

PO-CH/NL/0513

PART A

DO CH/INFLATION/OSIS

PART.A.

DO CH/INFLATION/OSIS
PART.A.

1989 BUDGET
LLOYDS INDEXED
BONDS.

3-3-89

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

LLOYDS INDEXED
BONDS. 1989.

32.

CONFIDENTIAL

pps-71



FROM: FINANCIAL SECRETARY
DATE: 21 December 1988

CHANCELLOR

Thanks. It would be a shame to do X, as the whole of the Lloyd's tax paid is under consideration. No same time?

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Beighton)
Mr Johns) IR
PS/IR

LLOYD'S INDEXED BONDS (INCLUDING STARTER 258)

I have had a preliminary meeting with officials to discuss Mr Johns' note of 15 December. There is obviously a read-across to Starter 453 on the tax consequences of abolishing COBO, so final decisions will have to be deferred until we have seen Mr O'Connor's paper on that. But I thought you might like my initial views.

*FST
CHG
21/12*

I am extremely reluctant to do anything about Lloyd's this year. Unfortunately, however, if we do nothing, and stick to our original idea of issuing a revised Statement of Practice on the tax treatment of indexed bonds, there will be a large hole which Lloyd's will almost certainly exploit. The result would be the disappearance of a substantial part of Lloyd's taxable profits and an effective tax subsidy to either Lloyd's names or (more likely) U.S. mortgage holders and students.

I do not believe we could plug the gap by using one of the options canvassed in Mr Johns' minute, namely to change the law on indexed bonds so that the return on these new bonds was taxable as income. That would smack of high-handedness; changing the rules every time

SF28.11.6



FROM: FINANCIAL SECRETARY
DATE: 28 November 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tryie

Mr Beighton)
Mr Isaac)
Mr Painter) IR
Mr Bush)
PS/IR

Chy
Agree FST's conclusions?
(You have already agreed to drop one or two of these).

28/11
Conrad

BUDGET STARTERS

I have reviewed my list of starters for next year's Budget.

The current projected size of the Bill is 170 pages, of which 146 will fall on the Inland Revenue. Although some 25 pages of this merely implements the recommendations of the Keith Committee, and so will be relatively uncontroversial, this is obviously far too long to be manageable.

I believe we can drop some starters immediately; 210 on hobby farming, 257 on minor issues relating to the CGT residence relief, and 117 on mortgage interest relief for example. And I have identified a larger number of starters which are potentially strong candidates for dropping, subject to further quick examination and your agreement.

FST
TO
CX
28 NOV

These are:-

- 102/154: NHS Review Starters (I have minuted you separately on these) - *folded behind*
- 110: Schedule E Lump Sum Payments
- 202: Purchase of Own Shares
- 204: Business Expansion Scheme
- 214: Sports Governing Bodies
- 258: Lloyd's CGT Treatment
- 260: IHT Liability of Trustees of Defunct Trusts
- 403: EEIGs
- 454: Electronic Payment of Dividends

Furthermore, there is a real possibility that parts of the starters on trusts, residence and (perhaps) the subcontractors scheme may be dropped or deferred until later years. But even though these changes will make a substantial difference, the Bill will still be long.

I am also about to receive a submission on Starter 150, covering one-off payments to charities. I know you are keen on this, but it may also become a candidate for dropping.

Finally, I very much agree with your conclusion that CGT on housing should be forgotten for 1989. This will help Mr Pitts' division and enable them to concentrate on abolition of the CGT rollover relief on gifts.

R.C.M.J.

PP NORMAN LAMONT

SF28.11.6



FROM: FINANCIAL SECRETARY
DATE: 28 November 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Beighton)
Mr Isaac)
Mr Painter) IR
Mr Bush)
PS/IR

BUDGET STARTERS

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Robert Subhull

PP NORMAN LAMONT



Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

CONFIDENTIAL

*Assume we go ahead with
this starter, will
it show up as
a tax demand
What wd be the yield in
1989-90 or 1990-91?*

From: L J H BEIGHTON
4 January 1989

FINANCIAL SECRETARY

LLOYD'S INDEXED BONDS
(INCLUDING BUDGET STARTER 258)

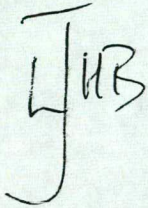
In his minute attached, Mr Johns is attempting to quantify the effects of any changes in the treatment of Lloyd's (the final paragraph of your minute of 21 December to the Chancellor refers). For the reasons which he gives, the figures are not straightforward, but on the best assumptions we can make without any legislation the tax take from Lloyd's is likely to fall to around 10 per cent - the same level as it was before the accrued income scheme was introduced - and could well become negative (ie repayments to Names on their non-Lloyd's sources could more than wipe out any tax liability on their Lloyd's sources). On either of the legislative routes we have suggested, the take would return to about the same level as it was on the introduction of the AIS, though in one respect it would be higher (the scope for setting-off indexation relief on Lloyd's assets against non-Lloyd's gains, which is in any case arguably wrong in principle, would be removed).

BEIGHTON
TO
FST
4/1

- cc Chancellor of the Exchequer
- Chief Secretary
- Paymaster General
- Economic Secretary
- Sir Peter Middleton
- Mr Scholar
- Mr Culpin
- Mr Odling-Smee
- Mr Gilhooly
- Mr Ilett
- Mrs Chaplin
- Mr Tyrie
- Mr Jenkins
- (Parliamentary Counsel)

- Chairman
- Mr Isaac
- Mr Painter
- Mr Beighton
- Mr Miller
- Mr Johnston
- Mr Corlett
- Mr Deacon
- Mr Bush
- Mr Johns
- Mr Davenport
- Mr Skinner
- Mr Nield
- Mr Cayley
- Mr Templeman
- Mr O'Connor
- Mr Bolton
- PS/IR

The Chancellor asked whether there were any sweeteners we could offer. Mr Johns concludes that with the proposed legislation there would be a broad balance between Lloyd's and corporate insurers, but that the two areas where Lloyd's might possibly have some disadvantage are the tax rate on reserves and the frequency of capital gains charges. We would need to have discussions with Lloyd's after Budget Day on the detailed treatment of their capital gains in which we could pick up the second point. The first point looks most suitable for a sweetener in the form of an improvement to the Special Reserve Fund (though we might take the opportunity to tidy up some anomalies on this at the same time). We are working urgently on the possibilities in this area but did not want to hold up this note in view of the imminence of your lunch with Alan Lord and of Dorneywood.

A handwritten signature in black ink, consisting of a large, stylized 'J' with 'L J H' written vertically inside it and 'B' written to the right.

L J H BEIGHTON



Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS

DATE 4 JANUARY 1989

1. MR BEIGHTON *JUB 4,*
2. FINANCIAL SECRETARY

LLOYD'S INDEXED BONDS

1. At your meeting on 19 December you asked (in advance of your lunch with Alan Lord) for some figures on the total tax paid by Lloyd's in the recent years in order that our estimate of £50m potential loss from indexed bonds can be seen in context.

HOW LLOYD'S BUSINESS WORKS

2. Put crudely, an insurance business consists of taking in premiums, investing them and receiving investment income and capital gains on the funds invested, and reserving for ⁱⁿ paying out

cc	Chancellor of the Exchequer	Chairman
	Chief Secretary	Mr Isaac
	Paymaster General	Mr Painter
	Economic Secretary	Mr Beighton
	Sir Peter Middleton	Mr Miller
	Mr Scholar	Mr Johnston
	Mr Culpin	Mr Corlett
	Mr Odling-Smee	Mr Deacon
	Mr Gilhooly	Mr Bush
	Mr Ilett	Mr Johns
	Mrs Chaplin	Mr Davenport
	Mr Tyrie	Mr Skinner
	Mr Jenkins	Mr Nield
	(Parliamentary Counsel)	Mr Cayley
		Mr Templeman
		Mr O'Connor
		Mr Bolton
		PS/IR

claims. The premiums received are invested to provide funds to meet claims. It is well established by case law that the profits or losses arising on the disposal of the portfolio investments of a general (non life) insurer are part of the trading result. As such, these realisation profits are not taxable as capital gains but as income. (As you know, the position is different for life assurance companies.) The investment income arising from the investments is also taxed as income. Lloyd's Names also receive investment income and gains on their personal reserves and their Special Reserve Funds but we accept these are part of their personal investments and would not expect - at least as the Special Reserve Fund is presently constituted - to treat these as part of trading profits under existing law or any change.

HISTORY

3. Until 31 December 1985 when the accrued income scheme came into force for Lloyds, Names reduced the income they received from investments to a low level and took capital gains by bondwashing - buying securities ex-dividend and selling them cum-dividend. Something like 70% of the "income" was converted in this way. At that time indexation was not available for capital gains on assets held for less than a year so the full gain was chargeable but only at 30% instead of income tax rates rising (with investment income surcharge) to 75%.

4. The accrued income ^{scheme} was designed to stop this, not just for Lloyd's but for all investors. And in 1986 Lloyd's Names invested nearly all their US funds in securities which both we and they would accept generated taxable income. As I explained in my previous note they were able to generate tax free capital gains on much of their UK funds by investing in indexed and low coupon gilts. But during that year they started to look around for investments which gave them certainty (so they knew they could meet claims), liquidity (so they could realise them at any time that claims came in) but got capital gains treatment. They looked at a number of schemes which either did not work or were

blocked by legislative amendments to the Accrued Income Scheme. Towards the end of 1986 and during 1987 they focused on short term capped indexed bonds and increasingly invested their American funds in these. As you know, our advice is that these are not effective in securing capital gains treatment but we will be accepting that in a small number of cases we had given assurances which mean we must concede such treatment.

5. During the first part of this period, therefore, both Lloyd's and we would accept that most of the return on their investments came in the form of income. However, on their US investments they would be buying and selling chargeable assets and now indexation was available on disposals within less than 12 months. There could be capital gains or losses from movements in currency even though the basic return was all income and indexation would be available against to set against this. Over time currency movements have tended to generate capital losses and together with the effect of indexation there would be losses available to set against other non Lloyd's gains. But it is unlikely that these would be sufficient to absorb the full benefit of indexation.

6. During the second part of this period, Lloyd's would argue - but we would contest - that half of their returns on their US funds came in the form of capital gains. In this case indexation would cover the gains; while there would be some additional losses to set sideways against other gains (because the US inflation rate, to which many of these bonds were linked, has been lower than the UK rate) it is almost certain that they would get much more benefit from indexation than under the scenario in paragraph 5. They would be better off than they were before bondwashing was stopped. At the earlier time the gain was larger because the whole of the income could be converted to gain but it was chargeable to tax at 30%. Now only an amount equal to the increase in inflation could get any benefit but this amount would be totally exempt.

7. On 30 March this year we told Lloyd's of our doubts on the indexed bonds. We do not know how they have been investing their US funds since then. But some syndicates have clearly been continuing to invest in capped bonds - presumably on the grounds that they have little to lose and the Courts may find in their favour. Others have switched to uncapped short term indexed bonds which may be open to challenge but probably are not. And some syndicates have never tried any of these devices but since January 1986 have been investing in straight bonds. If we now issue a Statement of Practice which indicates that some forms of uncapped indexed bonds are not open to challenge we would expect the situation to be as described in paragraph 6.

GOVERNMENT TAX TAKE FROM LLOYD'S

8. It is not easy to put all this into figures of UK tax take from Lloyd's because:

- Lloyd's has made underwriting losses overall in the last few years so its profit is made up of investment income and capital gains less underwriting losses. These losses can be set against other income but we have no central information about how much set off has been possible; our impression is that most losses have secured immediate relief.
- In the same way we have no central information about how much capital losses have been set off against other gains. Here our impression is that if the basic return on Lloyd's investments is not converted into capital gains the losses due to indexation cannot get fully relieved against other gains.
- On its foreign underwriting and investments Lloyd's will pay some foreign tax (particularly US and Canadian) which will be credited against UK liability. However, we have not taken any account of reductions in UK tax take because of double tax relief since if Lloyd's is paying tax to a

foreign exchequer it is not reasonable to expect them to pay tax also to the UK.

- The investment income and capital gains accruing in any year have to be spread across 3 separate tax years. This is because at any time the premium trust funds include invested premiums for three separate years of account. This means that the separate phases described in paragraphs 3 to 7 get blurred when translated into tax liabilities for Lloyd's years of account. For example, although bond washing was ended for transactions after 31 December 1985, the new regime partly affected tax years as far back as 1984 since part of the investment income attributable to that year actually arose from transactions in 1986. Similarly if Lloyd's start now to invest in uncapped indexed bonds, they will get some benefit from 1987 onwards.

- Lloyd's accounts do not close for 3 years so the last figures we have relate to Account 85 (closed 31 December 1987).

9. The best we can do given all these problems is to set out very broadly the position for Accounts 1983 to 1985 and look at a stylised presentation for a future year (for which the current income tax and CGT rates apply). We consider the position if they get the full benefit of indexation through uncapped indexed bonds and if they get no benefit (because of legislation). We have assumed underwriting losses of £200m and investment profits of £450m. We have considered a worst case where virtually all their investment income is washed and a central case where only half is. The position is

Account	1983	1984	1985	£m		
				Central case no legislation	Worst case no legislation	Legislation
<u>Profit</u>						
Underwriting	-381	-154	-162	-200	-200	-200
Capital gains	299	100	47	193	317	NIL
Investment income	117	332	326	257	133	450
Total	35	278	211	250	250	250
<u>Tax</u>						
Underwriting	-190	- 75	- 75	- 70	- 70	- 70
Capital gains	100	NIL*	NIL*	NIL+	NIL+	NIL
Investment Income	60	165	150	90	47	157
Total	- 30	+ 90	+ 75	+ 20	- 23	+ 87

* some capital losses will have been carried sideways.

+ some capital losses would be carried sideways but less than in 1984-85.

For other notes see Annex.

10. These figures can only be regarded as a stylised indicator of trends rather than firm forecasts. They should not, therefore, be quoted to Alan Lord. But it looks to us as if

- i. In the early 1980's, when bondwashing was available tax was low, and in 1983 it was actually negative (ie there were repayments of tax on other income). Although there was an overall profit, relief for the large underwriting losses exceeded the tax on the income and gains.
- ii. For 1984 and 1985 when bondwashing had almost come to an end Lloyd's paid an average rate of tax of around 30%. We would expect this to continue into 1986 if our view of the treatment of capped bonds is upheld.
- iii. In future years if there is no legislation the average rate of tax falls below 10% on our central case but could again be negative, depending on the extent to which indexed bonds are used.
- iv. Legislation would push it up towards 35%.

COMPARISON WITH EARLY 1980'S

11. Broadly, therefore, legislation (under either route) would put Lloyd's in much the same position as they were after the Accrued Income Scheme legislation whereas not legislating would in effect allow them to defeat the intention of that legislation.

12. There is one respect, however, in which legislation would make them worse off: in Accounts 1984 and 1985 even if all their nominal gains took the form of income indexation of the capital of their investments gave rise to capital losses which could be set off against gains on non-Lloyd's assets; this would no longer be possible under either legislative option. (Under the COBO legislation deep discount stocks would be taken out of the capital gains system and so lose any benefit from indexation.) It is arguable, however, that it is inappropriate for Lloyd's Names to be able to reduce the capital gains on other assets because they invest premiums received in a particular way.

COMPARISON WITH CORPORATE INSURERS

13. A tax rate of around 35% would put the tax treatment of Lloyd's retained profits in a very similar position to that of corporate insurers. There would be a number of pluses and minuses to consider in the comparison (whereas before last year's tax reforms Lloyd's were clearly at a disadvantage as their retained profits were taxed at up to 60% like other unincorporated businesses whereas corporate insurers' retained profits were taxed at 35%). The main advantages Lloyd's would have is the ability to have sums put into the Special Reserve Fund and taxed at only 25% (and, for working Names, into personal pension schemes paying no tax) and the fact that they do not pay tax for three years after income is earned. The main disadvantages are that their rate of tax on reserves which do not go into the SRF will be 40% compared with 35% for corporate insurers, and that they may have to realise their investments more frequently than corporate insurers because of the change of membership of syndicates each year. Whether the advantages outweigh the disadvantages overall will probably vary with individuals.

SWEETENERS

14. In his note of 30 December the Chancellor asked whether there was any sweetener in the Lloyd's tax field which we could consider offering. Given that their main disadvantage vis-a-vis corporate insurers is the rate of tax on reserves, the best option is probably an improvement in the rules of the Lloyd's Special Reserve Fund. This was set up to reflect their unique position as individual financial traders. We are working up a note on the possibilities and will let you have it as soon as possible. As for their relative disadvantage because of their

need to realise capital gains more frequently than corporates, we will in any case need to discuss the exact rules with Lloyd's after the Budget. At present they are deemed to dispose of securities every 12 months; we would not require this to continue but Lloyd's may need to retain something similar for operational reasons.

M A Johns

M A JOHNS

ANNEX - MAIN COSTING ASSUMPTIONS

1. An average rate of tax on income of 50% is taken for 1983 and 1984 on the basis of a sample exercise done about then. For 1985 this is rounded down to 45% to take account of the abolition of investment income surcharge and for future years to 35% (below 40% higher rate because of transfers to SRF and personal pensions).
2. Underwriting losses for the stylised future year are rounded up from 1984/85 levels to £200m as 1984 and 1985 were good years.
3. Investment profits for the stylised future year are 10% above 1983 because the current dollar exchange rate is about 10% above 1983 levels (it was much higher in 1984 and 1985).
4. For future it is assumed funds are split 67% US, 10% Canada, 23% UK. It is assumed US and Canadian funds make total returns of about 7% pa and in the worst case 5% of this is converted to capital gains through uncapped indexed bonds with a 2% coupon; in the central case only $\frac{1}{2}$ this amount is converted. It is assumed two thirds of the return on UK funds is capital gains on gilts (exempt unless there is legislation).
5. Stop loss policies (which tend to smooth out underwriting losses and the tax relief on them) are ignored.



Inland Revenue

Oil and Financial Division
Somerset House

BUDGET CONFIDENTIAL

Counsel's advice at 2(a)
relates to the bonds actually
issued. Nothing that

FROM M A JOHNS
DATE 21 FEBRUARY 1989

Handwritten initials

- 1. MR BEIGHTON he said reduces the need to deal
- 2. FINANCIAL SECRETARY with indexed bonds generally as per
of section 453 (COBO), since, with attention
LLOYD'S INDEXED BONDS - LITIGATION now focussed on this area bonds could
be devised which would give capital

1. As requested at your meeting on 18 January (and recorded in your note of 19 January to the Chancellor) we have obtained Counsel's advice on this litigation.

Treatment (and hence effectively exemption) on the inflation element

2. At a Conference yesterday Mr Alan Moses (standing junior Counsel to this Department) advised us that:

*AMB
√ 2 1/2*

a. Putting on one side any question of assurances, the correct legal treatment of the 6 month Sallie Mae bonds is to tax the whole return including the purported "indexation uplift" as income. Although the correct legal treatment of the various 3 year bonds is not directly in issue in the judicial review proceedings (because we had decided that we should stand by what we had said in earlier statements was the appropriate tax treatment), Counsel considered that the whole return on these bonds is also income for tax purposes.

- cc
- Chancellor of the Exchequer
 - Chief Secretary
 - Paymaster General
 - Economic Secretary
 - Sir Peter Middleton
 - Mr Scholar
 - Mr Culpin
 - Mr Odling-Smee
 - Mr Gilhooly
 - Mr Ilett
 - Mrs Chaplin
 - Mr Tyrie

- Chairman
- Mr Isaac
- Mr Painter
- Mr Beighton
- Mr Miller
- Mr Johnston
- Mr Corlett
- Mr Deacon
- Mr Bush
- Mr Johns
- Mr Davenport
- Mr Skinner
- Mr Nield
- Mr Templeman
- Mr O'Connor
- Mr Walters
- PS/IR

b. We are right to defend the judicial review case and we have a reasonable chance of success. There is no clearance system and our primary duty is to apply the law after the event and in the light of all the facts. There are good legal arguments for saying we can not be bound in law even by specific unqualified assurances and our letters in the 6 month bonds case were in fact very qualified. It was unreasonable for taxpayers to rely on them in the way Lloyd's did. Counsel suggested that we need not have conceded on the 3 year bonds and indeed thought that our case would have been stronger if we had not. But he accepted the Board could properly take the view that we were entitled to exercise our discretion to act as we did in the pursuit of good administration.

3. In the light of this reassuring advice we shall proceed to defend the case. The current state of play is that 24 applications for judicial review have been received. They vary in detail but effectively they all seek on behalf of groups of Names and agents,

- a declaration that we have acted ultra vires and unlawfully
- an order to quash our decision to charge income tax on the indexation uplift on the 6 month Sallie Mae bonds
- an order to quash the assessments made on that basis.

Four of the applications have been approved by the Courts for early hearing and a tentative date of 19 and 20 April has been fixed. It is to be hoped that the remaining cases can be held open and settled without litigation on the strength of the decision on the first group.

4. We will keep you in touch with developments.

M. A. Johns
M A JOHNS

Rup



FROM: R C M SATCHWELL
DATE: 23 February 1989

MR JOHNS - IR

cc

PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie

Mr Beighton - IR
PS/IR

LLOYD'S INDEXED BONDS - LITIGATION

The Financial Secretary was most grateful for your minute of 21 February. This is welcome news.

R.C.M.S.

R C M SATCHWELL
Private Secretary



Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS

DATE 3 MARCH 1989

1. MR BEIGHTON *JHB 3/3*
2. FINANCIAL SECRETARY

LLOYD'S - COMMUNICATION OF BUDGET CHANGES

You have decided that you do not want any publicity for the Lloyd's angle on the deep discount proposals. The question arises, however, of what, if anything, we should say to Lloyd's themselves. We could leave them to discover the changes from the Press Releases. But on past form, wishful thinking can very easily enter into their interpretations and it could be unfortunate if they misunderstood the proposals and told either their members or the press factually incorrect statements.

On balance therefore we would favour, following recent practice, drawing their attention to the proposals and ensuring that there is a channel of communications about them open with us. A low key way of doing this would be for Mr Nield to write to his opposite number at Lloyd's in the first instance about the specifically Lloyd's changes (stock lending and the changes in vires on regulations) but also drawing their attention to the deep discount legislation as a general change which particularly affects them. I attach a draft of such a letter for your consideration.

M.A. Johns

M A JOHNS

cc	Chancellor of the Exchequer	Chairman
	Chief Secretary	Mr Beighton
	Paymaster General	Mr Corlett
	Economic Secretary	Mr Bush
	Sir Peter Middleton	Mr Johns
	Mr Scholar	Mr Skinner
	Mr Culpin	Mr Nield
	Mr Odling-Smee	Mr O'Connor
	Mr Gilhooly	Mr Templeman
	Mr Ilett	PS/IR
	Mrs Chaplin	
	Mr Tyrie	

Dear [Goddard]

1989 BUDGET

I am writing to let you know about a couple of legislative changes which the Chancellor has announced in his Budget today affecting Lloyd's. At the same time, it may be of interest if I mention one other change of general application which will be of particular interest to Lloyd's members.

The main change specifically affecting Lloyd's is that legislation is being introduced to permit Lloyd's names to take part in approved stock lending schemes using securities in their premium trusts funds. As you may know, it has up to now not been possible to approve stock lending schemes involving Lloyd's because of the special rules for deeming a disposal of premium trusts funds assets at the end of each accounting period. If the Revenue had approved stock lending arrangements, any assets lent out over a year end would not have been liable to tax (either capital gains tax or accrued income scheme) at the time of the loan but nor would they have been assets of the premium trust fund at the end of the year for the purposes of the deemed disposal. In order to permit approval to be given and to make the deemed disposal rules work properly in relation to loaned stock the Finance Bill will contain proposals to treat stock on loan at the year end under approved stock lending arrangements as still being assets of the premium trust fund. This will mean that, as soon as the legislation is passed and the stock lending regulations have come into force we shall be able to approve schemes involving Lloyd's. It is hoped this will be of benefit to Lloyd's Names by enabling them to enter the stock lending business and earn fees from it if they wish to do so.

The other measure specifically affecting Lloyd's is that the Chancellor proposes to rectify some anomalies in the regulation making powers in relation to the administrative changes in last year's Finance Act. As you know, the regulations issued on 10 March were only able to cover Account 1986. This was because we were advised that the vires in Finance Act 1988 only permitted us to make regulations for the account next but one before the one in which the regulations are made. Furthermore we were not able to include all the extra-statutory concessions we had included in the first draft (for example, the time-limits for farmer's averaging). The vires did not permit us to cover time-limits related to income of Lloyd's members or their spouses from non-Lloyd's sources. The Chancellor's proposals will extend our power to make regulations and we will be drafting permanent regulations covering all the relevant time limits. We will, of course, let you see these in draft.

Turning to the general provisions in the Finance Bill, I would like to mention one which will be of special interest to Lloyd's. This is the new regime for deep discount securities. Following the new General Consent under the Control of Borrowing Order which the Chancellor announced, a wider range of issuers will be able to issue deep discount securities on the sterling market than hitherto, many of them (those by non-corporate issuers) outside the 1984 deep discount legislation. This could lead to distortions in the market and loss of tax with bonds by some issuers being taxed on the discount as income, and identical bonds by other issuers not being taxed in all cases as income. This is a distortion which already exists with foreign bonds. The Chancellor has decided therefore to extend the 1984 legislation to cover deep discount bonds by all issuers (public sector as well as corporate).

BUDGET CONFIDENTIAL

The 1984 legislation applies to an investor on disposal of deep discount bonds. It takes the difference between acquisition cost and disposal proceeds and splits it into a income and a capital gains component. The former is the appropriate proportion of the total discount from issue to redemption of the bond for the time the investor has held it. This approach can only be made to work where the bond does not contain any variable features and the overall discount on the bond and its life are known. An adapted version of the regime will therefore be applied to deep discount bonds with variable features which will tax the whole of the difference between acquisition cost and disposal proceeds as income.

There will be a specific exclusion from this regime for indexed bonds, but only if they meet a number of conditions to ensure that they are giving genuine long-term protection against inflation. The most important condition is that they must have a term of at least 5 years on issue and no provision or arrangements for earlier redemption. But there will also be restrictions requiring the index to belong to the country in whose currency in which the bond is denominated and limiting any lagging of the indexation to 8 months. And interest will have to be paid at least annually, at a reasonable commercial rate of securities with similar characteristics and calculated on the indexed value of the capital without any capping.

I enclose copies of the Press Releases dealing with these proposals. If there are any points you wish to discuss or clarify please do not hesitate to get in touch with me. You will, of course, appreciate that it will not be possible to give full details until the Finance Bill is published.

Yours sincerely

A G NIELD



FROM: R C M SATCHWELL
DATE: 6 March 1989

MR JOHNS - IR

cc

- PS/Chancellor
- PS/Chief Secretary
- PS/Paymaster General
- PS/Economic Secretary
- Sir P Middleton
- Mr Scholar
- Mr Culpin
- Mkr Odling-Smee
- Mr Gilhooly
- Mr Ilett
- Mrs Chaplin
- Mr Tyrie

Mr Beighton - IR
PS/IR

LLOYD'S COMMUNICATION OF BUDGET CHANGES

The Financial Secretary was grateful for your minute of 3 March. He agrees with your suggested approach to informing Lloyd's of the Budget changes affecting them. However, he had a number of minor drafting amendments to your suggested letter; I attach a revised version.

R.C.M.S.

R C M SATCHWELL
Private Secretary

DRAFT LETTER

1989 BUDGET

I am writing to let you know about two legislative changes which the Chancellor has announced in his Budget today, and which will be helpful to Lloyd's. At the same time, it may be of interest if I mention one other change of general application which will be of particular interest to Lloyd's members.

The main change specifically affecting Lloyd's is that legislation is being introduced to permit Lloyd's names to take part in approved stock lending schemes using securities in their premium trust funds. As you may know, it has up to now not been possible to approve stock lending schemes involving Lloyd's because of the special rules for deeming a disposal of premium trust fund assets at the end of each accounting period. If the Revenue had approved stock lending arrangements, any assets lent out over a year-end would not have been liable to tax (either capital gains tax or income tax under the accrued income scheme) at the time of the loan; nor would they have been assets of the premium trust fund at the end of the year for the purposes of the deemed disposal.

In order therefore to permit approval to be given and to make the deemed disposal rules work properly in relation to loaned stock, the Finance Bill will contain proposals to treat stock on loan at the year-end under approved stock lending arrangements as still being assets of the premium trust fund. This will mean that, as soon as the legislation is passed and the stock lending regulations have come into force, we shall be able to approve schemes involving Lloyd's. This will be of benefit to Lloyd's names since it will enable them to enter the stock lending business and earn fees from it if they wish to do so.

The other measure specifically affecting Lloyd's is that the Chancellor proposes to rectify some anomalies in the regulation-making powers in relation to the administrative changes in last year's Finance Act. As you know, the regulations issued on 10 March were only able to cover Account 1986. This was because we were advised that the vires in Finance Act 1988 only permitted us to make regulations for the account next but one before the one in which the regulations are made. Furthermore we were not able to include all the extra-statutory concessions we had included in the first draft (for example, the time-limits for farmer's averaging). The vires did not permit us to cover time-limits related to income of Lloyd's members or their spouses from non-Lloyd's sources. The Chancellor's proposals will extend our power to make regulations and we will be drafting permanent regulations covering all the relevant time limits. We will, of course, let you see these in draft.

Turning to the general provisions in the Finance Bill, I would like to mention one which will be of special interest to Lloyd's. This is the new regime for deep discount securities. Following the new General Consent under the Control of Borrowing Order which the Chancellor announced, a wider range of issuers will be able to issue deep discount securities on the sterling market than hitherto, many of them outside the existing 1984 deep discount legislation. This might have led to distortions in the market and loss of tax as the discount on bonds by some issuers was taxed as income, and that on identical bonds by other issuers was not in all cases. The Chancellor has decided therefore to extend the 1984 legislation to cover deep discount bonds by all issuers (public sector as well as corporate).

The 1984 legislation applies to an investor on the disposal of deep discount bonds. It takes the difference between the acquisition cost and disposal proceeds and splits it into an income and a capital gains component. The former is the

appropriate proportion of the total discount from issue to redemption of the bond for the time the investor has held it. This approach can only work ^{mathematically} where the bond does not contain any variable features and the overall discount on the bond and its life are known. An adapted version of the regime will therefore be applied to all deep discount bonds with variable features. It will tax the whole of the difference between the acquisition cost and disposal proceeds as income.

There will be a specific exclusion from this regime for indexed bonds, but only if they meet a number of conditions to ensure that they are giving genuine long-term protection against inflation. The most important conditions are that they must have a term of at least 5 years on issue and no provision or arrangements for earlier redemption. But there will also be restrictions requiring the index to belong to the country in whose currency in which the bond is denominated and limiting any lagging of the indexation to 8 months. Furthermore, interest will have to be paid at least annually, at a reasonable commercial rate comparable to that paid on securities with similar characteristics, and calculated on the indexed value of the capital without any capping.

I enclose copies of the Press Release dealing with these proposals. If there are any points you wish to discuss or clarify, please do not hesitate to get in touch with me. You will, of course, appreciate that it will not be possible to give full details until the Finance Bill is published.

Yours sincerely

A G NIELD