using trusts to channel funds to other individuals, including their own student children and other relatives.

d. following a recent Court of Appeal decision the scope for trustees to accumulate income in a trust and then pay out the accumulated income as capital is increased. Without the additional rate the income would be charged at basic rate only (with no repayment to the beneficiary, but no higher rate liability either).

e. There is a danger of avoidance of higher rate tax on accrued income. It is probable that gilts unit trusts would be used to avoid higher rate tax on accrued income on a large scale. Prior to AIS, bondwashing by gilts unit trusts was costing the Exchequer around £15 million (and was on a rising trend). The AIS, with the additional rate on accrued income, has reduced the tax loss, we think, to negligible dimensions. But if additional rate is removed, gilts unit trusts would be a convenient and attractive medium for avoidance of higher liability on accrued income. The Revenue cost could be substantial - quite possibly exceeding the £15 million tax loss prior to introduction of AIS. There could be criticism that Ministers were reopening a loophole which they had closed with AIS in 1985.

f. greater use of discretionary trusts may also lead to a decline in IHT revenue;

Administration costs

20. The additional rate charge is sometimes criticised, particularly by solicitors, on the grounds that it involves trustees in extra work, and that if the beneficiaries are non-taxpayers (eg children) the tax is likely to be repaid in due course anyway. There is something in this argument, because where the trust's income has suffered basic rate tax at source, an assessment will be needed for additional rate only. But the argument is sometimes overstated. Even if there was no additional rate, the trustees would still have to deal with basic rate tax liability in cases where the income is not taxed at source; and many beneficiaries might still have to claim repayment of basic rate tax anyway.

21. For the Revenue abolition of additional rate would undoubtedly be a simplification but any manpower saving might be more than off-set by the increase in number of new trusts.

Exchequer cost

22. As explained in paragraph 16, the net yield of the additional rate charge is about £m30 a year. The cost of abolishing it could be higher, depending on how many new trusts are set up to take advantage of the reduced trust rate (ie basic rate only) and the scale of higher rate payers' investment in gilts trusts.

Balance of argument

23. You will want to consider carefully the relative weight of the arguments for and against abolition. On balance, we would recommend retention, mainly because of the new shelter which abolition would open up for higher rate taxpayers, particularly under a system where there were only two rates, thereby undermining both this year's covenant reform and the accrued income scheme.

Fixing the rate

24. If the additional rate charge is to be retained, a decision will be required on how the rate should be fixed for the future. At present it is fixed automatically by reference to the second higher rate.

25. The choice is between linking it to -

a. the higher rate (ie 15 per cent if the basic rate is 25 per cent and the top rate 40 per cent). This gives maximum protection against the use of trusts as a shelter. On the other hand this may be criticised as unduly harsh, for example on small trusts; or

b. an intermediate point - eg half way (7.5 per cent), or a flat 10 per cent. We recommend 10 per cent, giving a total rate of 35 per cent (25 per cent basic plus 10 per cent additional).

26. Either way, you may wish to consider defining the rate by reference to the ordinary tax rates, so that (as now) legislation is not needed each year to fix the rate afresh.

Heritage Maintenance Funds

27. National heritage maintenance funds which qualify for the IHT exemptions also get special income tax treatment. These funds are discretionary trusts, and their income is therefore subject to basic and additional rate tax. In many cases the income may well be treated as the settlor's income under the ordinary rules whereby trust income is treated as the settlor's if he retains any benefit from the trust. But there is a special rule for heritage maintenance funds that if the income would, under the ordinary rules, be taxed at the settlor's rate (for example because he benefits from the fund as the owner or occupier of the house it maintains), the trustees can elect for the income to be charged at the basic and additional rate instead of the settlor's rate.

Clearly this is beneficial if the settlor's own marginal rate is above 45 per cent. If the additional rate was abolished, the effect of the election would be that the income of the fund would be taxed at basic rate only, instead of the settlor's rate. This would be welcomed by the heritage lobby, who have argued that these funds should be exempted from additional rate tax (and perhaps even from basic rate tax) to encourage historic house owners to set up maintenance funds.

28. There is also a 30 per cent charge on any accumulated income not already charged at the settlor's rate included in money taken out of a maintenance fund for non-heritage purposes. The aim of the charge was to remove any possible income tax advantage if income was taken out. But the heritage lobby have pointed out that the 30 per cent charge means that the total charge can be 75 per cent - ie more than the top personal rate.

29. The 30 per cent charge is very much a long-stop, and we are not aware of any case where a charge has actually been levied. It could be reduced to 15 per cent (or perhaps fixed automatically as the difference between basic and higher rates). Alternatively it could be left as it stands, on the grounds that it is essentially a deterrent to taking funds out for non-heritage purposes and that it removes any advantage from rolling up income in the fund in the meantime.

30. It is very much a matter of judgment whether you wish -
- a. to leave the 30 per cent rate as it stands, and consider the point if the heritage lobby raise it; or
 - b. to reduce it to a level where the basic rate plus additional rate plus heritage rate equals the top rate of tax.

Either way the heritage lobby may take the opportunity to press for further tax concessions.

Disaster Funds

31. The possibility of exempting disaster funds from the additional rate has been raised. Though their reports are garbled, this is the thrust of the campaign in the Sun and Mirror.

32. Disaster fund are normally either charitable trusts or ordinary discretionary trusts.

- If they are charitable trusts, they get the same tax exemptions as other charities. But the trustees' freedom to make payments to beneficiaries is restricted to what is charitable in general law (eg relief of poverty).
- If they are non-charitable discretionary trusts, the trustees have greater freedom, but the ordinary tax regime for discretionary trusts applies.

Trustees can choose which form of trust to set up, and in some recent cases (eg Bradford), the trustees have deliberately chosen the non-charitable form.

33. It is not clear whether, in practice, the additional rate charge is a significant problem for trustees. The fund will earn interest (taxable), but normally the trustees will want to pay the money out pretty quickly, and when they distribute the income the beneficiaries will get credit for the tax (and obtain repayment where appropriate). Removing the additional rate charge on income would still leave the basic rate charge.

34. Disaster funds could be exempted from the additional rate (and the basic rate) without much practical difficulty. But two issues would have to be faced:

- i. Ministers would have to justify drawing a line between those trust funds and others established for other good causes - for example to help a disabled child.
- ii. There would need to be a decision on each occasion as on whether a particular tragedy qualified as a disaster for this purpose. It is difficult to see how that could be coped with legislatively. The alternative would be certification. The Revenue is not qualified to make that judgement; and the last thing we would want is the Department to be drawn into frequent public disputes over whether some event was sufficiently tragic or large-scale to qualify. This suggests that the certification should be done by a competent authority, such as the Home Secretary or the Home Office (or perhaps an appropriate Division of the Treasury).

Implications of abolition

35. If, on the other hand, the additional rate is to be abolished, it will be necessary to decide how to handle the transition - and in particular what if anything to do about accumulated tax deducted in past years. This is dealt with in more detail in the Annex.

Questions for decision

36. The questions for decision are:

1. Should the additional rate charge be retained or abolished (paragraphs 18 and 19)?

2. If the additional rate is retained, what should the rate be for 1988-89, and how should it be fixed in future (paragraph 25)?
3. Should anything special be done about disaster funds (paragraphs 31-34)?
4. Should the 30 per cent "long stop" charge when property is taken out of heritage maintenance fund for non-heritage purposes be reduced to 15 per cent (paragraph 30)?
5. If the additional rate is to be abolished, should the charge continue for 1988-89 only to allow trustees time to distribute income which has already borne additional rates in the past (paragraph 5 of Annex)?

CS

C STEWART

IMPLICATIONS OF ABOLITION

Credit for beneficiaries

1. If the additional rate charge is abolished, trust income assessable for 1988-89 and subsequent years would be charged at basic rate only. (There would still be some additional rate tax payable during 1988-89 on assessments for 1987-88.) But it would be necessary to consider whether beneficiaries should get any credit against income paid to them in 1988-89 and subsequently, for additional rate tax paid by the trustees in earlier years.

2. At present, trustees pay tax on the income at the rate for the year in which they receive it. They thus accumulate a "pool" of tax which is available for credit when the income is paid to the beneficiary. When the beneficiaries in due course receive income payments, these are treated as net sums which have suffered tax at the rate for the year in which the income is paid to them.

3. Thus if the trustees receive income in year 1 and pay 45 per cent tax on it, and then pay income out in year 3 when the combined basic and additional rate charge is 40 per cent, the beneficiary will get credit for 40 per cent tax. The remaining tax paid by the trustees remains in the pool for future use. Conversely, if the rate in year 3 is 50 per cent, the beneficiaries will get credit for 50 per cent tax and the trustees may then have to pay extra tax to the Revenue to cover the credit, unless they have sufficient tax already available in the pool to cover the full 50 per cent credit.

4. The credit was designed to work in this way for the sake of simplicity. Because the beneficiary gets credit at

whatever rate is in force in the year when the income is actually paid out, it is not necessary to try to identify particular payments to the beneficiary with particular items of income received by the trustees in earlier years. But if the additional rate is abolished from 1988-89, the effect of the present credit rules would be that on any income payments made to the beneficiaries from 6 April 1988 onwards, the beneficiary would get credit only for basic rate tax. Any additional rate tax paid in an earlier year by the trustees on the income out of which the payment to the beneficiary was made would remain in the "pool". It would thus be available for credit against future distributions. But in practice it would be likely to become stranded.

5. If you wanted to do something to enable beneficiaries to get credit for this "stranded" tax, one possibility might be to continue the additional rate charge for one more year to give trustees time to distribute past income with full credit for additional rate tax, if they wished. An announcement this year that trustees would not be charged additional rate on income arising after 5 April 1989 and beneficiaries would not be given credit of additional rate on payments made to them after 5 April 1989 would give trustees time to decide what they wanted to do about accumulated income. It also avoids some awkward administrative problems which would arise if we had to make special arrangements to allow beneficiaries credit for tax paid by trustees in past years. If you want us to explore this, or other, possibilities to unblock the "stranded" tax, we shall let you have a further paper.

Capital gains

6. If CGT reform goes ahead, with gains taxed at the rates that would apply were they the top slice of income, the decision on the additional rate will also affect gains. If the rate is kept, it will apply to gains of discretionary and accumulation trusts. If it is abolished, then these

gains will, like the income of the trusts concerned, be liable at the basic rate only. If the additional rate is kept for one year only, and then abolished, we would recommend against applying it for capital gains for that one year only.

Dividend stripping

7. There is a similar form of tax avoidance which could also be encouraged by abolition of the additional rate. This is "dividend stripping". This is potentially attractive when a company has profits which it wants to distribute and its shareholders are higher-rate taxpayers who wish to avoid an income tax charge. For example, what they could do is sell some shares to a pension fund (possibly the company's own pension fund). As part of this arrangement the company would then pay a large dividend to the pension fund, which would be able to reclaim the tax credit. The shares might subsequently be sold back to their original shareholders. Not only would they have avoided higher rate income tax but the pension fund would have received a payment of tax credit (the value of which would no doubt have been split between the parties). This is wrong in principle because the profits being distributed really belong to the former shareholders, and are simply being diverted to the pension fund.

8. In 1973 legislation was introduced to prevent this kind of abuse. Its effect is to deny a repayment of the tax credit and it also charges the pension fund at the additional rate. Without this additional rate charge, dividend stripping could still be attractive. (There might be some CGT liability on the sale of the shares but this could be a lot less than the income tax that would have been paid if the former shareholders had received the dividend.)

9. So the abolition of the additional rate would weaken the deterrent effect of the 1973 anti-avoidance provisions, although it is difficult to estimate how much avoidance would result.



FROM: A C S ALLAN

DATE: 16 February 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Culpin
Mr Cropper
PS/IR
Mr Isaac -IR
Mr Corlett - IR

ADDITIONAL RATE ON TRUSTS (STARTER 120)

The Chancellor has seen Mr Corlett's minute of 12 February. He feels we must exempt disaster funds, and would be grateful if further consideration could be given to how a "disaster" should be defined, and by whom.

2. If we did exempt disaster funds from the additional rate, would there be any case for stopping there rather than giving basic rate relief as well? And what about CGT etc?

3. Miss Sinclair's note of 4 February on Budget lollipops discussed the general issue of drawing a line between disaster funds and other deserving cases, and concluded that this raised "serious problems of a definitional and technical nature which could involve a great deal of work and it is most unlikely that these could be resolved in time for this year's Budget". It was largely for this reason that this proposal was ruled out at the fourth overview meeting. Does Mr Corlett's note imply that these problems could be overcome?

A large, stylized handwritten signature that reads "ACSA".

A C S ALLAN

ACSA
TO
PS/FST
16 FEB

BUDGET CONFIDENTIAL

FROM: P J CROPPER
DATE: 17 February 1988

PS/FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Culpin
Mr Isaac IR
Mr Corlett IR
PS/IR

ADDITIONAL RATE ON TRUSTS (STARTER 120)

If at all possible, it would be good to see the back of the Additional Rate on Trusts. It is one more complexity, one more source of income for solicitors.

2. The Additional Rate, as Mr Corlett says, goes back to the days of IIS. When IIS was abolished in 1984 I thought there was a strong case for doing away with the Additional Rate and still do. Current plans for reduction of the top rate reinforce that view.

3. Trusts are, and I am open to be corrected here, more often used for capital tax planning than for income tax planning. If the gap between basic and top rate of tax were narrowed in line with present plans I could not see many people going to the labour and expense of setting up a trust even without the Additional Rate to contend with, simply to avoid tax at the higher rate. Trusts are cumbersome, and if they are small or middle sized it can be quite difficult to manage their investments efficiently. Since the Additional Rate will be reclaimed by the income beneficiaries in many cases, because they are not higher rate taxpayers, the Additional Rate process will come to be seen in future as just a nasty little chore.

CROPPER
TO
PS/FST
17 FEB

4. Given the extra advantage of clearing up a corner of heritage taxation, and saving the Inland Revenue from having to take on the invidious task of defining what a "disaster" is, the case becomes even clearer.

5. I am open to the suggestion that special measures might still be needed to deal with abuse in gilt funds and accrued income cases.

A handwritten signature in black ink, consisting of a stylized 'P' and 'J' followed by a horizontal line.

P J CROPPER

BUDGET CONFIDENTIAL

PS/FINANCIAL SECRETARY

FROM: A G TYRIE

DATE: 18 FEBRUARY 1988

cc PS/Chancellor
 PS/Chief Secretary
 PS/Paymaster General
 PS/Economic Secretary
 Sir P Middleton
 Sir T Burns
 Mr Anson
 Mr Scholar
 Mr Culpin
 Mr Isaac
 Mr Corlett
 Mr Cropper
 Mr Call

ADDITIONAL RATE ON TRUSTS (STARTER 120)

I agree with Peter Cropper on this, not only on his general arguments for removal, but also his observation that the chief beneficiaries of retention would be solicitors and accountants making a living from giving advice in this complex field.

Nobody would have a bigger advantage than 60% payers do now. What's more, I am not convinced that the increase in the number of taxpayers who might be able to exploit this would necessarily lead to far greater cost (Mr Corlett's paragraph 19). Would these people take advantage of trusts en masse? I am guessing, but I would have thought that most of the people using these wheezes would be at the top end of the higher rates and not among the existing 40/45% taxpayers. If that were the case there would not only be simplification but also manpower savings (Mr Corlett does not foresee manpower savings, paragraph 21).

X On the other hand, Mr Corlett's point that we could be accused of reopening a loop hole closed with AIS looks more of a problem.

A G TYRIE

TYRIE
 TO
 PS/FST
 18 FEB

1A6f 25



Inland Revenue

471

Policy Division
Somerset HouseFROM: C W CORLETT
FAX No. 6766
EXTN. 6614
18 February 1988

1. MR ISAAC

*From Sir Allan's note. The
power now limited to discretion
on a discretionary basis and (i) by a
minister. (Feb 18. 2)*

2. FINANCIAL SECRETARY

*Both map for the
(RIS, discussion & tax)*

ADDITIONAL RATE ON TRUSTS (STARTER 120): DISASTER FUNDS

1. The Chancellor has asked (Mr Allan's minute of
16 February) for more work to be done on this.

2. The original FP note in the lollipops' paper rightly
brought out the difficulties of defining a "disaster" in
sufficient detail for the purposes of objective legislation.
My note was an attempt to skirt round that problem to some
extent by giving some competent authority power to
designate.

3. The legislative framework for the designation approach
could be a good deal less specific. For example, it might
require the competent authority to satisfy himself or
herself that -

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Scholar
Mr Culpin
Mr Cropper
Sir Anthony Wilson
Mr Jenkins - Parliamentary
Counsel

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Deacon
Mr Pitts
Mr Stewart
Mr Davenport
Mr Spence
Mr Yard
Mrs Fletcher
PS/IR
Mr Corlett

CORLETT
TO
FST
18 FEB

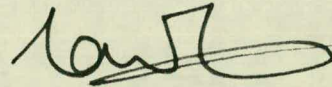
- there had been a major tragedy involving serious loss of life; and
- the disaster appeal was organised or sponsored by a local authority; and
- its purpose was to collect subscriptions from the public and to assist victims of the disaster and their dependants.

4. The question of who the competent authority would be is obviously tricky. I understand that Treasury officials are bitterly opposed to taking the job on, and consider that constitutionally it must be a Minister. This suggests either a Treasury Minister or the Home Secretary (plus the appropriate Secretaries of State for Scotland, Wales and Northern Ireland). But whoever had the job would have the political (but not the technical) problem of distinguishing between, for example, an accident at a football ground and a bad accident on the M1; or justifying why an accident involving loss of life qualified but a trust fund set up to help thalidomide victims (or even a single disabled child) did not.

5. However, once a disaster was designated by the competent authority, we could then readily provide the appropriate exemption or relief. As the Chancellor suggests, exemption could extend to the basic rate tax as well as to the additional rate tax on the trust fund. The CGT and IHT aspects would also need to be considered. Moreover, it would be for consideration whether -

- the beneficiaries themselves should be totally exempt from tax on the income payments made to them out of the fund;
- donors should also be given the same tax reliefs on gifts to the fund as on gifts to charities.

6. Thus one question is whether the aim is to put the fund in the same position for all tax purposes as if it was a charity, or to deal only with tax charges on the fund itself (eg income tax on income it earned). In either event, however, the trustees, unlike the trustees of a charity, would continue to be able to pay money out to whomever they wished, on a discretionary basis, irrespective of whether any hardship (or other charitable objective) was involved, which is why they now tend to set up an unfettered discretionary trust fund rather than a charity, despite the tax disadvantages.



C W CORLETT



Ch,

Most recent scorecard enclosed.

I shall ask for an updated
version to be ready in good time
for your meeting.

JF

14
/11



FROM: FINANCIAL SECRETARY

DATE: 19 February 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Jenkins OPC
Mr Isaac IR
Mr Corlett IR
Mr Stewart IR
PS/IR

ADDITIONAL RATE TAX AND DISASTER FUNDS

I have considered Clive Corlett's minutes of 12 February and 18 February and this note sets out my recommendations.

Additional Rate

2. I think the arguments here are finely balanced. My own inclination is to keep the additional rate but to reduce it from 18% to 10%.

3. I recognise that the tax advantages of trusts are quite small and are confined to the opportunity they offer for higher rate taxpayers to have their investment income rolled up at a tax rate lower than their own marginal rates. Nevertheless, these tax savings can be fairly substantial for wealthy individuals and to the extent that other tax shelters are being removed the incentive to use the trust route post-Budget may be increased. In addition, there is the problem of the Accrued Income Scheme.

4. I am conscious that the main argument in favour of abolition is fairly attractive. The key point is that the gap between the top rate

BUDGET SECRET: TASK FORCE LISTFST
TO
CX
19FEB

of tax and the rate of tax payable by trusts would be the same under the proposed income tax regime (without an additional rate) as it is now. Thus, there should be no greater incentive to 'shelter' income in trusts post-Budget than there is now, if the additional rate is abolished and thus no increase in the number of these funds set up. On the other hand higher rate payers would retain the tax advantages.

5. If you agree that the additional rate should stay, my preference for the new rate would be 10%. I think 7½% looks a little fussy. 15% (as Sir Anthony Wilson has suggested) would seem unduly harsh on basic rate or non-taxpayers. I therefore suggest that henceforth the additional rate should be computed as the basic rate plus 10%.

Heritage Maintenance Funds

6. I think we should not exempt these funds from additional rate tax. At present there is also a charge at 30% if money is taken out of the fund for non-heritage purposes: we should reduce this so that the total charge is no greater than the new higher rate.

Disaster Funds

7. My own strong inclination would be to do nothing. I believe that the present position is defensible and has not been adequately put across in the media. Although tax is deducted from trust income it can be reclaimed by non-taxpayers, and basic rate taxpayers too can claim back any over-paid tax. If trust income recipients are taxpayers then I think they should pay tax at the appropriate rate whether the money has ultimately come from a public donation or from some other source. I do not think that critics appreciate that the Revenue is not simply pocketing the money!

8. Moreover, it is clear to me that it will be very difficult indeed (if not impossible) to define what we mean by a 'disaster fund' in a way that will not actually generate more criticisms for unfairness than we currently get for miserliness. At my meeting this morning a few obvious rough edges were identified:

- (i) Why should it be a 'disaster' if a train-load of people get killed but not a disaster if one person is killed in a train-crash? Should there be a limit on the number of deaths such that if fewer than this number die, there is no 'disaster'? If so, what should this number be and how could it be defended?
- (ii) Are we concerned only with natural disasters or do we also exempt funds set up to help the victims of some company's negligence? Should Zeebrugge be exempt because a large number of people died or taxable because P&O will pay out compensation? Of course, to the extent that companies are forced by the courts to put money into trusts to help victims, then tax exemption may reduce the amount these companies are asked to pay up;
- (iii) Are we just as concerned about disability or physical deformity as with death? What about 'shock'?
- (iv) What about the members of a Working Mens Club who start a local campaign to raise money for _____ a kidney machine for a friend's child?

9. No doubt we can all think of many more situations and no doubt, also, we would all prefer not to have to decide what is and what is not deserving of tax relief.


10. I firmly believe that if you want to pursue this a full legislative solution is too difficult. The only practical route would seem to be to give someone the discretion to decide on an ad hoc basis whether or not Fund X is a disaster fund. The legislation would then be fairly simple: tax exemption would be given to whatever funds the 'chosen person' defined as disaster funds.

11. The obvious person on whom to bestow this power would be the Home Secretary although I cannot believe that he would welcome this discretion. It might be possible to give him some guidance in the legislation - but that takes us right back to the problems I have already mentioned of

trying to set down even in general terms what we mean by a disaster fund. If you were attracted by this 'administrative' solution I think you will need to speak to Douglas Hurd.

12. I would just make two further points on all of this:

- (i) The underlying cause of our problems is that the (case law) definition of 'charitable purposes' is too narrow so that giving money to help the victims of a disaster will not in general be regarded as charitable giving. Thus, people set up discretionary trusts not charitable trusts so that they are able to channel money to the victims of disasters without having to concern themselves about whether the payments are for strictly charitable purposes. The tax treatment follows automatically;
- (ii) At first sight, the difficulties in finding an answer to the disaster trust issue seem to swing the balance in favour of abolishing the additional rate. In my view, however, this would not buy off the Daily Mirror and the Sun since trusts would still pay basic rate tax. If you decide not to pursue the special treatment route for disaster funds, our best defence will be to emphasise the refunds not to claim credit for reducing the rate on trusts.



NORMAN LAMONT