

PO - CH/NL/0608
PART A

PO CH/NL/0608
PART. A

CONFIDENTIAL

PO CH/NL/0608
PART. A

1988 BUDGET
STARTER

5.12.88

DD'S 28715 NAREJ 8/8/96

THIS FOLDER HAS BEEN
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~~11/14/87~~

1988 Budget
Starter.

~~608~~

608



Inland Revenue

Policy Division
Somerset House

FROM: D L SHAW
EXTN: 6300
DATE: 19 FEBRUARY 1988

- 1. MR CORLETT *DLJ 22/2*
- 2. FINANCIAL SECRETARY

BUDGET STARTER 452: KEITH ADMINISTRATIVE IMPROVEMENTS: END
OF YEAR INTEREST ON PAYE AND NIC

1. The purpose of this letter is to propose that you write to the Minister of State for Social Security seeking his formal agreement that interest be charged on late payments of Class 1 and 4 NIC.

Background

2. This year's Keith package for the Budget includes an interest charge on employers who delay payments of PAYE beyond the end of the tax year. This will not come into

- cc PS/Chancellor
- PS/Chief Secretary
- PS/Paymaster General
- PS/Economic Secretary
- Mr Scholar
- Mr Culpin
- Miss Sinclair
- Mr Riley
- Mr Cropper
- Mr Byatt
- Mr Hudson

- Mr Isaac
- Mr Beighton
- Mr Corlett
- Mr Calder - Stats
- Mr Ko - Stats
- Mr Shaw - P2
- Mr Bush - M4/8
- Mr Eccleshall - P2
- PS/IR

BUDGET CONFIDENTIAL

effect before 1992, but legislation is needed now to allow employers time to bring themselves up-to-date and the Revenue time to computerise.

3. But, operationally, we will not be able to charge interest on PAYE without also charging interest on Class 1 NIC, since it is collected in a single sum together with the PAYE. And for reasons of equity, as well as for administrative efficiency, interest will then have to be charged on Class 4 NIC which is collected together with Schedule D.

4. At your meeting of 19 November 1987 to discuss the Revenue Keith package, you agreed that interest should be charged on late payments of Class 1 and 4 NIC when the interest charge comes into effect for PAYE.

5. At that stage, there was concern that NIC could be a sensitive issue in this year's Budget, and the feeling was that it would be advantageous if interest on NIC were not announced in the Budget. We thought that it could be avoided in the Budget speeches and Press Releases, but that Ministers would have to acknowledge that it was under consideration if asked in debate. And, we thought that it would be easier if Ministers were able to announce that interest would be charged on NIC too.

Discussions with DHSS

6. The details of the interest charge have already been worked out and agreed with DHSS officials, and DHSS Ministers are known to have accepted the proposal informally. What is needed now is a formal exchange of letters between Ministers agreeing that interest should be charged.

7. We recommend that this is done before the Budget, since the measure to be introduced then - the interest charge for late PAYE - cannot be implemented without an identical

charge being introduced for NIC by the Department of Health and Social Security. We understand that they are prepared to do this as part of a Social Security Bill later in this Parliament.

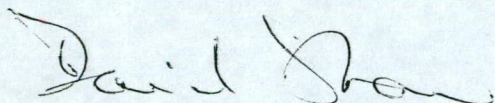
Budget Day Press Release

8. Since NIC is no longer a sensitive issue for this Budget, it will be possible to announce the interest charge for Class 1 and 4 NIC at the same time as the interest charge for late PAYE in the Budget Day Press Release. In addition to tidiness, this will draw less attention to the charge than would result if it were only acknowledged as a possibility in debate and had to be confirmed at a later stage.

Conclusion

9. We recommend - and FP agree - that you write to the Minister of State for Social Security seeking his agreement to the NIC interest charge. I attach a draft letter.

10. We suggest that the charge be announced, together with the interest charge for late payment of PAYE, in the Budget Day Press Release on the Keith package.



D L SHAW

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DRAFT LETTER FROM FINANCIAL SECRETARY TO
MINISTER OF STATE FOR SOCIAL SECURITY

Nicholas Scott Esq MBE JP MP
Minister for Social Security and the
Disabled
Richmond House
79 Whitehall
London
SW1A 2NS

INTEREST ON LATE PAYMENTS OF CLASSES 1 AND 4 NIC

I am writing to you, on the usual "Budget Confidential" basis, to let you know that we are proposing in this Budget to introduce an interest charge on employers who delay payments of PAYE to the Revenue beyond the end of the tax year. This is to encourage employers to pay on time, and to compensate the Exchequer if they do not. Although the charge will be announced now, it will not come into effect before 1992. This is to allow employers time to bring themselves up to date with their payments and the Revenue time to computerise the operation.

As you will know, Class 1 NIC is collected in a single sum together with the PAYE. So it will be necessary for the interest charge to extend to the Class 1 liabilities. Furthermore, for reasons of equity, as well as for administrative efficiency, interest should also be charged on outstanding Class 4 NIC, which is collected together with Schedule D income tax. In both cases the rules for interest on the NIC will need to match exactly with the rules for the corresponding tax.

The details of the charge and arrangements for collecting it and accounting are being worked out between our officials, and I understand that agreement in principle has

been reached. But before we make any announcement in the Budget I should be grateful for your agreement that we can announce also the intention to charge interest on delayed payments of Classes 1 and 4 NIC, and that the necessary statutory authority will be secured in due course to allow the new system to be implemented in 1992.

Our officials can discuss the timing, but we would not expect your legislation to be needed until after we have completed public consultations on the proposals generally, which will be towards the end of this year.

NORMAN LAMONT



Inland Revenue

Policy Division
Somerset House

FROM: H B THOMPSON


DATE: 22 FEBRUARY 1988

1. Mr Pitts *SM 2/2*
2. Financial Secretary

CAPITAL GAINS OF COMPANIES**BS 258: INDEXATION AND GROUPS****BS 259: INTRA-GROUP SHARE EXCHANGES**

1. You have agreed (Miss Feest's note of 17 February to Mrs Burnhams) that legislation on both these starters should be included in this year's Finance Bill.

2. We shall be glad to know whether you are content for us to issue a Press Release on each topic, in the terms of the attached drafts, on Budget Day.


 H B THOMPSON

cc	PS/Chancellor	Mr Isaac
	PS/Chief Secretary	Mr Pitts
	PS/Paymaster General	Mr Beighton
	PS/Economic Secretary	Mr Cleave
	Mr Scholar	Mr Hamilton
	Mr Culpin	Mr J R Calder
	Miss Sinclair	Mr McManus
	Mr Michie	Mr Cayley
	Mr Cropper	Mr Fitzpatrick
	Mr Tyrie	Mr Thompson
	Mr Riley	Mr Creed
	Mrs Burnhams	Mr Gill
	Mr Jenkins (Parliamentary Counsel)	Mr Evans
	Mr Davies (Parliamentary Counsel)	Mr Michael
		Mr Gordon
		Mr Walker
		Mr Willmer
		PS/IR



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INLAND
REVENUE

Press Release

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

[3x]

15 March 1988

ARTIFICIAL CAPITAL LOSS DEVICES COUNTERED

The Chancellor proposed in his Budget to counter the exploitation of the capital gains indexation allowance which can occur through intra-group financing.

DETAILS

1. When a company

- disposes of, or receives payment in respect of, a debt on a security owed by a linked company; or
- disposes of redeemable preference shares in a linked company,

no indexation allowance will be given if the companies were already linked when the debt or shares were acquired. The indexation allowance will be restricted if the companies became linked between the dates of the acquisition and the disposal.

2. When a company disposes of other shares in a linked company no indexation allowance will be given if

- the companies were linked when the shares were acquired; and
- the acquisition was directly or indirectly financed by an intra-group loan; and
- the sole or main benefit which might have been expected to accrue from the acquisition was an indexation allowance on the eventual disposal of the shares.

3. Companies are linked for this purpose if they are in the same group or under common control or if one controls the other.

4. The measures will apply to disposals on or after Budget Day.

/NOTES FOR EDITORS

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NOTES FOR EDITORS

1. These new measures will counter arrangements by which groups can use the capital gains indexation provisions to create large artificial capital losses for taxation purposes.

2. Transactions between members of the same group of companies do not normally attract tax liability. A debt on a security is however a chargeable asset even if the loan is between group companies. Although the company lending the money might receive repayment of such a debt in full, it is still entitled to an indexation allowance which creates a capital loss. This allowance is not available for straightforward intra-group loans. It is obtained by clothing the loan in a particular legal form.

3. This can be further exploited in two ways

- the groups can interpose one or more member companies between the member with money to lend and the member that wants to borrow it. Each intermediate company receives and makes a loan of the same amount and each will be able to get indexation relief. This means that more than one amount of relief will be given on what is really the same asset. If the true borrower buys an asset with the money then that asset will also qualify for indexation relief on disposal;
- funds can be passed round in a circle back to the lender. There is no real asset at all, but again more than one amount of indexation relief arises.

Very large sums may be involved.

4. Similar effects can be obtained by using redeemable preference shares or ordinary shares whose acquisition is financed by an intra-group loan.

5. The measures proposed by the Chancellor will counter these devices by withdrawing or restricting the indexation allowance (Sections 86 and 87 and Schedule 13 Finance Act 1982; Section 68 and Schedule 19 Finance Act 1985) on the debts and shares concerned.

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Press Release

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

[3x]

15 March 1988

DOUBLE TAXATION OF COMPANIES' CAPITAL GAINS FROM INTRA-GROUP SHARE EXCHANGES TO BE PREVENTED

The Chancellor proposes in his Budget to amend the rules for taxation of companies' gains to ensure that share exchanges by companies in the same group do not result in capital gains or losses being charged or allowed more than once.

The amendment will remedy a defect in the law revealed by a recent Court decision. It will be included in the Finance Bill and will apply to share exchanges on and after Budget Day.

NOTE FOR EDITORS

1. This amendment corrects an unintended overlap in the tax rules about transfers of assets between members of the same group of companies and the rules about share exchanges.
2. Disposals between companies within the same group do not normally attract tax liability. The general rule is that the accrued gain or loss is rolled over with the transferred asset to be taxed or allowed when it leaves group ownership.
3. But special rules can apply if the asset is a holding of shares and those shares are acquired by another group member in exchange for the issue of new shares. In this case the accrued gain or loss on the existing shares is rolled over to the new shares, for taxation when they leave group ownership.
4. The special rules were meant to apply instead of the general rule. The Courts have however said - in the case of Westcott v Woolcombers Ltd [1987] STC 600 - that both rules apply to the existing shares. This means that the pre-exchange gain or loss is rolled over with the existing shares and to the new shares: the gain or loss will eventually be taxed or allowed twice.
5. The proposed amendment will put this right by providing for the general rule (in Section 273 of the Taxes Act 1970) to be ignored when the special rules (in Sections 78 and 85 of the Capital Gains Tax Act 1979) apply.

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Inland Revenue

Policy Division
Somerset House

PWP

FROM: C GORDON
EXT: 6739
DATE: 23 FEBRUARY 1988

1. MR PITTS *23/2*
2. FINANCIAL SECRETARY

CAPITAL GAINS TAX**BS 261 : DEPENDENT RELATIVES RESIDENCE RELIEF****BS 265 : RETIREMENT RELIEF**

1. We shall be grateful to know whether you are content with the attached draft Budget Day Press Releases on two capital gains tax changes.
2. We did wonder whether the dependent relatives residence relief change could be covered in the general release on Income Tax allowances. However the capital gains tax point did not fit readily into that release and we have therefore dealt with it separately.

C GORDON

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Michie
Mr Cropper
Mr Tyrie
Mr Riley
Mrs Burnhams

Mr Isaac
Mr Pitts
Mr Beighton
Mr Hamilton
Mr McManus
Mr Cayley
Mr C Gordon
Mr Walker
Mr Willmer
PS/IR



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Press Release

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

[3x]

15 March 1988

CAPITAL GAINS TAX: RETIREMENT RELIEF

The Chancellor proposes in his Budget to increase the amount of relief available to people who

- dispose of their business when aged 60 or above, or
- who retire earlier on ill-health grounds.

Relief is to be available at 50% on gains between £125,000 and £500,000. This is on top of the full relief now available for gains up to £125,000. The additional relief will be available where the disposal takes place on or after 6 April 1988.

NOTES FOR EDITORS

1. The capital gains tax retirement relief provides an exemption of up to £125,000 of gains on the disposal of a business or of shares in a family company for individuals aged 60 or above and those retiring earlier on grounds of ill-health. Where the disposal takes place on or after 6 April 1988 it is proposed to give a further relief of 50% on gains between £125,000 and £500,000. As now, the maximum relief will be available to an individual who has been running his business for at least 10 years with the maximum proportionately abated for those who have been running the business for at least one year but less than 10. The maximum available relief on a disposal is reduced to the extent that any relief has been given previously.

2. The following examples show how the relief will work:

Example (a): A (age 65) disposes of his business, which he has been running for 20 years, on 1 May 1988. The gain after indexation is £250,000. He has had no earlier retirement relief.

£: Gain

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	£
Gain	: 250,000
Amount available for full relief	: 125,000
Amount available for 50% relief:	
250,000 - 125,000	: 125,000
Amount of relief available:	
125,000 + (50% x 125,000)	
	= 187,500

Gain	:	250,000
- retirement relief	:	<u>187,500</u>
Chargeable gain		62,500
		=====

Example (b): B (age 65) disposes of his business, which he has been running for 6 years, on 1 May 1988. The gain after indexation is £250,000. He has had no earlier retirement relief.

	£
Gain	: 250,000
Width of "full relief band" 125,000 x 60%	: 75,000
Width of "50% relief band"	
(500,000 - 125,000) x 60%	: 225,000
(ie relief available at 50% on gains between £75,000 and £300,000)	
Amount available for full relief	: 75,000
Amount available for 50% relief:	
250,000 - 75,000	: 175,000
Amount of relief available:	
75,000 + (50% x 175,000)	
	= 162,500

Gain	:	250,000
- retirement relief	:	<u>162,500</u>
Chargeable gain		87,500
		=====



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**INLAND
REVENUE**

Press Release

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

[3x]

15 March 1988

CAPITAL GAINS TAX: DEPENDENT RELATIVES RESIDENCE RELIEF

The Chancellor proposes in his Budget to abolish the capital gains tax relief available to people providing homes to dependent relatives.

The change applies to homes provided on or after 6 April 1988. Relief will continue to be available for homes provided before that date.

This change, and the corresponding proposal to withdraw mortgage interest relief on homes provided for dependent relatives, are consequential on the proposal to abolish the small personal allowance for those with dependent relatives. Further details about these proposals can be found in the Press Releases dealing with Mortgage Interest Relief and changes to Income Tax rates and allowances.

NOTES FOR EDITORS

1. At present an individual (or married couple) who owns a home which is or has been occupied rent-free by a dependent relative is entitled to relief from capital gains tax when the property is sold, by reference to the period during which the relative lived in the property. Broadly, full exemption is available where the dependent relative has been in occupation throughout the period of ownership. A reduced level of relief is available where the dependent relative has been in occupation only for some of the period of ownership.

2. As a result of the change this relief will no longer be generally available. However relief will still be available:

(i) in respect of any periods prior to 6 April 1988 during which a dependent relative occupied the property; and

(ii) in those

(ii) in those cases where a dependent relative is actually in occupation on 5 April 1988 for as long as that relative remains in occupation.

3. A dependent relative is:

- (i) a relative of the taxpayer or his wife who is incapacitated by old age or infirmity from maintaining himself, or
 - (ii) the taxpayer's mother or mother-in-law if she is widowed, separated or divorced.
-



Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-620 1313

FROM: B H KNOX

DATE: ^{29 February} ~~March~~ 1988

PS/CHANCELLOR

a
*Rejected (sight
unseen) @ Overruled
for this year.*
Concur: [Signature]

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr P R H Allen
PS/IR

MOTABILITY: POSSIBLE BUDGET STARTER

1. Your note of 25 February asks for a quick note on the case for giving car tax relief on cars supplied to Motability for leasing. This matter has been addressed in depth on two previous occasions in connection with possible Budget "lollipops" in 1984 and 1987. On both occasions there was a strong recommendation against granting such relief, and the arguments leading to that conclusion have not changed.

2. The proposal was also discussed in detail this year by the Economic Secretary when he met Sir Jeffrey Sterling (Chairman of Motability) on 12 February. Briefly, the arguments against granting relief are:

- (a) **Revenue cost.** A loss of between £7 and £17 million has been estimated, with no recovery of car tax where the vehicles are sold after the period of leasing or diverted to a non-entitled use.
- (b) **Control problems.** Scope for abuse is significant, with attendant administrative and control problems in an area which would be very sensitive to monitor.

Internal distribution:

CPS
Mr Jefferson Smith
Mr Cockerell

Ms Barrett
Mr Green
Mr Hamilton

- (c) **Repercussions.** It would be difficult to resist similar applications from other bodies. The proposal would increase the gap between leasing and hire purchase schemes, leading to pressure further to extend relief and increase revenue cost/control problems.

- (d) **Ancillary costs.** There would be an increase in demand for vehicles which would raise the level of DHSS funding required to cover Motability's administrative costs.

- (e) **Operation of Car Tax.** Car tax is a single-stage tax and there is no mechanism for recouping any part of the tax relieved if the vehicle is sold after a period of leasing and transferred to a non-entitled use. In this, car tax differs from VAT which is a multi-stage tax allowing recovery of VAT on second-hand selling prices. This conceptual difference makes it difficult to achieve parallel tax treatment.

- (f) **Other reliefs.** Relief is already available for substantial adaptations to vehicles. The proposed relief would benefit only car users - there would be pressure to give relief to general purpose goods used by others - eg the house bound, disabled.

- (g) **General.** Many of the leased vehicles proposed for relief are not adapted for disabled persons. They are used where the disabled person is a passenger only; this increases the risk of diversion to non-entitled use.

3. To give more detailed background, and greater depth to the arguments involved, I attach copies of the briefing notes provided in 1984 and 1987. I attach also a copy of the full briefing supplied to the Economic Secretary for his February meeting with Motability and a copy of the note of that meeting.

Bryce Knox

B H KNOX

*pro*

FROM: A C S ALLAN

DATE: 2 March 1988

MR KNOX - CUSTOMS AND EXCISE

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr P R H Allen
PS/IR**MOTABILITY: POSSIBLE BUDGET STARTER**

The Chancellor was grateful for your minute of (?) 29 February. This was discussed briefly at the Overview meeting, where it was agreed that this lollipop should not be introduced this year, but should be reconsidered as a starter for next year.

A handwritten signature in black ink, appearing to read 'ACSA' with a stylized flourish underneath.

A C S ALLAN



Ch.

FST may want a word with
you about the point in
para. 2-5 of Mr Stewart's
note of 8/3, behind.

H
1/3

Wt have
discuss.

BUDGET CONFIDENTIAL



FROM: JILL RUTTER

DATE: 8 March 1988

MR STEWART - IR

cc:

PS/Chancellor

PS/Financial Secretary

PS/Paymaster General

PS/Economic Secretary

Sir Peter Middleton

Mr Scholar

Mr Culpin

Mr Cropper

Mr Tyrie

Mr Corlett - IR

PS/IR

MAINTENANCE AND COVENANTS (STARTER 150)

The Chief Secretary has seen your minute of 4 March covering two press notices and two draft leaflets and the Financial Secretary's comments recorded in Mr Heywood's minute of 7 March.

Covenants: Press Release

2 The Chief Secretary agrees with the Financial Secretary's comments on this press release.

Maintenance Payments

3 Paragraph 8 - the Chief Secretary dislikes the formulation here. Redraft: "if a divorced husband remarries he will be able to claim the married man's allowance as well as maintenance relief for payments to his ex-wife." You are checking the point in paragraph 9 which Mr Culpin raised with you on Friday evening.

Deeds of covenant: draft leaflet

4 The Chief Secretary believes that the section "how are students affected" should make a reference to the student grant measures.

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Maintenance payments leaflet: Section A

5 This needs some reference to the position of existing orders made to children. At present it is unclear what the position of children is - and the Chief Secretary has commented that it is not reasonable to expect people to cross-refer from this leaflet to the covenants leaflet.

Section C

6 Again the Chief Secretary thought that the section on payments to children needed expanding. He thought that as well as making the point that the payments would not qualify for relief you should bring out that the child will not be liable to tax on such payments.

7 As the Chief Secretary commented last week the "what if I remarry" and "what if I am reconciled with my ex spouse" sections both have slipped back into the assumption that it is only an ex-husband who will be making maintenance payments. You might like to look at this again. He is also unclear whether the married allowance can be claimed for the whole year or only part of the year post-reconciliation. Could the section be redrafted to bring that out more clearly.

Section D

8 The Chief Secretary thought the "Am I affected by the changes" section should bring out that the recipient can use the personal allowance - presumably against both any excess over the maintenance limit of £1,490 and against any other income. You will want to consider how best to draft that. Similarly in the post-Budget Day arrangements section, the Chief Secretary thought we should add to the answer about maintenance payments: "They are tax free and you will be able to use your full personal allowance against any other income you may have."

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9 Otherwise the Chief Secretary is content.

J. Rutter

JILL RUTTER
Private Secretary



Handwritten signature

FROM: J J HEYWOOD
DATE: 7 March 1988

MR STEWART IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Corlett IR
PS/IR

MAINTENANCE AND COVENANTS (STARTER 150)

The Financial Secretary had several comments on the attachments to your minute of 4 March. He was content with what you proposed in paragraph 5 of your minute.

Covenants: Press Release

2. The Financial Secretary would prefer to replace the first sentence of the press release with something along the following lines:

"The Chancellor proposes in his Budget to abolish tax relief for non-charitable payments made by individuals under Deeds of Covenant. This will greatly simplify the existing system"

3. The Financial Secretary thinks that the opening paragraph should also refer to students and to the compensatory measures we are proposing.

Maintenance Payments: Press Release

4. The Financial Secretary thinks that the rationale for the changes should be rehearsed in the press release. He also thinks that there needs to be some reference to the removal of tax penalties on marriage.

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5. On paragraph 9 of the "Details" section, he did not recall having agreed to this. On paragraph 15, is it impossible to get the leaflets in tax offices by 16 March?

Covenants: Leaflet

6. Again, the Financial Secretary thinks there should be some reference to the student grant changes.

g.h.
/

JEREMY HEYWOOD
Private Secretary

BUDGET CONFIDENTIAL

From: S D H SARGENT

Date: 8 March 1988

MR C STEWART - IR

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie

Mr Isaac)
Mr Painter)
Mr Corlett)
Mr Beighton)
Mr Davenport) IR
Mr Yard)
Mr Walker)
Miss McFarlane)
Mrs Fletcher)
PS/IR

MAINTENANCE AND COVENANTS (STARTER 150)

Sir Peter Middleton has seen your note of 4 March to the Chief Secretary. He has commented that one question which needs to be covered in the briefing on student covenants is whether people who take out a new covenant each year in line with increases in student grant scales will be disadvantaged by comparison with those on the new grant arrangements.



S D H SARGENT
Private Secretary

PWP



Inland Revenue

Policy Division
Somerset House

FROM: C STEWART
FAX No. 6766
EXTN. 7414
8 March 1988

*Personal to
PS/IR, who
will deal.*

- 1. MR CORLETT *AcwB*
- 2. MR ISAAC *AcwB*
- 3. FINANCIAL SECRETARY

*X is slight
ambiguity, x
acc notes
have redrafts*

MAINTENANCE AND COVENANTS (STARTER 150)

1. The press notices and leaflets have been revised in the light of your comments (Mr Heywood 7 March) and final policy decisions. The redrafts are attached.

Divorced wives remarrying

2. You questioned the statement in paragraph 9 of the draft Press Release that where a divorced wife remarries, relief for maintenance paid by her first husband would then cease. This point came up at a earlier stage in the context of relief for children, but on looking back I am afraid it does not seem to have been specifically recorded in the various papers.

3. If Mr and Mrs A are divorced and he pays maintenance to her, he will get relief under the new rules, up to £1490. If Mrs A then marries Mr B, Mr B will get married allowance

- cc Chancellor of the Exchequer —
- Chief Secretary
- Paymaster General
- Economic Secretary
- Sir Peter Middleton
- Mr Scholar
- Mr Culpin
- Mr Cropper
- Mr Tyrie
- Mr Jenkins - Parliamentary Counsel

- Mr Isaac
- Mr Corlett
- Mr Beighton
- Mr Davenport
- Mr Yard
- Mr Walker
- Miss McFarlane
- Mrs Fletcher
- PS/IR
- Mr Stewart

for her. In practice it is likely that Mr A's maintenance payments to her would then come to an end anyway; but if the payments were being made to her wholly or partly for the maintenance of their children, they might continue to some extent after her remarriage.

4. In this situation Mrs A will no longer have her own separate household (the original justification for the maintenance relief). Unless the children go back to their father, they will presumably join the B family. Mr B would not get relief for maintaining his own children by a previous marriage. The question is whether Mr A should get relief for maintaining his children who have become part of the B family with their mother.

5. Stopping Mr A's relief in these circumstances may be criticised. On the other hand, it is not easy to justify giving relief for maintaining children in that case, while denying it to (say) the divorced parent maintaining his children who are living with him. Hence the proposal that relief should come to an end when the ex-wife remarries. If, however, you wish the relief to continue in these cases, we will need to have the draft Resolution and Press Notices amended very quickly.

Leaflets

6. Arrangements could be made to get the leaflets into tax offices by 16 March but this would involve releasing them into the hands of the Post Office or other delivery agencies before the Chancellor has announced the changes in the Budget Speech. We think this is an unnecessary risk. Copies of the leaflets will be available from Somerset House on the morning of 16 March and from all tax offices on 17 March.

Justification for maintenance reforms

7. You asked if the maintenance press release could include the rationale for the changes.

8. We would prefer not to say more than the initial words about simplification. This is a long and quite complex release, which we want to aim at the professional advisers and, particularly, the Courts, so they immediately know what to do in drawing up Orders and agreements. In a sense, it is a technical instruction. Would you be content for us to proceed in this way, and leave the political message to be set out more fully in the Treasury Press Notice which Mr Hudson is preparing and to which we refer in the introduction to our press release.

Maintenance - examples

9. At the end of the maintenance press release, we think it would be useful to add a couple of examples - one showing how the changes will affect the ordinary case where the maintenance is below the new limit, and one showing what happens when it is above the new limit. We shall add these to the approved version.

Chief Secretary's comments

10. We have also taken on board the Chief Secretary's comments generally (Miss Rutter's note of 8 March). But on the points raised in paragraph 7 of her note, it is not possible to give an answer which applies equally to the husband and the wife, because the married allowance is at present an allowance for the husband. We have redrafted these two answers to deal with maintenance relief only.

C

C STEWART

[3x]

15 March 1988

DEEDS OF COVENANT

The Chancellor proposes in his Budget to abolish tax relief for payments made by individuals under non-charitable Deeds of Covenant made on or after today. This will greatly simplify the existing system.

This change will apply to covenants made to students by their parents, as well as to other covenants. Parental contributions to student grants will, however, be reduced for students starting their studies from the next academic year.

DETAILS

1. Non-charitable covenants made by individuals on or after 15 March 1988 will have no effect for tax purposes. This means that:

- payers should not deduct tax from covenanted payments and will not get tax relief on them, and
- recipients will not pay tax on them or be able to claim repayment.

2. The present rules will continue to apply to

- all covenants in favour of charities;
- other covenants made by individuals before 15 March 1988 provided they are received by the tax office by 30 June 1988.

Deduction of tax

3. The effect of the reduction in the basic rate of income tax on charitable covenants, and on other covenants made before today, is set out in a separate Press Release.

NOTES FOR EDITORS

Present tax position

1. A deed of covenant is a way of legally transferring income from one person to another. It can be effective for tax purposes under present law if it is capable of running for more than 6 years (or more than 3 years if it is in favour of a charity).
2. On making each payment under the covenant the payer deducts basic rate tax and so gets basic rate relief. If the recipient is not liable to tax he can claim the tax deducted from the payment back from the Inland Revenue.

Effect of Budget proposals

3. The payer will not be entitled to deduct tax from payments made under a new covenant (unless it is to a charity). If he covenants to pay £100, that is the amount he will pay and the recipient will receive. The Inland Revenue will not be involved. A separate Treasury Press Release explains the background to the proposals. Details will be available from tax offices shortly.

Students

4. Student covenants made on or after 15 March 1988 will be treated in the same way as other new covenants. But since the payments will no longer be taxable, students will have the whole of their personal tax allowances to set against other income, such as vacation earnings. Furthermore, for students beginning their course from the next academic year there will be a new and more generous scale for assessing parental contributions to their maintenance grants.

A word of warning

5. A Deed of Covenant is a legal document and it is not permissible to put a date on it earlier than the date it is executed. This will result in refusal of any tax refund. It can also result in prosecution by the Inland Revenue for attempted fraud.

Other transfers of income

6. Covenants which transfer income from one person to another are "annual payments". The proposals will also apply to other "annual payments" which transfer income in a similar way from an individual to someone else; but they will not apply to interest payments or to payments made for commercial reasons in connection with the payer's business.

[3x]

15 March 1988

REFORM OF THE TAXATION OF MAINTENANCE PAYMENTS

The Chancellor proposes in his Budget to simplify the tax treatment of maintenance payments.

For maintenance arrangements made from today (15 March), there are to be new rules. Anyone receiving maintenance payments under these new arrangements will not pay tax on them. People paying maintenance to their separated or divorced wives or husbands under the new arrangements will get relief up to a limit (which will be £1490 for 1988-89). Other maintenance payments, including payments to children, will not qualify for relief.

Payments under existing arrangements, including payments to children, will continue to be treated under the present rules for the coming year 1988-89. But people who are separated or divorced and receiving payments under existing maintenance arrangements will be exempt from tax on the first £1490. From 1989-90 there will be a limit to the payer's relief, based on the relief given in 1988-89; but payers will be able to choose to go into the new system if they prefer.

A Treasury Press Release explains the background to these proposals.

DETAILSNEW COURT ORDERS AND AGREEMENTS

1. The proposed new rules for new Court Orders made after today, and for maintenance agreements made on or after today, are:

- the recipient will not be liable to tax on any payments received;
- where one divorced or separated partner is required to make payments to the other, the payer will qualify for tax relief (at basic and higher rates) for payments up to a limit equal to the difference between the single and married personal allowances (£1490 for 1988-89);

/- there will

- there will be no tax relief for other new maintenance or alimony payments;
- payments will be made gross (ie without deduction of tax).

Court Orders already in the pipeline

3. There will be transitional arrangements for Court Orders:
- applied for on or before 15 March 1988; and
 - made by 30 June 1988

In these cases, the present tax rules will apply in the same way as to existing Orders (see paragraphs [] below).

Payments qualifying for relief

4. All periodical payments to a divorced or separated spouse which are required to be made under a UK Court Order or legally binding written agreement will count towards the £1,490 limit. This will include not only direct payments, but also such items as household bills, which the payer is required to meet.

5. Some payments (for which tax relief is generally not available under the present rules) will not count. These include

- payments which are voluntary and not made under a legal obligation;
- payments under a foreign Court Order or agreement;
- payments for which the taxpayer already gets tax relief in some other way;
- capital payments or lump sums.

Multiple Payments.

6. Where a person is paying maintenance to more than one divorced or separated spouse, all the payments will count towards the £1,490 limit.

Interaction with Married Allowance.

7. In the year of separation or divorce, married allowance is given for the whole tax year and is not apportioned. A husband will continue to get the married allowance for that year, and will also get maintenance relief up to the £1,490 limit for payments made for the part of the year during which he is separated or divorced.

8. If a divorced husband remarries he will be able to claim married allowance as well as maintenance relief for payments to his ex-wife.

/9. If the person

9. If the person receiving the payments remarries, maintenance relief for the payer will then cease.

EXISTING COURT ORDERS AND AGREEMENTS

10. It is proposed that the existing rules will continue to apply for 1988-89 to payments made under

- Court Orders made before 15 March 1988;
- Court Orders applied for on or before 15 March 1988 and made by 30 June 1988;
- maintenance agreements made before 15 March 1988 (provided that a copy of the agreement has been received by the Inspector of Taxes by 30 June 1988);
- Court Orders or agreements made on or after today which vary or replace such Orders or agreements.

New exemption for recipients

11. From 6 April 1988, however, the first £1,490 of payments by one divorced or separated spouse to the other will be exempt from tax in the recipient's hands.

Limit to payer's relief and recipient's liability

12. After 5 April 1989 there will be special rules for all maintenance payments under arrangements to which the existing rules continue to apply. Under these special rules -

- the payer will get tax relief on payments up to the level for which he got relief for 1988/89; and
- the recipient will be taxable on an amount not exceeding the amount which was taxable in 1988/89 (after allowing the exemption for a divorced or separated spouse, see paragraph).

In arriving at these limits for 1988/89, account will be taken of payments due in 1988-89 under any amending Court Order or agreement made before 6 April 1989.

13. All payments of maintenance due after 5 April 1989 will be paid gross - without tax deducted by the payer.

Switching to the new rules

14. Payers under the existing rules may, if they prefer, switch to the new rules. The new rules will then apply to the recipient as well. An election, which will apply for a whole year of assessment, can be made at any time during the year of assessment and up to 12 months after that year of assessment. Generally there is no benefit to the payer in making an election for 1988-89. An election may be beneficial in later years if payments increase, and the limit for relief "pegged" at the 1988-89 level is below the maximum amount of relief available under the new rules.

Publicity

15. The Inland Revenue will be issuing a leaflet containing the details of the new system. It will be available from tax offices shortly.

NOTES FOR EDITORS

Present Tax Arrangements

1. At present tax relief for maintenance is generally available for payments made under a United Kingdom Court Order

- a. by a divorced or separated husband or wife to his/her spouse or ex-spouse for his/her own benefit or for the maintenance of a child of the marriage
- b. by a parent direct to a child of the marriage following a marriage breakdown, and

where the parents are not married to each other

- c. by a father to the mother of his child
- d. by a father or mother direct to his or her child

2. Payments within a. and c. which are made under a separation agreement or some other legally binding arrangement, which is not a Court Order, can also qualify for tax relief. (Payments within b. and d. - other than under a Court Order - do not qualify because of special provisions in the Taxes Acts, known as the settlements legislation, which treat the payments as the parent's income). The recipient is taxable on the payments.

3. "Small maintenance payments" (that is United Kingdom Court Order payments which do not exceed £48 a week or £208 a month) must be paid gross. All other payments, including Court Order payments which exceed these limits, are paid under deduction of tax. Where the recipient is not liable to pay tax he/she can claim a refund from the Inland Revenue of all or part of the tax deducted.

Retrospective Court Orders

4. Statement of Practice SP 6/81 explained the Inland Revenue's practice where a Court Order provides for payments for a period prior to the date of the Order. The Revenue accepted that such payments were taken into account for tax purposes provided

- a. the payments did not relate to a period before the date of application for the Order; and
- b. the parties agreed; and
- c. there had been no undue delay by the parties in pressing the application.

/5. The decision of

5. The decision of the Court of Appeal in the case of Morley-Clarke v Jones showed that the relief given under this practice is in some circumstances not legally due. The practice will however continue to apply to Court Orders made or varied up to 30 June.

6. For other Orders where a Court orders payments retrospectively only payments made on or after the date of the Court Order will qualify for tax relief and will count towards the limit on which relief is available in that year. Payments made under a legally binding agreement before the Court Order may qualify for relief in their own right.

DRAFT LEAFLET

DEEDS OF COVENANT

In his Budget Speech on 15 March 1988 the Chancellor of the Exchequer proposed changes which will -

- end tax relief for new deeds of covenant by individuals
- make money received under new covenants exempt from tax in the recipient's hands.

X | ~~Existing covenants~~ and Charitable covenants are not affected by the proposals. *Now do any existing covenants non-charitable covenants.*

This note explains the proposed changes, and should be read as amending, where appropriate, the information set out in the Inland Revenue leaflet IR74 on Deeds of Covenant. The changes are subject to the approval of Parliament.

COVENANTS MADE ON OR AFTER 15 MARCH 1988i

WHO IS AFFECTED BY THE BUDGET PROPOSALS?

- Any individual making a deed of covenant, other than a charitable covenant, on or after 15 March 1988 and
- anyone receiving payments under such a covenant.

HOW AM I AFFECTED?

If you make a new covenant (which is not to a charity) you must not deduct tax from the payments. You will get no tax relief for them.

If you receive payments under a new covenant you will not be taxable on them. Nor will you be able to claim a tax refund.

HOW ARE STUDENTS AFFECTED?

Student covenants made on or after 15 March 1988 will be treated in the same way as other new covenants to individuals. But since the payments are no longer taxable, students will have the whole of their personal tax allowances to set against other income, such as vacation earnings.

For students beginning their course from the academic year 1988-89, the Government is proposing a more generous scale for assessing parental contributions to their maintenance grant.

EXISTING COVENANTS

ARE THERE ANY CHANGES IN ARRANGEMENTS FOR EXISTING COVENANTS?

No - the present rules will continue to apply without change to covenants made before 15 March 1988 until the covenant runs out. But new covenants to increase or replace existing covenants will come under the new rules.

I MADE/RECEIVED A COVENANT BEFORE 15 MARCH 1988. DO I NEED TO DO ANYTHING?

Yes - but only if you have not already sent the covenant to the Inspector of Taxes. In that case, make sure it is

in his hands by 30 June 1988, if you want to get tax relief or a tax refund under the existing rules.

If the Inspector has already seen your covenant, you need to nothing.

WHAT IF I SEND IT TO THE INSPECTOR AFTER 30 JUNE 1988?

The new rules will apply - no tax relief for the payer and no tax refund for the recipient.

CHARITABLE COVENANTS

ARE THERE ANY CHANGES HERE?

No - existing covenants and new covenants to charity will continue to be dealt with under the present rules.

CHANGE OF BASIC RATE

SHOULD I STILL DEDUCT TAX FROM MY PAYMENTS?

Yes - if the covenant is to charity or was made before 15 March 1988. But if you have covenanted to make a "gross" payment, you will need to alter your payment to take account of the change in the basic rate of tax from 27 per cent to 25 per cent from 6 April 1988 (as you did when the basic rate changed last year).

Example -

	1987-88	1988-89
Gross covenant payment	£ 100	£ 100
less basic rate tax	<u>£ 27</u>	<u>£ 25</u>
Your payment	£ 73 =====	£ 75 =====

If you have covenanted to make a "net" payment (eg "such an amount as after deduction of tax at the basic rate is £ X"), you will not need to alter your payment. But the total income covered by your covenant will be less than before.

Example -

	1987-88	1988-89
Net covenant payment	£ 73	£ 73
Basic rate tax	<u>£ 27</u>	<u>£ 24.33</u>
Total covenanted income	£ 100 =====	£ 97.33 =====

DRAFT LEAFLET

TAXATION OF MAINTENANCE PAYMENTS FOLLOWING DIVORCE
OR SEPARATION

This leaflet explains the changes to the tax treatment of maintenance payments announced in the Budget on 15 March 1988. The changes are subject to the approval of Parliament.

SUMMARY

It is proposed that for future Court Orders and maintenance agreements:

- the recipient will not be liable to tax on the payments;
- the payer will qualify for tax relief only if the payments ~~they~~ are made by a divorced or separated husband to his wife (or vice versa);
- the payer's maximum tax relief in any year will be equivalent to the difference between the married and single person's allowances;
- payments will be made gross (without deduction of tax);
- there will be no tax relief for other new maintenance payments.

For existing arrangements the present tax treatment will broadly continue, but with some changes described later in this leaflet.

IF YOU ARE PAYING MAINTENANCE PAYMENTS

If your arrangements were made before 15 March 1988 - see section A.

If you were in the process of making arrangements on 15 March 1988 - see section B.

x If your arrangements were made~~3~~ on or after 15 March 1988 - see section C.

IF YOU ARE RECEIVING MAINTENANCE PAYMENTS
see section D.

A. IF YOU ARE ALREADY DIVORCED OR SEPARATED

I AM ALREADY PAYING MAINTENANCE AND/OR ALIMONY UNDER A COURT ORDER OR LEGALLY BINDING AGREEMENT MADE BEFORE 15 MARCH 1988. WHAT DO I DO?

x Nothing at present - except that if you have not already done so, you should send your agreement to the Inspector by 30 June 1988. The existing rules will continue to apply to you. Your tax relief will continue as now, but for 1989/90 and later years it will be limited to the total payment which qualified for relief for 1988/89.

But if you prefer you can switch to the new rules instead (see the end of this section).

DO I STILL GET RELIEF ON PAYMENTS TO MY CHILDREN?

Yes.

MY COURT ORDER/AGREEMENT PROVIDES FOR MY PAYMENTS TO INCREASE AUTOMATICALLY. WILL I GET RELIEF ON THE INCREASE?

If your payments are not stated amounts but can vary because they are based on a formula - for instance if you are required to pay household bills or school fees - tax relief will continue to be given under the existing rules, even though the payments increase after the Budget. But that applies only until 5 April 1989. For 1989/90 and later years the maximum relief you can get is the amount you got for 1988/89. (But you can switch to the new rules, if you choose to do so.)

CAN I CHANGE MY ARRANGEMENTS IN 1988/89 AND STILL GET TAX RELIEF?

Yes - Court Orders or agreements made before 6 April 1989 which amend payments made under existing Court Orders or agreements will continue to be treated under the present rules.

ARE THERE ANY CHANGES IN APRIL 1989?

Yes. From 6 April 1989

- all payments must be made gross, ie without deducting tax
- your relief will remain at the 1988/89 level and cannot be increased, even if your payments are. But you can at any time choose instead to switch to the new rules.

WHAT DO I HAVE TO DO TO MAKE GROSS PAYMENTS HAPPEN IN 1989?

If you are already paying "gross" because you are making "small maintenance payments", you need do nothing different in 1989.

But if you deduct tax at present and pay only the "net" amount to the recipient you will need to change your payments and pay the full amount due under your Court Order or agreement without any deduction for tax.

DOES THIS MEAN I SHALL HAVE TO PAY MORE?

Not overall. Instead of deducting tax, you will be given equivalent tax relief through your PAYE coding or in your tax assessment. So the end result is that you will pay the same (while your arrangements stay the same).

HOW DO I MAKE AN ELECTION?

An election to switch to the new rules must be made by the payer to the Inspector at any time during the tax year to which it is to apply or within the next 12 months. It will take effect from the beginning of a tax year.

X
WILL AN ELECTION BENEFIT ME?

In 1988-89, if your payments to your divorced or separated spouse are £1490 or below, it will make no difference to your tax relief on them. And if you pay more than £1490, your tax relief will be reduced. (You will lose all tax relief on payments to children if you switch.) If at present you are deducting tax from your payments, you will also have to switch to making payments gross.

But an election could benefit you in later years. For 1989-90 and subsequent years your relief will be limited to the amount given in 1988-89. If you are not making payments to children and your payments to your divorced or separated spouse

increase, you may find that the maximum relief available under the new rules is more than the relief you got in 1988-89. If so it will clearly pay you to switch.

B. IF YOU ARE IN THE PROCESS OF DIVORCE

AM I AFFECTED BY THE NEW RULES?

- Yes - if you applied for a Court Order on or before 15 March 1988 and the Order is made by 30 June 1988 - see Section A.
- if you applied for a Court Order after 15 March, or your Court Order was made after 30 June 1988, or if you have an agreement made on or after 15 March - see Section C.

I HAVE AN AGREEMENT IN SCOTLAND, BUT IT WAS ~~NOT~~ REGISTERED AFTER BUDGET DAY

Then it will be treated as an ordinary agreement and not as a Court Order for the purpose of these rules.

C. IF YOU DIVORCE OR SEPARATE ON OR AFTER 15 MARCH 1988

WHAT ARRANGEMENTS DO THE NEW RULES APPLY TO?

- All new Court Orders made after 30 June 1988 (except those which vary or amend existing Orders);
- Court Orders made before 1 July 1988 for which application is made to the Courts ~~on or~~ after 15 March 1988;

- All other arrangements made on or after 15 March 1988.

WILL I GET RELIEF ON MAINTENANCE PAYMENTS I MAKE?

Yes, if the payments are made to your divorced or separated wife or husband.

HOW MUCH RELIEF WILL I GET?

You can claim tax relief on payments up to the difference between the married and single personal allowances (£1490 for 1988-89).

CAN I PAY MORE?

Yes. But you will not get tax relief for anything above the limit set each year.

SHOULD I DEDUCT TAX FROM MY PAYMENTS?

No - you pay over the full amount ordered or agreed. (This is known as paying "gross".)

WHAT MUST I DO TO GET TAX RELIEF?

You must be making payments under a United Kingdom Court Order or a legally binding written agreement which is subject to the jurisdiction of the United Kingdom Courts; and the payments must be made to your separated wife or ex-wife, or to your separated husband or ex-husband.

HOW DO I GET MY TAX RELIEF?

Tell your tax office about your separation or divorce and send them a copy of your Court Order or separation agreement. At the end of the year

show the total amount of your payments in your tax return.

The tax office will give you your tax relief, usually through your PAYE code or your tax assessment.

WHAT PAYMENTS WILL COUNT?

All periodical cash payments and any bills you pay on behalf of your separated wife or husband, ex-wife or ex-husband (provided that the payments are due under a legally binding agreement or Court Order).

WHAT ABOUT PAYMENTS TO CHILDREN?

These will not qualify for tax relief in future and the child will not be liable to tax on them.

WILL PAYMENTS TO A THIRD PARTY FOR THE BENEFIT OR SUPPORT OF A CHILD GET RELIEF?

No.

ARE THERE ANY OTHER PAYMENTS WHICH WILL NOT COUNT?

Yes. You cannot get relief under the new rules for some payments which did not generally qualify under the old rules. These include:

- voluntary payments (that is, payments which are not made under a legal obligation);
- payments for which you already get tax relief in some other way;

- payments made under a foreign Court Order or agreement;
- capital payments of lump sums, even if paid in instalments.

I MADE/AM MAKING SOME PAYMENTS WHILE WAITING FOR THE COURT ORDER/AGREEMENT TO BE MADE. DO THESE COUNT?

Yes, if they were made under a legally binding agreement.

THE COURT ORDERED ME TO MAKE PAYMENTS FOR A PERIOD BEFORE THE ORDER. DO THESE COUNT?

Yes, if they are paid on or after the date of the Court Order. They will count towards the total qualifying for relief in the year in which they are paid.

WILL I BE ABLE TO CLAIM FOR PAYMENTS TO MORE THAN ONE EX-WIFE OR HUSBAND?

Yes. But the upper limit on relief you get in any one year is still the same, however many people you pay.

DOES THE NEW MAINTENANCE RELIEF START AS SOON AS I AM SEPARATED/DIVORCED?

Yes, provided that the separation is permanent and you have a Court Order or legally binding written agreement.

WHAT IF I RE-MARRY?

Relief for the maintenance payments will continue if the payments continue.

WHAT IF I AM RECONCILED WITH MY WIFE/HUSBAND?

You can claim maintenance relief for the part of the year before reconciliation.

D. IF YOU ARE RECEIVING MAINTENANCE PAYMENTS.

a. UNDER EXISTING ARRANGEMENTS

AM I AFFECTED BY THE CHANGES?

Yes. From 6 April 1988 if you are a divorced or separated spouse the first £1490 of your payments will be exempted from tax. You will still be taxable on any amount above this but you will be able to use your full personal allowance against it (and any other income you may have).

SO I MAY STILL HAVE TO CLAIM TAX REFUNDS?

Yes - until 6 April 1989. After that date, all payments will be made gross without deduction of tax, so refunds will not apply.

b. UNDER NEW POST-BUDGET DAY ARRANGEMENTS

MUST I PAY TAX ON THE PAYMENTS?

No. They are tax free.

WILL I HAVE TO CLAIM A TAX REFUND?

No - the full amount is paid to you without tax being deducted.

MORE INFORMATION ABOUT THE PRE-BUDGET RULES

The information in this leaflet is generally about arrangements made after 15 March 1988. For information about earlier arrangements, to which the previous tax rules apply, ask your tax office for a copy of leaflet IR30, Income Tax Separation and Divorce.

4367/79



A handwritten signature in black ink, appearing to be "Nigel Dawson".

MR C CORLETT - IR

FROM N M DAWSON

DATE: 10 March 1988

cc PS/Chancellor
Miss Sinclair
Mr Cropper
PS/IR

MAINTENANCE: FOREIGN COURT ORDERS (STARTER 150)

The Financial Secretary has seen and was grateful for your minute of 8 March.

A handwritten signature in black ink, appearing to be "Nigel Dawson".

NIGEL DAWSON



Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: P A MICHAEL

DATE: 8 November 1988

1. MR PITTS *W/8/11*
2. FINANCIAL SECRETARY

STARTER 253: CGT - QUALIFYING CORPORATE BONDS

1. This note seeks Ministers' views on whether countervailing action should be taken in next year's Finance Bill to block a loophole in the interaction between the CGT gifts relief and the capital gains exemption for qualifying corporate bonds.
2. For the purposes of this note we assume the continuance of the general CGT gifts relief. If, on the other hand, the relief were to be abolished (Mr Cayley's note of 24 October) then this starter would drop in consequence.

cc. PS/Chancellor
Mr Scholar
Mr Culpin
Miss Sinclair
Mrs Chaplin
Mr Jenkins (OPC)

Mr painter
Mr Pitts
Mr Bush
Mr Cayley
Mr Hamilton
Mr Gonzalez
Mr Boyce
Mr Michael
PS/IR

BACKGROUND

3. CGT deferral is available on exchanges of shares and securities. Some takeovers etc involve the exchange of shares in the target company for bonds issued by the predator. In most of these cases the bonds (usually debentures or loan stock) will be exempt because they are qualifying corporate bonds. What happens here is that the gain on the shares up to the date of exchange is deferred until the bonds are themselves subsequently sold. However, the relevant legislation does not deal with the situation where prior to sale the bonds are given away with gifts relief to someone else. In policy terms, at least, the right result is clear: the gain deferred on the original exchange (but not the exempt gain on the bonds) should be brought back into charge on a sale of the bonds by the donee.

4. We have recently taken legal advice, in connection with an actual case, on whether this result is achieved. The point is pretty technical and centres on a true construction of the gifts holdover provision. The legal advice is that although we may have a presentable case for arguing that the gain in these circumstances falls into charge at the time the gift is made we would almost certainly lose before the Courts. So the present position is that, where the bonds are given away, the gain on the original share exchange almost certainly falls completely out of charge. Even if our technical argument did succeed the gain would come into charge on what is arguably the wrong occasion ie when the gift is made, whereas the logical result is that the gain should come into charge only when the bonds are sold by the donee.

Scope for exploitation

5. In practice, the potential scope for exploitation would lie almost exclusively in cases of private companies being taken over by quoted public companies. One group of cases

which immediately springs to mind is that of the stockbroker/jobber firms which were bought up by financial institutions prior to "Big Bang". For the most part former partners of those firms have received loan stocks in the banks etc which acquired the shares in the companies into which the firms were incorporated, and these loan stocks will invariably constitute qualifying corporate bonds. There will, of course, be other areas where similar arrangements have been entered into. But in either case it would be possible to dispose of the bonds prior to sale by way of gift (perhaps to a close relative) or, alternatively, to dress up as a gift what is in substance a sale.

6. At present we have no evidence of substantial exploitation of this loophole. But one leading firm of accountants has asked us to confirm, in relation to an individual case, that the loophole exists and once we reply to this, the word is bound to get round and exploitation to develop. (If Ministers decide to include a counter-measure in the 1989 Bill, we can probably delay replying to the firm concerned until around Budget Day.)

Revenue at risk

7. We have fairly comprehensive records of loan stock etc issues going back over a number of years. Not all of these will be qualifying corporate bonds. Nevertheless, we estimate the potential revenue at risk could be as much as £m100 a year. In the stockbroker cases alone, large sums are potentially involved.

Staffing and compliance costs

8. The staffing and compliance costs implications are negligible.

Commencement

9. If Ministers wished to legislate to stop this potential abuse it would be possible to have either -

- a Budget Day commencement date, or alternatively
- a prior announcement with legislation retrospective to the date of it.

As we said earlier (paragraph 6 above) we do not, at present, have evidence of substantial exploitation of this loophole. So, the balance of the argument would appear to us to point towards a Budget Day commencement date. However, we shall continue to monitor the position closely and if there are untoward developments in the run up to the Budget we would come back to you on this.

Legislation

10. Subject to Parliamentary Counsel, we estimate that legislation would be up to one page of Finance Bill space.

Conclusion

11. We would be grateful to know whether Ministers wish to take action in next year's Bill to block this loophole and, if so, whether the provision should apply (as we would presently envisage) to gifts of qualifying corporate bonds on or after Budget Day.

PAM
P A MICHAEL

CONFIDENTIAL



FROM: R C M SATCHWELL
DATE: 14 November 1988

MR MICHAEL - IR

cc

PS/Chancellor
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Michie
Mrs Chaplin
Mr Jenkins (OPC)

Mr Pitts - IR
Mr Cayley - IR
PS/IR

STARTER 253: CGT - QUALIFYING CORPORATE BONDS

The Financial Secretary was grateful for your minute of 8 November. But now that starter 252 (the abolition of CGT gift relief) is to go ahead, this starter falls, since qualifying corporate bonds will not come within the scope of the definition of "business assets" for which CGT gift relief will continue to apply.

R.C.M.S.

R C M SATCHWELL
Private Secretary

BUDGET CONFIDENTIAL



FROM: R C M SATCHWELL

DATE: 25 NOVEMBER 1988

MR CAYLEY - IR

cc

PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Painter - IR
Mr Pitts - IR

PS/IR

CQT
STARTER 257: MINOR CHANGES TO THE ~~GT~~ EXEMPTION FOR HOMES

The Financial Secretary was most grateful for your minute of 21 November. He agrees that this starter should be dropped.

R.C.M.S.

R C M SATCHWELL
PRIVATE SECRETARY



Inland Revenue

Capital and Valuation Division
Somerset House

FROM: M F CAYLEY
DATE: 21 November 1988

- 1. MR PITTS ✓
- 2. MR PAINTER ✓
- 3. FINANCIAL SECRETARY ✓

This is a good example of what I described at your meeting as a 'starter' but not necessarily a 'finisher'. We may need to put it to you again for 1990 but there is a reasonable chance that the

STARTER 257 - MINOR CHANGES TO CGT EXEMPTION HOMES

1. The CGT exemption for the private residence extends to people's homes and the surrounding grounds. Over the years we have had a succession of Court cases as to how far the exemption extends, in particular as regards

Court cases will give us a helpful decision
27/11

- accommodation provided for staff at a distance from the building where the taxpayer himself lives, and
- land comprised in an estate which surrounds the home.

2. The Courts have determined each case on its own facts, laying down little that is of any precedent value in settling other cases. So there is a considerable degree of uncertainty, and a substantial amount of senior time - in local offices, Valuation Offices, Head Office and our

cc. Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Painter
Mr Bush
Mr Pitts
Mr Cayley
Mr Hamilton
Mr T R Evans
Mr C E Gordon
PS/IR

Solicitor's Office - is taken up in disputes with a relatively small number of taxpayers. A few people have taken advantage of the uncertainty in the law to attempt to make what, on any commonsense view, are excessive claims as to what land and buildings attract the exemption. In individual cases, sizeable amounts of tax can be at stake.

3. Against this background, we thought that Ministers might wish to have an opportunity to consider the possibility of amending the private residence provisions to give more certainty and to rule out some of the excessive claims for exemption that are sometimes made. In suggesting this as a possible Starter for 1989, we were conscious that it was likely to be technically tricky to achieve both equity and greater certainty - and further study has confirmed the difficulties.

4. There has now been one new development. A case has come up which could serve as a good test case in the Courts, with, we hope, a reasonable chance (though there can be no guarantee) of obtaining judicial dicta which will give more certainty and have precedent value in other cases. We think it would be preferable to await the outcome of this test case before pursuing the possibility of legislation - and it is conceivable that the outcome will be such as to render it unnecessary to consider further whether the law might be amended. Accordingly, we would recommend dropping this topic from the Starters list for 1989. I would be grateful to know if you agree.



pp M F CAYLEY



Inland Revenue

Capital and
Valuation Division
Somerset House

pay

Payers

FROM: M F CAYLEY
DATE: 5 December 1988

1. MR PITTS *6/12*
2. FINANCIAL SECRETARY

STARTERS 252 AND 253 - GIFTS AND QUALIFYING CORPORATE BONDS

1. Mr Michael's minute of 8 November on Starter 253 described an avoidance route involving exchange of (CGT chargeable) shares for (exempt) qualifying corporate bonds followed by a gift of the bonds with gifts relief. The effect of this route is that gains on the original shares escape CGT. A copy of the submission is attached for ease of reference. The avoidance route will disappear for gifts made on or after the date from which general gifts relief is withdrawn under Starter 252.

2. I am sorry to bother you again on this subject, but there has just been a new development. As far as we know, hitherto the qualifying corporate bond avoidance route has not been exploited on any significant scale. But we have now learnt that it is just beginning to be featured in conferences on tax planning. This means that there is a real possibility of people taking advantage of the loophole between now and Budget Day. The question is, do Ministers wish to block the avoidance route quickly, by making an advance announcement specifically confined to the loophole

cc. Chancellor
~~Chief Secretary~~
~~Paymaster General~~
~~Economic Secretary~~
 Mr Scholar
 Mr Culpin
~~Mrs Chaplin~~
~~Mr Tyrie~~
 Mr Jenkins (OPC)

Mr Painter
 Mr Pitts
 Mr Cayley
 Mr Hamilton
 Mr Michael
 PS/IR

(and not, of course, saying anything about gifts relief more generally).

What form might action in advance of Budget Day take?

3. If there were to be early action, we would recommend that it should have two components. The first is targeted on the precise scheme which tax planners have spotted. This involves setting up a trust of which the settlor is the beneficiary. The bonds are transferred to the trust, and immediately the deferred gain on the original shares has fallen out of charge. The proceeds from the sale of the bonds can be routed back, tax-free, to the settlor. So, by interposing the thin veil of a trust while still (in substance) effectively retaining his interest in the bonds, the taxpayer has taken gains outside the CGT net. For this type of scheme we would recommend bringing the deferred gains on the original shares into charge if the trust disposes of the bonds on or after the date of announcement. There is a precedent for commencement arrangements of this kind in other anti-avoidance provisions concerned with the use of trusts for CGT avoidance.

4. If action in advance of Budget Day stopped there, people would find other ways of exploiting the qualifying corporate bond loophole. So we would recommend that the second component of any early action should be to deny gifts relief on any gift of qualifying corporate bonds on or after the date of announcement. Since the bonds themselves are exempt, the sole effect of this would be to bring into charge the deferred gain on the assets which had been exchanged for the bonds - that is, on the the original shares. This would mean anticipating, for qualifying corporate bonds only, what will happen when general gifts relief is withdrawn.

Is there a need for action ahead of Budget Day?

5. Now that the loophole has been spotted, some people are likely to take advantage of it ahead of Budget Day. The

Exchequer is therefore at risk, unless something is done, in relation to gifts before the loophole is closed by the general withdrawal of gifts relief.

6. We do not think there would be any surprise if there was early action. One speaker at a recent tax planning conference described the loophole as "fortuitous".

7. The extent of the Exchequer risk must be entirely a matter of guesswork: it will be a year or more before we have objective information. Mr Michael's minute of 8 November said that the loophole might cost the Exchequer up to £m100 a year if it was widely used. Since the device is only just starting to be publicised, it is likely that many people will not get round to taking advantage of it before Budget Day, after which it will no longer be available. But there are bound to be some who will act quickly because they anticipate early legislative counter-action. In individual cases, relatively large gains - running for some taxpayers to several millions - could escape tax. In aggregate, the cost to the Exchequer of doing nothing until general gifts relief is withdrawn may well be under £m50, and could well be £m25 or less. But any such estimates are guesswork, and may in the event prove completely wrong. On a worst scenario, the cost could be much higher.

Conclusion

8. Against this background, I would be grateful to know if you would like to block this loophole in advance of the withdrawal of general gifts relief. If you would, I shall prepare a Parliamentary Question and Answer and accompanying press release to announce the change.

Michael Caggs