PO-CH/NL/0614
PART A

PO CH/NL/0614
PART. A

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PO CH/NL/0614
PART. A

1989 BUDGET
STARTERS. AND
HOUSING POLICY.

25.1.89

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

DD'S 2545 NA343 9/8/96.

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001.JRF.42

FINANCIAL SECRETARY TO THE TREASURY

FROM: **FINANCIAL SECRETARY**

DATE: **20 September 1988**

**CHANCELLOR**

Further advice (+ simplification from Mr Arbuthnott) necessary before we can see whether this is worth pursuing.

cc
Chief Secretary
Economic Secretary
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr McGivern ) IR
Mr Reed )
PS/IR

**CLOSE COMPANY APPORTIONMENT: SCOPE FOR ABOLITION**

It did seem to me that it would be politically attractive if we could put together a package of measures for next year's Budget which simplified the tax system in a number of areas and which we could present as a consequence of last year's reductions in top rates. There are a number of such anti-avoidance areas; and one where there has been some pressure for change (notably from James Abuthnott and David Heathcote-Amory) is the apportionment rules for close companies.

This is a very messy area of the tax legislation, running to some 23 pages of particularly complicated text; and the revenue which it brings in is negligible. However, after closer examination, I have came to the conclusion that the case for its abolition is not so clear cut.

- the apportionment rules do not apply to trading income, nor to the investment income of trading companies which is genuinely needed for reinvestment in the business. Abolition would therefore only affect those investment companies which were not part of a trading group.

- although the current yield from the rules is small, if they did not exist, taxpayers would have a very strong incentive to shelter income by exploiting the difference between the 25% small companies rate for corporation tax and the 40% higher rate of income tax. It is a matter of judgment how many taxpayers would choose to do so. But the example earlier this year of using trusts to avoid capital gains tax at the higher rate shows that it would be exploited by some. And if many higher - rate taxpayers chose to do so, the revenue loss could be very great indeed.

One alternative to straight abolition is to repeal the provisions, but put something in their place which was targeted specifically on investment companies which were not part of a trading group. The new rules might include a requirement that the company was taxed at the main rate of corporation tax (or even at 40%); and that no more relief in respect of interest was given to the company than would be the case for an individual. There might also have to be provisions dealing with dividend income (which is not liable to corporation tax) and instances where children of proprietors were made directors simply in order to exploit unused personal allowances.

This would probably be sufficient to prevent leakage. However, the immediate reaction to such a package might well be "what is the point?" We would merely have replaced the set of provisions whose practical effect is to tax only one class of companies with narrower provisions having a similar effect. We would also be open to criticism on the grounds that, albeit in a small part of the tax system, we had raised the effective tax rate from 25% to 35% or 40%! The only reason to proceed would be if the rules really were much simpler. I have therefore asked the Inland Revenue to come to a firmer view on this. I will also ask James Abuthnott, and the others interested in this area, to amplify their views. At the moment the case for abolition is not overwhelming.

NL

**NORMAN LAMONT**

Alex

PEM is content with this, with the O-Smee + Evans replacements as shown

Simon. 24/11

## Overview cast

All ministers and advisers.

Sir P Middleton
Sir T Burns
Mr Wicks
Mr Anson
Dame A Mueller [in practice rarely came]
Mr Hardcastle

Mr Byatt [Mr Monck not last 2 years]
Mr Scholar
Mr Culpin
Mr Sedgwick
[~~Mr Odling-Smee replacement~~] Mr Riley
[~~Gareth Evans replacement~~ — ~~Miss Simpson~~ / Mr Macpherson]

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton [now 3 Deputy chairman]

Mr Unwin
Mr Jefferson Smith.

95719 78/9

75033

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**Inland Revenue**

Compliance and
Collection Division
Somerset House

FROM: C D SULLIVAN

DATE: 21 NOVEMBER 1988

1. MR BEIGHTON 22/11

2. FINANCIAL SECRETARY

SUBCONTRACTOR SCHEME EFFICIENCY SCRUTINY: CONSULTATION WITH GOVERNMENT DEPARTMENTS

1. You have now seen the scrutiny Action Plan. The next step is to put the scrutineer's report to interested Government departments. We think you will want to do this at Ministerial rather than official level. We think you should write to the NIO on the one hand: to DTI and D.Emp on the other: and to DOE. The attached draft letters to the DTI and D.Emp follow the general line suggested in the Sullivan/Green submissions to you of 14 October. But since then, you and the Chancellor have endorsed a 2-stage consultative process with, for the time being, a fairly low-profile treatment of future consultations on the eligibility rules.

2. You will note that the drafts ask for the report to be kept confidential to Government. This is partially because of the Chancellor's comments on presentation. But it is

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cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Mr Hoare
Miss Hay
Mrs Chaplin
Mr Tyrie

Mr Beighton
Mr Roberts
Miss James
Mr Martin
Mr Willis
Mr Eastman
Mr Dunbar
Mr Sullivan
PS/IR

also because we genuinely think it would be damaging for the scheme's defences and their weaknesses to become widely known in the industry. The likelihood of increasing press and other speculation on the full content of the scrutiny report might mean that some indication of the "medium term" issues became desirable sooner rather than later. But in any event, you will want the nature of timing of any publicity to be as much as possible in your hands.

Letter to Mr Stewart at the NIO

3. You will want to think carefully about the terms of this letter, especially against suggestions of putting all subcontractors in Northern Ireland under deduction at source. We anticipate that Mr Stewart will want to seek Mr Needham's views on the scrutiny report. We understand that they are likely to seek a meeting with you.

4. The draft is intended to bring out the following points:

- that the staff savings will be taken (although without saying the savings have already been built into PES)

- that there is an important deregulation angle

- that the existing deduction scheme is relatively insecure, but will get a certain amount of reinforcement

- that the Scrutineer is aiming to make certificates markedly harder to get, although that aim will meet opposition from deregulation departments

- that a 2-stage implementation is planned, with the largely deregulatory first stage imminent.

Letter to Mr Maude at DTI

5. You will also want to consider this letter carefully, as the recipient is likely to have views very different from those in NIO and DOE (NI). The draft is intended to bring out the following points:

- that a special tax scheme for subcontractors is still needed

- that there are useful deregulation gains that may be taken without unacceptable damage to the security of the scheme

- that the scrutineer recommends a shift from exemption to deduction, but with a fairer deduction rate

- that you support the idea of that shift, as part of the scrutiny's overall package, even though you intend a two stage process of consultation and implementation.

Letter to Mr Cope at D.Emp

6. The D.Emp interests are sufficiently similar that we suggest an effectively identical letter may be sent.

Letter to Mr Trippier at DOE

7. The Scrutineer asked DOE officials for representations at the start of his scrutiny. None materialised. However, since the Department is the one responsible for the construction industry, we think you should nevertheless make them aware of the scrutiny proposals. Again, we think a letter effectively identical to the DTI one should suffice.

C. Sullivan.

C D SULLIVAN

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DRAFT LETTER FOR FST TO SEND MR STEWART

EFFICIENCY SCRUTINY: SUBCONTRACTORS TAX SCHEME

In your letter of 16 September you asked me to let you know my thinking, as it develops, on the recommendations of the Efficiency Scrutiny of the Subcontractor Tax Scheme. I have now had a number of discussions with officials.

I enclose two copies of the scrutineer's report as delivered to me. I commend it as a well-researched and thoughtful piece of work, which recognises the need to balance deregulation against effective deterrence of tax evasion. In view of its analysis of the scheme's defences against fraud, I would be grateful if you would regard the report as confidential to government.

The scrutineer concludes that the risk of extensive tax evasion in the construction industry remains sufficiently great that a special tax regime for subcontractors is still needed to deter evasion, despite its very considerable staff and compliance costs. I am sure that, with the special concerns in Northern Ireland about extraction of funds, you will endorse that view.

The scrutineer does, however, suggest very worthwhile staff and deregulation benefits from changes in internal Revenue procedures and from cutting down the amount of paperwork the scheme generates. I am confident that these "short-term" staff savings may safely be taken. With less paper flowing through the system, the Revenue will be better able to identify and deal with defaults in key areas of the scheme, such as ensuring contractors send in "715" vouchers promptly. The proposed upper limit on the value that may be put on a "715" will also help the prompt detection of misuse. Further, the scrutiny identifies the relative insecurity of the deduction scheme: and recommends some shift of resources from the exemption scheme to reduce that weakness.

The scrutiny also confirms that the present eligibility rules for both initial and renewed exemption certificates have not been successful in separating out those likely to default on their tax obligations. The question of the eligibility rules is difficult, both politically and at a technical level. We are repeatedly urged to make certificates easier to get, especially for the long-term unemployed. The present rules were intended to deny certificates to labour-only subcontractors. They have signally failed to do so. So, deregulation aside, devising new eligibility rules that will not be circumvented in practice is by no means straightforward.

The scrutineer envisaged cutting the deduction rate - to reduce the staff cost of repayments to uncertificated subcontractors, as a sweetener for tightening up the certificate eligibility rules and as a measure justified in its own right. The choice of deduction rate would be a balance between staff savings and fairness to subcontractors on the one hand: and on the other, the high initial Exchequer cost, and the likely disappearance from the Revenue's records of those no longer driven by repayments to come forward with accounts.

The scrutineer also suggested a number of feasibility studies - such as of longer-term centralisation of work now undertaken in tax districts and of eliminating or further reducing the requirement to deliver 715 vouchers.

You will want to know how I propose to deal with this scrutiny report. Subject to the views of colleagues, I intend to ask the Inland Revenue to press ahead with implementing internal procedural changes: and with consultations, in time to allow legislation next year, with the industry on the "short-term" measures on scope and coverage of the scheme, and on reducing the flow of "715" vouchers by measures such as allowing aggregation of small payments. I would like the Revenue to do more work on the difficult issue of the certificate eligibility rules before consulting the industry again next summer.

I would be very interested to have your views on implementation of the scrutiny recommendations. If you would like a meeting, or would like our officials to meet first, I would be very happy to have this arranged.

I am also sending a copy of the Scrutiny report to John Cope, Francis Maude and David Trippier.

DRAFT LETTER FOR FST TO SEND TO MR MAUDE

EFFICIENCY SCRUTINY: SUBCONTRACTORS TAX SCHEME

1. You will know that one of this year's topics for an Efficiency Scrutiny in the Inland Revenue was the special tax regime for Subcontractors in the Construction Industry. I have received the Scrutineer's report and, now, the Revenue's action plan. The Scrutineer has taken careful note of his terms of reference. Those required to him examine the resource-intensive aspects of the scheme for both the Revenue and the Construction Industry: and to consider whether changes would reduce costs to both sides while safeguarding tax revenues.

2. I attach a copy of the Scrutineer's report. I commend it as a well-researched and thoughtful piece of work. In view of its analysis of the scheme's defences against fraud, I would be grateful if you would regard the report as confidential to Government.

3. The Scrutineer feels that the tax yield protected by the scheme may be up to £500M. So he concludes that the risk of tax evasion in the Construction Industry remains sufficiently great that a special tax regime for subcontractors is still needed to deter evasion, despite its very considerable staff and compliance costs. I am confident that this is right. There is no reason to believe that the long-running problems caused by non-compliant or itinerant workers have diminished, especially against the background of a major shift to self-employment in the Construction Industry.

4. The Scrutineer does, however, suggest very worthwhile staff and deregulation benefits from changes to internal Revenue procedures and from cutting down the amount of paperwork the scheme generates. These changes carry some risk to the security of the scheme. But I am confident that the "short-term" staff savings are sufficiently large that

they should be taken. Some refocusing of Revenue effort, together with other changes recommended by the scrutineer, should maintain the security of the scheme. For the industry, there would be reductions in paperwork (such as handling 715 vouchers and being asked to submit end-year returns): and a faster turn-round by the Revenue for document issue and for repayments.

5. The Scrutineer also suggests taking firms out of the special regime where possible. He feels we can safely take many large firms out of the scheme, whether they are subcontractors or are non-Construction Industry companies deemed to be contractors for scheme purposes.

6. The Scrutineer confirms that the present certificate eligibility rules have failed to ensure good tax compliance amongst the certificated population. In particular, the present "3 year employment" rule is no useful indicator of future compliance performance. As a result of this, and the way in which subcontractors with a poor compliance record nevertheless often get their certificates renewed, the Revenue's administrative costs are unnecessarily increased. Businesses that pay tax on time face competition from those that do not.

7. The Scrutineer therefore proposes refocusing the eligibility rules so that fully-fledged businesses continue to get exemption certificates: but labour-only subcontractors much more commonly would work under deduction - but with deduction at a rate well below the present 25%. The Scrutineer puts forward alternative eligibility rules. These include a one-year period of satisfactory tax compliance while self-employed. That would provide some real evidence of the applicant's ability to meet the responsibilities of maintaining business accounts and putting money aside to meet tax bills. And these rules would involve a minimum turnover test, to target exemption at genuine small businesses with modest overheads, rather than the labour-only subcontractor.

8. Under the scrutineer's proposals, a genuine entrepreneur with no recent history of stable employment could get a certificate faster than at present. Those who could not meet the proposed new rules, or did not wish to, would work under a deduction rate much less likely to lead to overpayment of tax. Accordingly, working under deduction would be more attractive than it is now to the individual. With far less expectation that labour-only subcontractors would have exemption certificates, discrimination against the uncertificated (if any remains at a time of increasing tightness in the labour market) should still further reduce.

9. You will want to know how I propose to deal with this Scrutiny Report. I intend to ask the Inland Revenue to press ahead with implementing internal procedural changes: and with consultations, in time to allow legislation next year, with the industry on the "short-term" measures on scope and coverage of the scheme, and on reducing the flow of "715" vouchers by measures such as allowing aggregation of small payments and extending the "self-vouching" experiment. I would like the Revenue to get the industry's views on the details of how to minimise costs and maximise benefits from the changes. Subject to those views, I hope that these sort of changes will be widely welcomed. My officials are, of course, at your disposal on these topics.

10. I would like the Revenue to do more work on the difficult issue of the certificate eligibility rules before consulting the industry again next Summer. As the Scrutineer recognises, his outline needs more detail, plus anti-avoidance provisions. I see the Scrutineer's proposals on the eligibility rules very much as linked with his other proposals. I am also very attracted by the idea of a shift to a fairer and more widespread deduction regime: and I know I am not alone in thinking in that direction. However, there is no purpose in introducing new rules if they are not fair, practicable and effective in deterring the non-compliant. Again, my officials would be very ready to discuss these aspects with yours next Summer.

11. In the meantime, I am sure you would not want me to delay implementing changes that should significantly reduce the paperwork burden on the construction industry.

12. I am writing in similar terms to John Cope and David Trippier: and also to Ian Stewart.

[Letters to Mr Cope and Mr Trippier identical apart from address; and changing names in last sentence].

N WILLIAMS
(ESS) 6/12

CONFIDENTIAL

**Inland Revenue**

Personal Tax Division
Somerset House

FROM: N WILLIAMS
DATE: 6 December 1988

1. MR FARMER Seen in draft.

2. FINANCIAL SECRETARY

**REVIEW OF EMPLOYEE SHARE SCHEMES (STARTER No 112)**

1. Following the fall in share values in October last year and the Budget changes in income tax and capital gains tax rates, a number of requests were received for easements in the taxation provisions affecting employee share interests.

2. Mr Farmer's note of 7 April reported on these requests and suggested that Ministers later in the year might want to take stock of the progress made with the approved employee share scheme (ESS) legislation, taking account of the two factors above and also acknowledging that the first element in the approved scheme legislation has now been in existence for ten years.

3. You agreed with this suggestion (PS/FST 18 April), and this submission therefore examines the workings of the existing legislation, looks at possible changes of direction or improvements and offers some recommendations. The review has not been publicized. Treasury officials (FIM and FP) have been consulted.

4. Separate submissions deal with the two subjects on which there has been most interest in the last year or so - ESOPs, and the material interest provisions (relating particularly to employee eligibility to participate in a registered PRP scheme, but with relevance also to the approved ESS). We imagine you will wish, however, to take an overview of all three starter submissions when considering the shape and nature of any possible changes in or additions to the legislation.

5. This paper is structured as follows:

A. BACKGROUND - a brief description of existing approved ESS legislation and of recent relevant changes (paragraphs 6-12 and Annex A).

B. ASSESSMENT OF PROGRESS - describing experience with and progress of the ESS legislation to date (paragraphs 13-32 and Annex B).

C. POTENTIAL FOR FUTURE DEVELOPMENT AND CHANGE - examining a variety of major and minor possibilities for change in the present approved ESS legislation (paragraphs 33-59).

D. CONCLUSION - (paragraphs 60-62).

## A. BACKGROUND

Existing legislation and recent improvements

6. In general, where an individual is enabled by reason of his employment to obtain shares in a company either free of charge or at less than market value, he is liable to income tax on the benefit under Section 19(1), ICTA 1988. However, under the provisions of the three Inland Revenue approved schemes employees can acquire shares and are eligible for relief from IT as follows:

FA 1978 Profit-sharing scheme: employer finances (with CT deductibility) a trust's acquisition of shares for appropriation to all employees on similar terms. Employees receive their shares tax free if they are left in the trust for 5 years. CGT charged on disposal, on difference between share value at appropriation and proceeds.

FA 1980 SAYE scheme: company grants to all employees (who wish) and on similar terms options over shares at minimum 90% of value at time of grant; employees save on monthly basis to finance purchase of shares if they decide to exercise options. Options can be exercised tax free 5 (or 7) years after being granted. CGT charged on share disposal on difference between price paid and proceeds.

FA 1984 Discretionary ('executive') share scheme: company grants options over shares at market value to chosen employees. Employees can exercise with tax relief after 3 years but only one tax relieved exercise in any 3 years. CGT charged on share disposal, on difference between price paid and proceeds.

(If an option over shares at market price is granted and later exercised outwith the approved scheme legislation, the employee is charged IT on exercise of the option on the difference between price paid and the market value of the shares at that time. CGT on subsequent share disposal is charged on the difference between price paid plus amount charged to IT and proceeds.)

7. Leaving aside the introduction of new schemes in 1980 and 1984 improvements have been made to the approved ESS legislation in 8 out of the last 9 Budgets. These have included

- increases in the limits on individual employee participation in approved ESS (1980, 1982, 1983 and 1984);

- measures to strengthen the all-employee requirements of FA 1978 and 1980 schemes to ensure that all employees who participate do so on 'similar terms' (1983 and 1984);

- changes to mitigate the administrative work caused to trustees of approved profit-sharing schemes by rights issues (1982);

- permitting companies to impose 'pre-emption' restrictions on the shares of employees who leave service (1986);

- easements in the material interest provisions (1986);

- making it possible for employees in a company which is taken over to exchange their existing share options under an approved scheme for options over shares in the acquiring company (1987).

8. In this year's Finance Act two sets of measures impinged upon employee share ownership generally:

- Following a review of the legislation relating to share acquisitions by employees outside the approved schemes (formerly section 79 FA 1972), provisions were included in this year's Act (sections 77 to 89) designed to target what were and remain essentially anti-avoidance measures, more narrowly than before. The changes made should be of particular help to companies (such as those in the unquoted sector) anxious to encourage employee share ownership in and commitment to the company but which are unable or unwilling to set up a formal approved scheme.

- 1988 Budget changes in income tax and capital gains tax, ie the reduction of the higher rates of income tax to the single 40%, the alignment of income tax and capital gains tax rates, and the reduction in the CGT annual exemption limit from £6,500 to £5,000.

9. You will recall early post-Budget reactions to the effect that the attractions of the approved schemes had been reduced, some even claiming that it was no longer worth

seeking approval for a scheme since the liability to CGT on share acquisitions was no lower than the alternative (unapproved) income tax charge. These reactions were understandable, but justified only on certain assumptions and qualifications. They were particularly inappropriate for all-employee FA 1978 schemes, under which employees receive free shares and never have to face any tax charge on the value of those shares at appropriation. Here the value of the tax relief has come down with the cuts in income tax rates, but the relief remains a major benefit. Early post-Budget reactions were a little more relevant in the case of all-employee FA 1980 share option schemes, because the principal benefit of participation in these is the CGT - rather than income tax - treatment of option gains. But participants for the most part are likely to be able to take advantage of the annual CGT exemption, and most again are likely to find a single resort to that exemption adequate to cover the option gains made.

but then, the CGT treatment can no longer be described as "the principal benefit".

10. The concern expressed after the Budget centred particularly, however, on its impact on the attractions of discretionary FA 1984 share option schemes. Here the advantage of the tax relief has in some circumstances been very substantially reduced or even eliminated. Annex A illustrates for a top rate taxpayer in 1988-89 how the advantages of an approved scheme, compared with an unapproved one, have changed following the 1988 Budget. It shows that

- the pre-Budget disparities in IT and CGT rates (30% in this case) gave a significant tax benefit under an approved scheme, but post-Budget that benefit is eliminated if the CGT exempt amount is not available for use.

- where the CGT exempt amount is available, post-Budget the approved schemes have a lower, but nonetheless a worthwhile, tax benefit.

11. The attractions of participation in approved schemes by contrast with the unapproved remain, therefore, even if the tax benefits have been reduced; but these attractions depend more crucially now upon the availability of the annual CGT exemption and the individual's timing or staggering of his share disposals. The very wealthy, with much larger than average approved scheme options, and with their annual CGT exemption perhaps regularly committed to cover other gains, may now see little or no advantage. Others will, but more depends now on access to the annual exemption, on the opportunities for its effective doubling with independent taxation, on an individual's capacity to delay disposals until his marginal tax rate falls (eg after retirement), or on his willingness to leave his shares in his estate in order to escape CGT. However, any delays in share disposal which the new tax rates encourage will tend to chime in, of course, with the objective of the approved ESS legislation to encourage a lasting link between the employee and the company which employs him.

12. It is perhaps because the continuing if diminished tax-related attractions of approved schemes have since been recognised - as well perhaps as the 'seal of approval' point mentioned in paragraph 19 below - that the immediate post-Budget reactions and criticisms have not persisted; that they have not been converted into demands for new or enlarged tax reliefs for FA 1984 schemes; and that the number of schemes being submitted for approval is continuing at much the same level as in recent years.

## B. ASSESSMENT OF PROGRESS

### Progress to date : statistics

13. Annex B notes the numbers of employee share schemes of the three types which have so far been approved by the Revenue (this is the take-up table attached to my

minute of 26 October adjusted to show October figures). After 10 years of operation of the legislation we have now attempted also to discover how many of these approved schemes have since ceased operation, eg because the companies concerned have been taken over, have changed their employee share ownership policies etc. This is information which would not usually come our way - a 'nil' annual return might signify either non-operation of a scheme in the year in question or its actual cessation. The latest estimated figures for cessations showing the position as it is at present are 36, 107 and 160 respectively for the 1978, 1980 and 1984 schemes. We do not know how many employers or employees covered by 'ceased' schemes may now come under new approved schemes, and have not yet been able to estimate what the past annual totals of 'live' schemes were. We hope, however, to do some further work on this subject and return to it when we report, at the end of the year, on scheme operation for the year 1987/88.

14. Interesting as these figures of 'active' approved schemes might be, however, as indicating the number of companies actually subscribing at any given time to the precise objectives of the approved scheme legislation, the more important and relevant statistics are those relating to the number of employees participating and the extent of their participation.

15. We estimate that by the end of the tax year 1986/87 over 1.5 million employees had benefited under the approved all-employee schemes with a cumulative initial market value of shares granted or made the subject of options over £3 billion.

16. The final figures for 1987/88 will be available by the end of the year and will be contained in our annual report. We have however some preliminary figures which provide a basis for evaluating any changes that may be necessary. These are derived from returns in respect of 70% of the FA 1980 and FA 1984 schemes but only some 50% of FA 1978

schemes. They are therefore necessarily somewhat tentative. Nonetheless they provide an interesting basis of comparison when set alongside the figures for 1986/87

| | 1986/87 | 1987/88 |
|---|---|---|
| Value of shares granted or made the subject of options (£m) | | |
| All-employee schemes | £730m | £1,120m |
| Discretionary schemes | 1,100m | 2,500m |
| Employees participating | | |
| All-employee schemes | 840,000 | 860,000 |
| Discretionary schemes | 50,000 | 90,000 |

17. These figures appear to provide a sounder basis for concluding that the encouraging trends of recent years continue, than the statistics of scheme approvals or 'live' schemes.

18. We have of course been particularly interested in developments in recent months, as the effects of the crash in particular and latterly the Budget tax changes have filtered through.

19. As indicated in paragraphs 9 and 10, there was a commonly expressed view in the immediate aftermath of this year's Budget that the various tax changes introduced would diminish the attractiveness of the approved schemes, particularly the discretionary schemes. On reflection, however, most commentators now seem to have come to the conclusion that significant advantages remain. Apart from the continuing tax advantages to participants, practitioners and advisers stress the importance when persuading companies to set up share scheme arrangements of being able to point to a scheme carrying the Revenue seal of approval by comparison with an 'unapproved' scheme. The number of both

all-employee and discretionary schemes being submitted for approval has remained at a fairly constant level, although, as noted in the latest quarterly report (my note of 26 October) FA 1978 profit-sharing scheme approval levels have shown some signs of falling recently and the number of discretionary schemes being submitted now seems to have returned to 1986 levels.

20. As regards the impact of the October 1987 crash, some may perceive that lower share prices might actually increase the attractions of share scheme participation by providing a lower starting point for acquisitions of share interests, with the potential for larger capital gains than existed at the height of the pre-crash boom.

Progress to date : Achievement of objectives

21. A number of surveys in recent years have pointed to the impact of employee share schemes in increasing the employees' understanding of their company's financial position and their loyalty and enthusiasm, and in helping also in both the recruitment and retention of staff.

22. In a recent report, for instance, dealing with more than 1,100 employees participating in company share schemes, the Policy Studies Institute stated that "large proportions of employees did feel that share schemes influenced cost consciousness and provided an incentive to work efficiently".

23. This sort of finding gives good reason to believe that the all-employee schemes are succeeding in one of their aims - to make employees feel a part of the company for which they work, and consequently to work harder at improving its fortunes.

24. Another of the more important longer-term aims of the approved schemes is to encourage employees to hold on to their shares. Surveys paint an encouraging picture here too. In a Copeman Paterson survey of 192 companies

operating approved all-employee schemes in 1987, for instance, 80% of FA 1978 scheme participants had chosen to retain their shares after they had qualified for full IT relief at the 5 year point.

25. The objectives of the FA 1984 schemes are, of course, somewhat different since, in addition to the retention and motivation of highly valued employees in established companies, they are designed also to enable small and growing companies to attract key personnel with the prospect of high rewards in future rather than large salaries now. Here too there are indications that these objectives are being achieved. The view was expressed at this year's Wider Share Ownership Council Forum, for example, that a Finance Act 1984 scheme is an integral part of any incentive package for such a company.

26. The indications, although based on somewhat narrow evidence are, therefore, that the ESS legislation is generally achieving its objectives. But save for the limited research commissioned by the Department of Employment in 1985 (paragraph 34 below) and 1988 (which concentrated on looking in detail at 20 firms with 'a significant degree of employee ownership'), no effort has yet been made by Government to measure this progress - to establish, for instance, what employers have perceived as the real benefits of operating schemes, why some have not done so or have preferred to go for unapproved schemes, and indeed how many employees are involved in such schemes. We need perhaps to be able to assess whether the benefits of employee share participation are now well enough recognised to enable some or all of the present tax reliefs to be reduced or withdrawn, to discover how long employees retain their shares once they have qualified for the tax reliefs etc. There may be a case for an evaluation or market research effort to secure answers to questions such as these.

Progress to date : cost of tax reliefs

27. Each scheme is costed on the basis of the income tax relief allowed on the difference between the full value of the shares and the price paid. It therefore includes both discounts and gains in share value between options being granted and exercised. The relief is assumed to be borne at the time the income tax charge would have arisen. Any changes to capital gains tax liability have been ignored so far because they are likely to have been small, but in the longer-term the extra CGT yield from approved discretionary schemes may become significant. Reliable estimates of the tax costs borne in each financial year are extremely difficult to prepare since they require detailed information on each scheme, the participants, and the precise details of transactions. Estimates are therefore prepared on a broad-brush basis only and they are, as such, rather tentative.

28. Estimates of tax costs for the three schemes in 1987-88 and 1988-89 are as follows

| | 1987-88 | 1988/89 |
|---|---|---|
| | £ million | |
| FA 1978 | 100 | 100 |
| FA 1980 | 40 | 50 |
| FA 1984 | 50 | 90 |
| Total | 190 | 240 |

The costs for the FA 1984 discretionary share option schemes require some explanation. Until the stock market crash in October 1987 we expected costs to be much higher because the rising market made the options look very attractive. However, the limited information we have received on options eligible to be exercised since then suggests that take-up of options has been low and that, where options have been exercised, gains have been less than we expected before the crash. The increase in costs from 1987-88 to 1988-89 incorporates an allowance for options that could have been exercised in 1987-88 being exercised in 1988-89. However, estimates for 1988-89 and any forecasts for future years are heavily dependent on assumptions about share price movements and options exercised.

29. These costs are already considerable. Moreover, we expect them to continue to grow. For example, existing members of discretionary schemes are entitled to tax relief when the options are exercised and the costs, in each case, will increase if the stock market improves. Also, the overall trends suggest that new participants will continue to be attracted to the schemes, although the balance between the schemes might change.

30. Unlike some other tax expenditures (eg early PRP experience), however, there is unlikely to be much deadweight cost. The revenue cost of ESS may be considerably greater than PRP and PEPs, for instance, but in the case particularly of the all-employee schemes, they may be regarded as to some extent combining the merits of PRP and PEPs, both improving employee identification with the company and furthering the growth in share ownership respectively.

Progress to date:

Practical and operational difficulties

31. As with any legislation the majority of difficulties occur when it is still new. It is fair to say that the legislation associated with all three types of schemes has now become familiar to those operating in the area. Initial difficulties have therefore for the most part disappeared. With a total of over 5,000 schemes now approved there are few complaints from companies either about the scope of the reliefs available, about the technical details of the legislation or about the administrative and compliance costs involved in establishing and operating an approved scheme (the cost of establishment for instance has been estimated

at £10,000, although this will obviously vary from case to case. If a company were for instance to adopt a scheme very similar to one of the Inland Revenue's published Model Schemes the cost would obviously be kept lower).

32. The CBI's was the only Budget Representation in this area last year. It referred to delays in approving schemes. The representation has now been repeated this year. As to this, a year ago formal approval was taking on average between 4 and 6 weeks. With the deployment of additional staff however, the situation has greatly improved. Although there will be the odd exception, formal approval for a scheme, when it has been put into a final, acceptable form, is currently being given in under two weeks. Similarly the average reply time to initial and subsequent correspondence is also about two weeks. Any delays occurring at this stage of the application process are now usually because a response from the company's advisers is being awaited by the Revenue.

**C. POTENTIAL FOR FUTURE DEVELOPMENT/CHANGE**

Scope for change or improvement

33. We have first attempted to quantify the extent to which the coverage of the schemes can be expanded.

34. A reasonable starting point is the conclusion of independent research conducted for the Department of Employment in 1985, that the take-up of schemes was "quite substantial and demonstrates the degree to which concepts of wider share ownership have been taken up". We have noted above that there are currently about 1,500 approved all-employee schemes, and well over 1.5 million employees have now benefited under them. As the Treasury/Stock Exchange survey earlier this year noted, this represents some 10% of employment in the corporate sector. It also amounts to some 7 to 8% of all employees.

35. This progress may be compared with US progress with their actively supported ESOPs. A General Accounting Office survey in March 1986 found that there were 5,200 ESOPs with 7 million participants representing 7% of the employed labour force. Latest estimates used by the ESOPs proponents (Ian Taylor MP's pamphlet of 9 November) are that the number of participants may now be between 7 and 8 million in some 8,000 ESOPs. This constitutes approximately 7% of the US workforce.

36. Therefore even without ESOP-type tax reliefs directed at the owner and employer (compared with essentially employee reliefs in this country) the proportion is approximately the same. This of course also takes no account of employees' participation in schemes without Revenue approval, which may have increased here as a result of the Budget tax changes. (We can make no reliable estimate of the number of employees involved in such arrangements. As mentioned in paragraph 26, above, this is the sort of information we might seek to obtain from a market research project.)

37. Whether or not US/UK comparisons of this kind are useful, there is still clearly a good deal of further potential for the spread of ESS in this country. Although we know the extent of UK employment in the corporate sector, where an employer may introduce and operate ESS, there is no available breakdown of this figure by reference to the quoted and unquoted company sectors. Thus, we are unable to judge precisely the scope for growth in each. The majority of approved schemes have so far been established in the quoted company sector. Nonetheless there is clearly room for further growth there. Relatively few approved schemes have been set up in the unquoted company sector. Although this takes no account of arrangements made outwith the approved schemes it is clear that here too there are potentially many more companies who could be persuaded to establish schemes of one sort or another.

38. Leaving aside the probability that future privatisations will substantially increase both the 'market' for, and employee participation in approved ESS, these indications suggest that - impressive as progress may have been in the past decade in promoting employee share ownership - there remains considerable scope for further advance in the quoted as well as the unquoted company sectors. The fact that some 500,000 of the 1.5 million employees referred to above have benefited as a direct result of privatisations lends further weight to this view.

39. In considering detailed options for promoting such further advances, below, we should first note, however, that while the scope may seem greater in the unquoted sector it is in that area that progress may be particularly difficult to achieve. Despite what some see as the unhelpful attitude of institutional investors and their Investment Protection Committees, there is unlikely to be major difficulty confronting the quoted company wishing to introduce an approved scheme. Indeed the problem may well be one of encouraging a company to adopt this particular route in preference to others available. The choice is more likely to be between adopting a share scheme or opting for some other form of employee incentive such as performance related bonuses paid in cash, rather than having no arrangements at all. This is the sort of area that a market research study could focus on. It is arguable that little effort has so far been put into discovering why companies do not participate in approved schemes.

40. In the case of the unquoted company, however, a variety of factors has been mentioned over the years as inhibiting ESS - the non-availability of shares, the reluctance of existing shareholders to dilute their present holdings or to yield any part of their present voting power, concern for business confidentiality which could be jeopardised by employee shareholders leaving to join competitors, difficulty in providing a market for employee shareholders

wishing to sell, etc. These are the kinds of considerations which lead the proponents of ESOPs to centre their arguments on employee share interests in unquoted companies, and to seek special new tax reliefs for unquoted company owners and unquoted companies themselves. These aspects are picked up in our companion paper on ESOPs. For present purposes, therefore, we consider a range of suggested changes in the approved ESS legislation without concentrating solely on either the quoted or unquoted company sector.

Conditions for change

41. In what follows we assume Ministers will have no thought either of promoting employee share ownership by any form of compulsion, or of withdrawing the existing tax reliefs for employee share schemes as a whole.

Possible changes

42. We consider first some major changes as follows:

A. the Hardman suggestion of substantial abolition of the present legislation on both approved and unapproved employee share schemes;

B. the suggestion of a new tax relief for payments by employees for shares obtained by them through a savings contract;

C. an increase in the limits on employee participation in all-employee schemes and discretionary schemes;

D. the suggestion that employees should be given the opportunity to purchase shares in their company at a discount;

E. a change in the CGT rules for share option schemes

F. the suggestion that employee shares might be held in a PEP.

43. We have not covered the possibility of outright abolition of the FA 1984 discretionary ('executive') scheme legislation, which was aired at the Chancellor's recent meeting when it was decided not to introduce a linkage requirement that operation of an FA 1984 scheme should be conditional on operation of an all-employee scheme. The Chancellor said that he did not wish to consider abolishing the 1984 discretionary scheme (Mr Taylor's minute of 10 October).

POSSIBLE MAJOR CHANGES

A. Repeal the whole of the share option and unapproved share scheme legislation

44. a. Philip Hardman of Grant Thornton has suggested that in the interests of tax simplification

- "the whole of the share option and unapproved share scheme legislation could be repealed"

  [We understand him to refer to the whole of the legislation relating to income tax, or relief from income tax, on all benefits received from the acquisition of shares or interests in shares by directors and employees by virtue of their employment];

- no tax liability should arise on the grant or exercise of a share option (liability to CGT should be left to arise when options or shares were disposed of - or alternatively an income tax charge on disposal should be introduced);

- there is little point now in much of the unapproved share scheme legislation, partly because companies will be influenced by the CT relief they can obtain on bonus payments to employees but not on benefits given in the form of shares or interests in shares.

He regards new levels of CGT liability, following the 1988 Budget, as facilitating these 'simplifications'.

b. Adoption of these suggestions, involving reliance solely on a CGT charge on the disposal of options or shares obtained by virtue of employment, would facilitate substantial avoidance of income tax. A CGT charge at disposal would mean a capacity to defer any tax charge on these employment emoluments (meantime enjoying income from the shares at a level disproportionate to the investment made), and then to abate that charge by timing disposals to take maximum advantage of the CGT indexation allowance, of the annual £5,000 CGT exemption which might effectively be doubled under independent taxation for married couples, and of any fall in the individual's marginal tax rate (eg after retirement).

c. If, taking Mr Hardman's alternative suggestion, reliance was placed solely on an income tax charge on disposal, this avoidance opportunity would be significantly reduced. However it would not be eliminated, because, apart from the delay in taxing his employment income, the employee's facility to time and stagger his disposals would still enable him to take advantage of any unused income tax allowances he had at any time, and particularly to arrange disposals only when his marginal tax rate was low (eg after retirement).

d. However, irrespective of whether an income tax or a CGT charge on disposal replaced existing tax provisions relating to employee share acquisitions, the proposal encounters several other related and significant objections:

i. the general rule is that employment emoluments, whether in cash or kind, are taxed when received or earned. To postpone a tax charge on emoluments in the form of shares or interests in shares until they were subsequently sold, without closely drawn rules, would be a major departure (it is an open question too what NIC arrangements would be necessary). The development of such rules, however, would imply the replacement of existing legislation so far as shares are concerned with a new set of unfamiliar statutory provisions.

ii. the tax benefits provided in the present approved employee share scheme legislation are carefully directed to circumstances where the Government's policy objectives are served - eg where, subject to specific value limits and to requirements such as all-employee, similar terms participation, employees are given shares or interests in shares which must be retained for specified minimum periods, to secure a lasting measure of employee incentive, commitment and involvement in their employing company (and where, also, wider share ownership policies are served). Since the reliefs provided for approved schemes remain of considerable - if diminished - value by comparison with any other general tax regime for employee emoluments in the form of shares (see paragraphs 9 to 12 of this submission), the conclusion must be that it would ill-serve these policy objectives to abandon the approved scheme system;

iii. abandonment of the special tax regime for approved schemes would substantially increase the taxation of employee share interests in some significant respects, and so positively harm the employee share ownership cause. The value at appropriation of free shares given to employees under an all-employee FA 1978 profit-sharing scheme, for instance, (well over £1 billion to date), is at present exempt from any taxation. Mr Hardman's suggestion would result in such appropriations being taxed at their full value on disposal, either under CGT or IT, unless new legislation to replace that abolished was promoted - but this, of course, would frustrate his basic simplification purpose.

e. Attractive as any proposal to abolish a substantial amount of current legislation must be, Mr Hardman's suggestion pays insufficient regard to the continuing attractions of CGT rather than IT treatment of employee share acquisitions and to the likely continuing success of present legislation in encouraging increasing employee - and wider - share ownership. To avoid these difficulties would involve replacing the present, well understood legislation which he wishes to see abolished with a range of new statutory provisions, which might be no briefer and simpler than the present ones, and which would have the additional disadvantage of being unfamiliar to practitioners, employers and employees. In consequence we cannot recommend Mr Hardman's suggestions.

f. Mr Hardman rests his suggestion for abolition of approved share schemes legislation largely on the reduced benefits available following the integration of CGT and IT. As already explained, approved share schemes still provide considerable benefits. If Ministers were concerned about the relative fall in the attractiveness of approved schemes, the opposite approach to Mr Hardman's would be to increase the value of the reliefs available. Given their generosity already, that is not easy. The only possibililty of that kind we have identified - improvements in the CGT treatment of approved share options - is discussed in paragraph 49 below.

B. Tax relief should be given for employees' purchases of shares through a savings contract

45. a. This sort of scheme could possibly run along the lines suggested by the Industrial Participation Association and put forward in representations by the Secretary of State for Employment prior to this year's Budget. Tax relief would be provided on amounts employees invest to buy ordinary shares in their company through a savings contract. Whether with a savings contract or not, this idea would, in effect, amount to a share incentive scheme, with the employee obtaining his shares at the outset and being allowed tax relief on the money subsequently used to pay for them. It would be a virtual amalgamation of the two existing all-employee schemes.

b. The arguments against a scheme of this kind are essentially twofold. First, it seems doubtful if it would be attractive to employees. If their employer is willing to operate a 1978 scheme, they already have the opportunity to get shares free, and without any IT charge if they leave their shares in trust for 5 years. They are likely to receive more shares than they would be willing to buy - even on extended credit terms. And they stand to lose nothing if the shares decline in value. Similarly, if their employer is willing to operate a 1980 scheme, they obtain a right at the outset to acquire shares at a discount, but if the shares lose value while the options are outstanding they again lose nothing. They continue their savings, and take cash plus bonus at the end of the SAYE contract. The IPA and Employment suggestion would seem unattractive to employees by comparison with these alternatives.

c. It seems doubtful too whether employers would find such a scheme attractive. They would have the task of obtaining payment by instalments from employees, including those who left before payment had been completed, and might have difficulty in doing so where shares fell in value compared with their purchase price. These burdens would be compounded by the necessity of operating the tax relief on instalment payments, and by such events as rights issues. Further, the employer might see little benefit in terms of employee incentive, commitment etc, especially where it happened that shares actually fell in value after purchase.

d. In general policy terms too, there are unattractive features in this proposal. Unless the employee was compelled to retain his shares until after they had been paid for - and what of defaults by leavers? - an important feature of the existing ESS legislation would be missing, since it ensures that employee commitment, incentive etc exist for at least a matter of 5 years (while the tax relief is earned). We can see few real advantages in this suggestion of either an employee share ownership or a general wider share ownership kind.

C. i. <u>An increase in the limits on employee participation in all-employee schemes</u>

46. a. The table below indicates how the limits have been increased since the schemes were introduced. The last increases were in 1983 (FA 1978 schemes) and 1984 (FA 1980 schemes).

| Finance Act | FA 1978 Profit-sharing schemes (Annual appropriation of shares to employees) | FA 1980 SAYE-Related Share Option Schemes (Monthly savings limit) | SAYE scheme limit for public |
|---|---|---|---|
| 1978 | £500 | -- | £20 (set in 1974) |
| 1979 | | -- | |
| 1980 | £1,000 | £50 maximum (£10 minimum) | |
| 1981 | | | |
| 1982 | £1,250 | | |
| 1983 | £1,250 or 10% of salary subject to £5,000 limit | | |
| 1984 | | £100 maximum | |
| 1988 | | | |

b. There are a number of reasons why an increase in the limits seem desirable as follows:

*In 1989 it will be at least 5 years since these limits were last raised and there is now pressure in some cases at the upper end; employers want to appropriate more shares or grant larger options than at present permitted.

*Higher limits are indicated by wage increases since 1983. Increases in line with the rise in average earnings would indicate limits of about £1,800 and £130 respectively for the FA 1978 and FA 1980 schemes.

*There has been a steady, if not large, number of representations calling for an increase in FA 1978 scheme limits - apart from the Department of Employment there were two Budget representations in the last round, from the Law Society and the Stock Exchange. Sainsburys have also urged an increase on more than one occasion (they provided further information on this at the recent WSOC forum). We have also seen a number of representations over the last year for an increase in the FA 1980 limit from, for instance, the Secretary of State for Employment.

*Increases would be well received generally. They would also give a boost to the Government's policy of encouraging wider share ownership. The all-employee schemes, it is alleged in some quarters, have been neglected at the expense of the FA 1984 discretionary schemes and, as noted in the recent quarterly report to Ministers, approval levels have begun to decline slightly in recent months.

*Cost of the increases indicated above is likely to be fairly small (negligible at first, rising to perhaps £5-10 million after 5 years). Average employee participation currently is well below the limits. Those taking advantage of the increase may initially be relatively few, although the cost may be increased if the raising of limits leads to increased take-up and operation of schemes generally.

c. The main argument against an increase is simply that there is apparently no need - average appropriations are well below existing limits, as is the average monthly savings level (£400 and £30 respectively in 1986/87). In addition, there have been relatively few representations on the point.

d. <u>Comment and Conclusion</u>:

Although there is no evidence that the existing scheme limits are causing difficulties in a great number of cases, the limits are apparently beginning to cause problems in certain companies. The main effect of any increase would be to confirm the Government's continued interest in and support for employee share ownership, and all-employee schemes in particular (and at relatively little cost).

As to where new limits might be fixed, increases in line with the rise in average earnings since the last increases took place would point to figures of £1,800 and £130. We suggest going further, however, both in order to ensure that there is a 'real' increase and also to settle on round figures.

We see no strong case for raising the limit for only one of the two all-employee schemes. We therefore recommend increasing the limits in both. For the FA 1980 scheme we would recommend an increase in the maximum monthly permitted savings level from the present £100 to £150. This would meet, for instance, representations from Secretary of State for Employment prior to the last Budget. It should also please the WSOC. In their most recent survey the increase in the limit by exactly the amount proposed came second in their list of measures to improve the prospects for employee share ownership. (First was a proposal to allow statutory corporation tax relief for money put into an "employee benefit trust" to acquire shares passed on to individual employees. This is one of the proposals examined in the separate ESOPs Starter No 113.)

The shape of an increase in the FA 1978 scheme limits is less straightforward. There is the option of not just increasing the limit but also simplifying it by moving away from the alternative percentage figure (10% of salary, up to £5,000), introduced in 1983, back to a straightforward limit. The reason for the change at the time was to make profit-sharing schemes more flexible and attractive for companies and, in particular, for their senior management. This reasoning remains powerful. Although it could be argued that the need to involve senior management directly in this scheme has greatly diminished following the introduction of the FA 1984 discretionary schemes this would be to miss the point. Senior managers are more likely to favour the establishment of an all-employee scheme if it is worth their while participating.

We would recommend, therefore, retaining the flexibility of the present structure of the limit(s); but you may wish to consider concentrating an increase on the lower end of the scale rather than increasing all the limits by the same amount. Employers would retain the flexibility of measuring share appropriation to the individual employee (in terms of his pay and length of service); but such an approach might avoid the risk of a simple proportionate increase in each component of the limit resulting in increasingly disproportionate appropriations to directors and senior management, and other employees.

Against this background, the limits might become the greater of £2,000 or 10% of salary, subject to a limit of £6,000 (instead of £8,000, which would be the corresponding increase). There is of course a wide range of possibilities, which could be further explored if desired.

We suggest these increases would be sufficiently large to make clear the Government's intentions, would be welcomed, and, if no increase was made in FA 1984 scheme limits, would succeed in sending a message that the Government intends to build upon previous take-up and encourage further success for all-employee schemes. It would also succeed (so far particularly as the FA 1978 scheme increases are concerned) in complementing any ESOPs measures by making possible the more rapid appropriation of shares.

C. ii. <u>FA 1984 Discretionary Scheme : Individual limit on the amount of options that can be granted should be increased/abolished</u>

47. Currently options can be granted up to a figure of four times annual earnings or, if greater, £100,000.

a. Points for an increase include:

*According to some (BVCA etc) the present limit is restrictive and is making schemes less efficient and effective than they should be.

*An increase in scheme limits would help to stimulate renewed interest in the schemes following the Budget tax changes which are perceived to have reduced their appeal, particularly for relatively wealthy investors who are likely to require all or most of their annual CGT exemption for other gains.

*An increase is likely to cost little. Few people are actually granted options at the maximum level.

b. Points against an increase however are as follows:

*An upper limit is needed for presentational/political reasons. An increase (or abolition) would rekindle criticism that the discretionary scheme is elitist (WSOC etc).

*Effectively the upper limit is already indexed to earnings for anyone already earning £25,000 pa or more.

*The average size of option granted in 1986/87 was £22,000 and in 1987/88 appears to have been about £26,000 - well below the current limit.

*There is no sign of a dramatic fall in take-up, thus no need for an increase in limits to encourage it.

*An employee can always be granted more options outside an approved scheme. This has become a more attractive alternative following the Budget tax changes.

c. <u>Comment and Conclusion</u>:

The possibility of an increase was looked at in February 1988 following a BVCA suggestion to increase the limit to six times salary with the £100,000 limit remaining (this increase possibly to be restricted to unquoted companies). There certainly seems to be no need for an increase. Although the attractiveness of the schemes may have been somewhat reduced by the Budget tax changes, the recent WSOC forum confirmed the generally held view now that they are still an integral part of an incentive package. Moreover, given lower tax rates generally it could be argued that there is less need now for discretionary schemes. The main argument against an increase however is the 'political' one, with an increase likely to be widely criticised. It would also reduce the impact of an increase in all-employee limits. We recommend no change in the FA 1984 schemes limit. (If Ministers did wish to improve the attractions of 'executive' schemes, for all participants however, they might consider the possibility in paragraph 49 below.)

D. Tax relief should be given for employees to purchase shares at a discount

48. a. This proposal would enable employees to acquire shares in the company for which they work at a discount to the market value. It is sometimes argued this would be a simple and potentially effective way of achieving employee involvement in the company by making them give a commitment in the form of purchasing the shares.

b. The arguments against this idea are, however, numerous.

i. Ministers have recently confirmed publicly in the context of privatisations that the discount element in employee offers should remain taxable. To move so suddenly on a much wider front would be a sharp policy reversal.

ii. Employees are already offered the opportunity to acquire shares at a discount in the FA 1980 schemes and, of course, free, in FA 1978 schemes. They are perhaps not likely to take this new opportunity to any greater extent.

iii. If the employees acquired their shares immediately, and were free then to dispose of them at any time, there would be little benefit to employers in terms of lasting employee motiviation and involvement.

iv. Unless limits were imposed both on the value of shares that could be offered in this way and also on the amount of discount available this could easily become a form of income substitution. This might be a more pronounced risk if, also, employers were free to offer shares at a tax-free discount only to selected, rather than all employees.

v. Firms can already in practice offer their shares at a discount by using a matching FA 1978 scheme where an employee buys one share and gets one free.

c. Our conclusion is that an arrangement such as this, would in practice require the creation of a new approved scheme to enable it to work properly, for example, in relation to "similar terms" offers to employees, and a retention period to secure continuing association with the employer's interests. But since shares at a discount can already be obtained under existing approved schemes, it is doubtful whether another approved scheme for this purpose will be worthwhile.

E. <u>Approved share option schemes and CGT</u>

49. a. <u>Proposition</u>

CGT rules for approved share option schemes should be changed so that an employee is charged on the difference between the sale proceeds and market value of shares when exercised. At present CGT liability arises on the difference between disposal proceeds and the price paid by the employee (ie the price at which he was given the option to purchase them).

b. There are number of arguments in favour of adopting this course.

i. at present, following the normal CGT rules, employees under the option schemes are treated less favourably than under a profit-sharing scheme. Both are liable to CGT on the disposal of shares by reference to the disposal proceeds. But whereas those acquired under an FA 1978 profit-sharing scheme are treated as having a 'CGT cost' equivalent to the market value of the shares when appropriated to the employee, the 'CGT cost' of shares acquired under the approved option schemes is the amount actually paid under the option, which will inevitably be less than its market value. So the identical shares acquired on the same day and sold on the same day would be subject to a smaller CGT gain if they had been acquired under a 1978 scheme than if they had been acquired under an option scheme - despite the fact that under the FA 1980 and FA 1984 schemes the employee will have paid something for his shares (the option money) whereas under the FA 1978 scheme they were a free gift. The 1988 changes in CGT have increased the disparity of treatment and this change would redress the balance.

ii. As illustrated in Annex A, the benefits from the approved discretionary schemes in particular are now substantially reduced following the Budget tax changes. This change, as part of a package, would first provide an improvement for FA 1984 schemes (if, as we suggest, any increase in limits is confined to FA 1978 and FA 1980 schemes) and second would greatly enhance the incentive effect of option schemes whose participants would otherwise have been liable to CGT on selling their shares. Thus it would increase the present level of the tax advantages flowing to participants in such schemes, while also decreasing any potential CGT charge for FA 1980 scheme participants.

iii. It may lead to an increased scheme take-up and might partly meet demands that approved scheme shares should be permitted to attract PEP benefits (point F. below).

c. There are however also a number of arguments against a change:

i. Such a change could have a potentially 'very significant' cost. On the 1988/89 estimated cost for FA 1984 schemes for instance of £90m, this measure could lead to an extra cost of some £65-70m.

ii. Such a change could appear at odds with the Government's attitude that the 1988 tax changes reducing the value of tax reliefs do not justify compensatory increases in the value of these reliefs.

iii. Any enhancement of benefits perceived as particularly favouring FA 1984 scheme participants will probably lead to criticism given the political perception, certainly pre-1988, that the tax benefits of the FA 1984 scheme were already very large.

iv. Unlikely in practice to help many FA 1980 scheme beneficiaries most of whom will already be within the annual CGT exemption.

v. Exempting option gains from CGT could prompt demands for similar exemption for gains made by FA 1978 scheme shares while they serve their five year holding period in the scheme trust.

vi. Minimising the CGT charge on disposal would encourage the sale of holdings, thus bringing it in conflict with the employer/employee link that the approved option schemes are designed to encourage.

vii. The market value of the shares on exercise of options would need to be established specially for this purpose.

viii. Legislation might need to be complicated to take special account of premature departure by participants in approved schemes and to cover the interaction between IT and CGT.

d. <u>Comment</u>

There is no need to consider this proposal <u>unless</u> you see a strong case for restoring some of the relative advantages of the discretionary share option scheme for those few for whom they have most been eroded by the 1988 Budget changes - those who have no CGT annual exemption to set against option gains.

If you wish to do that this proposal has the advantage also of applying to the FA 1980 share option schemes, and, arguably, bringing the CGT treatment of both approved option schemes more into line with the FA

1978 profit-sharing schemes. But it would be controversial, would have a substantial cost and would have the perverse effect of encouraging earlier disposal of shares.

F. <u>Employee shares should be allowed into a PEP</u>

50. a. The suggestion put forward by George Copeman (WSOC) last year is that shares acquired under an approved share option scheme should be capable of being held in a company nominated PEP. This would entail moving away from the present rule that contributions to a PEP must be in cash. It is argued that it would broaden the appeal of both share schemes and PEPs.

b. The idea seemed unattractive last year for two main reasons:

i. PEPs are designed to encourage wider and deeper share ownership. There seems little reason in principle to allow the transfer of an existing shareholding into a PEP. Although it could be argued that it would prolong the employee's involvement in share-ownership, there is insufficient evidence to suggest that a step of this kind is necessary;

ii. the transfer of a non-cash asset into a PEP would need to be deemed a disposal for CGT purposes, if an undue tax break for such transfers was to be avoided. This would complicate what is essentially a simple scheme.

Moreover, individuals who are able to participate in share schemes already enjoy significant tax benefits over those who are not able to. (Should, for instance, a departing or retiring employee, who obtains unrestricted possession of his approved shares by virtue of his departure, be enabled to use a PEP to prolong his tax advantages when they no longer serve to motivate his performance, loyalty etc in work?) Adoption of a proposal of this kind would accentuate this treatment while not encouraging any new shareowners. The problem of retention is not serious enough to warrant adopting this sort of solution.

c. The whole shape of PEPs is of course currently under separate consideration by Ministers.

51. We now turn to consider a range of less sweeping changes as follows:

A. a change in the option price discount on FA 1980 schemes;

B. restriction of the tax free gain on option exercise when a flotation occurs between grant and exercise;

C. use in approved schemes of the shares of 'independent' subsidiary companies;

D. publicity for approved ESS;

E. participation in discretionary schemes of part-time employees;

F. facility to pay IT on unapproved options in instalments;

G. removal of the 3 year exercise rule for discretionary scheme options.

This selection, from a very wide range of detailed suggestions heard over the years, has been dictated by consideration of likely popularity, topicality, and relative simplicity.

## POSSIBLE MINOR CHANGES

### A. FA 1980 All-employee SAYE Share Option Schemes : Option Price Discount

52. a. Proposition:

An increase in the statutory limit on the share price discount at which options may be offered to employees.

b. Factual:

Shares made the subject of options granted under all-employee FA 1980 schemes must be priced at market value at the time of option grant, or at a discount to that price of no more than 10%. This discount limit was included in the original legislation.

c. Points for an increase:

*Some regard the SAYE share option scheme (FA 1980) as more likely to secure the benefits of employee incentive, commitment etc than the profit-sharing scheme (FA 1978) because the former requires employee cash saving and eventual payment for his shares, while under the latter shares are given to him. Employee participation in the operation of the average SAYE scheme, however, is estimated in various external surveys at no more than about 25%, compared with virtually 100% for the profit-sharing scheme. The obligation to save for 5 years out of his own taxed income no doubt accounts very largely for this disparity. It may also account for the fact that while schemes are enabled to offer options equivalent to monthly savings of between £10 and £100, the actual average is barely £30.

*An increase in the discount on market value in the share price at which FA 1980 options may be granted would improve employee perception of the benefits to be gained from acceptance of option offers made to them under such schemes. An increase from the present 10% to say 15%, whether or not accompanied by the increase in the maximum monthly savings limit suggested above, could usefully increase employee take-up of SAYE option offers.

*Such a result would be consistent with any Budget initiatives to increase saving in the economy generally.

d. Points against an increase:

*Employers, the vast majority of whom offer the present 10% discount, may not be inclined to offer a larger discount.

*We can recall no representations for an increase in the discount.

*Arguably, allowing any discount is illogical. The scheme is intended to encourage employees to improve the company's performance as reflected in the share price, not to give them a tax-free gain related to the present price.

*An initial cost estimated at between Nil and £5m would be involved, although this might increase in future as the number of options being exercised increases.

e. Comment and Conclusion:

There is a case for encouraging greater take-up by employees of share options offered to them under all-employee FA 1980 schemes. With take-up currently estimated at barely 25%, the all-employee character of these schemes is only served to a limited extent, since participation is actually confined to employees who are able and willing to save regularly, for five years, and who may have difficulty in perceiving the attractions of share options when they know little about share investment. This perception might be improved by increasing the maximum permitted discount from the present 10% to, say, 15%, in a way not achieved by increasing the overall limits on participation suggested above. A higher figure might achieve more impact if employers chose to adopt it, but it would be difficult to go above 20% given that any discount is in some ways alien to the scheme.

B. Restriction on the tax free gain from an option exercise when a flotation occurs between grant and exercise (FA 1984 'discretionary' share option schemes)

53. a. Factual:

Reporting a survey prepared by Mr David Cohen of Paisner and Co, the City law firm, a 'Financial Times' article in June referred to 'massive' tax sheltered gains being made as a result of options being granted before companies go public, at which time the value of the options is likely to increase sharply. This article was, in turn, referred to by Opposition members during the course of the Finance Bill Standing Committee Debates. These criticisms of the FA 1984 schemes reflected those made before the October 1987 fall in share prices (which led to a dramatic reduction in the value of many of the "paper" option gains up to then).

b. Points for:

*The potential for making vast paper gains of this nature over a very short period, and without any reference to changes in the underlying circumstances of the company concerned, damages the standing of the 'discretionary' schemes.

*Setting a limit on the amount of the gain which could be tax free would show the Government's intention to direct the tax relief available to the appropriate destination, focusing it on the real gain in value derived from the company's increased performance levels.

c. Points against:

*These very large gains may be only on paper since at least three years must elapse between grant and exercise for the gain to be tax free.

*There are already limits on the size of options that can be granted under approved schemes as well as various conditions relating to the exercise of options, all designed to avoid abuse of the tax relief.

*Effective legislation could be difficult to devise although it should be feasible to remove the worst excesses of this sort of situation. Points to be covered would include the need to decide what sort of limit to apply (a money or percentage limit?), how far in advance of a flotation the restriction was to apply, and how to prove that a flotation is definitely intended at the time of valuation. (The particular price at which the option is granted is negotiated with the Revenue's Share Valuation Division. They can only act on the basis of the information available to them at the time the option is granted.)

*The bull market that existed at the time that the survey was conducted has ended. Very large gains of the sort referred to may, therefore, be less likely now.

*This sort of problem is unlikely to arise in privatisation issues. Guidance to Departments firmly discourages the establishment of discretionary schemes prior to flotation.

d. Comment:

There will always be difficulties in valuing a company prior to a flotation occurring. Much of this sort of criticism has now subsided, and in view of this and also of the difficulties in devising completely effective legislation to tackle what may in the end prove only to be 'paper' gains, you may conclude there is no need to consider further any action on this point.

C. Use of independent subsidiary shares in approved schemes

54. a. Proposal:

Shares in independent or qualifying subsidiaries (as defined in the FA 1988 legislation replacing Section 79 FA 1972) should be usable in approved employee share schemes. (A qualifying subsidiary for this purpose is a company whose trade and other activities are wholly or mainly independent of other companies in the same group and where any transactions that do occur with other group companies do so on an arm's length basis so as not to entail any significant transfer of value to the subsidiary company.)

b. Factual:

At present the shares of unquoted subsidiaries of unquoted parents may not be used in approved schemes, although use of shares of quoted companies' subsidiaries is allowed.

c. Points for:

*If an independent subsidiary is regarded as fit to have the same tax regime as a non-subsidiary company in an unapproved scheme, the same should be accepted for approved schemes

*Would in theory be easy to police - the documentation needed for new Section 79 purposes could be used here too.

*Would be of further assistance to unquoted companies.

d. Points against:

*The present conditions provide a straightforward test. The time taken to decide on whether a company has 'independent' subsidiary status at the outset could lengthen the approval process.

*Independent subsidiary status could change in any year, depending on the way in which the company carries on its business; loss of that status would result in loss of approved scheme status. As a consequence, those with approved options which had been granted when the company was an independent subsidiary could find their options lost approval when, later, the company subsequently lost qualifying status. More importantly, options granted in these circumstances would not just be unapproved but would be rendered void.

*In practice the problems of 'policing' may be greater than expected. To gain approval would entail producing the necessary documentation at the outset. This may cause difficulties for companies.

*With the Budget IT/CGT changes, approved schemes may now be perceived in some quarters as having less of an advantage over unapproved - there may therefore be less need and demand for access to approved schemes by the sort of company referred to immediately above.

*We have had no experience of how the 'independent subsidiary' concept is working in practice, since to be deemed as such the directors of the ultimate parent company of the group of which the subsidiary is a member has to submit a certificate to that effect within 2 years of the end of the period of account. It may, therefore, be some time yet before we are able to see how the new approach is working in practice.

e. Comment and Conclusion:

Use of the independent subsidiary concept in the replacement Section 79 legislation was to ensure that this sort of company could set up unapproved share scheme arrangements which did not fall foul of this anti-avoidance legislation. This year's changes were of benefit to the unquoted sector and perhaps due to a combination of that and the impact of the Budget tax changes, there have been no representations seeking to extend the independent subsidiary concept to approved schemes since it was raised by a single commentator in February.

Since any change might benefit only a few companies, could be costly to administer, could possibly add a significant extra complexity to the legislation and potentially lead to delays in approval for those seeking to adopt new schemes, we recommend 'wait and see' as still the best option at present. The concept of the 'independent subsidiary' has not yet proved itself in practice, amd it might be unwise to attach an unproven test to approved scheme legislation.

D. Publicity for approved employee share schemes

55. a. Proposition:

Increased publicity should be given in an attempt to boost the operation and take-up of all-employee schemes.

b. Factual:

There are currently a leaflet and a booklet covering the FA 1978 scheme (IR35 and 36) and two covering the FA 1980 scheme (IR38 and 39). In addition there are explanatory booklets/notes giving model scheme rules for all three schemes.

c. Points for:

*There has been criticism that the Government has neglected the all-employee schemes since the introduction of the discretionary schemes. Part of this criticism is due to the perception that 'little emphasis' is being put on encouraging companies to take-up the former. The introduction of profit-related pay has also contributed, it is argued, to the diversion of attention from the all-employee schemes.

*In a recent survey 13% of companies said that 'they did not know much' about the all-employee schemes and knew little of the possibilities.

*If changes were made this year (eg to all-employee limits) this would be the ideal time to launch additional or improved publicity.

*The existing schemes seem currently to be 'drowning' in a sea of ESOPs publicity.

d. <u>Points against:</u>

*Literature currently available covers all aspects.

*No sign of take-up in approved schemes falling away to any great extent. The cost of extra publicity could produce little return.

e. <u>Comment and Conclusion:</u>

Although the existing booklets and leaflets cover the area adequately they are not nearly so attractive as the more modern PRP guidance notes. The problem appears to be more one of how to increase general awareness of the all-employee schemes in particular and of their coverage.

The most effective way of doing this initially is probably through higher-profile Ministerial statements emphasising the success of the schemes and encouraging their further use.

As with PRP, this could be backed up by selective use of Press Releases, for instance when the number of all-employee schemes reached a certain figure (1,500) etc. This would increase the profile of the schemes and again point to how effective they are and what is already on offer.

We would recommend, therefore, integration of the present booklets with the model scheme rules, taking the opportunity to revise both to include recent legislative changes and thereby to provide an up-to-date source of reference. Ideally, if resources permit, we would also suggest taking the opportunity to republish in the much more up-to-date and attractive format of the new PRP Guidance Notes (which have been well-received).

E. Part-time employees should be allowed to participate in FA 1984 schemes

56. a. Factual:

At present only those employees working in excess of 20 hours a week can participate in the discretionary schemes.

b. Points for:

*All part-timers should be able to participate in the schemes and enjoy the benefits available.

*Part-time employment is growing and the exclusion from FA 1984 schemes discriminates against them.

*Would meet the complaints of Freemans, CBI, Rowntree Mackintosh (1987 Finance Bill Debate saw the proposal supported by Sir William Clark MP and Tim Smith MP).

c. Points against:

*The FA 1984 scheme reliefs are very generous (by comparison with the all-employee schemes), and only those employees who make the most substantial contribution to the company's success should be allowed to participate.

*There would be scope for options being granted to only a few employees working part-time thereby giving no benefit at all to the 'low-paid part-time worker' cited in representations in favour of the proposal.

*There has been very little pressure for change. The CBI, for instance, although making a representation on this point last year, have not done so this year.

d. Comment and Conclusion:

In a small number of cases where the 1984 schemes are operated on an all-employee or nearly all-employee basis, companies may be keen to extend the benefits to part-time employees for 'genuine' reasons. However, to allow 'part-timers' to participate would enable companies to grant options to favoured people working very few hours and contributing little to the company. The purposes of the tax relief would be ill served. There seems too much scope for abuse and too little demand for change to warrant accepting this suggestion.

## F. Re-introduction of legislation to provide a facility to pay income tax on unapproved share option gains in instalments

57. a. Factual:

For options granted (outside an approved scheme) prior to 5 April 1984 there still exists a statutory facility whereby, on election to the Inspector of Taxes within a 60 day period at the end of the tax year concerned, payment of income tax due on option exercise may be made in instalments over a five year period.

The facility was withdrawn for options granted from 5 April 1984 onwards, in recognition of the introduction of the new FA 1984 scheme legislation.

b. Points for:

*Restoration of the instalment facility would be of most help in a situation where options are exercised and the price of the shares has fallen since the option was exercised. A 'heavy' tax charge could be spread out, and the need to sell shares to provide the money with which to pay the charge could be avoided.

c. Points against:

*Most options since 1984 granted within an approved scheme.

*All extant pre-5 April 1984 options already covered.

*Little pressure for reinstatement. Share prices have now risen again since October 1987.

d. Comment and Conclusion:

There has been little demand for re-introduction of the relief. Should share prices fall dramatically again, or should Ministers return to the idea of abolishing the discretionary FA 1984 scheme legislation, there may be a case for reviving the instalment facility. Otherwise there seems to be no very persuasive argument for pursuing the point.

G. Removal of the rule (FA 1984 schemes) whereby options can only be exercised with the benefit of tax relief every three years

58. a. Factual:

Relief from the income tax charge is only available where exercise of the option occurs between three and ten years from the date of grant and provided three years have elapsed since the last exercise of an FA 1984 option, with tax relief. The purpose of this 'three year frequency' rule is to prevent exercise of options being treated as annual, tax-efficient supplements to salary income ('annualisation').

b. Points for:

*Removal of the rule would give more freedom as to when exercise could take place.

*Annualisation is now less likely following the Budget tax changes.

c. Points against:

*There is nothing to stop those participating in FA 1984 schemes from exercising every year. An income tax charge would arise, but since the 1988 Budget the disadvantages of doing so have diminished.

*Facilitating quicker exercise of options would conflict with the purpose of the tax relief, to encourage involvement in the company over a worthwhile period.

*Annualisation is still a possibility and would certainly become more attractive if any future adjustment in tax rates restored the pre-1988 attractions of CGT over IT.

d. Comment and Conclusion:

There are still significant advantages available to those participating in FA 1984 schemes. Any relaxation of this kind would be seen as giving further preferential treatment to those participants. There is, moreover, less of a case for this than there was before the IT/CGT changes. We do not recommend pursuing this suggestion.

Cost of changes to the legislation

59. Adoption of any of the more minor suggestions covered in paragraphs 52 to 58 would not result in a significant increase in the cost of the schemes. Increasing the all-employee scheme limits would produce a cost in the first year which would be negligible and would rise to, perhaps, between £5-10 million after 5 years. A measure such as a change in the CGT rules for share option schemes could have a cost of up to £70 million in 1988/89, however.

**D. CONCLUSION**

60. In conducting this review of the present approved ESS legislation, we have assumed that

- Ministers remain determined to promote by fiscal means individual employee share ownership of shares in their employing companies;

- as they have said publicly, they regard the progress already made as a success story, and as contributing significantly to their wider share ownership policies generally; and

- they would not favour, therefore, any very radical changes to the present legislation which might jeopardise continued progress in this area and unless it held out the prospect of worthwhile further gain.

61. Against this background, the review points to the conclusion that the efforts and tax reliefs expended over the past 10 years to promote employee share ownership appear to have achieved - and to be continuing to achieve - their

objectives. None of the changes discussed in this paper seem essential. But there are a number of measures which could be taken to boost ESS - and at the same time help with ESOPs.

62. Ministers will of course wish to form their own views on the wide range of possible changes discussed. Those which seem attractive, without having any significant drawbacks, are:-

i. an increase in the FA 1978 all-employee profit-sharing scheme limit from the present £1,250 or 10% of salary whichever is the greater subject to a £5,000 ceiling to £2,000 or 10%, subject to a £6,000 ceiling (paragraph 46);

ii. an increase in the FA 1980 all-employee SAYE share option scheme limit from £100 to £150 per month (paragraph 46);

iii. an increase in the statutory limit on the share price discount at which optons may be offered to employees under FA 1980 all-employee schemes (paragraph 52);

iv. amalgamation and re-launch of all-employee scheme literature as part of a general campaign to promote awareness of the all-employee schemes. This should include increased public Ministerial commitment to the schemes and a greater number of Press Releases at selected intervals (paragraph 55);

v. consideration of the possibility of commissioning evaluation or market research into the success of the employee share scheme legislation to date (paragraph 26 above).

N. Williams

N WILLIAMS

Encls.

ANNEX A

## Pre- and post 1988 values of FA 1984 approved share option scheme tax reliefs

General Assumptions

1. Option over shares worth £25,000 (approximate average size of recent FA 1984 scheme options) granted to top rate taxpayer.

2. Value of shares on option exercise after 3 years (at 10% increase pa) £33,275, produce option gain of £8,275.

| | Pre-1988 Budget £ | | | Post 1988 Budget £ | | |
|---|---|---|---|---|---|---|
| | Unapproved scheme | Approved scheme | Tax benefit | Unapproved scheme | Approved scheme | Tax benefit |
| A. Total IT and CGT tax burden arising from option gain, assuming<br>- share disposal immediately after option exercise<br>- no access to annual CGT exemption | 4,965 (IT) | 2,482 (CGT) | 2,482 | 3,310 (IT) | 3,310 (CGT) | Nil |
| B. Total IT and CGT tax burden arising from option gain, assuming<br>- share disposals timed/staggered to take full advantage of annual CGT exemption by keeping each year's gain below the CGT exempt amount. | 4,965 (IT) | - | 4,965* | 3,310 (IT) | - | 3,310* |

*Each of these two comparisons overstates to an extent the benefit of approved schemes because, pending final share disposal, the value of deferred tax payment to the approved scheme participant is likely to be exceeded by the value to the unapproved scheme participant of the CGT indexation allowance (which is based on the market value of his shares at the time of option exercise, not the price he has paid). For the same reason the fall in the value of approved scheme participation post the 1988 Budget is slightly understated. The significance of these over- and under- statements grow with delay in share disposal.

ANNEX A

**ANNEX B**

The number of approved employee share schemes which had received formal approval by 31 October 1988 was as follows:

| | |
|---|---|
| FA 1978 All-Employee Profit Sharing Schemes | 767 |
| FA 1980 All-Employee SAYE-Related Share Option Schemes | 781 |
| Combined total of all-employee schemes | 1,548 |
| FA 1984 Discretionary Share Option Schemes | 3,475 |

**FA 1978 and FA 1980 All-Employee Schemes:**

**Combined Yearly Totals:**

| Year to | Schemes Approved |
|---|---|
| October 1979 | 53 |
| " 1980 | 117 |
| " 1981 | 187 |
| " 1982 | 145 |
| " 1983 | 130 |
| " 1984 | 156 |
| " 1985 | 191 |
| " 1986 | 190 |
| " 1987 | 205 |
| " 1988 | 174 |
| | 1,548 |

**FA 1984 Discretionary Share Option Schemes:**

**Yearly Totals**

| Year to | Schemes Approved |
|---|---|
| October 1984 | 4 |
| " 1985 | 1,020 |
| " 1986 | 882 |
| " 1987 | 731 |
| " 1988 | 838 |
| | 3,475 |

CONFIDENTIAL

**Inland Revenue**

Business Tax Division
Somerset House

FROM: D J HUFFER

DATE: 9 DECEMBER 1988

1. Mr Reed seen in draft

2. Financial Secretary

SIR EMMANUEL KAYE - CLOSE COMPANY APPORTIONMENT

X 1. Sir Emmanuel wrote to you on 14 October suggesting the abolition of the rules on the apportionment of close company income. He also returns to the question of charitable covenants. I am sorry about the delay in dealing with this but we have had to give priority to work on taxation aspects of the Water and Electricity Bills. As Mr Reed told you in his note of 2 September Lansing Bagnall won their appeal against the apportionment of certain covenant payments to charity; and we have decided that we should not appeal.

2. Abolition of Apportionment

Sir Emmanuel proposes that "in due course" the apportionment of close company income should be abolished. Other parties have also put forward this idea - which as

HUFFER TO FST 9 DEC

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PS Chancellor
PS Chief Secretary
PS Economic Secretary
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Ms Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr McGivern
Mr M L Gordon
Mr Reed
Mr Huffer
PS/IR

you know is a Starter for the 1989 Finance Bill (the proposal is to do away with the present rules, but to replace them with a special (and simpler) tax regime for close investment companies).

3. Charitable Covenants

Sir Emmanuel says that charitable giving by trading companies "has recently been put in a worse position". This remark is rather puzzling. He is presumably referring to the changes - in the Finance (No2) Act 1987 - which removed the Inspector's discretion to apportion payments under charitable covenants. However, as he acknowledged in a letter to you at the time, the removal (under the Finance Act 1986) of the limit on higher rate relief means that there will now only be apportionment of charitable covenants in very exceptional circumstances. It will only happen where the charity itself is denied tax relief - broadly where it is not applying its funds for charitable purposes.

4. Sir Emmanuel goes on to express concern - assuming this Government abolishes apportionment at some stage - that a future Government might wish to introduce it, perhaps with a limit on the deductibility of charitable covenants. He thinks the resurrected version would simply follow the repealed rules. So he suggests that the Inspector's discretion to apportion these payments should be reinstated - that is, before abolition - so that parity between close companies and others could be taken into account as in Lansing Bagnall.

5. As I have explained, there is no longer any apportionment of covenanted payments to genuine charities. And under the proposals for simplification the apportionment of covenants by trading companies would not have to be considered at all. But, regardless of the outcome of the review, we would see the reintroduction of a power of

discretion - in whatever circumstances - as a return to difficulty and uncertainty both for the Inland Revenue and for taxpayers. These problems were amply demonstrated in the Lansing Bagnall case. Apart from all this, it seems inappropriate to legislate on the basis of dubious assumptions about possible actions of future Governments.

6. I attach a draft reply.

DJ. Huffer

D J HUFFER

DRAFT REPLY

Sir Emmanuel Kaye
Lansing Bagnall Ltd
Kingsclere Road
BASINGSTOKE
Hampshire
RG21 2XJ

You wrote to me on 14 October with your ideas on the future of the apportionment rules. I am sorry about the delay in replying. You propose that in due course the apportionment of close company income should be abolished. Following the wider tax changes in the Finance Act 1988 we are reviewing various provisions, including the apportionment rules, but you will understand that I can say nothing more at this stage.

You say that charitable giving - even by trading companies - has recently been put in a worse position. I take it you have in mind the changes, in the Finance (No2) Act 1987, which removed the Inspector's discretion to apportion certain payments. However, as you are aware, the removal (under the Finance Act 1986) of the limit on higher rate relief means that there will now only be apportionment of charitable covenants in very exeptional circumstances. It will only happen where the charity itself is denied tax relief - broadly where it is not applying its funds for charitable purposes. I hope this eases your worries on this point.

But you are also concerned that if this Government were to abolish apportionment at some stage, a future Government might wish to introduce it, perhaps with a limit on the deductibility of charitable covenants. In particular, you fear that the resurrected version would simply follow the repealed rules and to anticipate this you propose that the Inspector's discretion to apportion these payments should be reinstated - before abolition - so that parity between close companies and others could be taken into account as in the Lansing Bagnall case.

I know how strongly you feel about the importance of charitable giving by companies. The Government share your views that this should be encouraged and indeed have actively promoted it. But I do not think it would be appropriate to legislate now with the intention of affecting the possible actions of a future Government. Moreover, if a Government were minded to act as you suggest, I very much doubt that they would be influenced greatly by the nature and scope of the repealed legislation.

CONFIDENTIAL

**Inland Revenue**

Business Tax Division
Somerset House

FROM: J H REED
DATE: 9 DECEMBER 1988

1. MR McGIVERN  9/12 · Note at end.

2. FINANCIAL SECRETARY

STARTER 206: CLOSE COMPANY LEGISLATION

1. In discussion of this starter you said that you were worried about the potential cost. You were not convinced that the simplification would be worthwhile if it involved a significant loss of tax.

2. I said that this pointed towards imposing a 40 per cent rate of CT on close investment companies. You were concerned about the effect of this on companies which distributed their income as dividends and, generally, on property companies. I said I would send you a further note, which would look at the possibility of an exclusion for close investment companies which distributed the great bulk of their profits.

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cc PPS
PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Ms Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Corlett
Mr McGivern
Mr Deacon
Mr Johns
Mr Bush
Mr Cleave
Mr Campbell
Mr Davenport
Mr Gordon
Mr Stewart
Mr Eason
Mr Fitzpatrick
Mr Mace
Mr Cayley
Mr Reed
Mr Golding
Mr Huffer
PS/IR

REED TO FST 9 DEC

## Exclusion for distributing companies

3. What we propose is that a close investment company which distributed at least, say, 85 per cent of its profits would be liable to CT at the normal rates. So, for example, if its profits did not exceed £100,000 it would be liable at the small companies rate of 25 per cent. This would mean that an individual who made his investments through such a company would be no worse off than if he had invested directly.

4. There are precedents for this kind of test. For example, in order to be treated as an investment trust (and so be exempt from tax on its capital gains) a company cannot retain more than 15 per cent of its income. And an offshore fund is treated as a 'distributing fund' (so that its investors are not liable to income tax on a disposal of an interest in the fund) if it distributes at least 85 per cent of its income.

5. The test would also be broadly consistent with the possible radical reform of the income tax regime for resident trusts (Mr Golding's note to you of 25 November). Under that, there would be no tax on income in the hands of the trustees provided that they distributed it to beneficiaries before a specified cut-off date after the end of each year of assessment.

## Details of the test

6. The test would start with the company's taxable profits (ie, income and capital gains) for an accounting period. And for this purpose a company's dividend income would be treated as part of its profits. Provided that the company's dividends (and any other distributions) in the period amounted to at least 85 per cent of its profits the company would not be subject to the special 40 per cent CT rate. To allow for a reasonable delay in the payment of dividends, a company would be able for the purposes of the test to treat any dividends paid in the period of, say, six months following the accounting period as having been paid in the period.

7. Where there was a group of investment companies, the test would look at the profits of the group as a whole and the dividends paid by group members to outside shareholders. If the test were passed, none of the companies would be liable to the special rate of CT. If the test were failed, all the companies would be liable to the special rate.

8. The main reason the proposed test is based on taxable profits, rather than commercial profits, is that the purpose of the test is to establish which rate of CT should apply to the taxable profits.

Property companies

9. Under the existing apportionment provisions, a company's income is not apportioned to its shareholders if the income is required for the purposes of its business. In the case of a trading company, allowable requirements include money to be spent on expanding the business. But for a property company, money to be spent on buying, building or extending property is not regarded for this purpose as being required for the purposes of the business. So income spent in this way can nevertheless be apportioned to the shareholders.

10. We think that this difference between trading companies and property companies points towards treating the latter as close investment companies. This would mean that income spent on maintaining the properties, which would be deductible in computing the company's income, would not be subject to the special rate of CT (just as, at present, it is not apportioned). But income spent on expanding the business, which would not normally be tax-deductible, would be liable to the special rate of CT (just as it is currently subject to

apportionment). By contrast, treating property companies in the same way as trading companies would mean that property companies would be able to reinvest all their income and capital gains in acquiring property and still benefit from the small companies rate of CT.

11. Treating property companies as investment companies would not leave them worse off than individuals holding property. All they would have to do to avoid any risk of this would be to distribute their income and capital gains. If they needed more money for expansion, or capital improvements on their properties, this could be provided by the shareholders, either as loans or as new equity.

Existing companies

12. This approach of exempting distributing companies from the special rate of CT would also help existing investment companies. Under the proposals in my previous note, there would have been some double taxation of their non-dividend income and capital gains if they had distributed these. And if they had retained them the shareholders would have been liable to CGT on the resulting gains if and when they sold the shares.

13. In principle, the shareholders could have avoided this by winding-up the company and investing the proceeds themselves. But they would be reluctant to do this if this triggered an accrued capital gain on the investments held by the company.

14. But under the new proposal, all they would have to do is to distribute at least 85 per cent of their income and capital gains and the shareholders would be no worse off than they are at present, or than they would be if they held the investments directly.

Cost

15. The only advantage of a close investment company under the new proposal would be the ability to retain 15 per cent of the income or capital gains and pay only 25 per cent CT on this. If the rest of the income and capital gains is liable to higher-rate tax in the hands of the shareholder, the overall average tax rate would be 37.75 per cent. By comparison, under the previous proposal, the average tax rate would be 35 per cent if the special rate of CT were 35 per cent and the company retained all its income and capital gains. The new proposal therefore reduces the potential tax saving by over a half, from 5 per cent to 2.25 per cent. At this reduced level we do not believe that forming a close company would generally be an attractive option.

16. It might still be attractive for someone with investment income of £50,000 or more. If £50,000 of investment income accrues to a company and it distributes all but 15 per cent of it, the tax saving would be £1,250 a year. If everyone with an investment income of over £50,000 transferred this to a company the tax cost (treating individuals separately, as under Independent Taxation) would be £55 million a year (this figure is based on forecast levels of investment income in 1989-90, which are considerably higher than those underlying my previous note which was based on forecast levels for 1988-89).

17. Clearly, this is an extreme assumption. Firstly, about half of the income takes the form of dividends. The underlying shares will typically have an accrued capital gains and this would be realised, and CGT would be payable, if the shares were transferred to a company. This would deter people from doing this.

18. Secondly, about a quarter of the income comes from bank or building society accounts which are liable to composite rate tax if the interest is paid to an individual. But if it is paid to a company, it is charged at CT rates - composite

rate tax does not apply. This means that more tax is payable, since the composite rate is less than the basic rate. For example, for 1989-90 the composite rate will be 21.75 per cent, which is 3.25 per cent lower than the current basic rate. This tax penalty would deter people from switching bank and building society accounts to a company. Combining this with the disincentive to the transfer of shares, three-quarters of the current investment income is likely not to be transferred to a company - except perhaps gradually over a long time. So the potential tax cost might drop to £10-15 million.

19. Thirdly, it is clearly unrealistic to assume that even the remaining income would all be transferred to a close investment company. While there would be a timing advantage in retaining 15 per cent of the income in a company, where it would be subject to the small companies rate, this is likely to be clawed-back when the individual eventually takes the money out of the company (when higher-rate income tax would be payable), or sells the shares in the company (when CGT may be payable).

20. Our conclusion is that the cost of the proposed change would therefore be very small. The real risk would be the political one that the Government would be criticised for giving another hand-out to the wealthy. As the figures show, there would be no real substance in this charge, but you might find it difficult to explain why this is so.

21. You could of course make a close investment company still less attractive by requiring a company to distribute more than 85 per cent of its profits in order to qualify as a distributing company. A figure of 90 or 95 per cent could be justified on the basis that the running expenses of the company should be small since the investment decisions are likely to be taken by the shareholders, rather than by paid employees in the case of investment trusts or offshore funds. The main point of choosing a figure higher than 85 per cent would be to attempt to head off any criticism of the change.

Other changes

22. If you were to adopt this proposal we would see no need for a provision deducting dividends paid by the company from dividends received by it when applying the special rate of CT to the company profits (paragraphs 34 to 40 of my earlier note). This would be a useful simplification of our earlier proposals. The only companies which would be worse off as a result would be those which distributed some of their profits but not as much as 85 per cent. Since a close investment company is controlled by its shareholders it would be easy for them to avoid this.

23. Since dividends paid by the company would not be deducted from dividends received there would not be the same problem of dividends being diverted to shareholders who were exempt from tax or liable only at the basic rate (paragraphs 55 to 66 of my earlier note). However, we would instead wish to disregard such diverted dividends when calculating whether a company had distributed 85 per cent of its profits. So the rules would need to be much the same. As I said in my previous note, if you decide to go ahead with this starter we shall send you a further note about how best to prevent the diversion of dividends.

Conclusion

24. If the new proposal were adopted the legislation for close investment companies would be as follows.

X i. A close investment which distributed at least 85 per cent (or possibly 90/95 per cent) of its profits (income plus capital gains) would be liable to CT in the normal way.

ii. A close investment company which did not fall within (i) would pay CT at 40 per cent, including on its dividend income (although the tax credit attaching to the dividend would reduce the tax rate on dividends to 15 per cent).

iii. In applying the 85 per cent test, no account would be taken of dividends artificially diverted to basic-rate taxpayers or those with unused tax allowances.

iv. A close investment company, whether or not it distributed at least 85 per cent of its profits, would get no tax deduction for interest or annual payments, or for its management expenses, except to the extent that these would be deductible if made by an individual.

25. We would still expect this legislation to take under 5 pages and we still believe that it would be a real simplification.

I agree
ChG.

J H REED

Financial Secretary.

I believe the distribution test plus a 40% tax rate for retentions – together with the existing disincentives identified in paras 17 to 19 – would effectively deter the use of close investment companies to shelter income. The distribution rule would also remove some rougher edges in the original proposals; and it provides a neat let out for existing companies which wish to ~~and~~ avoid a 40% tax charge. But you might like to consider starting with, say, a 90% test which would reduce the cost even further and would give you room to manoeuvre in Committee.

Although we cannot say there would be no cost, given the above deterrents I would expect that actual costs would in practice be much less than the amounts suggested. They would in any event be negligible in the first couple of years.

ChG
9/12

chex.ps/aa/57 **CONFIDENTIAL**

FROM: A C S ALLAN

DATE: 12 December 1988

MR J H REED - IR

cc PS/Financial Secretary
Mr Culpin
Mr Gilhooly
Mrs Chaplin

Mr McGiven - IR
PS/IR

**STARTER 206: CLOSE COMPANY LEGISLATION**

The Chancellor would be grateful for advise on what the cost would be of scrapping close company apportionment and substituting a 35 per cent corporation tax rate for close investment companies (ie instead of 40 per cent).

ACSA

A C S ALLAN

FST

Ch

Some other papers below (I'm told the answer to this is perhaps £50m)

What wd it be in years ① & ②?

Thanks: I will discuss with FST. I am sure that this starter is a worthwhile simplification. The question is whether we go for CT @ 35% or 40% (tho' there is the question of ...)

ACSA TO REED 12 DEC

chex.ps/aa/57 CONFIDENTIAL

FROM: A C S ALLAN

DATE: 12 December 1988

MR J H REED - IR

cc PS/Financial Secretary
Mr Culpin
Mr Gilhooly
Mrs Chaplin

Mr McGivern - IR
PS/IR

**STARTER 206: CLOSE COMPANY LEGISLATION**

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ACSA

A C S ALLAN

ACSA TO REED 12 DEC

FST

Ch

Some other papers below (I'm told the answer to this is perhaps £50m)

What would it cost in years ① & ②?

Thanks. I will discuss with FST. I am satisfied the starter is a worthwhile change. Supplementary: the question is whether we go for CT @ 35% or 40% (tho' there is no question of ... OK)

AA

Robert 1.09.12.88

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY

DATE: 9 December 1988

CHANCELLOR

cc
PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr McGivern )
Mr Reed ) IR
Ms St Quinton )

PS/IR

I agree that we shd hold out on the ways discussed here. But we shd look at proposal re @ raising the limit for the 1988 share option scheme.

Ch/ Agree FST (i.e. against doing anything)?

12/12

**STARTER 203: ENTREPRENEURS SCHEME**

The British Venture Capital Association have put forward a proposal for a tax concession, modelled on the BES scheme, whereby managers investing up to £120,000 in the equity of either a new business which they start, or an unquoted company which they join, should be exempted from CGT on the eventual disposal of the shares. The aim would be to induce high quality managers to move from large firms (where the lock-in incentives of occupational pension schemes may be quite large) to small ones, and so address what the BVCA perceive to be the biggest problem in the venture capital industry at the moment, namely a dearth of high quality managers.

I have seen the BVCA and discussed their proposal with them. My feeling is that a change of this sort would look somewhat odd following the alignment of income tax and CGT in last year's Budget. It would be an admission that we hadn't got it quite right. Moreover, surely an intended consequence of those reforms was that an individual became indifferent as to whether he was remunerated in income or capital? The BVCA's proposal puts a greater emphasis on capital.

The legislation would need to be closely targeted in order to minimise deadweight and to prevent people investing in property and asset backed situtations as in BES. This means that it would inevitably be complex; though many of the provisions could be "borrowed" from the existing BES legislation. Andrew Tyrie has suggested a variant which builds on the CGT retirement relief. But this would have even greater deadweight, and yet still require complex legislation.

I am also not convinced that the venture capital industry is suffering at the moment; indeed, the stock market crash many actually have helped it in some ways. But it is true that a lot of the funds available are going into MBOs, and not into seedcorn businesses. However, a relief attempting to change the culture underlying this would be difficult to target. It is a matter of judgement whether you wish to give the industry a helping hand just now. But on balance I am against.

R.C.M.S.

pp NORMAN LAMONT

CONFIDENTIAL

B.F. 15/12

**Inland Revenue**

Business Tax Division
Somerset House

FROM: J H REED
DATE: 13 DECEMBER 1988

1. MR McGIVERN  Note at end. 13/12.

2. CHANCELLOR

Ch This answers the question in Alex's note - and the flare up in the middle of today. FST is going to have a meeting on this tomorrow, and will then minute you himself. Leave your talk until then?

REED TO CX 13 DEC

**STARTER 206: CLOSE COMPANY LEGISLATION**

Your private secretary's note of 12 December asked for advice on the cost of scrapping close company apportionment and substituting a 35 per cent corporation tax rate for close investment companies (instead of the 40 per cent rate which was costed in my note of 9 December to the Financial Secretary).

2. These costings are difficult because we have to guess at the behavioural effects. The proposal in my note of 9 December was that a company would not be subject to the special rate of CT (40 per cent) if it distributed at least 85 per cent of its profits (we also raised the possibility of a higher distribution requirement - such as 90 or 95 per cent). This meant that there could be a tax advantage only to the extent that profits were retained. We thought that this regime would effectively deter the use of close investment companies to shelter income, and so the cost would be small.

cc Financial Secretary
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Corlett
Mr McGivern
Mr Deacon
Mr Johns
Mr Bush
Mr Campbell
Mr Eason
Mr Fitzpatrick
Mr Mace
Mr Cayley
Mr Reed
PS/IR

3. With a 35 per cent rate of CT there would be a much bigger incentive to retain profits. The maximum tax advantage would now be gained by retaining all of the company's profits, instead of only 15 per cent of them.

4. The costing in my note of 9 December took as its starting point the assumption that an investor would consider setting up a close investment company if at least £50,000 of investment income could be transferred to a close investment company, but would not if less could be transferred. The tax saving on a transfer of £50,000 of investment income would be £1,125 a year (wrongly shown as £1,250).

5. Here the tax saving would be 5 per cent (40 per cent - 35 per cent), so to get a tax saving of £1,125 a year, the amount of investment income which would have to be transferred to a company would be £22,500. If we then proceed with the costing on the same basis as the one for a 40 per cent rate, the cost if everyone with an investment income of more than £22,500 transferred it to a close investment company would be about £300 million a year. I explained in my earlier note that a CGT charge would be likely to arise if shares were transferred to a close investment company and we thought that this charge would deter people from making such a transfer (although, of course, not all shares will be showing a real gain). Similarly, since bank and building society accounts held by a company did not obtain the benefit of tax at the composite rate (instead of the basic rate) it was unlikely that many people would choose to hold such accounts through a close investment company.

6. And, as I said before, it is clearly unrealistic to assume that even the remaining income would all be transferred to a close investment company. While there would be a temporary advantage from the 5 per cent tax saving, this would be likely to be more than clawed-back when the individual took the money out of the company (when higher-rate income tax would be payable), or sold the shares in the company (when CGT might be payable). So in practice it would be likely to appeal only to a family which intended to make a long-term

investment, or where someone intended to avoid a CGT charge (eg by holding the shares until he died, or until he had become non-resident). And even if he avoided the CGT charge, there would still be an accrued capital gain on the investments which a prospective purchaser would take into account.

7. It is difficult to produce a reliable costing taking all these factors into account. It seems likely that the cost could still be significant - perhaps up to £100 million a year. This cost would take a few years to build up, and we expect that the first year cost would be negligible.

J H REED

For the reasons which Mr Reed sets out above, it is exceedingly difficult to judge possible behavioural changes if apportionment were abolished and the new (simpler) regime substituted. With a 35 per cent rate, some very wealthy taxpayers must be expected to use a close company to shelter large amounts of investment income. But there are clearly disincentives to doing so, including possible CGT charges on transfer into the company and on disposal of shares. The cost would not be negligible but I would expect it to be in the lower end of the range of up to £100 million.

E McGIVERN

Robert 3.13.12.88

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

For overview meeting 16/1

FROM: FINANCIAL SECRETARY

DATE: 14 December 1988

CHANCELLOR

cc Chief Secretary
Economic Secretary
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Riley
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr McGivern (IR)
Mr Reed (IR)
PS/IR

Ch./ FST suggests you may like a meeting with officials. A word with him in the first instance, as you originally suggested - in the margins of Prayers?

14/12

FST TO CX 14 DEC

**STARTER 206: CLOSE COMPANY LEGISLATION**

As you know, I have been looking at the tax legislation with a view to simplifying certain areas following the reductions in income tax rates and the alignment of income tax and CGT. A number of possibilities have been put forward as candidates by both the Revenue and outside commentators (notably Philip Hardman), and the close company legislation appears to be the most promising of these. But as with all "simplification" measures, it is not quite so simple as at first sight.

The problem with removing all of the existing legislation is that it would give taxpayers a very strong incentive to shelter income by exploiting the difference between the 25% small companies rate for corporation tax and the 40% higher rate of income tax, with a consequential loss of yield. The Revenue have therefore been working up replacement proposals designed to bite specifically on investment companies which are not part of a trading group. You will recall from my earlier minute that I said I would only proceed if these new rules really were much simpler than the legislation they will replace. Having discussed Mr McGivern's and Mr Reed's minutes of 16 November and 9 December with officials, I believe they would be. Nineteen pages of legislation and 200 of departmental instructions would be replaced by less than 5 of legislation and a substantially reduced internal system of guidance.

I was initially attracted by the Revenue's proposal to tax these close investment companies at either the corporation tax rate (35%) or the higher rate of income tax (40%). Close companies are inevitable; but I see no reason for close investment companies other than as a mechanism to shelter investments which would otherwise be held directly and taxed at personal tax rates. Raising the tax rate for this type of company might well have been viewed by some as harsh. But Emmanuel Kaye has rather surprisingly suggested this approach to Tony Battishill.

However, both of these options have drawbacks. A 40% rate would completely eliminate any incentive to hold investments in a close investment company, and would (under the original proposed rule for taxing the excess of dividends received less paid out) leave nobody worse off if all dividends were distributed quickly. But it would also leave the effective tax rate at 52% for non-dividend income and capital gains. And presentationally, it would of course be higher than the tax rate for the biggest multinational.

Reducing it to 35% means that the rate is aligned with the corporation tax rate for companies generally. But in doing so, it exposes a gap between that rate and the 40% higher rate of income tax. On the worst possible assumptions, the loss of yield from exploiting this gap could theoretically be of the order of £300m. This would only happen if everybody took advantage of this opportunity to shelter all their investment income. In practice of course, not everybody would; yet the loss of yield might still be substantial. The Revenue's current estimate is that the longer-term cost would be £50m a year. You also asked what would be the cost for Years 1 and 2. The Revenue estimate it as negligible and £25m respectively.

I therefore asked officials to see if another solution could be found. Their new proposal is that close investment companies would continue to be taxed as a normal company (at either 35% or 25% if it were small) only if they distributed at least 85% per cent of their taxable income and capital gains within (say) 6 months of the end of the accounting period; otherwise they would be taxed at a penal 40% rate. This option builds on the present distribution rules for investment trusts, and means that the minimum average tax rate in a close investment company for a higher-rate taxpayer would be 37.75%. This still leaves a potential window for tax avoidance of 2.25%. But as Mr Reed points out, this would only be attractive for very wealthy individuals, and might well not be exploited on a large scale. The risk of a loss of yield to the Exchequer would therefore be very small. And it would of course be open to us to reduce that risk even further by increasing the percentage payout above 85%.

However, I am concerned that requiring a property company to distribute 85% of its income could be harsh where (for example) a company had to retain profits in order to pay for future major repairs. I would therefore propose a lower percentage requirement (say 70%) for all "property companies".

I am inclined to agree with officials that we should go ahead with this starter. The change would represent a major simplification to the legislation at little cost to the Exchequer. But it is a very complex subject and you might like a meeting to discuss it.

R.C.M.S.

pp **NORMAN LAMONT**

CONFIDENTIAL

**Inland Revenue**

Compliance and
Collection Division
Somerset House

FROM: J H ROBERTS
14 December 1988

FINANCIAL SECRETARY

SUBCONTRACTOR TAX SCHEME - FEASIBILITY STUDY ON ABOLISHING VOUCHERS

1. As required in the Action Plan for this efficiency scrutiny that you recently approved we have made a study of the prospects of further reducing subcontractor vouchers. Mr Sullivan's note attached reports on the details of the study. The next step is for us to draw up a consultative paper for the industry on the possible changes following the scrutiny and for this purpose we need to have your views, in the light of this study, on whether or not this question of abolition should be included in the consultations.

---

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Mr Hoare
Miss Hay
Mrs Chaplin
Mr Tyrie

Mr Beighton
Mr Cherry
Mr Muir
Miss James
Mr Martin
Mr Willis
Mr Eastman
Mr Norris
Mr Webber
Mr Davison
Mr Phillips
Mr Sullivan
Mr Dunbar
PS/IR
Mr Roberts

2. The first part of the report describes the working of the system at present and the role of vouchers both as safeguards to the subcontractors and as an aid to the Revenue in the checking of misuse. It confirms the deficiencies of the system as identified by the scrutineer, but also his view that abolition of vouchers without tightening up the exemption scheme would be most unwise.

3. The report then goes on (paras 21-29) to identify the requirements that a replacement scheme would have to meet - ranging from the detection and tracing of certificate abuse to the burden on industry and the staff costs of administration for the Revenue. It considers in detail some alternatives based on contractors' returns, trade invoices and restriction of exemption to payments into nominated business bank accounts - and how these would measure up to the criteria (paras 45-46).

4. What emerges from all this is the difficulty - as the scrutineer also found - of finding a balance between the needs of deregulation on the one hand and of control over an important but specialised type of tax fraud on the other.

5. Each of the alternatives poses a number of questions which would have to be studied further and answered before it could confidently be put forward as a viable scheme. But the general conclusions which emerge from the study are that

- there are unlikely to be sizeable further Revenue staff savings from any of them

- if our present ability to deter fraud by prosecution is to be retained, abolition of vouchers means a new requirement for trade vouchers, which would probably be <u>more</u> burdensome for many in the industry

- major deregulation gains might come only from a regime in which both vouchers and checks on certificates were to go and there were no new invoicing requirements. But all payments gross would have to be made between business bank accounts and not in cash.

6. A system of this sort where cash payments must be made under deduction of tax would have advantages in controlling what is now widely a cash trade. It could also be relevant to suggestions from Northern Ireland of putting subcontractors more widely under deduction. But we can already see types of misuse where the new system would be no more effective than the present one - and more difficult to detect.

7. The recent PES settlement takes account of staff savings from cutting the flow of vouchers by regulations effective from April 1990. These follow from the scrutineer's proposals. We assume that you will not wish to reopen that settlement. This means effectively that the options are

- to defer further study on voucher abolition to the longer term when with revised certificate eligibility rules having led to a more reliable certificated population it became safer to reduce the special burdens on those entrusted with exemption certificates; or

- to link further study with work on the eligibility rules to allow for possible trade-offs between areas where at least some in the industry (and in Whitehall) may press you to justify the scheme's special requirements

but in either case to continue working up the scrutineer's proposals for reduction in voucher flow for enactment next year.

8. The second option would mean a two stage consultative process with the second phase next summer linking voucher abolition with tightening of the certificate eligibility rules. It would also mean two sets of disruption for our staff and for the industry.

9. We should be glad to know whether you wish to pursue the two stage consultative process or whether you feel that retaining the

existing control over subcontractor fraud points against further work at this stage on abolishing vouchers leaving the consultation to cover only the issues in next year's package of primary and secondary legislation.

JHR.

J H ROBERTS

CONFIDENTIAL

**Inland Revenue**

Compliance and
Collection Division
Somerset House

FROM: C D SULLIVAN

DATE: 8 DECEMBER 1988

FINANCIAL SECRETARY

SUBCONTRACTOR TAX SCHEME - INITIAL REPORT OF FEASIBILITY STUDY ON ABOLISHING VOUCHERS

1. Recommendation 7.7 of the Subcontractor Scheme Efficiency Scrutiny recommended "a feasibility study should be mounted into the replacement by vouchers with better pursuit and scrutiny of end year documents or by a quarterly return". The Action Plan described this as "a central issue which will need initial consideration before pursuing changes in legislation covering vouchers and their submission". A working party comprising interested Inland Revenue divisions "should:-

- review the purpose and use made of form 715 (the vouchers) within the Revenue

- consider whether the 715 system could be abolished, amended or replaced by an alternative checking system which would be less costly to the Revenue and the Industry

- take account of the present costs and benefits of the present system and any alternative system and to make recommendations by 9 December 1988 on whether further change is practicable before revised eligibility rules provide a more compliant certificated population."

Present exemption scheme

2. Under the present scheme, holders of 714I, P and S exemption certificates are issued with voucher books. Such holders amount to over 90% of the certificated population. Larger companies are issued with 714C certificates, which need no supporting vouchers. When a contractor makes a payment to a holder of a 714I, P or S certificate, he should ensure that the payee is the proper holder of a valid exemption certificate. He should also make every effort to obtain a "715" voucher. The voucher is preprinted with the subcontractor's name and the voucher number. The subcontractor should fill in his certificate number, his business address, the name of the contractor and the gross payment; and date and sign the voucher before handing it to the contractor.

3. The contractor should then, every week, forward all vouchers he has collected, together with a form identifying him (form 739), to the Inland Revenue's Liverpool computer centre (LCS). The contractor must also record the name and address of the subcontractor; the amount of the payment; the certificate number; and the certificate's expiry date. At the end of each tax year, he must send in a form showing the name and certificate number of every subcontractor to whom he has made gross payments; and the total of the payments made to that subcontractor.

4. LCS key in information from vouchers received each week. This processing can throw up errors in the completion of the vouchers. The end-year return is also keyed in. This allows a check on whether the figures match the total of all the vouchers submitted. LCS can list all the vouchers rendered by a subcontractor irrespective of the recipient contractor; and all the vouchers submitted by a contractor, irrespective of the subcontractor handing them over.

Safeguards provided by the voucher scheme

5. Unless signed in the presence of the contractor, the voucher itself adds little to the identification of the subcontractor provided by the certificate. But it is an official receipt for payment that is hard to forge by comparison with ordinary business invoices. It is a written requirement in what in practice is often a cash trade. Indeed, subcontractors may have little else by way of business records. The existence of this Revenue-provided prime record encourages some discipline in those least able or inclined to keep their own records: and discourages them from falsifying their accounts. Vouchers form part of the link in establishing whether transactions were in accordance with the scheme: or were open to civil or criminal penalties.

6. The requirement to submit vouchers quickly allows the Revenue to detect patterns of misuse (such as continuing use of documents reported stolen) much more quickly than relying on the end-year returns which is important in a trade when the workforce is often itinerant. Perhaps surprisingly, dishonest contractors do submit misused vouchers, sometimes quite promptly. The requirement for the subcontractor to give a voucher showing the amounts received is a disincentive to the contractor inflating his labour input without the subcontractor's connivance. (Inflating inputs, whether labour or otherwise, reduces a contractor's declared taxable profits: and so saves him money at his marginal rate of tax, or tax plus national insurance contributions, on alternative routes of cash extraction.) If the end-year return is different from the vouchered amount, the blame is fairly clearly the contractor's. So the voucher provides a safeguard to the subcontractor.

Deficiencies in these safeguards

7. The Scrutineer has confirmed deficiencies in the safeguards that vouchers were supposed to provide.

8. There are limits to the effectiveness of vouchers in deterring inflation of labour inputs by contractors. Contractors can inflate other inputs or inputs of uncertificated labour. If prudent, they will also understate sales, to keep their gross profit ratio up. As with other trades, the only attack on those evasion routes is accounts investigation and PAYE Audit of a small percentage of traders.

9. The ability of LCS to provide totals and details of the work done by a subcontractor, or the labour inputs of a contractor, should in principle be a very valuable tool in tax district accounts investigations. However, LCS can only provide breakdowns by tax year, and not by reference to the firm's accounting period which will often be different. Also business accounts will show credits and debits as they have accrued, rather than as they are paid. So in fact it is usually very difficult to reconcile a trader's business accounts with LCS printouts even where there is nothing amiss. Virtually no use is made of this information source in accounts investigations.

10. Prompt identification of misuse depends on prompt submission of vouchers to the Revenue as well as conscientious checking by the contractor of the subcontractor's documents. In practice, no action is taken to pursue firms that have stopped sending in vouchers, or are late with their end-year returns. One would expect (and there is some evidence to support this) that delays are particularly likely to occur where the contractor is falsifying his labour inputs. Even where vouchers and returns are submitted the aggregate amounts from the two sources may not agree; though the explanation where the discrepancy is investigated may be simple clerical error.

11. Of the errors on vouchers that are detected promptly, virtually all are mere careless error. People out to commit fraud generally ensure their paperwork contains no obvious slips.

12. The subcontractor scheme documentation has proven very effective at aiding prosecutions. Subcontractor prosecutions far exceed those for all other trades. Hitherto, the majority of prosecutions have been of subcontractors who have sold their documents rather than of the contractors who buy them in. Increasingly, investigation resources are being devoted to these contractors and to dealers in misused documents. But the scheme documentation cannot of itself demonstrate criminal intent by contractors to defraud the Revenue. So, where we can show that the contractor did not take due care, we commonly settle for payment by the contractor of just the tax (and, under new legislation, the interest) that should have been deducted from the alleged payment to the subcontractor who had misused his documents, without further penalty. In some cases, this will still leave the contractor in pocket despite detection. And in practice, when a suspect contractor knows he faces a big tax bill, we often have difficulty in actually collecting this tax.

13. Around 6.5 million vouchers a year are submitted. There are a further 720,000 forms 739 and 380,000 end-year returns. Handling this amount of paper is a substantial task for the industry and the Revenue.

## The Scrutineer's proposals

14. The Scrutineer proposed reducing the occasions on which vouchers must be provided. Subject to consultations with the industry and other Government departments, and subject to this feasibility study, his recommendations are accepted in the Action Plan and by Ministers. He envisaged his changes would reduce the flow of vouchers by around 3 million a year and would appreciably reduce the flow of other forms. Such a reduction would, he estimated, save around 85 staff. It is therefore a key element in the staff savings arising from the scrutiny.

15. These savings are mainly achieved by dropping the principle of one voucher for every payment. Subcontractors would be allowed to aggregate small payments. So they would have less paperwork to complete: but contractors would be at risk of having to find deductions if the aggregation limits were carelessly exceeded. Further, some contractors may already in practice (and improperly) be aggregating their payments. So it may not be straightforward to achieve the full paperwork reductions and staff savings envisaged.

16. These aggregation rules would make it much more difficult to prove criminal offences involving multiple payments of less than £2500 per voucher. However, frauds tend to involve relatively large amounts per voucher: the scrutineer's upper limit on amounts per voucher is intended to provide some new protection here.

17. With less paperwork, there is in principle the potential to check up on late vouchers and returns more readily. However, that would require new resources.

18. The scrutineer also proposed a number of studies of improving abuse detection through the voucher system. There are limits to what this can achieve in detecting document misuse: and it can do nothing about other routes of cash extraction in the construction industry.

19. Many in the industry accept the need for a special regime for the construction industry. Nevertheless, in their representations to the scrutineer, the industry's Joint Taxation Committee said "the voucher system should be abolished unless the Revenue can make a convincing case for its retention". More recently, the Federation of Master Builders said "The question is not whether we should be tarting up the system, but whether we should have it at all." Given the Government's commitment to deregulation and the identified continuing limitations of the scheme, it is right to take such industry comments very seriously.

20. The Scrutineer felt that to go further in reducing vouchers was unwise before his new eligibility rules led to a smaller but more compliant certificated population. We agree that abolishing the voucher requirements at this stage without compensating tightening of the exemption scheme is unwise. The rest of this submission considers what could be achieved by abolishing vouchers coupled with some tightening; and whether this is likely to be worthwhile.

Requirements for a replacement for vouchers

21. The present scheme is intended to hit a number of targets. It is intended to discourage contractors from inflating their labour inputs and so reducing their taxable profits. It is intended to discourage subcontractors from selling false invoices. It is intended to discourage cash in hand, black economy, payments to subcontractors (though the deduction part of the scheme is paramount in this). And it is intended (through the certificate eligibility rules rather than through vouchers) to tax at source subcontractors unlikely to meet their eventual Schedule D liabilities. We think any replacement for vouchers must adequately hit those targets. It must also meet a number of other requirements.

22. First, it must allow the possibility of fairly prompt detection of misused certificates. This is in part a matter of deterrence. Provided the Revenue is known to take some compliance action, a regime which allows detection in a matter of weeks must be a more effective deterrent than one which cannot detect misuse for a year or more. It is very hard to quantify the strength of this argument. But, at least currently, we feel it unsafe to rely on end-year returns. We therefore rule out this part of the Scrutineer's recommendation, at least with the present certificated workforce.

23. Second, the replacement must allow the establishment of a trail, for audit or prosecution purposes. The latter is without prejudice to the recommended medium-term review of

the Revenue's prosecution policy. Whether or not the present level of prosecutions of subcontractors is maintained, we think the history of evasion in the construction industry is such that the regime should provide better evidence on which to base prosecutions than is available for other trades.

24. Third, the regime should preferably be simpler or less burdensome for the industry to operate than either the present or the prospective voucher scheme.

25. Fourth, the regime should, for a given level of security, need less staff than required under the Scrutineer's recommendations; or offer greater security for the same number of staff.

26. Fifth, to allow relatively early introduction and to reduce costs especially of computerisation, the regime should be as compatible as possible with existing administrative procedures.

27. Sixth, the regime should be capable of being presented, especially in the light of Northern Ireland concerns, as dealing better with areas of abuse.

28. Seventh, there are negligible controls on moderate degrees of falsification of non-labour inputs or suppression of takings in the construction industry and other trades. Even the subcontractor deduction scheme (as opposed to the exemption scheme) has little control over any contractor whose marginal tax and NIC rate is higher than the deduction rate who is cautious enough to pay the deduction and pocket just the surplus. There seems limited merit in putting Inland Revenue resources, and burdens on industry, to deal with one known problem where there may be larger problems going under-checked.

29. Not all these requirements can be wholly met simultaneously. In particular, there is a tension between the sort of leakproof system hoped for in the paramilitary

finance context and the deregulation/staffing requirements. So judgement is necessary on where the balance should be struck.

An alternative regime

30. We do not see much attraction in reducing the circumstances in which vouchers are required further than the Scrutineer's recommendations. Increasing the £2500 aggregation limit, or taking small payments out of the voucher system completely, seems to us risky with the present subcontractor population. And any rule stipulating when vouchers are due must be simple and unambiguous. Otherwise the industry will keep sending in vouchers rather than risk being penalised for getting things wrong. Nor do we think that at present we can extend 714C certificates (which need no supporting vouchers) more widely. The scrutineer recognised increasing concern amongst investigators that 714C fraud is on the increase. He recommended tightening the circumstances in which 714C, rather than 714P, certificates are given to companies.

31. So we think a different approach would be needed. Our starting point is the records the contractor already has to keep: and the requirement, commonplace in the tax system, for persons to make a return of payments to other taxpayers. Instead of obtaining, checking and submitting vouchers, then totalling the amount per subcontractor for the end-year return, the contractor could be expected to render a more frequent return. This return would contain the names and certificate numbers of subcontractors paid gross in the period; and the date and amount of each payment. As discussed below, it might need to contain some further information such as about the subcontractors' bank accounts. (Further study might alter the requirements.) These returns would be keyed by LCS like the present vouchers and end-year returns. There would be no need for a separate end-year return.

32. A number of issues would need deciding, such as:

(i) Should the return be monthly or quarterly?

Monthly returns would allow markedly quicker detection of abuse: though the actual advantage would depend on whether new resources were put in to policing late returns. With quarterly returns, there would be fewer documents to chase. Monthly returns would mean firms only making occasional payments to subcontractors could face more, not less, paperwork - especially if nil returns were required.

(ii) Should contractors have to send in nil returns?

Without nil returns, it would be much more difficult promptly to detect defaults by contractors. However, enforcing prompt completion of nil returns is a superficially unrewarding compliance task. And nil returns could mean a lot more returns to be processed, both by the industry and ourselves, relative to a regime with no nil returns. The extent would depend on how effective the mechanism was of identifying which construction firms should be expected to make gross payments and which should not: and hence which should be expected to make returns.

(iii) Can a 'payments likely' return basis be sustained without vouchers?

At present, end-year returns are asked from all known subcontractors who are not judged unlikely to make payments. The Scrutineer recommended shifting to a "payment likely" basis. He felt this would reduce the issue of end-year returns from 380,000 a year to around 250,000. Returns would go to those making a return in the previous year or who had submitted vouchers totalling over £5000 in the previous year.

Both the existing "payment unlikely" and the prospective "payment likely" system turn on past return history <u>and</u> whether vouchers are being submitted. It is for consideration whether the abolition of vouchers would mean some other way of picking up new contractors would be needed. Since new contractors would no longer be given vouchers as a trigger to action, they might be less likely to volunteer themselves to our attention. One approach would be to introduce an obligation to notify the Revenue of payments made, and penalties for failure to do so: and to back this by checks on whether returns were being received from contractors showing labour deductions in their business accounts. This would mean introducing a new tax district check, albeit a check helpful to scheme security.

(iv) <u>Should the return show every payment to a subcontractor, or just the total for the period?</u>

The scrutineer's recommendation for aggregating small payments onto one voucher has limited relevance to a regime of periodic returns by the contractor: though it establishes the principle of having no specific document per payment. Allowing the contractor to return the total payment to each subcontractor for the period may or may not be less work for him, depending on his accounting system, than showing every payment separately. (At present, contractors have to provide total payments in their annual returns.) It would certainly make less keying work for us. It would reduce the LCS keying (and hence staffing) requirements below the Scrutineer's requirements, rather than restoring them to the present level. However, returns showing separate payments are preferable for audit purposes. In either case, we would envisage adopting the Scrutineer's recommendations of increased use of machine - generated returns, to reduce the clerical burden on companies and, in time, perhaps on the Revenue.

(v) Should the return show payments to 714C companies?

There is increasing worry amongst our investigators that larger companies with 714C certificates are once more becoming used for fraud. The present end-year returns contain entries in respect of 714C companies, but often just for labour-only payments. Requiring the periodic returns to contain entries for all payments to 714C companies could nip this developing area of fraud in the bud. Machine - generated returns would substantially reduce the burdens on big companies.

(vi) Should the return also show payments made under deduction?

The scrutineer saw advantages in having an end-year return combining gross and net payments. There would similarly be advantages in having deduction material in more frequent returns. But this would have a lot of implications, in particular for the separation from PAYE of the very similar subcontractor deduction scheme procedures: and for staffing in Collection offices.

(vii) Can there be a limit on the amount paid to a subcontractor in the period?

The scrutineer had suggested that an upper limit of £10,000/voucher would restrict the extent of fraud likely to occur before the Revenue could notice it. An earnings limit by time rather than paperwork looks unacceptable if applied to all subcontractors: and unworkable if different subcontractors had different 'credit limits'.

33. Depending on the decisions taken on these options, the overall regime could be either substantially less or appreciably more burdensome on the industry than the scrutineer's recommendations. The staffing effects would vary from being about neutral to significantly better from the LCS clerical standpoint: but slightly worse from the

viewpoint of Auditors checking returns: and significantly worse if more action to enforce prompt submission of returns were thought necessary than under the existing or the scrutineer's regime.

34. Furthermore, we think that a regime relying on contractors' returns is not likely to offer adequate security where contractors are tempted to inflate their labour inputs either with or without the collusion of subcontractors. We think that, if vouchers are to be abolished, some other deterrent to inflation by this route is needed: while recognising contractors would in any event still have other ways to falsify their accounts.

35. Applicants for a subcontractor certificate are required to run their business mainly through a bank account. Nevertheless, in practice, cash transactions are prevalent especially in the lower tiers of subcontracting. Such transactions destroy the audit trail. They are also redolent of the black economy. We therefore think that the quid pro quo for dropping vouchers may be to make the "no cash" rule effective.

36. We therefore suggest that all gross payments should be made in accordance with the present certifying document payment requirements for 714C companies, where no vouchers exist. This means that the contractor must pay:

- by cheque in favour of the firm concerned, or

- by bank or National Giro credit into a nominated account.

The funds should come from the nominated business account of the contractor. Thus all gross payments to a subcontractor should be evidenced in the bank statements of both firms. This may provide an adequate deterrent to one route for inflation by the contractor without the subcontractor's connivance. Adequate similar arrangements might well be needed for Building Society accounts.

37. If we could be sure that a contractor's payment could only go to the nominated account of the authorised certificate-holder, the scheme's security against illegal sale of documents would be significantly improved. In principle, a bank should only pay a cheque crossed with a specific account number into that account number. In practice, it may well pay it into a different account held in the same name. So even if certificates bore their nominated bank account, there would be some risk of certificates falling into the wrong hands and the proceeds paid into an account opened in a false name. That risk would be removed if all payments had to be made by Giro. But the benefit would have to be balanced against the further complications for small businesses.

38. Also, a bank is unlikely to question instructions from the account-holder to add another authorised signatory or, at least for a company, to replace the authorised signatories. So we think there would still be some risk of certificates being sold on: but that the risk would be less than at present. Where subcontractors sell their documents, this is often because they are in debt. So a document purchaser gaining access to the bank account would often be buying an overdraft. It is for consideration whether the risk is low enough to drop the physical identity checks on the certificate holder. Certainly this could only be done if the certificates bore the nominated account number, to stop purchasers substituting their own. (And although we have no evidence that details on existing certifying documents have caused 714C companies to suffer non-tax fraud, a 714 containing a name, bank account number and signature looks a vulnerable document from the authorised holder's viewpoint.)

39. Overall, we think that a regime involving payment into the nominated account number shown on a certificate will still be open to real risk of abuse involving substantial sums. However, the present scheme is also not wholly watertight. So a judgement is required on the balance of risk against the major possible deregulation gains of

dropping both vouchering and physical identity checks: and the possibility of more effective control of cash transactions. Our investigators take the view that, at least with the present subcontractor population, the risks are substantial.

40. A regime without vouchers is appreciably less easy to audit and investigate than one with vouchers provided the vouchers are properly submitted. The position, particularly in relation to detecting cash payments not properly made under deduction, would be improved if the business bank statements were included in the subcontractor scheme records to which we have right of access. In principle, that would offer a technically - adequate audit trail. (In practice, such work would be outside the present coverage either of PAYE Auditors or the Board's Investigation Office.) But an automatic right of access to bank statements would be controversial.

41. Without a contemporaneous document of some sort, we doubt if we could continue the deterrent of successful prosecutions for subcontractor fraud. Thus another improvement - from the technical rather than the workload viewpoint - would come from insisting on proper business invoices and business records. Certificated subcontractors are already supposed to keep proper business records. So for the more business-like, a requirement to give contractors invoices would be nothing new. But at the lower end of subcontracting, the subcontractor scheme documentation is likely to be the prime or only documentation: and we expect many small firms would prefer to stay with familiar procedures than have the burden of devising and operating their own. Accordingly, we suspect there are very few advantages for industry, relative to the voucher system, in a system which requires trade rather than Revenue invoices and requires more frequent returns than at present. As well as being controversial, a requirement for proper invoices may be difficult to define and enforce.

42. In principle, one of the purposes of the LCS keying work is to allow cross-checks to assist in detecting inflation or other evasion. In practice, the work does not achieve that purpose. We recommend that as a matter of priority the LCS procedures should be developed to allow accounting period rather than tax-year printouts. In the interim, we consider our protection against inflation, either on the present or the alternative regime, is very largely the public presumption that we would not collect all this information for no purpose.

43. The wider imposition of VAT on subcontractors may be relevant. VAT similarly requires adequate business records and an adequate means of checking them. It operates on quarterly returns. Deregulation reasons alone would justify study of the interaction between the requirements of the Revenue departments.

44. There is also an interaction with the certificate eligibility rules. With at least some of the no-voucher options above, the alternative regime could not come into force until around the same time as the new certificate eligibility rules started to operate. There is little doubt that we could more confidently consider abolition of vouchers if the certificated subcontractor population were more, or was becoming more, compliant. However, generating new eligibility rules more effective in distinguishing those likely to be compliant will be controversial and not technically straightforward. There could be trade-offs between the nature of the eligibility rules, the removal of vouchers and the imposition of extra requirements like more frequent returns and the proper use of bank accounts.

<u>Advantages of possible new regime</u>

45. Depending on the detailed options chosen, we could envisage a scheme comprising, say

- returns required only from selected contractors

- quarterly returns (submission staggered, like VAT returns, to lessen peaks of work for LCS).

- nil returns required

- 714C payments included

- only aggregates of payments per subcontractor required

- no upper limit on total payments to subcontractor in the quarter

- adequate penalties for failure to notify payments and for late or incorrect returns

- payments by cheque or giro transfer only

- Revenue access to business bank statements.

- physical certificate checks probably still necessary: no nominated account information on certificates

- trade invoices, and Revenue access to them, probably required.

46. We should stress that this is only an illustrative option. It is not a considered opinion or our agreed view of the best balance between conflicting factors. Producing that would need longer and more careful study: and probably consultation. How would such an option meet up to the requirements for an alternative to vouchers?

(i) Targets

It is arguably better at dealing with cash in hand payments than the present (or the Scrutineer's) scheme: though there is the risk of pushing such payments into the black economy. It is probably better at discouraging document misuse by subcontractors. It will be worse at discouraging certain types of inflation by contractors, while providing much better defences than elsewhere in the tax system: and being as irrelevant as the present voucher system to other opportunities for false accounting.

(ii) Prompt detection of misuse

In principle worse than the present scheme: in practice dependent on whether follow-up action taken in the future when not taken now. Worse than scrutineer's £10,000/voucher limit.

(iii) Audit and prosecution trail

Adequate, though more labour-intensive - provided invoices required. Otherwise no adequate prosecution trail: though scrutineer's proposal also loses this in smaller cases.

(iv) Burden on industry

A whole class of paperwork disappears. But if trade invoices required, more paperwork involved: if not, less overall. Very straightforward "no cash" rule for determining when gross payment may be made. Simplification of payment procedures, especially if physical certificate checks could be reduced. Cash payments would have to be made under deduction (less onerous with scrutineer's proposed lower deduction rate).

(v) Staffing

We have not commissioned staff costings at this stage. But we think there would be modest further clerical savings at LCS relative to the scrutineer's recommendations. (The scrutineer's recommendations save significant district clerical staff and some at LCS.) The tax district effects would be adverse, with involvement in whether firms should make returns. The limitations on accounts investigation and on chasing late returns would become more obvious: though that is not the fault of the alternative regime. The main difficulty would be in establishing investigation based on quarterly returns and business records rather than on stolen Revenue documents.

(vi) Ease of introduction

If there were no bank account numbers to be added to certificates, this regime might just be put into force from April 1990 in lieu of the scrutineer's new voucher regime: but would more prudently be left until the full 1991 package of eligibility rules with the scrutineer's changes as an interim staff-saving measure: though that would increase transitional costs for the industry and disruption for the Revenue. A regime with bank account numbers on certificates would have to be introduced on a longer or staggered timescale, as all certificates would have to be replaced. The computerisation costs would also be larger.

(vii) Clamp-down on abuse

A crack down on cash payments. Any contractor making cash payments (including payments under duress) would know he was at risk of being pursued for the deduction he should have made. It would be less straightforward for certificate holders to sell their certificates and there would be no vouchers to sell. However, even with greater emphasis on bank accounts, it would be more difficult to deter this route of inflation by contractors. Getting LCS printouts onto an accounting period basis would help; but only if tax districts could improve their checking performance.

(viii) Use of resources consistent with other abuses

Position similar to present (and Scrutineer's) regime.

Conclusion

47. Accordingly, we think further study could produce a different regime from the present voucher-driven one. We do

not feel that the different regime would be unambiguously better in every respect: but would offer a different balance between conflicting requirements.

48. We have so far identified a range of options for a return-driven scheme that could meet a number of preferred alternative balances in this area.

49. Within this range, we doubt if there are further big staff savings to be had. Nor is there unambiguous further deregulation with some options. Deregulation gains would require a decision not to require trade invoices. That would be a decision to move further away from prosecution as a policing and deterrent tool than the scrutineer's recommendations have. With neither vouchers nor invoices our evidential position would be weak. Big deregulation gains would require abolishing physical identity checks on certificate-holders as well. That might yield sufficient deregulation and simplification gains to counteract concern over putting cash payments under deduction and giving easier access to bank accounts.

50. The present scheme as it is operated has well-perceived weaknesses. These are only partly addressed by the scrutineer's proposals. Nevertheless, going, with the present subcontractor population, for the most radical options would mean a decision to favour deregulation over security concerns - even though such options might offer better security in changing behaviour at the cash end of the trade.

51. The recent PES settlement takes credit for staff savings from cutting the flow of vouchers. We imagine Ministers will be reluctant to reverse that saving by abandoning the present immediate plans to consult and then to lay regulations, effective April 1990, on reducing vouchers; and instead to consult and work up options for replacing vouchers by alternative safeguards.

52. Therefore, the options are

i. to leave further work on eliminating vouchers aside until after the Scrutineer's proposed new eligibility rules have taken effect in producing, hopefully, a more compliant certificated population; or

ii. to proceed with consultation and implementation of the scrutineer's voucher reduction as a first step, and then to consult next summer on the possibility of abolishing vouchers and tightening the certificate eligibility rules as a more far-reaching medium-term structural reform.

The second option means that our staff and the industry would face two sets of disruption. A link between the eligibility rules and voucher elimination may be difficult to break once forged: and will widen the scope and hence perhaps the duration of the consultation. Yet the linkage might yield trade-offs in a difficult area: and so the possibility of deregulation gains without a large loss of scheme security overall and with some advantages.

53. We would be grateful for advice on which option you prefer.

C. Sullivan.

C D SULLIVAN

**Inland Revenue**

Central Division
Somerset House

FROM : D DENTON
EXT : 6302
DATE : 19 December 1988

Re residences: ~~[illegible]~~ given the stress we've put on the worldwide premium option, I shd be grateful for the FST's views on the minimum tax idea. N.

FINANCIAL SECRETARY

**TAX CONSULTATIVE COMMITTEE**

I attach the minutes of the TCC meeting held at the end of last month. If you are content I shall send copies to the outside members of the Committee. As agreed, they will be informed that the next meeting will be in the Spring following the 1989 Budget.

~~[illegible]~~

D Denton

D DENTON

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

Mr Isaac
Mr Painter
Mr Beighton
Mr Houghton
Mr Deacon
Mr Corlett
Mr Bush
Mr Bryce
Mr Haigh
Mr Kuczys
Mr McManus
Mr Hallam
Mr Denton
PS/IR

**TAX CONSULTATIVE COMMITTEE: NOTE OF MEETING HELD AT THE TREASURY AT 10.30 AM ON 30 NOVEMBER 1988**

Present:

| | |
|---|---|
| Financial Secretary | Mrs Chaplin ) Treasury |
| Mr Potter | Mr Scholar ) |
| Mr Sutherland | |
| Mr Stitt | Mr Isaac ) |
| Mr Chown | Mr Painter ) |
| Mr Avery Jones | Mr Beighton ) Revenue |
| Mr Flight | Mr Houghton ) |
| Mr Esam | Mr Kuczys ) |
| Professor King | Mr Denton ) |
| Mr Cropper | |

(Apologies for absence had been received from Mr Thompson, Mrs Pickering and Mr Brooke.)

RESIDENCE

1. The Financial Secretary welcomed members and said he would like to discuss the scope for changes to the residence rules. Following the tax rate reductions of recent years these rules were ripe for rationalisation and simplification. There were obvious anomalies which should be corrected - for example, the limited charge on long-term, non-domiciled residents and the opportunities for the washing of capital gains by means of temporary absences abroad. It would be necessary to consider carefully the implications of possible changes for overseas executives who came to this country for a few years. He felt that these were much more deserving of sympathetic treatment than long-term, non-domiciled residents. He was grateful to Mr Avery Jones for the summary paper he had prepared and he invited him to outline his ideas to the Committee.

2. Mr Avery Jones said that the primary question for consideration was the basis on which foreigners resident here should be taxed - worldwide income or something less. He felt that the answer to this should be determined largely on political and economic grounds. Charging them on worldwide income would undoubtedly drive a number away, including some

whom we would prefer to stay. An inherent difficulty was that there was no obvious way of distinguishing desirable foreigners from less deserving cases. The alternative bases outlined in his paper depended on the answer to the fundamental question. His paper gave reasons why, if the worldwide income basis were favoured, he would prefer to see some changes to the approach outlined in the Consultative Document. If it were decided to go for a more limited approach he thought it would be right to remove the obvious and known limitations of the remittance basis by adopting the receipts basis outlined in his paper. However, there would need to be some latitude at the margins, as indicated in his paper, so that all foreigners were not automatically driven away from the UK. But, whatever the answer, he favoured changing the rules for determining residence status, particularly by excluding the relevance of available accommodation. But he wondered whether it would be fair to count both the day of arrival and departure.

3. Mr Isaac mentioned three points which would need careful consideration. First, the rules for determining residence proposed in the consultative document were simple and objective. The "tie breaker" rule in double tax agreements could give a measure of flexibility where a taxpayer's main centre of interest was in another country, not a tax haven (and it could, if wished, be applied to bring into liability the traveller abroad whose main centre remained in this country). Second, if something less than a worldwide income approach were favoured for foreign-domiciled residents should a distinction in treatment be drawn - with retention of the wider basis - for certain categories such as British citizens with an overseas domicile? Third, what would be the impact on the non-domiciled, long-term residents (such as the Greek shipowners and Arabs) of the introduction of a worldwide income basis? If it were judged that they were likely to move elsewhere and that this was too high a price to pay, would it be sensible, and administratively practicable, to have a receipts basis of taxation which put the tax treatment of such people on a better and more sensible footing?

4. Mr Chown thought the proposed definition of residence to be generally sensible and workable. But a charge on worldwide income would lead to problems with the currently non-domiciled resident foreigner (he saw no problem with non-domiciled British citizens). With 1992 in mind, it would be important to ensure that foreign executives were not treated harshly and to get this point across in public. For the Greek shipowners etc, there were likely to be serious objections to providing information about overseas sources of income and a number would almost certainly leave. He thought an acceptable way forward lay in a receipts, or quasi-expenditure tax, basis.

5. The Financial Secretary said that he had made it clear to the representative groups he had seen that the Government had no wish to drive away genuine foreign executives. But there was far less justification for continuation of the present regime for non-domiciled residents who simply chose to live here. Although a difficult point to judge, he thought it probable that shipping business would continue to come to London even if some owners moved abroad.

6. Mr Scholar asked whether there were other countries in Europe of sufficient attraction to which these people might move. The general feeling was that, quite apart from places such as Switzerland and Monte Carlo, France, Italy and the Irish Republic were prepared to do deals on an individual basis to ensure that nominal tax rates did not apply.

7. Mr Sutherland said he favoured the more limited basis of charge outlined in Section II of Mr Avery Jones' paper because the overriding consideration should be to continue to encourage United States and Japanese executives to come and work here, with the ensuing economic advantages for the country. He agreed that the charge on long-term non-domiciled residents should nevertheless be broadened but he thought it would be detrimental, and counter-productive, to tax, for example, pictures or works of art simply brought to London for auction. As regards the proposed residence test, he favoured

counting only whole, rather than part, days - otherwise airline pilots, amongst others, might be treated harshly.

8. Mr Potter said he was in favour of removing domicile as a basis for liability. In his experience a good deal of dubious evidence was furnished about both this and the extent of remittances. The general approach should be to charge British nationals on worldwide income. For various reasons there would always be problems in getting information from, and a full tax charge on, the super-rich non-domiciled residents and he suggested that one possible approach would be for the Inland Revenue, under their care and management powers in the Taxes Management Act, to make individual agreements with these people on the amount of tax to be paid. Mr Cropper endorsed this call to remove the domicile concept. A worldwide charge on citizens ought to be tenable. It was difficult to make a judgement on non-domiciled foreigners without a clearer view of who were the potential losers. The press were likely to highlight the hard cases.

9. Professor King said he would not be enthusiastic about a prospective capital receipts basis of charge in an era where there were no capital controls. It would be relatively easy to circumvent the charge by financing one's living expenditure by borrowing against capital lodged outside the country. Although anti-avoidance measures could be designed, it would then be clear that the basis for charge was not receipts as such, but some measure of the income obtained from, or expenditure financed by, assets held overseas. The logic of the receipts basis would unwind. The argument that foreign executives should not be discouraged from coming to the UK did not justify especially generous treatment for them. Of course they added to economic activity in the UK, but so did British executives. The real issue was the impact of their tax treatment on the total revenue derived from them.

10. Mr Stitt said he too was attracted by the proposition of dispensing with the concept of domicile. Any new framework for determining residence status should aim to provide as much certainty, and to be as objective, as possible. He was not

convinced that an eventual reform package on these lines would receive as bad a press, or general reaction, as the Consultative Document had done. He thought that the proposal to count presence for part of a day as a whole day would lead to inequities and suggested presence at midnight as an alternative criterion. There were likely to be administrative difficulties for taxpayers in maintaining records of visits here and these could increase once the channel tunnel was completed. He added that consideration should be given to determining non-residence by reference to a period of 62 days (or one-sixth of a year), rather than the 30 day period mentioned in the Consultative Document. Mr Avery Jones pointed out that using midnight as a basis for determining residence would provide a loophole for residents of the Channel Islands who could commute to the mainland on a regular basis.

11. As regards the basis of charge, Mr Stitt thought that this could be graduated - perhaps based on income received per annum for the first five years of residence, then the worldwide basis for UK citizens. If the concept of domicile was retained this might be applied after 10 years of residence with deemed domicile applying after 14 years of residence. But the remittance basis needed to be tightened up and he thought that action should be taken to counter the inherent artificiality of dual contracts for UK and overseas duties. He was attracted by the idea of a special minimum tax for the super-rich but doubted whether this would be the right way forward.

12. Mr Flight said the first priority should be to correct the present imbalance of the current rules, which encouraged long-term residence here by non-domiciled foreigners but drove UK entrepreneurs abroad. He favoured the removal of domicile and offering to long-stay foreigners the option of a flat-rate income tax charge of, say, £20,000 per annum. The new rules should be practical to administer and, with 1992 in mind, should harmonise, as far as possible, with the corresponding provisions of EC partners. Mr Avery Jones said he doubted

whether any equitable system could represent a simplification of the present rules. Mr Painter said that it was difficult to envisage any new system being less certain and certainty itself would be a valuable contribution to the broad aim of simplification. He added that there were arguably two sides to the 1992 argument; a greater interchange of people within the EC would underline the need for a reasonable evenhandedness of treatment of UK and EC nationals as well as requiring that any new UK tax regime should not put the UK at a competitive disadvantage.

13. Mr Esam said that the effects on multinational companies of the costs of sending foreign executives here should not be underestimated, although he accepted that this was not such a problem at the moment with the lower rates of tax chargeable. It would be important to ensure that the new rules should not conflict with taxing rights under double taxation treaties.

14. The Financial Secretary thanked everyone for their comments which reflected a number of different viewpoints. Mr Avery Jones' paper was a very useful contribution to the overall debate. He said that the document published in July represented one approach but it did not necessarily mean that the Government would not contemplate another. He emphasised that it was not the Government's intention to drive away foreign executives from this country and he hoped that this message would be passed on to those who thought otherwise.

LIFE ASSURANCE

15. The Financial Secretary asked whether anyone had any specific comments to make about the proposals in the Consultative Document. Mr Chown said that he would like an opportunity to make some detailed observations and it was agreed that he would get in touch with Mr Beighton about these.

16. Mr Avery Jones questioned whether 1992 would have a significant effect on the industry and, if so, whether major changes to the present UK regime should be deferred until the

international aspects could be fully taken into account. The Financial Secretary acknowledged that known future developments within the EC would have detailed consequences for the life assurance industry and the tax rules relating to it but said that any necessary changes were unlikely to become clear until well after 1992. He therefore considered that it would be better to proceed with changes to the UK domestic rules at this stage and adjust later for EC consequentials, as and if necessary. Professor King supported this approach. Mr Chown said that Italian lawyers were displaying considerable interest on behalf of clients in entering the UK market.

17. Professor King said that the Consultative Document had been well produced and set out clearly the present shortcomings and the options for change. Of the latter, he thought that B or C were the more viable.

PENSIONS

18. The Financial Secretary said that now that the statutory changes of recent years had bedded down he would welcome comments from the Committee on the administrative aspects of the current tax rules for pensions. He had received a good deal of correspondence about this, particularly the new free standing AVCs and the amount of record keeping required.

19. Mr Flight said he feared that the major political object of the recent changes had been frustrated. He was aware of cases involving non-contributory pension schemes where, because employers were not prepared to contribute, employees were not prepared to opt out of their occupational schemes for personal pensions. He suggested that the statutory rules should be changed to give the employee the right to specify to which scheme the employer should make its contribution. The Financial Secretary pointed out the difficulties of compelling employers to contribute to personal pensions, and noted that highly mobile individuals who changed jobs several times during their careers could nevertheless be better off in personal pensions. Mr Kuczys said that the evidence from

providers was that the new personal pensions arrangements had got off to a successful start. And, as a side effect on occupational pensions schemes, communications between employer and employees had improved - because employers were facing competition from personal pensions providers. Mr Isaac added that Mr Flight's proposed scheme would require a means of quantifying the level of the employer's contribution; there was no such measure at present.

20. Professor King said that the position of free-standing AVCs being subject to benefit limits was unsatisfactory: if investments did better than expected, main scheme benefits had to be cut back. Mr Isaac explained that AVCs had to be seen against the occupational schemes which they complemented: a single overall limit had to apply to both. If contribution limits applied to AVCs, people would effectively be able to get two rations of pensions tax relief. Mr Flight thought the problem Professor King had raised was unlikely to arise in practice: few people taking out AVCs were right up against their benefit limits.

CONFIDENTIAL

FROM: A J G ISAAC

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

22 December 1988

~~Pl attach Jonathan's minutes of mtg yesterday.~~

FINANCIAL SECRETARY

RESIDENCE: RECEIPTS BASIS

1. The attached notes from Mr Bryce and Mr Houghton respond to your request for a brief explanation of

- the weaknesses of the present remittance system, and
- the shape of a possible new receipts basis

for non-domiciled aliens resident in the United Kingdom.

2. Perhaps I could add my own perception of a receipts basis, coming new to the debate since last summer.

3. In its essential concept, a receipts basis is pretty simple. You pay tax on income and gains arising in this country and on money which you bring into this country from abroad. You do not pay income tax on money which arises abroad and stays abroad.

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cc PS/Chancellor
PS/Paymaster General
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gieve
Mr Gilhooly
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins (Parliarmary Counsel)

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Houghton
Mr P Lewis
Mr Bryce
Mr Cayley
Mr Elliott
Mr Phalp
Mr Thomas
Mr Davison
Mr S C Jones (Bootle)
Mr Richardson
PS/IR

4. However, to operate this concept in the real world, you have to broaden it in some ways (or it will be as worthless as the present remittance basis) and narrow it in other ways (or it will operate unduly harshly). The Green Paper (paragraph 6.27 and following) and subsequent notes have signalled that there would be some significant complications. The questions for decision in due course - and much work clearly remains to be done - are:

- how far you need to broaden/narrow the concept, to make it work reasonably effectively and fairly.

- How far these adjustments will complicate the legislation, add to its administrative and compliance costs, or reduce its yield.

- At the end of the day, the point at which the potential gains from the new "adjusted" receipts basis (in terms of revenue and/or perceived equity) justify the transitional and other costs.

The judgment of the proper balance will be vital: something that does not strain to be watertight, but holds a good deal more water than the present remittance basis.

Broadening the system

5. It would be essential to bring in the value of benefits provided in this country to the taxpayer by a non-resident company or trust connected with him. Otherwise, it would be all too easy for the taxpayer to take out of the charge to tax the value of his accommodation, his domestic servants, his car, perhaps even his food and drink. Many of the issues here are familiar to us all from the Schedule E benefits provisions. There is the equally familiar question of loans.

6. Similar issues arise in the case of goods and services which the taxpayer enjoys in this country, but invoices to an overseas postbox. (For example, he picks up his Porsche from a UK dealer,

but the paper invoice is payable to an overseas principal. Similarly, his domestic staff are hired from a non-resident employment agency; and so forth.)

7. Yet another obvious area concerns physical assets imported into the country, (anything from bearer securities, through gold ingots, or diamonds to jewellery and commodities) and then sold to finance living costs here. The job here would be to devise rules which stop people making a mockery of the receipts basis, but don't involve us or them in having to record and value every item which they bring with them across the frontier every time that they travel.

8. The legislation on a receipts basis would need to deal carefully with these areas to ensure that it was worth the paper it was written on - but did not add unacceptably to compliance costs. It would also be necessary to handle a number of other special questions: such as Inheritance and other gifts, pre-immigration transfers; and so forth.

Narrowing the tax base

9. The merit of the "receipts base" is that it does not necessarily require either the taxpayer or the Revenue authorities to decide whether money or money's value bought into this country is "capital" or "income". In that way, it avoids a rock on which the present remittance base has in practice foundered. Of course, there will be people - classically pensioners returning from overseas - whose living costs exceed their income, and who will therefore effectively be living at least partly on capital. For them, a receipts base would operate harshly: it would in effect tax them on an amount exceeding their worldwide income. But these people would be given the option of being taxed on their worldwide income - like UK domiciled taxpayers. Thus far, no great problem should arise.

10. However, I think all of us in the discussion so far feel that there would need to be <u>some</u> adjustment for non-domiciled aliens who bring substantial amounts of capital into this country and invest it in capital assets. If a Greek ship owner or Arab princeling wants to come and live in this country, and spend between (say) £5 million and £10 million on a pied-a-terre in Belgravia, it would be difficult to apply the receipts basis in its pure form, and treat that £5 million or £10 million as taxable income.

11. You will remember that one approach, suggested by John Avery Jones, was to leave open a "window" of say 3 years from the taxpayer's arrival in this country. While the window was open, he could effectively bring capital into the country without paying tax (and without the Revenue enquiring too closely whether the money was capital or income). After the window closed, <u>all</u> receipts from abroad would be taxed as income.

12. In due course, you would need to decide whether this "window" would be enough. Is it sufficient to say that, for example - if the taxpayer subsequently decides:

- to increase the proportion of his personal fortune invested in UK securities, he will do so through ADR's in New York or through the medium of a non-resident company;

- to acquire, in addition to his London pied-a-terre, a stud in Newmarket or a grouse moor in Scotland, he must pay income tax on the purchase price at his full marginal rate (or if he uses a non- resident company to acquire them, pay tax at his marginal rate on the derived benefit in kind);

- and similarly if he decides to buy a Van Gogh or Picasso.

We are looking at some ideas for a kind of "special account" to handle special situations of this kind, should you think that necessary. But inevitably they would add to the legislation; and reduce its yield. Again, balance would be vital.

13. As the papers below emphasise, work on these questions is still a long way from the point at which we could ask Ministers to take a decision even in principle in favour of a receipts basis. They are more in the nature of a quick "annotated agenda" for further work that would be needed through 1989. But I hope that they are enough to give you the general shape of a possible receipts basis and the flavour of the issues that would require a decision; and that they are therefore a helpful first step to working up the form of the Budget announcement which we discussed with the Chancellor yesterday morning.

(A J G ISAAC)

CONFIDENTIAL

**Inland Revenue**

International Division
Somerset House

FROM: B T HOUGHTON

22 DECEMBER 1988

1. MR ISAAC 22.12
2. FINANCIAL SECRETARY

RESIDENCE: A NEW RECEIPTS BASIS

1. This note outlines a possible alternative to the world income approach - the new receipts basis. Annexed are a description of the present remittance basis and an analysis of its defects, as you requested.

2. The remedy which was the front runner in the Consultative Document was the world income approach. The alternative - the receipts basis (described in paragraphs 6.27 - 6.32 of the Consultative Document) was said to be likely to give rise to new complexities and impose substantial compliance burdens. If it was to be effective, it would have to be very widely drawn, with the implication that it could have significant economic and

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c. PS/Chancellor
PS/Paymaster General
Sir P Middleton
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Mr Culpin
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Miss Hay
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Chairman
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Mr Bush
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Mr Lewis
Mr Bryce
Mr Cayley
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Mr Phalp
Mr Thomas
Mr Davison
Mr S C Jones (Bootle)
Mr Richardson
PS/IR

social effects. The world income approach would not be simple (many of the representative bodies have drawn attention to the problems which might arise for instance as a result of the mismatching of the overseas and the United Kingdom tax bases). On present indications, it seems probable however that an acceptable receipts basis would not offer much scope for simplification.

3. If the new basis is to provide a more effective charge than the remittance basis, it must focus on the money or money's worth which the taxpayer on the intermediate basis uses to finance his living in the United Kingdom. The target is not what he actually spends here but what is the measure of his potential UK spending capacity represented by the cash he uses here, the benefits he and those connected with him enjoy, the facilities provided for him and the obligations removed from him. This basis would not necessarily apply to the visiting foreign executive. He could be taken out of liability on non-UK income by for example a 5 years out of 10 residence test. The new receipts basis would only apply to him when he fell outside of the 5 out of 10 year safe haven. (It might be necessary to extend this safe haven period - as far as 10 out of 15 - as proposed in some of the representations).

4. The concept of potential spending capacity makes no distinction between an income source and a capital source. Nor does it make any distinction between capital expenditure and other expenditure. Thus it does not signify whether capital or income is used to finance living in the United Kingdom or whether capital acquisitions come out of capital or income sources. At its crudest, the receipts basis would look simply at the potential expenditure capacity of the taxpayer and treat that as income liable to UK tax.

5. An approach of this kind would, however, provide a deceptively simple basic structure. Among the problems which we shall have to consider are:-

a. supporting the UK lifestyle by disposing of assets brought into the United Kingdom. Jewellery, objets d'art and indeed anything that can be turned into money could be brought into the country time after time if necessary, realised and used to finance United Kingdom living expenditure. Even though these objects are theoretically chargeable when sold in the UK under the present remittance basis, taxpayers do not need to use this route because they can import capital tax free. Once the capital route is blocked they would clearly turn to importing and realising items which can be turned into spending power. Trying to bring such realisations into charge would involve difficult and extensive valuations for both new residents and old. But if the charge does not extend to such realisations, it would be as flawed as the present remittance basis. The existence of the UK's capital gains tax charge would not inhibit such realisations in the case of the new incomer (you would simply arrange for an appropriate base price before arrival). In the case of the existing resident the effect is less easily predictable;

b. the valuation of benefits enjoyed in the United Kingdom. In covering this ground we would be guided by our experience with current anti-avoidance legislation in the field of trusts, but it could have the effect of bringing many more taxpayers into the benefits net and of extending an already difficult area;

c. the use of loans instead of free income. Instead of realising assets, taxpayers could use them as security for loans out of which to finance their living in the United Kingdom. It would be for consideration whether borrowings from UK sources should enjoy different treatment to foreign borrowings;

d. the treatment of gifts and windfalls. Again, it would be for consideration whether a UK source, as against a foreign source, affected liability. It would no doubt be argued that a pre-death UK gift caught for inheritance tax purposes should not be doubly taxed.

e. accumulations before coming resident. The far-sighted, wealthy incomer would accumulate large quantities of spendable assets in the United Kingdom before he became resident. It would not be easy to charge these.

This is a bare summary and we shall have to devise appropriate solutions for these and other difficult areas for your approval over the coming weeks.

6. But these difficulties are not crucial to the development of the new receipts basis. They can either be overcome at the cost of some complication and with an additional compliance burden all round or left as imperfections in the structure. The central problem is whether it would be acceptable to treat all the potential expenditure capacity of a taxpayer as income even though it had clearly come from a capital source and was being applied to capital purchases. At present, taxpayers on the remittance basis can import large amounts of capital to use in the United Kingdom. Some of this, of course, may go on living expenditure but some could go to promote the art market in this country or on charitable benefactions or on investments in United Kingdom companies or small businesses. It is true of course that some of this capital expenditure could come out of income and fungibility inevitably obscures the picture. The test case here is that of an incoming resident who brings with him money to purchase his principal private residence. It would seem difficult to justify charging him to income tax on funds brought in to buy his house. For example if a charge were imposed he would need to import some £3.3m to buy a £2m house.

<u>3 Year window</u>

7. There are a number of ways of meeting cases of this type. The first would be to provide a window of, say, three years during which time the incomer would be permitted to import capital and spend it on purchases of all kinds. Thereafter he would be subject to the ordinary receipts basis regime under which, if he imported capital, for example to acquire a second

establishment in the United Kingdom, he would be liable to United Kingdom income tax on the moneys brought in. But the cliff-edge effect would be sharp and a scheme of this kind might be criticised as arbitrary and exploitable; it could have significant and possibly undesirable behavourial effects. New residents might be tempted to make hay while the sun shone but find that after the protected period purchases or investments that they wanted to make and which it would be desirable that they should make would be discouraged.

Segregated Capital Account

8. An alternative approach is to introduce the concept of a segregated capital account. This account would comprise items, expenditure on which was not subject to a charge under the new receipts basis. It could comprise immovable property in the United Kingdom, quoted securities of all kinds, heritage items and objets d'art and business interests (eg investments in the small business sector). On one approach the immunity from the receipts basis created by the segregated account would not depend upon whether the purchase had been made out of income or capital. The other approach would be to say that the capital expenditure in the segregated account should be financed by imported capital and only to that extent would expenditure on the capital account be immune. Either way the segregated account would have to be maintained on a running basis so that, for instance, the ordinary rules of capital gains tax could apply to disposals in it. The segregated account would also have to have its own special rollover rules so that moves in the account between designated assets not involving withdrawals of money would not give rise to income tax liability. The CGT rollover rules would apply separately.

9. An approach on these lines would have a number of significant effects:-

a. it would remove a good deal of the opposition to a receipts basis both by the taxpayers concerned and by the UK interests who benefit from international money (including the London art market, the UK property market and business financing generally);

b. but it would introduce new complexities - the rules for the segregated account and for the interaction between segregated account income tax and capital gains tax are unlikely to be simple;

c. and, most importantly, it would reduce considerably the yield of the new basis and bring into question the scope and complexity of a scheme devised to deal sensitively with such a small segment of the taxpaying population.

9. It will be clear from the above that we are still only at the designer stage of a new receipts basis. We hope to be able to develop an approach which is at least an improvement in terms of its effectiveness as compared with the present remittance basis. But the result may well be fairly complicated and, as you have suggested, further consultations on the form of the new basis would be desirable.

10. We shall be letting you have notes next on the future of ordinary residence as part of the new residence rules and its relationship to the one year CGT drop out.

Uh

B T HOUGHTON

ANNEX 1

OUTLINE OF PRESENT REMITTANCE BASIS

1. The concept of a remittance basis of taxation is that foreign income or gains are subject to UK tax to the extent that the income or gains are enjoyed in the country. The scope of this basis has, over the last 75 years, been reduced by

- limiting the categories of people who can benefit from it, and

- reducing the sources of income to which it applies.

i. Income Tax: those who qualify

2. At present for income tax purposes the remittance basis applies to two groups of individuals. An individual may qualify under both heads - the categories are not mutually exclusive.

- A person who is not domiciled in the United Kingdom.

- A British subject or citizen of the Republic of Ireland who is not ordinarily resident in the United Kingdom.

ii. Income Affected

3. Not all income with a foreign connection received by such individuals will be taxed on a remittance basis. For example, the profits of a trade carried on both in the UK and abroad are assessable on an arising basis - there is no division of profits so that the remittance basis can be applied to the foreign element.

4. The remittance basis has a part to play in two areas

(i) (a) Tax on income from foreign securities (Case IV of Schedule D) is computed:

"On the full amount .... of the sums received in the United Kingdom".

(b) Tax on income from foreign possessions (Case V of Schedule D) is computed:

"On the full amount of the actual sums received in the United Kingdom .....

from remittances payable in the United Kingdom,

or from property imported,

or from money or value arising from property not imported,

or from money or value so received on credit or on account in respect of any such remittances, property, money or value brought or to be brought into the United Kingdom".

(ii) The tax charge on remittances under Case III of Schedule E applies to three types of income:

(a) foreign emoluments (emoluments belonging to a person not domiciled in the UK from a non-resident employer) for duties performed outside the UK by an individual who is resident but not ordinarily resident;

(b) foreign emoluments for duties performed wholly outside the UK by an individual who is resident and ordinarily resident in the UK;

(c) emoluments for duties performed outside the UK by an individual who is resident but not ordinarily resident in the UK.

(iii) Gains Affected

5. For capital gains tax purposes the availability of the remittance basis is governed by the status of the person. If the individual is resident or ordinarily resident but domiciled outside the UK then the charge to tax on gains accruing from the disposal of an asset outside the UK is on the amount received in this country in respect of those gains.

ANNEX 2

WEAKNESSES OF REMITTANCE BASIS

1. The charge under both Cases IV and V is on "sums received". A sum must be cash or its commercial equivalent such as a banker's draft or credit to a bank account. If an individual applies foreign income to purchase a tangible asset (for example a work of art or a car) no remittance arises when the asset is brought to the United Kingdom. If the asset is sold in the UK the proceeds will be chargeable to tax (up to the amount of the foreign income applied in the original purchase). No taxation liability arises if overseas income is spent by a non-domiciled UK resident abroad, for example, on a foreign holiday.

Income v Capital

2. For a remittance to be taxable it is necessary to demonstrate it is derived from overseas income. A remittance from capital gives rise to no income tax liability under the present rules (but may have capital gains tax consequences in some circumstances).

3. Where an individual is genuinely living off capital from abroad then it may be considered reasonable that a charge to income tax should not arise. However, it is manifestly not reasonable where in reality an individual is living off income from abroad but is making remittances in such a way that they are regarded as capital.

4. A very common device to avoid remitting foreign income is to set up two bank accounts abroad. The first consists of the capital deposit and the second has credited to it the interest in respect of the deposit in the first account. Any remittances to the UK are then made only from the capital account ensuring that no tax charge arises under the present remittance basis.

Source Rule

5. It is a long established principle that income cannot be assessed for a year in which there is no source. The simplest way of avoiding the remittance basis charge is to remit to the UK money which represents income from a source which has ceased. In the case of foreign bank interest, for example, the interest on an account can be remitted tax free by closing the deposit account and bringing the funds to the UK in the following tax year. Alternatively, the income can be held temporarily in a current account before it is used to top up a "capital" account held overseas in the following year. Cessations can be manipulated to allow remittances to be made free of tax when required.

Gifts

6. If foreign income is transferred to another person it loses its identity as income. The recipient of the gift can remit it to the UK and there will be no charge to UK tax. In this way a non-domiciled resident can effectively remit income to his spouse or children without liability.

Loans

7. Broadly, a charge arises under the present remittance basis in the case of a person ordinarily resident if foreign income is applied to satisfy a loan made in the UK or interest on such a loan. Similarly foreign income applied to satisfy a debt for money lent outside the United Kingdom and brought to the United Kingdom will give rise to liability. However, if a taxpayer on the remittance basis borrows from an overseas lender to purchase a UK asset, say his house, then no liability arises provided interest on that loan is met out of foreign income paid abroad.

8. These anti-avoidance provisions for loans were introduced to prevent the export of UK debts to the country where the remittance basis income is held rather than importing the income

pay the debts. However, they have no application to individuals who are not ordinarily resident. They can also be side-stepped if the overseas income is not earmarked to repay debts incurred in the UK (or incurred abroad and brought to the UK). It is easily arranged that the loans which may be used to fund UK living expenses are not repaid until the individual has left the United Kingdom.

Conclusion

9. Taken together these loopholes mean that only the unwary are likely to incur liability to UK income tax on foreign income.

BUDGET CONFIDENTIAL

**Inland Revenue**

Capital and
Valuation Division
Somerset House

FROM: M F CAYLEY
DATE: 9 January 1989

The latest proposals make an unjustifiable proposition even less attractive. DP 9/1

1. MR PITTS

2. FINANCIAL SECRETARY

CGT - VALUATIONS OF MINORITY HOLDINGS IN UNQUOTED COMPANIES

1. After the meeting on 16 December with Mr Winterton and others, you asked me to look at the latest version of their proposals.

2. These proposals now have three legs:-

(i) that the normal valuation approach - looking at each shareholding in isolation - should apply for 1982 rebasing <u>unless</u> shareholders sell out together.

(ii) where shareholders do sell out together, 1982 valuations should be made by treating minority shareholdings as if they formed a single large shareholding, valuing that, and then apportioning the value between the shareholders. Thus if three people each have a 20% stake and sell together, one would value a 60% shareholding at 1982 (with the "control premium" built in) and then attribute

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| cc. | |
|---|---|
| Chancellor | Mr Painter |
| Chief Secretary | Mr Beighton |
| Paymaster General | Mr Pitts |
| Economic Secretary | Mr Hamilton |
| Mr Scholar | Mr Cayley |
| Mr Culpin | Mr Thompson |
| Mrs Chaplin | Mr Michael |
| Mr Tyrie | PS/IR |

a third of that value at each shareholder: under present rules one would do separate (minority basis) valuations of three 20% holdings. But this special rule would apply only where the shareholders were related to each other. (Earlier it was envisaged that it would apply even if they were not.)

(iii) where part of a pre-1982 shareholding was given to a relative after 1982, and the donor and donee sold out together, one should - in some unspecified fashion - allow the donee a proportion of the 1982 valuation of the whole original shareholding instead of treating him as having been given a minority holding.

3. In all of this, one would not disturb the basis of valuation for IHT, which - husbands and wives aside - normally looks at each shareholder independently of the others.

(a) 1982 Valuations

4. The proposal for 1982 valuations - (ii) above - is the same as that in the summer, except that it confines the special valuation rule to shares held by members of the same family. Effectively, we are being asked to apply hindsight to 1982 valuations, and, in the process, to exclude some post-82 real gains from tax.

5. The general issues here are the same as those discussed in the Inland Revenue notes of 30 June, yours of 7 July and Mr Taylor's of 11 July (copies attached).

6. The only new point is the suggestion of confining the rule to members of the same family. This would mean that where a company was owned by, say, a husband, wife and two adult children, they would benefit on a

takeover from the special rule: but where an identical company was owned by four unrelated people, they would not. Some of the representations in the summer concerned companies where not all the shareholders were close relations: and any restriction of a special valuation rule to shareholders in the same family would be likely to give rise to complaints and to come under pressure. It could well lead to more complaints than doing nothing.

(b) Post-82 gifts

7. The third leg of the proposals put to us concerns post-82 gifts. It can best be illustrated by a simple example. Suppose I have a 100% shareholding in 1982. If I sell that now, my 1982 base cost will be that of a 100% holding.

8. Now suppose I give one third of my shareholding to my son. For CGT, I am deemed to make a disposal at the time of gift. I will be treated as having disposed of a one-third shareholding for its market value, which will reflect the fact that it is a minority holding. My base cost - the 1982 value - will be on a controlling holding basis, since I then held all the shares. So I may well be treated as having made a loss. My son will be treated as having acquired the one third holding at its market value, so his base cost will reflect the fact that he acquires a minority holding. If later we sell out together on a takeover, my son's gain will include the control premium as compared with the value of a one-third shareholding. (And typically in a trading company the value per share of a one-third stake in a company might be half that of a controlling holding.) The proposal is to eliminate the "control premium" element in my son's gain, and at the same time clawback any losses I was deemed to make when I gave him the shares.

9. Putting some figures on this, and - to keep things simple - ignoring indexation, suppose:-

- 1982 value of my 100% shareholding is £300,000
- in 1989 I give a third of my shares to my son and the value of the company has risen to £420,000.

Then, at the time of gift, I will be deemed to have disposed of a third of my shares for perhaps around £70,000 (half of a third of the value of a 100% holding) and to have made a loss of £30,000.

10. Now suppose I and my son sell up on a 1990 takeover for £600,000. I - for my two-thirds of the shares - receive £400,000 and have a 1982 value base cost of £200,000, giving a gain of £200,000. My son has a base cost (at time of gift) of £70,000, and receives £200,000, giving a gain of £130,000. Our combined gains are therefore £330,000.

11. If I had kept the whole shareholding, I would have had a gain of £300,000 (£600,000 less the £300,000 value of all the shares in 1982). The difference of £30,000 corresponds to the £30,000 loss I am deemed to have made at the time of gift. (In practice, indexation, the annual exemption, and other factors mean the figures are unlikely to work out quite so neatly.)

12. The proposal put to us is in effect to clawback that £30,000 loss and correspondingly reduce my son's gain by £30,000. In effect one would treat my son and myself as having had throughout proportionate parts of a single 100% holding. One would do this only

- for gifts within the family, and

- where family shareholders sold together.

So once again we are being asked to rewrite history with the benefit of hindsight, and to read back the circumstances of sale to an earlier event.

13. This approach runs quickly into a major snag. This is that the loss I made at the time of gift may already have been used - in whole or in part - to offset gains on other assets. So clawing back that loss would be cumbersome and complex. There would also be some other, more technical difficulties in identifying how much loss should be clawed back.

14. The argument adduced for this proposal is that the present position discourages people from passing on some of their shares to a son or daughter actively involved in the business. Although the father may well be deemed to have a loss at the time of gift, because of the normal valuation basis, he may not be able to use that loss and the son or daughter will have a correspondingly increased gain. The tax loss of the father does not help the donee.

15. This is not a new point, nor is it really anything to do with rebasing: it applies equally to shareholdings acquired after 1982. And it is fairly straightforward to avoid the effects I have described by a judicious use of a trust. At the simplest, I as a 100% shareholder can transfer my shares to a trust (with gifts relief - which will continue for shares in unquoted trading companies after the Budget), and give my son or daughter a one-third interest in the trust, keeping the other two-thirds interest for myself. The trustees are regarded as having a single 100%

shareholding, so the same valuation basis runs throughout, but by using a trust I have given my child a one-third stake in the company. In this way, the problem put to us on gifts effectively disappears, without the need for complex or cumbersome provisions.

Court cases

16. At the meeting, Mr Winterton's advisers expressed concern about the possibility that, if there was no concession on valuing minority shareholdings, people might take us to Court in order to try and establish higher 1982 valuations for CGT, and that, if the Courts upped our valuations, this might lead us to impose higher valuations for IHT (where people want low valuations).

17. In fact this is unlikely to happen. There is a right of appeal on share valuations to the Special Commissioners, and the Courts would be very reluctant to overturn the Commissioners' valuations. The Special Commissioners already hear appeals of this kind in relation to market valuations of minority holdings at 1965 where the issues are identical, and our approach is consistent with the line the Commissioners have adopted over the years, so the likelihood of appeals disturbing our valuation basis is very small.

Conclusion

18. On valuations for 1982 rebasing, the proposal put to us is the same as in the summer, except that it is now limited to shareholdings in the same family.

19. As regards gifts within the family, there is a simple way, involving use of trusts, of avoiding the

results which concern Mr Winterton's advisers. To legislate here would involve complex and cumbersome rules, and - as with the suggestion for 1982 valuations - reading back later circumstances to an earlier event.

Michael Cayley

M F CAYLEY

NHO/

CONFIDENTIAL

FROM: J M G TAYLOR

DATE: 11 July 1988

PS/FINANCIAL SECRETARY

cc PS/Paymaster General
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Cayley IR
PS/IR

**CGT REBASING: 1982 VALUATIONS OF MINORITY HOLDINGS IN UNQUOTED COMPANIES**

The Chancellor has seen the Financial Secretary's minute of 7 July. He very strongly agrees with the Financial Secretary's conclusions.

J M G TAYLOR

66/77

CONFIDENTIAL

CHANCELLOR

Copy to Mr Isaac, Mr Pitts, Mr Hamilton, Mr McDowall

FROM: FINANCIAL SECRETARY

DATE: 7 July 1988

cc Paymaster General
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Cayley - IR
PS/IR

**CGT REBASING: 1982 VALUATIONS OF MINORITY HOLDINGS IN UNQUOTED COMPANIES**

I have had a number of representations from, inter alia, the Park Lane Hotel, Nicholas Winterton, Tony Favell and Sir Anthony Jacobs, on the question of how the Revenue establish 1982 valuations for minority holdings in unquoted companies for CGT purposes. The particular concern is that people with such holdings gain little or no benefit from rebasing.

**Current Rules**

2. The valuation rules are based on how the market values a particular shareholding. Thus to get a 1982 valuation of a minority shareholding the Revenue simply consider how much that particular shareholding would have fetched on the open market on 31 March 1982 if it had been sold.

3. The problem arises when minority shareholdings are subsequently disposed of in a take-over. In such circumstances the disposal price will obviously reflect the premium that the bidder is prepared to pay in order to gain control of the company. The capital gain equals the difference between a market price on disposal which reflects a control premium and a 1982 valuation which assumed that the minority shareholding would be disposed of independently of other shareholdings in the company (and would not accordingly have attracted a control premium).

4. In effect, the representations I have received are wanting 1982 valuations to be revised up ex post when it subsequently turns out that shareholdings have been sold in a take-over. It is argued that the 1982 valuation is done on one basis - which depresses the base cost for CGT purposes - and the disposal price results from a different basis of valuation.

## Evaluation

5. There has been a good deal of pressure on this point. We have raised the CGT rate for large real gains to 40%, and it is true that many people do not gain greatly from rebasing. Nevertheless I do not think we should make a concession:

(i) The capital appreciation post-82 in the event of a take-over is no different from a Rowntree situation - why help unquoted company shareholders but not the shareholders of quoted companies?;

(ii) We make no secret of the fact that post-82 real gains should be taxed;

(iii) The same people have benefitted from the same valuation rules for minority shareholdings when CTT or IHT rather than CGT has been at issue;

(iv) Although we do give IHT and CGT reliefs to enable unquoted companies to be passed on intact, I do not see the case for alleviating the burden on shareholders wishing to sell out on a take-over.

6. It will not be popular to stand our ground on this. But I see no real case for a concession.

NL

NORMAN LAMONT

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
30 June 1988

FINANCIAL SECRETARY

CGT REBASING - 1982 VALUATIONS OF MINORITY HOLDINGS IN UNQUOTED COMPANIES

1. You will wish to consider carefully the notes below from Mr Cayley and Mr Pitts.

2. If I were to try to summarise the message in four sentences, it would be that

- a concession would probably be technically possible - though not this year;

- however, it would be complex and for that reason alone an unwelcome addition to an already complex CGT code;

- it has no very obvious justification in principle;

- it would accordingly create anomalies at the margin, of a kind which look pretty difficult to explain.

A J G ISAAC

---

| | | |
|---|---|---|
| cc | Chancellor of the Exchequer | Mr Isaac |
| | Chief Secretary | Mr Beighton |
| | Paymaster General | Mr Pitts |
| | Economic Secetary | Mr Cayley |
| | Mr Scholar | Mr Hamilton |
| | Mr Culpin | Mr Michael |
| | Mr Cropper | PS/IR |
| | Mr Tyrie | |
| | Mr Jenkins (OPC) | |

Inland Revenue

Policy Division
Somerset House

FROM: M F CAYLEY
DATE: 30 June 1988

1. MR PITTS I have added a note at the end. 30/6

2. MR ISAAC

2. FINANCIAL SECRETARY

CGT REBASING - 1982 VALUATIONS OF MINORITY HOLDINGS IN UNQUOTED COMPANIES

1. Following the meeting on 20 June with Mr Favell, Mr Winterton, Sir Anthony Jacobs and Mr Forward, you asked me to let you have a paper on the proposal they have put to you.

THE PROPOSAL

2. Under the Bill, the 1982 value of an asset, for both rebasing and indexation, is obtained by establishing what that asset would have fetched on the open market on 31 March 1982. In the case of a minority holding in an unquoted company, it follows that (in the absence of any statutory rule directing to the contrary) each shareholding is considered separately and independently.

---

cc. Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Jenkins (OPC)
Mr Isaac
Mr Beighton
Mr Pitts
Mr Cayley
Mr Hamilton
Mr Michael
PS/IR

3. The market value of a shareholding - whether in a quoted or unquoted company - depends on the size of the shareholding. At one end, controlling shareholdings will normally attract a substantial premium, because the shareholder can exercise effective control over the company's affairs and assets. At the other end, the value of a small minority holding will normally be determined primarily by reference to company profits and dividends.

4. At the meeting, it was accepted by your visitors that it was perfectly right that these normal principles should apply for valuations at 1982 if shareholders disposed of their shareholdings individually, whether by sale, bequest or gift - and this is clearly appropriate, since the disposal value will be determined on the same basis.

5. It was however suggested that, for unquoted shares, there should be a different approach to 1982 valuations if some (or all) of the shareholders sold their shares in concert. In those circumstances a control or takeover premium could well be reflected in the disposal price. As a result there could be substantial additional gains. The suggestion made is that, instead, we should treat all the shareholdings which were in the event disposed of simultaneously as single shareholding in March 1982 valuation, instead of a series of independent minority shareholdings. If, for example, over 50% of the shares were sold, we would value all the shares concerned as a single controlling holding, with the control premium built in. We would then apportion that value between the shareholders pro rata to the size of their respective shareholdings. So if 50% of the shares were sold someone with a 5% holding would have it valued at 1982 at one-tenth of the value of a single 50% holding - producing normally a substantially higher 1982 valuations than if it was valued as an independent minority holding.

6. A simplified example may help. Take a minority holding worth £100,000 in 1982 which might, as a minority holding, be worth £200,000 now. On a takeover now, the holding might be sold for, say £750,000 because it was being sold as part of the sale of the whole business - giving, ignoring indexation, a gain of £650,000. And £550,000 of this will be attributable to the takeover situation.

7. Mr Winterton has suggested that we should in these circumstances value unquoted shareholdings in 1982 at the price they would have fetched in a takeover - in effect reading back to 1982 the circumstances of the final sale. On this basis, a holding worth in isolation £100,000 in 1982 as a small minority holding might have a 1982 CGT rebased value of around £400,000.

GENERAL ARGUMENTS

8. In principle it is not obvious that this is the right answer. In effect we are being asked to read back to 1982 the circumstances of a sale years - possibly decades - later - circumstances that would normally not have been predictable in 1982 (and if they <u>were</u> predictable then, that would be reflected in the 1982 valuation on normal market principles). It could not legitimately be claimed that the only circumstances in which minority unquoted shareholdings would be disposed of would be either where people acted in concert or where they did not: but they are much more usually sold, given away or bequeathed as independent holdings, and that is the more natural assumption to make.

9. The takeover or control premium that may arise where shareholders act in concert will be attributable to circumstances that came into existence after 1982. It represents a real post-1982 gain - in the same way as the takeover premium that attaches to quoted shares (eg Rowntree) when there is a takeover bid. As such there is an

argument for saying that it is right that it should, even with rebasing, remain liable to CGT.

10. Thus one way of looking at what we are being asked to do is that it is to give a special CGT relief, through a special 1982 valuation rule, for people who acquired minority interests in unquoted companies before 1982, and sell them in concert with other shareholders after 5 April 1988 in circumstances where a control or takeover premium is reflected in the disposal proceeds and where, as a result, there are large post-82 real gains.

11. The argument - as was, I think, reflected in the way our visitors put their case - for doing this is that, without this special rule rebasing will not give as much benefit as people would hope for in these circumstances; that substantial real gains would still be in charge, and quite often liable at 40%; and that this could have a disincentive effect on, in particular, family companies and other small unquoted unquoted companies.

THE COMPARISON WITH PARTNERSHIPS HOLDING SHARES

12. At the meeting with Mr Winterton, reference was made to the position of partnerships holding shares in companies. The valuation of the shares is on the basis that the partnership is a single investor, irrespective of how many partners there are, and we then apportion that value between the partners. So if a partnership owns all the shares in a company, and there are ten partners each with a one-tenth interest in the partnership, each partner's interest at 1982 in the shares is valued at 10% of the value of a single 100% holding.

13. This follows from the factual position and the position in law. In law the shares are held by the partnership, not in separate blocks by individual partners. And the partners

are not free to dispose of blocks of shares independently of each other: the partnership will act as (as in law it is) a single shareholder so their position is totally different from that of ordinary minority shareholders. The comparison with partnerships is thus a misleading one.

ANOMALIES

14. I mentioned to you that if one accepted Mr Winterton's suggestion one would be in danger of creating a number of anomalies.

15. Most of these centre on the contrast between people who acquired their shares before 31 March 1982, and those who acquired them after.

16. The first group (those who bought, were given, or inherited shares before 31 March 1982) would have the benefit of the special valuation rule. The second group (acquiring shares after that date) would not. So someone who bought a minority holding on, say, 27 March 1982 for £1,000 might, if in 1990 the company was taken over, have a 31 March 1982 valuation (and CGT base cost) of around £4,000 because the takeover premium would be built into that valuation. In contrast, someone who bought an identical shareholding on 5 April 1982 for £1,000 would have a base cost of £1,000 because rebasing (and hence the special valuation rule) would not apply as he did not hold the shares on 31 March 1982. Similar contrasts would exist, often only slightly less starkly, where the interval between the two acquisition dates was longer. There could well be complaints.

17. Indeed, the same person might have the benefit of the rule on some shares, but not on others. For instance, he might be given one block of shares in, say, 1981 - which would have the benefit of the special rule - and inherit another block in, say, late 1982 - which would not.

18. There is also the comparison with shareholders in quoted companies. On a takeover, a portfolio investor in a large unquoted company would have the benefit of the special rule: a portfolio investor in a quoted company of the same size would not. So takeovers of large unquoted companies would have a CGT advantage over takeovers of quoted companies of the same size. One way of reducing this contrast could be to limit the rule to people with shareholdings over, say, 5 per cent and/or to people related to each other: but that may not help everyone in a case like the Park Lane Hotel where the information put to us suggests there are over 30 shareholders.

Technical Issues

19. I think a relief of this kind would need to be subject to a claim. This is for two reasons. The first is that one can construct some - unusual - circumstances where it would work against people's advantage (eg where someone had a controlling holding in 1982, and a minority holding at the time of a takeover because since 1982 new share capital had been subscribed by other people). The second reason is that we could often not ourselves identify the cases where the rule should apply, because different shareholders would be reporting gains to different tax offices and all any one tax office might see is a disposal of a single minority holding.

20. A rule of this kind would presumably not apply where either

(i) the company became quoted between 1982 and the date of the share disposals, or

(ii) a company quoted in 1982 ceased to be so.

? Also need to exclude subsidiaries of a quoted group etc.

21. Rules would be needed to allow for share reorganisations between 1982 and the date of disposal, for increases or decreases in issued share capital after 1982, and for cases where the taxpayer increased or reduced his holding between 1982 and the date of disposal. At first sight, some of this looks pretty complicated territory.

22. Careful thought would need to be given to the definition of the circumstances in which a rule of this kind applied. One could not, for example, confine it to cases where shareholders sold their shares on a single day in a single joint transaction: in a takeover, for example, the bidder might write round to shareholders with a formal offer, with shareholders selling their shares on different days. The date of disposal for each shareholder would be normally the date he committed himself to sell his particular holding.

23. We would also need some anti-avoidance provisions to ensure that the sale was a genuine arm's length one, with the shareholders really relinquishing their interest in the shares. Again, the formulation of these provisions would need careful thought.

24. I doubt that any of these technical issues are insuperable: but they would need a little time to work through, and rule out any possibility of legislation at Report this year. I think the legislation could well run to two or three pages.

25. At the operational level, a special valuation rule of the kind suggested could impose a sizeable extra burden on the scarce resources in our shares valuation division and add significantly to the time it takes for valuations to be settled.

## Conclusion

26. Against this background, you will wish to consider whether or not you wish to announce at Report that you will look sympathetically at this point over the coming year. If you do, I can prepare a suitable short speaking note.

Michael Cayley

M F CAYLEY

The best I can do for Mr Winterton's case is to argue that, with the increase in rate (often) to 40%, there could now - despite rebasing - in some cases (not all) be an increase in deterrent, hardly to setting up or continuing to run businesses, but to selling out to a new owner.

This seems to fall a long way short of justifying rewriting history for this one kind of asset. Until a minority shareholder does something, all he has is the value of a minority shareholding: and that is normally the basis on which the price he paid for it (if he bought it) would have been calculated. There is no logic in valuing it at March 1982 as though circumstances had arisen simply because they did so later.

Without a strong argument in the context of your policy of encouraging businesses, there seems insufficient justification for favouring this particular asset by projecting backwards a change in circumstance which actually occurred later so as to cause - then - a change in value. That happens to other assets too.

And since such case as there is for doing so turns on the increase in rate to 40%, it could be setting out on a slippery slope to accept that that part of the CGT reform is a ground for a concession.

[illegible]

30/6

RESTRICTED

**Inland Revenue**

Savings and
Investment Division
Somerset House

These are the sort of minor starters we would put forward in a year when you were not making any wider changes.

FROM: A W GILBERT

DATE: 9 JANUARY 1989

I agree with X.

1. MR KUCZYS

X The first would be well worth doing in its own right (and would fit well with any wider change). The rest are not points we would press strongly, but (equally) should not take up much Finance Bill space

2. FINANCIAL SECRETARY

AWK 10/1

STARTER 153: MINOR CHANGES

1. This note deals with some "housekeeping" measures to tidy up a few minor matters relating to the pensions tax regime. There are three main points that we would like to include in the overall pensions package. They are:

i. a revision of the way in which the 25 per cent limit on personal pension lump sum retirement benefits is calculated;

ii. a change to the rules governing lump sum death benefits from personal pension schemes;

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir T Burns
Dame Anne Mueller
Mr Scholar
Mr Culpin
Mr Luce
Mr Riley
Mr Gilhooly
Mr Dixon
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Loades - GAD
Mr Jenkins - Parliamentary Counsel

Sir A Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Newstead
Mr Lusk
Mr Eason
Mr Kuczys
Mr Fraser
Mr M J Hodgson
Mr Toye
Mr Miles
Miss Dougharty
Mr Hinton
Mr Gilbert
PS/IR

iii. removal of the time limit within which the Board may grant provisional approval to personal pension schemes.

2. We also recommend three very minor technical changes in respect of occupational schemes which apply for automatic (as distinct from discretionary) tax approval and schemes approved under the pre-1970 legislation.

Lump sum retirement benefits

3. The legislation controlling personal pensions lump sums restricts the maximum amount payable to 25 per cent of the value of the member's benefits - ie excluding any benefits for a widow or other dependants after the member's death. The pensions industry have criticised this approach on two counts:

i. They contend that when a member buys a joint annuity (ie an annuity payable to the member for life and then continuing in payment to a widow or widower), it is not easy to separate the costs of each element for the purposes of calculating the lump sum.

ii. It is also suggested that the lure of a larger tax free lump sum may tempt some people to make inadequate provision for survivors' pensions.

4. The industry's criticisms about the complications in valuing each component of a joint annuity have some justification. But the present personal pension rules broadly follow those for occupational scheme lump sums (where widow's and dependant's benefits cannot be commuted). So to allow the personal pension lump sum to be 25 per cent of the value of the total fund would make personal pension lump sums more generous than those available from occupational schemes. It would thus be inconsistent with the level playing field that the industry call for in other areas.

5. But there is an additional problem with the present lump sums rules. At present the 25 per cent limit on the lump sum takes into account the fund built-up from "minimum contributions" paid by the DSS to contracted-out personal pension schemes as well as the fund arising out of the contributions paid in by the member. This is too generous. Because the product of the "minimum contributions" - which is called "protected rights" - may not (under Social Security rules) be commuted, some people can commute the whole of their own personal contributions. The following simplified example illustrates the point:

Example

| | | |
|---|---|---|
| Value of protected rights fund | = | £9,000 |
| Value of personal contribution fund | = | £3,000 |
| Value of total fund | = | £12,000 |

Maximum tax free lump sum (assuming no widow's pension) is 25% of £12,000 = £3000 ie equal to the personal fund.

6. It is possible to deal with both the pension industry's complaint and the over-generosity. The solution is to allow the personal pension lump sum to be 25 per cent of the total fund excluding the value of protected rights. The effect of this on the example illustrated above would be to reduce the lump sum to 25 per cent of £3000 = £750. But in other cases, where the "personal" contribution was greater, but the member had made significant provision for dependants, a larger lump sum than now would result.

7. A change on these lines would meet the industry's complaint about the administrative complexity of the present rules. This is because under Social Security requirements they have to keep a separate record of protected rights anyway, so the split between the protected rights fund and personal fund should always be known. It also deals with the alleged temptation for people not to make adequate provision for their dependants. People will be able to take

their lump sum and then decide how to divide the balance between pensions for themselves and for their survivors.

8. We would expect that the smaller lump sums from excluding protected rights, and the larger lump sums from counting the total 'personal fund', would be likely to balance each other out. The overall Exchequer effect should therefore be neutral.

9. We recommend this change to the personal pensions lump sum rules. It has been suggested by the ABI among others and should be welcomed by the pensions industry.

Death benefits

10. The second issue concerns an extra-statutory concession which ought to be put on a statutory footing.

11. If a member of a personal pension scheme dies, the tax rules will only allow the accumulated fund to be paid out as a lump sum if no annuity is payable under the scheme to a surviving spouse or dependant. On the other hand, the social security legislation allows a lump sum to be paid where there is no surviving spouse to whom an annuity can be paid - that legislation makes no mention of annuities to other dependants.

12. It would be helpful to remove this awkwardness and bring the tax rules into line with those which apply under social security legislation by removing the prohibition on payment of a lump sum where an annuity is paid to a dependant. The change would be beneficial to members, and as a concession is already in operation it would have no cost or staffing effects. We recommend accordingly.

Approval of schemes

13. In order that personal pension schemes should not face delay in obtaining tax approval, the Government took powers

in 1987 to grant provisional approval. This was considered desirable because, with the expected rush of applications for personal pension schemes ahead of the 1 July 1988 start date, there was a serious risk of a blockage developing in granting tax approval.

14. Tax approval is very important to personal pension schemes. This is partly because of the tax privileges which go with approval - relief for contributions paid to the scheme and tax free build up of investment income and gains. But just as important for most schemes is that the Occupational Pensions Board require a scheme to be tax approved before they will accept it as suitable for contracting-out purposes.

15. Provisional approval was therefore seen as a way to speed up the processes so that, as long as a scheme was prima facie set up properly, approval could be granted and the scheme start functioning. We could then organise our more detailed examination of the scheme's application for approval over a timescale which matched our resources.

16. The need for provisional approval was, however, seen as a transitional matter; and so the legislation has placed a 1 February 1990 deadline on its availability. The flexibility which provisional approval offers is, however, something which could usefully be retained as a permanent feature.

17. An amendment to achieve this effect should take up no more than 3 or 4 lines of Finance Bill space. It would have no Exchequer cost and should ensure that no increase in the numbers of staff engaged on approving personal pension schemes will be required from February 1990 - which could otherwise be necessary to avoid delays in approving schemes. We recommend accordingly.

Conflict with Preservation

18. The section of the tax code (Section 590 ICTA 1988) governing automatic approval of pension schemes specifies

that the only benefits which may be paid are a pension on retirement at a specified age, and death benefits. However the preservation provisions in the Social Security Act 1973 place a statutory requirement on scheme rules to provide short service benefits for early leavers. Such benefits are not within the very limited class permitted for automatic tax approval. Such a scheme therefore has to apply for approval under the Board's discretion (Section 591), even if every other condition of automatic approval is satisfied. It is clearly undesirable that Section 590 should be rendered unworkable by the Social Security legislation. We would therefore like to make a minor change to the legislation to allow the statutory benefits for early leavers to be payable under the rules for automatic approval.

Controlling directors of investment companies

19. Typically these investment companies are controlled by one or two individuals and the investments consist of a portfolio of stocks and shares or rented property. Little active management is normally required and so the remuneration these people receive is in reality no more than the investment return on capital washed through their own investment companies.

20. For the purposes of personal pensions and retirement annuities this remuneration is not regarded as 'relevant earnings' and so cannot be pensioned. By the same token, this group should be excluded from membership of occupational pension schemes. Any scheme with such people in membership which applies to the Superannuation Funds Office (SFO) for discretionary approval is accordingly turned down. But if a scheme fulfills all of the conditions for automatic approval set out in Section 590 of the Income and Corporation Taxes Act 1988 the SFO has no discretion to withhold approval.

21. This is not a real problem at present but it would become so if the suggestion at paragraph 18 for amending the rules for automatic approval is accepted. Only a small amendment to Section 590 would be necessary to remove this loophole. The change, although tightening controls on membership, is unlikely to be controversial as it merely confirms current general policy. There would be a small tax saving, spread into future years. On this basis, we recommend this change.

Pre-Finance Act 1970 pension schemes

22. Some schemes approved under the pre-1970 legislation have not sought tax approval under present legislation. This is normally because the schemes are dormant - ie they are closed to new members and receive no contributions from employers and members. They can, however, continue to receive tax relief on investment income if the terms on which benefits are paid are not altered. This restriction prevents such schemes from implementing some post-1970 measures which benefit members, such as cost-of-living increases of pensions in payment. The only way around this problem is for a scheme to seek re-approval under the 1970 legislation. But this results in extra administrative costs to both the scheme and the Revenue. It would be helpful to remove the restriction.

23. This change would be to the benefit of these pension schemes and their members and only a very few lines of legislation would be needed. We recommend accordingly.

## Conclusion

24. Of these measures only the 25 per cent lump sum limit is a substantive matter. We would, however, expect it to be generally welcomed as a simplification. The other matters are very minor, but desirable from either a technical or administrative point of view.

A W GILBERT

Robert/11.11.1.89

BUDGET CONFIDENTIAL

FROM: R C M SATCHWELL
DATE: 11 January 1989

MR ROBERTS - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Mr Hoare
Miss Hay
Mrs Chaplin
Mr Tyrie

Mr Sullivan - IR
PS/IR

**SUBCONTRACTORS TAX SCHEME - FEASIBILITY STUDY ON ABOLISHING VOUCHERS**

The Financial Secretary today discussed with you and others your minute of 14 December and Mr Sullivan's minute of 8 December.

It was agreed to go for the substance of option (i) in paragraph 52 of Mr Sullivan's note; namely decouple further work on abolishing vouchers from consultation on the new eligibility rules. But it was also agreed that that further work need not wait until the changes in the eligibility rules had produced "a more compliant certificated population" (which might take several years). Rather, it should be resurrected once the shape of the new eligibility rules have become clearer following consultations with the industry, EDU and Customs (on VAT requirements). This would imply a third stage of consultation following Stage 1 on this year's Finance Bill measures and Stage 2 on the changes to the eligibility rules (due to be implemented in the 1990 Finance Bill).

You also agreed to submit a further note on the content and timing of the consultations on this year's Finance Bill measures.

R.C.M.S.

R C M SATCHWELL
Private Secretary

**Inland Revenue**

Compliance and
Collection Division
Somerset House

FROM: J H ROBERTS
12 January 1989

FINANCIAL SECRETARY

SUBCONTRACTOR TAX SCHEME

1. At yesterday's meeting you were concerned at the prospect of the issue at this stage of a consultative paper on the proposed changes following the Efficiency Scrutiny and our embarking on discussion with the industry and representative bodies prior to the Budget. You felt also that any measures for 1989 should be published in the Bill and not left over to introduction at Committee.

2. CONSULTATIONS

Pending your decision yesterday on the vouchers question we had drafted a paper covering in detail the whole of the first package of changes including the measures for this year's Finance Bill. But we agree this is not now the right time to be issuing such a document and we propose therefore to redraft it for issue after the Budget and to defer the outside consultations accordingly. Reference to the consultations could then be included in the Budget Speech or made during the debates. If you are content we will submit a revised draft of the consultative paper after the Budget presentation has been settled.

---

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mr Gilhooly
Mr Hoare
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Chairman
Mr Beighton
Mr Cherry
Mr Crawley
Mr Muir
Miss James
Mr Sullivan
Mr Dunbar
PS/IR
Mr Roberts

## 3. 1989 FINANCE BILL MEASURES

The present starters consist of

a. some addition to our enabling powers to allow regulations to be made on reducing voucher flow

b. a number of small changes to the scheme mainly designed to take some concerns out of the scheme.

Only the measures in a. would have a significant impact on our staffing requirements and are essential to our achieving the short term savings from the scrutiny. Those in b. would be deregulatory, tending to benefit only larger firms.

You previously wished (Mr Satchwell's minute of 5 December 1988) to keep both a. and b. in the 1989 Bill subject to the discussions with the industry and/or the size of the Bill making this impossible. The measures in b. do really require preliminary consultations. As this is not now possible, are you content that they should be left over to next year. This year's primary legislation would then merely be extensions to enabling powers but drafted broadly enough to cover the package of voucher-reducing regulations resulting from the consultations. But the big reduction in paper work would still be achieved on the same timetable as in the Scrutiny Action Plan.

## 4. PUBLIC ACCOUNTS COMMITTEE

The Chairman is to appear before PAC on 30 January. The Committee have previously raised questions about the subcontractor scheme, particularly in connection with fraud and abuse. They are aware of the existence of the Efficiency Scrutiny and the NAO have seen a copy of the Report (but on a strictly confidential basis). If the Committee raise any questions on 31 January it is proposed that the Chairman should give no information about the content of the report, on the grounds that the report is still being considered by Ministers. Are you content with this line?

JHR.

J H ROBERTS

BUDGET SECRET

H.M. CUSTOMS AND EXCISE
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SE1 9PJ
01-620 1313

CHANCELLOR

FROM: P G WILMOTT

DATE: 12 JANUARY 1989

## BUDGET 1989 : EXCISE DUTY - UNLEADED PETROL

### INTRODUCTION

1. This note considers options on unleaded petrol, following discussions at Dorneywood. It assumes a rise in the tax differential (ie duty and VAT) between leaded and unleaded petrol of 5p a gallon, in the context of a general standstill on excise duties. (1.1p a litre)

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Circulation:

Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr Macpherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Gilhooly
PS/IR
CPS
Mr Jefferson Smith
Mr Gaw
Mr Kent
Mr Allen
Mr Spackman
Ms French
Mr Vernon
Mr Warr

WILMOTT TO CX 12 JAN

THE OPTIONS

**Option A**

2. This would involve increasing the excise duty on leaded petrol by 4.35p per gallon while leaving unleaded unchanged. This would raise about £280 million in 1989/90 and some £290 million in 1990/91 (or -£125 million and -£140 million respectively in scorecard terms). The RPI impact effect would be 0.08 per cent.

**Option B**

3. This would reduce the duty on unleaded petrol by 4.35p while leaving duty on leaded petrol unchanged. The cost would be about £20 million (from a non-indexed base) in 1989/90, assuming an increase in the market share of unleaded to 5 per cent for the year as a whole, with an increased cost in 1990/91 dependent upon further growth in market share of unleaded. The RPI effect would be negligible.

DISCUSSION

**Presentation**

4. Given a general standstill and a desire to boost the uptake of unleaded petrol it could seem odd to single out leaded petrol for an increase simply to raise the differential (Option A) rather than targetting unleaded for a unique decrease (Option B). Option B would also avoid the complication of an automatic rise in the price of AVGAS and gas for use as road fuel (the rates are linked to that on leaded petrol).

5. Increasing the tax differential by 5p a gallon (including VAT) gives an overall tax differential of 15.6p a gallon, the largest in the EC apart from Denmark. Doubling the pump price differential from roughly 5p to 10p a gallon would make unleaded cheaper than all but the most

heavily discounted four star leaded petrol. (The present 10.6p tax differential is reflected in a price differential of some 5p to 6p at the pumps compared with four star and an average differential of less than 1p compared with two star leaded petrol. This is because some of the difference is absorbed in the higher refining costs of unleaded fuel. But the Government could legitimately look to the oil companies to pass on any increase in the tax differential in toto).

**Other Factors**

6. Efforts by the Unleaded Petrol Group* to increase awareness of the existing general price advantage and the environmental issues appear at last to be having an effect on the take up of unleaded petrol. The Department of Trade and Industry's Price Marking (Petrol)(Amendment) Order, coming into force on 23 January will enable unleaded prices to be more prominently displayed. The unleaded share of the petrol market rose from less than 2 per cent in mid October to almost 3.5 per cent in mid December. The proposed increase in the tax differential can be expected to increase the market share at 31 March 1990 to between 5 and 8 per cent with continuing increases in subsequent years as awareness and availability grow.

*The Unleaded Petrol Group, chaired by the Parliamentary Under Secretary for the Environment comprises representatives from Government Departments, trade, motoring and consumers organisations together with CLEAR (the Campaign for Lead Free Air).

## 2 Star Petrol

7. A number of organisations have urged the Government to ban 2 star petrol on the grounds that virtually all cars using 2 star can use unleaded. A ban would enable smaller filling stations to switch storage and pump capacity from 2 star to unleaded thus ensuring greater take up. The example usually quoted is that of Germany who banned leaded 2 star in February last year. However the German market share of regular (2 star) petrol is much larger than UK and the German oil industry, unlike its UK counterpart, markets both premium (4 star) and regular (2 star) unleaded petrol. Germany has an unleaded market share of more than 40 per cent, of which 65 per cent is regular (2 star).

8. The Netherlands market is similar to the German and vehicle excise and petrol duty incentives, together with 100 per cent unleaded coverage at filling stations, resulted in the rapid elimination of unleaded regular.

9. The market share of 2 star in the UK is some 10 per cent and declining so that a ban, which would sit oddly with the Government's general deregulatory stance, would not achieve the dramatic results seen in Germany. A discriminatory tax differential against leaded two star would give rise to considerable presentational and control difficulties. Our view is that a tax differential of 5p a gallon for unleaded petrol, reflected fully at the pump, should significantly hasten the demise of 2 star, and that more drastic regulatory measures (or tax discrimination aimed specifically at 2 star) are not necessary.

P G WILMOTT

Robert 02.13.1.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 13 January 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr Lewis )
Mr Farmer ) IR
Mr N Williams )
PS/IR

Ch/ Agree FST?
JS 13/1

OK N.

**SHARE OPTION SCHEMES (STARTERS 112, 113 AND 115)**

In your minute of 16 December agreeing with my recommendation that we should not take up the British Venture Capital Association's idea of a tax relief to encourage high quality managers to move from large to small firms (Starter 203), you asked me to look again at the possibility of raising the limits of the 1984 discretionary share option scheme. This issue had been covered (para 47 of Mr Williams' minute of 6 December on Starter 112, which reviewed <u>all</u> the employee share schemes) as part of the collection of papers which we discussed at your meeting on 13 December.

I remain of the view that we should leave the limits for this particular employee share scheme as they are. My main reason is that since the limit is the <u>greater</u> of £100,000 or four times earnings, it is already indexed in practice. It is true that last year's Budget measures have reduced the attractiveness of this scheme somewhat. But the benefits remain substantial; and as Mr Williams' note to you of today shows, there is no sign of any dramatic decline in interest in discretionary schemes during the last 9 months. A change might also detract from those we are making to the all - employee scheme limits.

in pink folder behind.

I did consider whether an increase in the multiplier from four to perhaps six times would encourage the sort of change the BVCA would like to see happen by recompensing managers moving to small companies for reduced salaries. I am not entirely convinced however that managers in this situation do always necessarily take a vastly reduced salary. Moreover, a change of this kind would not be targetted, but would also help more than adequately remunerated executives. For those on lower salaries, the fact that the average size of option granted was about £26,000 in 1987-88 shows that there is still room for generous increases within the current limits.

I suggest we make no change for the moment. Andrew Tyrie and Judith Chaplin agree.

R.C.M.S.

pp NORMAN LAMONT

CHANCELLOR OF THE EXCHEQUER

Ch,

Housing policy

EST would like to raise this again tomorrow am at Prayers. (He is unclear whether you want both to write to backbenchers and to provide background briefing, or just the latter).

17/11

Discuss.

chex.pj/jc/13.1.2

CONFIDENTIAL

FROM: MRS JUDITH CHAPLIN
13th January 1989

CHANCELLOR

I v. much agree with most of this. Pse do go ahead with X. I assume a note on Y will be coming up with the briefing for the Ridley mtg. As I recall, this is something we considered v. carefully last year and ultimately rejected. But happy to look at it again.

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

**HOUSING POLICY**

I think the Economic Secretary is right in saying that repossession stories may grow like the "baby-dying" stories last year. Although I agree with you that many people, coping adequately with their own mortgage interest payments, will feel little sympathy with those who have got into difficulties, there will be genuine hard luck stories. Often the difficulties will arise from other factors which have been exacerbated by the interest rate rise, but the other factors will be played down while the rate rise is highlighted.

2. I think, therefore, we should make sure that both the DoE and Central Office have good briefing covering the scale of most people's mortgage interest payments (not just new mortgages), the size of mortgage interest payments related to income and the small numbers of repossessions related to total mortgages. It should also contain good quotes, such as those from Mark Boleat, that interest rate rises "should not lead to people losing their homes unless the loan was a bad loan at the outset", and from the Abbey National Building Society, saying that their arrears are falling. Would you like me to put a note together and talk to the Special Adviser at the DoE?

X

3. Because of the increasing interest in repossessions, it would seem unwise to add to the likelihood of such stories by the timing of any related measures such as the changes in help with mortgage interest for those on income support. The changes are to deal with abuse and would not affect changes related to the rate of interest, but it would obviously be poor timing if they were announced in the middle of a spate of repossession stories.

CHAPLIN → CHEX 13/1

4. On the other hand, anything that can be done to increase the supply of homes would be useful. You are meeting Mr Ridley on 18th January and hopefully will be able to dissuade him from any measures which discourage the release of land for building, as discussed at the "Regional Imbalance" meeting.

Y 5. On a narrower point, Mr Ridley, in his Budget representations to you, suggested a tax relief for those who let spare rooms. My first reaction was against the allowance as it contradicts the policy of removing allowances to enable taxes in general to be lower. On second thoughts, there do seem to be a number of points to recommend it.

i. It is clearly important to encourage people to let spare rooms not only to help with the homelessness problem, but also to encourage the unemployed, particularly young people, to go where the work is. In cities it would help keep down the costs of student accommodation and the demands from councils that they need to provide housing for young single people.

ii. The costs would probably be low, for I would think there is little doubt that many rooms are let without the landlord, or more usually the landlady, declaring it. Indeed, after they have taken the allowable expenses into account, there may be little or no tax due and this will be increasingly true once independent taxation is introduced if a wife who does not go out to work receives the income from the letting.

iii. Single parents with young children might be willing to let rooms and thus come off Income Support, although they would probably move on to Family Credit.

6. I doubt if it would lead to a big increase to the number of rooms available to rent, but I think the publicity surrounding any change would certainly encourage people to consider whether they

could increase their income by letting rooms. It would be a positive step in helping to deal with homelessness and labour mobility and, although it is an idea that originally emanated from the Social Democrats, I think is worth considering.

JC

JUDITH CHAPLIN

est.ld/tls/james/16 Jan/PS CX

CONFIDENTIAL

FROM: S M A JAMES

DATE: 16 January 1989

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call

**HOUSING POLICY**

The Economic Secretary has seen Mrs Chaplin's minute of 13 January. He strongly agrees with Mrs Chaplin in favouring tax relief for domestic lets by owner occupiers. The main source of rented accommodation in the short term must be existing housing stock. (It would also help in an oblique sort of way to offset concern about the impact of mortgage rates in hard cases to show we were doing something to stimulate the rented sector. But clearly this connection is a delicate one).

S M A JAMES
Private Secretary

chex.md/jmt/31 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 17 January 1989

PMP

MRS CHAPLIN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Gieve
Mr Tyrie
Mr Call

**HOUSING POLICY**

The Chancellor was grateful for your note of 13 January, and for PS/Economic Secretary's note of 16 January.

2. He very much agrees with most of what you say, and he is well content for you to put together a briefing note on mortgage interest payments/repossessions etc and to talk to the Special Adviser at the DoE.

3. On the Environment Secretary's suggestion of a tax relief for those who let spare rooms, he recalls that this is something we considered very carefully last year, and ultimately rejected. But he is happy to look at it again. (FP are providing briefing on this as well as on Mr Ridley's other Budget Representations.)

JMGT → CHAPLIN 17/1

J M G TAYLOR

CONFIDENTIAL

**Inland Revenue**

Personal Tax Division
Somerset House

FROM: R MASSINGALE
DATE: 17 JANUARY 1989

FINANCIAL SECRETARY

STARTER 106
BENEFITS IN KIND: PROVIDED ACCOMMODATION

1. At present, the benefit of free or cheap living accommodation provided to an employee by virtue of his employment is, in practice, measured and charged to tax mainly by reference to the rateable value of the property provided. There is a supplementary charge on properties costing over £75,000 (see paragraph 6). With the replacement of domestic rates by the Community Charge, in Scotland from April 1989 and in England and Wales from April 1990, new domestic properties will not be valued and the present valuation list will no longer continue fully to be maintained. (For Northern Ireland domestic rates are to continue.) It follows that it is necessary to devise new rules for valuing this benefit.

2. Even were that not the case, it would at some stage become appropriate to review the position since, with 1973 rentals (1978 in Scotland) forming the base for rateable values, this is another benefit (like cars) at present substantially undertaxed, leading to inevitable distortions in behaviour. A realistic contemporary measure of the benefit might typically produce tax charges 4 to 10-fold higher than at present.

3. A new benefit charge will have to apply throughout the country from the same date. Legislation in 1989 to take effect from April 1990 will give employers and employees fair warning of the change and operationally smooth the transition to the 'new system'.

## Present tax charge

4. Where an employee is provided with living accommodation by reason of his employment he is liable to tax on the value of the accommodation provided. This charge applies whether or not he is a director or "higher paid" employee. (But there are important exemptions - see paragraphs 36 and 37 - more people are exempt than liable.)

5. The main charge provides that the measure of the benefit is the annual value of the property reduced by any rent paid by the employee to the employer. Since "annual value" for this purpose is defined in the same way as the "gross value" for rating purposes in practice the income tax charge is based on the gross rating value.

6. Pending decisions on the future of rates and to counter both the worst effects of the undervaluation of the benefit and also an avoidance device, (see para 42) the 1983 Finance Act introduced a supplementary charging provision for expensive accommodation. This applies where the accommodation, broadly, has cost the employer more than £75,000. It gives an additional benefits in kind charge determined by applying the "official rate" (used for taxing the benefit of cheap loans - currently 14.5%) to the amount by which the cost of the property exceeds £75,000.

## The current regime in operation

7. Those taxpayers who are charged to tax on the benefit of provided accommodation (something less than 150,000) fall broadly into two groups at opposite ends of the employment spectrum. On one hand there are relatively low paid and modestly housed employees (primarily in the retail and catering trades) who often literally "live over the shop"; aligned with these are employees of small businesses of many kinds where the proprietor owns property and makes it available to an employee because such an arrangement suits both parties. This group have no interest in the capital value of the underlying property.

8. The other major group comprises close company directors who may well live in expensive employer provided accommodation. In such cases the corporate veil between employer and employee may be very thin; the two are often effectively one and the same. The employee faces a small tax charge (which can be reduced or expunged by paying a modest rent to the employer) in exchange for which tax relief would generally be available to the employer in his business for maintenance costs, insurance and any costs of financing the property, without regard to the £30,000 mortgage interest limit.

9. On the other hand, there is a potential CGT penalty for the employer who cannot qualify for the 'private residence' exemption but this is in practice likely to be modest. Here the employee as the tenant of the employer continues to a greater or lesser extent to benefit from any capital growth notwithstanding the strict legal status of his occupation. In a similar position are those (typically senior executives of large companies) who occupy properties with an option to buy at a low fixed value.

A new measure of the benefit

10. We have considered a number of ways in which the benefit of provided accommodation could be measured in future. Most methods would be unsatisfactory on grounds of operational or compliance difficulty, or because they would not provide a good fit with the circumstances of those who enjoy this benefit.

11. We illustrate briefly below some of the approaches which we believe need to be rejected:

Rental Value

Such an approach would attempt in relation to each provided property directly to assess the open market rental value. This is the conceptual basis of the present system based in practice on rating values and is a logical way of measuring the benefit of the use of real property. Reliance on the rating list has over the years meant that the measure of the benefit now bears little relationship to 'real' rental values. To found a new system on the concept of rental value would simply not be feasible. The thin UK domestic rented property market means that sufficient evidence of actual rents by reference to which valuations could be made simply does not exist. It would have high resource implications, for employers and for Valuation Office professionals. We would need to deploy professional valuers - who are not available - almost to 'invent' rental values. Because of the lack of evidence, the scope for disputes would be substantial.

A Scale Charge

This would involve a scale of charges by reference to the type of accommodation provided defined in some way eg by number of rooms/floor area, modified perhaps by location. Any such scale would need to be complex (much more so than for cars) so as to take account of the enormous variations in house types, quality, age and condition as well as geographical variations which can make a substantial difference to value. In practice we could not envisage administratively workable scales which would be other than unacceptably crude and lead to unsustainable inequities.

Indexing Rating Values

This would involve the continued use of the 1973 rating assessments, otherwise of course than for the growing number of new and adapted properties, increased by a multiplier which would need to be adjusted periodically. But it would make no sense to base a new tax system on an underlying valuation which is now accepted as so outdated and unfair that it is no longer sustainable for local taxation purposes. To an extent this would effectively perpetuate a deteriorating version of the present domestic rating system - especially since 1973 values would still have to be fixed for new properties.

A proportion of capital value

12. As all other possibilities seem clearly to lead to dead ends we think we are driven to looking to capital values as the starting point as a basis for measuring the benefit given the withering away of the rating lists. It would involve taking an arbitrary, though reasoned, proportion of the capital value of provided property as the value of the benefit on which tax would be charged. Some other OECD countries approach the tax problem in this way. (And a recent article by Samuel Brittan in the Financial Times on the implications of mortgage interest rate changes for the RPI mentioned it as the only satisfactory way (in the absence of rental evidence) of fixing the "shelter" value of accommodation - Annex A.)

13. Starting with capital values involves deciding:

- on what basis underlying capital values should be established

- by whom capital values should be established and how enforcement/compliance could be ensured

- what proportion of capital value to measure the value of the benefit

- how to deal with the transition to the new basis

- how to treat land (as opposed to accommodation) occupied by an employee.

The next section of this note looks at each in turn.

## MAIN FRAMEWORK OF A CHARGE BASED ON CAPITAL VALUES

### a) Basis of establishing capital value

14. The logical basis for establishing a capital value of accommodation would be, notwithstanding the employer's particular tenure of the property, the open market value of an unencumbered freehold on the basis of existing use. There are three reasons for this:

- equivalent properties would produce the same benefit charge without regard to the underlying tenure

- the effect of the encumbrance of the employee's tenancy - which would depend on the exact terms on which he occupied the property - would be disregarded

- artificially high benefit charges resulting from unrealised development value would be avoided.

### b) Establishment of capital values

15. This is the crux of any new charge on this basis.

### Implications for employers

16. As with other benefits in kind the initial responsibility would be for employers to report the capital value of properties occupied by employees on the annual (P11D) return of benefits. There are currently about 150,000 properties provided by employers and occupied by employees in non-exempt occupations.

17. Because the proposed new system involves individual judgments in each of these cases (rather than reference to an existing rating list) it will be more burdensome and less certain than the current regime. However, capital values are generally well understood and most employers are likely to have a fairly accurate idea of what a particular property is worth. In some cases an employer may have to engage professional advice (the typical cost of valuation might be £100 to £200); but companies may already need to do this for Companies Act reporting purposes. With the ending of rating values there are bound to be some extra compliance costs. Ultimately they are in the employer's hands if he wishes to give this kind of benefit.

18. We have considered whether, an initial capital valuation for a property having been established, it would be possible to uprate that figure each year by reference to some standard, readily available index of house price movements thereby avoiding the need for an annual return of value. Unfortunately, there is no single index that would be suitable for this purpose. There are, of course, various indices of house price movements - eg those published by the building societies - but these tend to focus on particular sectors of the market. There would be obvious difficulties in seeking to use a single index for all accommodation bearing in mind the very substantial differences in house price movements not only between one region of the country and another but within parts of the same region.

19. An alternative approach we looked at was the possibility of a fixed periodic (say, triennial) uprating of capital values but that appeared unattractive for a number of reasons, particularly because of the lumpiness it would introduce and its lack of flexibility which, it seemed, would paradoxically introduce additional staff and compliance costs. An annual statement of estimated value from the employer, therefore, seems unavoidable.

## Implications for the Revenue

20. There is here the familiar tension between a comprehensive and equitable level of enforcement with relatively high staff costs (and further implications for employers' compliance) and an approach which would have as its aim getting broadly the right results on a more pragmatic basis but with a realistic staff and compliance cost. We are reasonably satisfied that we can get a system which will keep the necessarily greater resource requirements in tax offices and the Valuation Office to a minimum while achieving a satisfactory level of enforcement in line with that in other parts of the tax system, and without putting an unacceptable compliance burden on employers.

21. Property values entered in forms P11D by employers would normally be accepted where they fall within certain clearly defined parameters. Once the system is up and running it should be possible to limit the number of detailed checks because the percentage charge on the capital value is likely to be at a fairly low level so that for most properties, outside the most expensive categories, a large proportionate increase in valuation would be necessary to make a worthwhile difference to the tax charge.

22. There will be circumstances where tax offices would need to seek Valuation Office advice or negotiation on their behalf. The Valuation Office envisages that most referrals from tax offices could be handled by non-professional staff and accepted without the need for formal negotiation in most cases. There will, of course, be some resource cost in the relation to professional staff for difficult or disputed valuations which will in practice, have to take account of other Valuation Office priorities.

## Date for capital valuation

23. It will be necessary to specify a date at which capital values should be established for the purpose of calculating

each year's benefit charge. The most obvious date, would be the first day of the tax year, 6 April. But, particularly in order to get the new scheme in place at April 1990 there would be operational attractions in establishing the capital value at an earlier date, say, the preceding 1 October. This approach would have ongoing attractions; in particular it would allow tax offices to get many benefit charges right in tax codings and so avoid end of year adjustments. It would generally mean a slightly lower tax base for the employee.

c) Appropriate proportion of capital value

24. Since the familiar, and "natural" conceptual basis for measuring the benefit of provided accommodation is rental value there is everything to be said for settling on a percentage of capital values which bears the closest practicable relationship to what the rent might be. There is, obviously, some correlation between rental values and capital values. But there is no direct relationship between capital and rental values for domestic property. The relationship is complex and there are no simple formulae for relating one to the other.

25. We have looked at some academic work on the relationship of rental values to capital values and the observed ratio noted by the Valuation Office and others. The results are shown in Annex B. While the results are not conclusive they do suggest a broad order of the relationship between rental and capital values at around 4-5 per cent. This is necessarily a rough and ready figure, but at this level the new benefit charge could be defended as broadly reasonable, by reference to a rental analogy. Valuation Office advice is that in the commercial world this relationship has been and is likely to remain reasonably stable so having set a rate, it should be possible to leave it unchanged for a fair length of time, if not indefinitely (subject to transitional proposals - see paragraphs 29 et seq below).

26. We think that there should be no hint of spurious accuracy in the figure chosen and on that basis (and also for computational simplicity) we recommend a whole number. Clearly whether the eventual figure, after transitional arrangements, is 4 per cent or 5 per cent (or indeed any other figure) is essentially a matter for Ministers' judgement. The main considerations seem to be

- 4% produces a lower charge which would be easier to present at a time when (after transitional arrangements) the tax charge for most provided accommodation would be going up steeply

- 5% would take some account of a lag in the annual valuation (see para 23);

27. Examples of the tax charge which would result for taxpayers in various typical categories of property and a couple of exceptional examples at the 4 per cent and 5 per cent rates are shown in Annex C and are there compared with the typical charge under the current rating value based regime.

d. Transitional arrangements

28. To move immediately from a valuation of the benefit based on 1973 rating values to one based (directly or indirectly) on current rental values would involve a big increase in the tax charge. The position varies widely from area to area, but broadly speaking the current charge is likely to be well below 1% of the capital value so the increase would be typically 4 to 10 fold.

29. Ministers will wish to consider how the impact of such a charge might be cushioned. One possibility would be to introduce the new basis for 1990/91 with a single low starting percentage and in subsequent Finance Bills step up the percentage until a proper level was reached. This would,

however, open the matter up for debate in later years and create uncertainty. It may well tend to prolong the current undertaxation of provided accommodation.

30. Alternatively if there was at the outset a decision of principle about the final appropriate level of charge it might be preferable to have a clear transitional regime with the target level made explicit.

31. With a system based on a percentage of capital value such a transition could be effected relatively simply by using a lower percentage for the first one, two or more years. Annex C (Table C) shows how transitional arrangements might operate in relation to those properties.

32. An example from Annex C is a typical 3 bedroom "semi" in the south-east with a capital value of £78,000; it illustrates how the increase could be spread over 3 years and shows that:

- the tax charge would move from £310 currently to almost £1,250 (with a 4% proportion of capital value) in the following steps - £310, £416, £832, £1,248

- even with a 3 year transition the year by year increase is steep because the overall increase is large

- this particular approach gives a relatively small increase in the first year and much larger increases in the second two years.

It would, of course, be possible to spread the introduction of the new charge over a shorter or longer period, and make the progression smoother (though that would entail a less straightforward arrangement).

33. A special transitional regime would be required for more expensive (over £75,000) houses where the full new charge may well be less - for very expensive houses, much less - than the current one. (This is because that provision was designed primarily for anti-avoidance purposes and produces a high charge; it is however a blunt instrument and applies in many cases where there is no question of avoidance. In these cases it can produce unjustifiably high charges.) It would not be right to give a temporary reduction through the transitional arrangements in these cases. The rule might be that where the full new charge for 1990/91 would be less than the charge under the old regime there should simply be no special transitional arrangements.

e. Other land

34. At present the main charge covers only the benefit of "living accommodation". There is a separate charge where an employee is provided by his employer with land and non-living accommodation but that charge only applies to directors and the higher paid. The value of the benefit is currently calculated along the lines of the accommodation charge - in practice we take the rating value. In the context of a substantial change in the basis of charge for living accommodation there is a case for a single charge covering the provision of all land including accommodation (if any) standing on it. This would however create some new charges for low paid workers provided with land such as agricultural workers.

35. There is a great range and variety in land (other than living accommodation) provided by employers for employees. Examples would include garages (not forming part of living accommodation), stabling for animals, orchards, paddocks and other agricultural land. Despite this range there is no reason to suppose that a charge at the proposed 4% or 5% might in any particular circumstances be disproportionate.

## OTHER MAIN ISSUES

### Exemptions from the charge

36. At present an employee living in provided accommodation is exempt from tax on the benefit in any of the following three cases:-

(i) Where it is necessary for the proper performance of his duties that he should reside in the accommodation. This test is a very strict one and in practice only people such as lock keepers, railway crossing keepers or housekeepers in office blocks qualify under it.

(ii) Where the accommodation is provided for the better performance of the duties of the employment and it is one of the kinds of employment where it is customary for employers to provide living accommodation for employees. This much looser test has brought in people like nurses, farm workers in tied cottages, police and prison officers, clergymen, the armed forces, diplomatic personnel, publicans living over the premises etc.

(iii) Where there being a special threat to his security, special security arrangements are in force and he resides in the accommodation as part of those arrangements. This was introduced to deal with a particular problem of diplomats and judges living in Northern Ireland and certain Ministers of the Crown.

The historical reasons for these exemptions are explained in Annex D.

37. Not all of the exemptions are particularly easy to justify and for many employees a very real benefit goes untaxed (the employee gets the living accommodation free,

even if it is not what he would have chosen for himself). Their application involves subjective judgments and invidious distinctions but there would be obvious presentational difficulties in removing them so that those affected (many low paid or in politically sensitive occupations) were moved from a regime where no tax charge exists to one with a potentially high benefit charge. We assume that Ministers will not want to open up this issue at this stage, particularly given the prospective size of the bill and the potential controversy which could rebound on the already difficult job of finding a new basis for the charge where it already applies. This suggests deferring any more fundamental reconsideration of exemptions to a later stage.

Properties rented by employers

38. At present where the accommodation provided to an employee is rented by the employer the benefit charged to tax is the greater of the rating value or the rent paid. In practice this usually means that the rent paid is the measure (because the rating lists are out of date).

39. In the context of a new charge there is an argument that any rent paid should be ignored and the proportion of capital value should remain the measure of the benefit in all circumstances. This would provide the best means of ensuring equity between all who live in provided accommodation and would avoid a number of technical complexities inherent in looking at the rent paid as the measure.

40. On the other hand there would be difficulties where a full rack rent was paid which was significantly higher or lower than the capital value based charge. Where the benefit charge on the capital value basis was more than the rent paid by the employer there would be an argument that the benefit was over assessed to tax. Alternatively the capital value basis could produce a lower charge and an arguable tax loss. The question of a special regime for employer rented accommodation therefore is finely balanced but the attraction

of a single clear cut measure of the value of the benefit with consequent horizontal equity points to providing no exception for these cases. (The car scales operate in this way in the (albeit few) cases where the employer's costs are less than the scale charge.)

Employees paying rent

41. At present where an employee pays his employer a rent for provided accommodation the rent paid is deducted from the annual value of the property before calculating the chargeable benefit. Very large numbers of employees effectively exempt themselves from the benefit charge by this provision. The rule is logical and in line with what happens for other benefits, and we assume that Ministers will wish to see it remain in place.

Options to buy and capital values accruing to employees

42. There remains a need for a provision - in line with the present additional charge - in circumstances where employees (generally directors) could institute arrangements whereby any increase in the capital value of the provided accommodation was reserved to themselves rather than for the employer. The arrangements might be at a formal level of an option to buy the property at a fixed price or more general, in the case of controlling directors, who might arrange a sale from the company to themselves at an open market value which is "clogged" by the employee's tenancy.

43. One way to tackle this matter would be to apply a higher rental factor (perhaps, comparable to the "official rate" of interest used now) to the capital value in any case in which arrangements were in place which would allow the occupier to acquire the property at less than its full unencumbered market value so as to tackle the "option" device directly. Another way might be to extend the beneficial loan provisions to cover it, rather than to complicate the accommodation provisions themselves. A third (and operationally

attractive) approach might be to tackle this issue only when a property is transferred from an employer to an employee and then to measure and charge a benefit as between the price paid and an unencumbered open market value.

44. Each of these approaches could be targeted more accurately than the current rather crude additional charge. But we would need to ensure "right to buy" cases in the public sector were not affected. We will let you have a further note about the best solution when decisions on the general form of the scheme are made.

Accommodation provided for shareholders in close companies

45. Where shareholders of close companies, who are not directors or employees, are provided with accommodation there is a special charge to tax which is broadly based on the Schedule E benefit charge. We think that this should be changed in line with the proposals for employees. Business Tax Division will be sending you a separate note as part of the review of close company legislation (Starter 206).

Numbers and yields

46. Our estimate of the total numbers of employees who currently have job related accommodation is shown in the table below:

| | Rent free | Some rent paid | Total |
|---|---|---|---|
| In non-exempt occupation | 85,000 | 65,000 | 150,000 |
| In exempt occupation | 105,000 | 95,000 | 200,000 |
| Total | 190,000 | 160,000 | 350,000 |

The current yield is around £15m, about half of which comes from the expensive houses charge.

47. If the benefit charge were to be based on a fixed proportion of the capital value of a property less any rental paid by the employee, but retaining the exempt categories as at present, it would be likely to increase yield by about £65m at a 4% rate and about £90m at a 5% rate. If, in the first transitional year (1990/91) the charge was set at 1 1/3% there would be a yield of about £10m. (These figures discount any behavioural response and are based on current property values.)

Length of legislation

48. We estimate that, depending on decisions, and assuming that all of the provisions are in primary legislation, the new charge will involve at least three pages of legislation.

Revenue staff requirements

49. As explained in paragraphs 16 to 23 above there are certain unavoidable resource costs in a new scheme for charging this benefit. In both tax offices and Valuation Office these will be primarily incurred in putting the scheme in place. Depending on decisions as to the final rate charged on capital values and the transitional regime we estimate that in tax offices the staff need might be about 50 units (predominantly clerical staff) for about two years from autumn 1989 when the necessary procedures will begin. In Valuation Offices we think the staff need will be between 15 and 20 units of professional staff and 20 to 30 non professionals depending on the level of referral from tax offices which is necessary in practice.

50. The costs are relatively high for putting the scheme in place because this involves identifying cases where the benefit is given and making a special enquiry about the current capital value of the property. We envisage that the novelty of the arrangement will add to the setting up costs.

51. All of these figures are fairly tentative. However, after the initial setting up period the staff need on an annual basis should fall to about 30 units a year in tax offices and about 15 units a year (in a similar proportion as between professional and non-professional grades) in Valuation Offices.

Summary and points for decision

52. The present arrangements for valuing the benefit of provided accommodation need to be changed because of the abolition of domestic rating values, on which it is at present based, (and as it happens the present rules leave the benefit substantially undertaxed).

53. The only practical approach we have identified, is to measure the value of the benefit by reference to a factor applied to the capital value of the accommodation. The points on which it would be helpful to have early decisions are:

a) Should a new system for taxing employer provided living accommodation, effective from April 1990 be included in the 1989 Finance Bill?

b) If so, should it be based on the existing use vacant possession freehold value of the property?

c) Should the taxable value be determined by taking a specified percentage of the capital value? After transitional provisions should that percentage be 4% or 5% or some other figure?

d) Where a property is rented by the employer should the measure be the same proportion of capital value?

e) Should there be transitional arrangements and should this year's legislation set out explicitly what they are together with the full rate for future years?

f) If so, should the transition be spread over 3 years or some longer (or shorter) period? Should the transition be on a 'straight line' basis (generally giving a smaller increase for the first year)? Or on some other basis?

g) Should the benefit in kind charge for other land be brought in line with that for living accommodation?

h) Should the current exemptions be maintained (at least for the time being)?

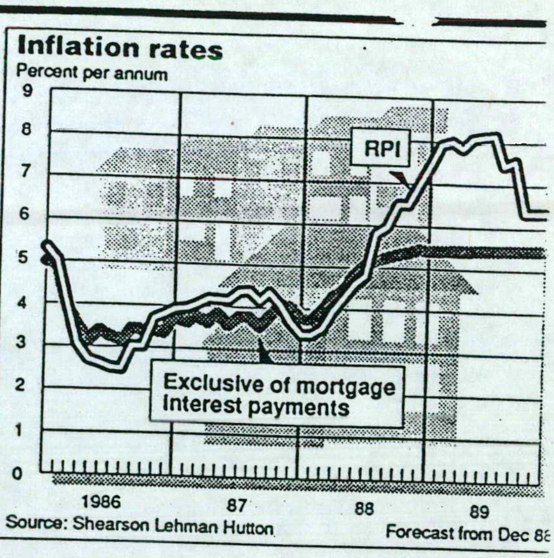
i) Additional rules are needed to cover the extra benefit obtained by the employee who has an interest in the capital value of the accommodation he occupies? (We will need to send you a further note when the main structure of the new system is clear.)

R MASSINGALE

FINANCIAL TIMES THURSDAY JANUARY 5 1989

# Mortgage rates and inflation

By Samuel Brittan




The absurdity of judging the inflation rate by the annual increases of the Retail Prices Index, including mortgage interest payments, is greater than people realise.

During the closing months of 1987 and early part of 1988, when inflationary pressure was building up, the rate of increase of the RPI was actually declining and reached a low of 3.3 per cent last February. In February 1989, on the other hand, when the latest round of mortgage increases has been incorporated, the recorded inflation rate will be well over twice as high.

Some plausible estimates by Peter Warburton of Shearson Lehman suggest that the RPI increase could then reach 7.9 per cent and peak at over 8 per cent in May – boosted by a probable increase in the weight of mortgage payments in the index following the recommendations of the Retail Prices Advisory Committee.

The mortgage interest distortion is to a large extent an echo effect. The measured RPI was low a year ago because the comparison was with a period another year back when the mortgage rate had just been increased. In the first half of 1989, measured inflation will be high because the comparison will be with a period of relatively low mortgage rates in early 1988. Measured inflation will then drop later this year, not because of anything actually going on, but mainly because mortgage rates rose in the course of 1988.

The effect of including mortgage interest in the RPI has swung from that of depressing the inflation rate by 1 per cent in mid-1986 to boosting it by 2½ per cent likely this year.

Do we not pay too high a cost for these switchbacks around an underlying rate of RPI increase, which according to official estimates is now around 5.1 per cent, and should peak at 5.5 per cent in the course of this year? The upward swings above the underlying inflation rate do harm, which is not offset by the periods when the RPI is depressed. When the RPI is artificially high, it is used as a pretext to back wage demands, as reported, for instance, in the December Report of Incomes Data Services. But there is no offsetting relaxation of pressure when distortions are downward.

Not all that is said about cost of living pressures should be taken at face value. The actual movement of earnings has taken the form of a very slow and gradual climb to a 9 per cent per annum rate of increase, and has not reflected at all closely the gyrations of the RPI.

Yet any influence, whether large or small, tending to boost pay settlements is one we need like a hole in the head. There are enough pressures as it is for labour market insiders to fix high rates of pay at the expense of depriving unemployed outsiders of jobs.

As for the financial markets: they have so far ridden through short-term inflationary alarms. This can be seen both from the strength of sterling and the stability of long-term interest rates. But overseas confidence will be put to an unnecessary test if it has to withstand announced inflation rates of 7 to 8 per cent, the reasons for which are not properly understood.

Overseas bankers and financial advisers in my experience express little alarm, or even knowledge, about the UK current payments deficit. On the other hand, they show concern about inflation and very small understanding of the effects of housing on the RPI.

And no wonder. Mortgage interest payments are excluded from the main consumer price indices in the US, Germany and all the the Group of Seven countries apart from Canada.

How then should owner-occupied housing be treated in the RPI? There is an interesting analysis in a paper, Measurement of Owner Occupiers' Shelter Costs, by Penelope Rowlatt of National Economic Research Associates (18 Park Street, London W1Y 3WD).

Dr Rowlatt, who was formerly concerned with these matters at the Treasury, points out that the RPI is meant to cover prices actually paid. It normally excludes the cost of credit and expenditure on investment. Yet the only payments made for accommodation by owner-occupiers are the cost of acquisition and the cost of credit.

Her own view is that no suggested method satisfies the full RPI criteria. Her paper states that complete omission of owner-occupiers' shelter costs should be considered.

More moderate reform is also possible. One suggestion would be to treat the acquisition of a house as the purchase of a consumer durable. This would involve incorporating an index of house prices into the RPI, with a weight corresponding to the proportion of households purchasing a new home in any given period.

A more indirect approach would be to include the imputed rent of what an owner-occupier would have to pay for shelter. Because of the state of the home rentals market in Britain, this could not be done directly as it is in the US. Instead, a rentals index would have to be based on house prices and some representative long-term interest rates.

Thus, both approaches incorporate house prices in the RPI, one directly, the other indirectly. Indeed it feels right that some account should be taken of them in an index of the "cost of living," but with the gyrations resulting from fluctuating credit costs omitted.

One wonders how long the UK Retail Prices Advisory Committee, which in 1986 turned down Treasury suggestions for changing the treatment of mortgage interest, is for this world. It would be too blatant to do anything about this last bastion of corporatism while the present RPI is soaring. But I would not put very much on its continued existence into the 1990s.

No redesign of the RPI can come in time to help the Chancellor with the 1989 inflation bulge. The only way to reduce the shock of the forthcoming figures is to publicise not merely the underlying inflation rate, but also to warn people of the full horror of the blip to be expected in the unadjusted RPI in the coming months. Then, when it occurs it will no longer give rise to such horror or have such news value.

If the need to explain the economic indicators conflicts with the requirements of the Chancellor's traditional pre-Budget purdah, so much the worse for purdah. His job is to explain just as much as it is to adjust taxes or interest rates. At the present juncture the explanatory role is paramount.

Even if Mr Lawson does not personally care what the pack of his slighted critics are saying, it is important to draw their teeth for the wider good of the economy.

**KEY ECONOMIC DATA**

| | 1988 % increase | |
|---|---|---|
| | CSO | GS revised |
| Consumers' expenditure | 5.5 | 6.0 |
| Fixed investment | 9.3 | 19.1 |
| Domestic demand | 5.2 | 7.8 |
| Exports (gds/servs) | 0.9 | 4.3 |
| Imports (gds/servs) | 13.2 | 14.6 |
| GDP (exp based) | 1.3 | 5.0 |
| Current account | -14.5 | -11.5 |
| Savings ratio(%) | 3.4 | 3.0 |

Based on published data for 1988 Q1-Q3, with estimates for Q4

Source: Goldman Sachs

## Filling in the holes

The Thatcher Government is the main sufferer from its own reluctance to put resources into improving official statistics. For the effect of the notorious gaps which have developed in between the various measures of national income is to downgrade the economy's performance, especially in the boom year of 1988 – a year which is crucial to any assessment of the whole economic record since the Government came to office and of any judgment of the supply side "miracle".

The forthcoming efforts of the Central Statistical Office to produce a balanced set of accounts cover only 1985 to 1987 and leave out 1988 when the discrepancies are greatest. Gavyn Davies and David Walton of Goldman Sachs have stepped into the breach with an impressive estimating effort of their own.

Their basic principle has been to follow the CSO's own view that the output measure of GDP is most reliable for recent periods and to boost most those expenditure items which have been revised upwards by the CSO in boom periods.

The result, shown in the table, is to boost the 1988 GDP growth rate to 5 per cent. The item which increases most is fixed investment, which is estimated to have risen by 19 per cent rather than the likely official estimate of 9 per cent. This is easily the largest investment increase in a single year, the previous record being in 1964 (when the Home Government lost office).

Goldman Sachs is less helpful to the Chancellor on the 1988 current deficit, which it is only prepared to revise down to £11½m because of under-recorded invisibles. It thus largely agrees with the CSO that the positive balancing item consists mostly of unrecorded capital inflows. But I doubt if we have heard the last of the wrangles about this overrated indicator.

ANNEX B

RELATING CAPITAL VALUES OF PROPERTY TO RENTAL VALUES

1. Observations of the rented domestic property market by the Valuation Office suggest that rent/capital relativities might typically lie in the broad range 4% to 7%. Expensive property in Central London is likely to be of the sort which will produce the highest percentage levels. On the other hand, in many places, Valuation Office think that there is virtually no rental market for better quality dwellings and suggests that it would be difficult to find tenants even willing to pay 3%.

2. A joint Revenue/Treasury/DOE exercise about a year ago looked at the shortage of private rented accommodation. Central to that work was an informal assumption that a tenant would be prepared to pay on average 4 to 5% of the capital value of the house as rent. If he paid more he would be better off buying his own house. It was recognised that the precise balance between buying and renting is affected by numerous factors, not least the expected capital appreciation of real property. The 4 to 5% was intended to be an average taking into account the current tax regime and the long term trend in house prices.

3. A discussion paper by John Hills (of the London School of Economics) "21 Century Housing Subsidies" takes the opportunity cost of capital as its starting point. This is the real return on money tied up in a house which could have been invested elsewhere. Hills calls this 5%. This is above the yield on long term indexed gilts, the difference being a "risk premium". To this he adds 1% of the capital value to cover depreciation or major repairs. A real capital gain of 1.5% is subtracted leaving 4.5%. This is his net rental yield but management and maintenance costs of 1.5% are added by Hills to give a gross rental yield of 6%. It is arguable whether the tenant should face any benefit charge on management expenses so Hills' figure might be regarded as a little high for our purposes.

4. John Muellbauer (Nuffield College) is a proponent of the reintroduction of a Schedule A type charge based on the capital value of property. He wrote an article in "The Sunday Times" recently which suggested a net rate of 2% to 3%. His justification for this figure is that the long term real return on all types of assets is of the order of 3% and his conclusions, therefore, have a limited relevance to the rented property market.

5. The "Inquiry into British Housing" in 1985 (charred by the Duke of Edinburgh) used a similar approach to John Hills in suggesting a rental figure of about 4% plus management and maintenance costs.

TABLE A

ANNEX C

<u>Comparison of capital value at Autumn 1988* and 1973 rateable value</u>

| | | AVERAGE NEW 3 BED-SEMI | POST 1960 DETACHED HOUSE | NEW 2 BED FLAT |
|---|---|---|---|---|
| SOUTHEAST (Tunbridge Wells) | capital value | £78,000 | 175,000 | 55,000 |
| | gross rating value | 370 | 560 | 235 |
| WEST MIDLANDS (Stafford) | capital value | 51,000 | 120,000 | 35,500 |
| | gross rating value | 290 | 550 | 190 |
| YORKSHIRE (Bradford) | capital value | 33,500 | 70,000 | 24,000 |
| | gross rating value | 224 | 493 | 220 |

* Autumn 1988 Property Market Survey.

TABLE B

ANNEX C

Comparison of tax charge on benefit calculated on a rental yield on capital of 4 per cent [5 per cent] and existing tax charge based on 1973 gross rating values plus the additional charge on property costing more than £75,000

| | TAX CHARGE BASED ON: | NEW 3 BED-SEMI (Tax at 40%) | POST 1960 DETACHED HOUSE (Tax at 40%) | NEW 2 BED FLAT (Tax at 25%) |
|---|---|---|---|---|
| SOUTHEAST | capital value | £1248 [1560] | 2800 [3500] | 550 [688] |
| | gross rating value | 310 | 5,624 | 59 |
| WEST MIDLANDS | capital value | 816 [1020] | 1920 [2400] | 355 [444] |
| | gross rating value | 116 | 2,650 | 48 |
| YORKSHIRE | capital value | 536 [670] | 1120 [1400] | 240 [300] |
| | gross rating value | 90 | 197 | 55 |

TABLE C

ANNEX C

Tax charge on benefit adopting transitional arrangements

Year 1 1/3 of 4% imputed rental yield

Year 2 2/3 of 4% imputed rental yield

Year 3 Full imputed rental yield (table B)

| | New 3 Bed-Semi (tax at 40%) | | | | Post 1960 Detached (tax at 40%) | | | | New 2 Bed Flat (tax at 25%) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Tax charge: (as % of ultimate charge) | Current | Yr 1 | Yr 2 | Yr 3 | Current | Yr 1 | Yr 2 | Yr 3 | Current | Yr 1 | Yr 2 | Yr 3 |
| South East | £310 (25%) | 416 (33%) | 832 (66%) | 1,248 (100%) | 5,624 (200%) | 2,800* (100%) | 2,800* (100%) | 2,800 (100%) | 59 (11%) | 183 (33%) | 367 (66%) | 550 (100%) |
| West Midlands | 116 (14%) | 272 (33%) | 544 (66%) | 816 (100%) | 2,650 (138%) | 1,920* (100%) | 1,920* (100%) | 1,920 (100%) | 48 (14%) | 118 (33%) | 237 (66%) | 355 (100%) |
| Yorkshire | 90 (17%) | 179 (33%) | 357 (66%) | 536 (100%) | 197 (18%) | 373 (33%) | 746 (66%) | 1,120 (100%) | 55 (23%) | 80 (33%) | 160 (66%) | 240 (100%) |

* No transitional relief proposed since full new charge is lower than existing charge.

TABLE D

ANNEX C

<u>Comparison of capital value and 1973 gross rating value for "one-off" properties not covered by Property Market Survey</u>

| | Mansion house | New large detached S East |
|---|---|---|
| capital value | £1m | £500,000 |
| gross rating value* | £1,975 | 2,350 |
| tax charge at 40% based on rental yield on capital of 4% [5%] | 16,000 [20,000] | 8,000 [10,000] |
| existing tax charge on rating value | 57,165 | 25,650 |

* Rating assessments of these properties will vary widely according to amenities and ancillary buildings etc. The new detached house is likely to be fitted to a very high standard (eg triple garage, swimming pool, tennis court) reflected in the higher rating assessment.

SECTION 145 ICTA 1988 EXEMPTIONS: HISTORICAL BACKGROUND

1. Prior to 1977 the tax treatment of living accommodation provided for employees was governed by two separate sets of rules, one for the lower paid and one for directors and "higher paid" employees.

2. The liability of a lower paid employee depended on his being the occupier of the premises; but, if he occupied the premises merely as the representative of his employer he was not regarded as the occupier and there was no liability. The liability of the higher paid employee did not however rest on whether he was the "representative occupier" but on whether he was required by the terms of his employment to reside in the accommodation provided, and whether it was necessary for him to reside on the premises for the proper performance of his duties.

3. But over the years the developing case law governing representative occupations meant that the definition became a great deal wider than the tests above for exemption applicable to the higher paid. So this distinction became increasingly unworkable. The 1977 provisions were therefore introduced with a view to regularising the position.

4. It was considered in 1977 that an exemption from the charge should continue to be available for those employees who are required to live in certain premises for the purposes of their employment and that the test for this exemption should be one which applied to the "higher paid" and "lower paid" alike. The general principle was that where an employee was obliged to live in the provided accommodation, rather than where he chose, the accommodation could in a sense be regarded not as a benefit but as compensation to the employee for

a disbenefit in undertaking his duties. The test that fulfilled this requirement was whether the occupation of the accommodation was essential for the performance of the duties.

5. There were, however, a good many groups of employees who had hitherto been exempt from tax as representative occupiers who would not be able to meet this first test. A second test was, therefore, introduced under which exemption was available where the accommodation was provided for the better performance of the duties and the employment was of a kind in respect of which it had become customary to provide accommodation. The fact that it had been found necessary through the years to provide houses for such a class and that there was a link between the practice and the performance of the job was regarded as showing that the employee must live in the house to do the job. This test brought in such groups as agricultural workers, school masters in boarding schools and police officers.

6. There remained a few instances where someone in the public service whose security was a risk and was thus provided with accommodation, but the provision of such accommodation did not need meet either of the two previous tests (for example a diplomat, an official in Northern Ireland or a particular minister of the crown). A third test was therefore introduced to cover such people. (This rule applies in terms to private and public sector employees but we suspect few if any claims have been made by private sector employees).

INLAND REVENUE

Press Release

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

[3x] 18 August 1988

BENEFITS IN KIND: EMPLOYER PROVIDED LIVING ACCOMMODATION

1. There are special rules for taxing the benefit an employee receives when his employer provides him with "expensive" living accommodation. The Inland Revenue have been advised that one aspect of these rules - the provision intended to bring properties with a market value of more than £75,000 within the scope of them - is defective. This press release explains the defect and the circumstances in which tax may as a result have been overpaid for earlier years.

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2. Under Section 145 Income and Corporation Taxes Act 1988 (formerly Section 33 Finance Act 1977) there is a charge on employees enjoying the benefit of free or cheap housing which in practice operates by reference to the rating value of the property. But since rating values for England and Wales were last fixed in 1973, they do not reflect the current value of accommodation. Accordingly, an additional charge was introduced in 1983 (Section 146 Income and Corporation Taxes Act 1988) on those employees enjoying the benefit of expensive accommodation.

3. The intention was that the additional charge should operate where either the actual cost of the property or, in certain circumstances, its market value at the date the employee first occupied the property, exceeded £75,000. But the Inland Revenue have been advised that the additional charge does not apply unless the actual cost of the property (plus expenditure on improvements before the year of assessment) exceeds £75,000. Only where the actual cost plus the cost of improvements exceeds this amount can the charge be calculated, in certain circumstances, by reference to market value. So properties whose actual cost (plus improvements) was less than £75,000 are not within the scope of the charge even if their market value exceeds £75,000.

/4. For 1988/89 tax

4. For 1988/89 tax will only be due on the basis of the new understanding of the law. The change of practice will apply from the beginning of 1987/88 and accordingly, for 1986/87 and 1987/88 a repayment of tax already paid may be due under the "error or mistake" provisions in Section 33 Taxes Management Act 1970 for anyone who first occupied property on or after 31 March 1983 and who has paid tax on the basis of the current market value, where the actual cost to the employer plus the cost of improvements was £75,000 or less.

5. Where tax has been charged on the previous incorrect basis for 1986/87 or 1987/88 and repayment appears to be due tax offices will invite claims to repayment of tax. PAYE codings will be altered for 1988/89 where these include an adjustment for living accommodation benefits on the previous incorrect basis. However, tax offices may not always be able to identify these cases, or to identify them quickly. Consequently, anyone who believes that he may be affected by the change should contact his tax office, giving his tax reference together with the name and address of his employer.

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NOTES FOR EDITORS

6. Where an employee is provided with living accommodation by reason of his employment he is (unless qualifying for a specific statutory exemption) liable to tax on the value of the accommodation provided.

7. The main charge is in Section 145 Income and Corporation Taxes Act 1988 (formerly Section 33 Finance Act 1977) which provides that the measure of the benefit is the annual value of the property occupied (or the outlay on rent if that is greater) less any rent paid by the employee. In practice the annual value has generally been measured by reference to the property's rating value.

8. The 1983 Finance Act introduced from 1984/85 a supplementary charging provision for more expensive accommodation in what is now Section 146 Income and Corporation Taxes Act 1988 (formerly Section 33A Finance Act 1977). Where the living accommodation plus improvements cost more than £75,000, there is an additional income tax charge which is determined by applying the "official rate" of interest (which is used for taxing the benefit of cheap loans and is currently 9.6 per cent) to the amount by which that cost or, in certain circumstances, market value exceeds £75,000.

9. Section 33 Taxes Management Act 1970 provides for relief to be claimed where, by reason of an error or mistake in a return, there is an overcharge to tax in an assessment which is final. But no relief is due where the return was made on the basis of the practice generally prevailing at the time the return was made. This means that no relief is due in connection with the change mentioned above for 1984/85 or 1985/86 if the return was made before 6 April 1987.

/10. Where no assessment

10. Where no assessment has been made Section 206 Income and Corporation Taxes Act 1988 will usually require any assessment made later than 5 April next following the end of the year of assessment, to be made on the basis of the practice generally prevailing on that 5 April. Paragraph 4 above indicates the years for which a repayment of tax may be due. But in some exceptional circumstances the new interpretation of Section 146 may be applied for 1984/85 or 1985/86, eg where an appeal remains open against a 1984/85 assessment made before 6 April 1986 or a 1985/86 assessment made before 6 April 1987.

11. Since the tax on employer provided living accommodation is for the most part based in practice on domestic rating values which will no longer be maintained following the introduction of the community charge, the Government will be reviewing the basis of the tax charge on living accommodation with a view to introducing, in due course, new rules for the future.

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**CONFIDENTIAL**

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: T J PAINTER
DATE: 18 JANUARY 1989

FINANCIAL SECRETARY

FST v. keen to go this in 1989.

PROVIDED ACCOMMODATION: STARTER 106

1. It may be helpful if I pick up one or two points arising from Mr Massingale's note (attached) on this, difficult, starter.

Background

2. It is of course concerned with taxing - as a benefit in kind - the benefit of free or cheap accommodation provided by an employer for his employee. On any objective view the present system is unsatisfactory. There are questionable exemptions taking large numbers of employees out of tax altogether, and the amount charged on those who are liable is far below the current value of the benefit.

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cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Chairman
Mr Isaac
Mr Painter
Mr Pitts
Mr Ridd
Mr Lewis
Mr Massingale
Mr O'Brien
Mr Hodgson
Mr Reed
Mr Dawson
Mr Boyce
Mr I Stewart
Mr Jarvis
Mr Shutler ) Valuation
Mr Coe ) Office
PS/IR

3. But our starting point for this proposal is not a general reform of the "accommodation" charge. The practical need is to change the basis on which the charge is assessed. At the moment tax is assessed on gross rating values. Since the domestic valuation lists will no longer be maintained, from April 1989 in Scotland and from April 1990 in England and Wales, a new basis of charge will be needed.

4. There is no doubt a case in principle for a more thorough-going reform, as in much of the messy benefits field. (The Institute of Directors say this in their Budget Representations). But against the well established background of difficulty and sensitivity as regards benefits in kind we have taken it as axiomatic for the time being that proposals should focus solely on the more restricted practical issue.

5. Mr Massingale's note deliberately does not spend time discussing the option of exempting the benefit of employer provided accommodation from tax entirely. Only 40% of cases where there could be said to be some benefit are charged to tax at present so that the current yield is small (about £15m). The proposed scheme would be more difficult to operate than the current, simple, system and legislation could well be contentious. That might suggest a case for getting shot of the problem by total exemption. But the case against is clear-cut, given the revenue at stake if there were anything like a realistic charge on those not currently exempt, Ministers' stance on benefits in kind generally, and of course, the need for reasonable evenhandedness in the treatment of all kinds of employment income.

Basis for a new charge

6. The note explains that the only practical possibility we can see is a charge derived from the capital value of the property occupied. We recognise that at first blush a charge on this basis may be thought to sit a little uneasily with

the rejection of capital-based rateable values for the reform of local authority finance. It would not, of course, be expressed as a charge on capital value; what we have to arrive at for this, as for other benefits, is the annual value of the benefit as a part of income.

7. The conceptual basis on which the present system rests is rental value. But, as for the domestic rating system itself, too few properties are rented at market rentals to make that a sustainable basis.

Amount of the charge

8. What proportion of the capital value should be taken to arrive at the annual value of the benefit for the employee is very much a matter of judgement. Mr Massingale's note suggests that a figure of 4% or 5% would - very broadly - reflect the long-term relationship between market rentals and capital value. But we suggest that you would want to avoid explicitly labelling the figure emerging from the new system as something directly equivalent to a market rent.

9. Going straight to 4% or 5% would mean unrealistically big increases in liabilities. Mr Massingale describes possible transitional provisions which would raise the charge to that level, over a period of years, if you decided that were your eventual aim. The precise phasing would be very much a matter for political decision.

Compliance/Administration

10. One great virtue of the present system is its ease of administration (for employers, employees and ourselves) because all that those involved have to do in most cases is to refer to a figure already determined for rating purposes. Any new system is bound to involve more work and be more troublesome because a figure will have to be found specifically for this purpose for each property.

11. On the Government's side the crucial resource question is the demand the new system will make on professional valuers in the Valuation Office (the more so in the light of the more recent development). A system which depends on valuations supplied by employers must be subject to a reasonable measure of checking and challenge in some cases. That inevitably means <u>some</u> professional involvement. But against the background of the very difficult professional staffing situation of the Valuation Office there is clearly no scope for diverting more than a handful of staff to this work as least in the early years.

12. If you decide to go ahead with legislation we shall need to do more work on the precise arrangements for checking of values and their reference to the Valuation Office or, of course, the possibility of sub-contracting. This could affect the conclusion in paragraph 50 of the note which from an operational viewpoint sensibly assumed, other things being equal, that there were advantages in a higher Valuation Office input in the setting up period.

<u>Timing</u>

13. If the case for keeping the benefit within tax is accepted it is not <u>essential</u> to legislate in the 1989 Finance Bill. It would be possible to continue to rely on rating values for existing properties and to ask the Valuation Office (the rating authorities in Scotland) for "tone of the list" valuations for new or substantially altered properties. (As a practical matter there would probably be only a small need for such valuations and in the Valuation Office they could be made by non-professional staff.) This approach would be needed in Scotland for next year in any case. But it could scarcely be a long term solution because the rating lists will continue to deteriorate and become less relevant. We would be perpetuating for tax a basis which had fallen into disrepute.

14. The positive case for legislating for the replacement system in this year's Bill is that it is the 'natural' time to do so. It would allow the new legislation to be in place (in England and Wales at least) and the detailed arrangements to be settled as the rating system ceases to apply and before the community charge comes into operation. You may also see attractions in keeping the legislation away from any controversy arising at that stage. There are in any case considerable presentational and practical advantages in legislating a year in advance of implementation to create a breathing space for employers and employees to review their arrangements and to comply with the new drill (and for us to devise the most economical method of administration). From that point of view the earlier the legislation the better.

15. The prospect of legislation was trailed, with Ministers' approval, in August last year in a press release (attached to Mr Massingale's note) about the current additional charge. That gave no commitment on timing. But delay beyond the 1989 Bill would, I suspect, raise the obvious question 'if not now, why not?'

16. The normal reason would be to allow a period for consultation. We would in any case expect the usual criticism of legislation of this sort whenever it was introduced, without consultation. And the Institute of Directors have already urged that legislation should be deferred until proposals they say they will be putting forward on this issue and on the benefits-in-kind regime generally can be taken into account.

17. Whatever the attractions of consultation elsewhere and in principle (and in practice, for getting the nuts and bolts right) it is, to say the least, unalluring in this case. The pressures would be largely predictable, and one-way - to limit the scope of the charge still further, to attack the rationale of the new basis, to seek fine-tuning, to reduce effective compliance and to fend off, or weaken, any move to a more realistic level of charge. And it would stimulate

debate on the present, difficult, benefits in kind regime generally when there are no Government initiatives for broader reform in prospect.

18. Perhaps I should add that delay of a year or two would not help with the Valuation Office resource problem; the prospective short fall in professional valuers is estimated to continue for several years. We need to find other ways of keeping that to a minimum.

T J PAINTER

Robert 01.19.1.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL
DATE: 19 January 1989

MR GILBERT - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Dame Anne Mueller
Mr Scholar
Mr Culpin
Mr Luce
Mr Dixon
Mr Gilhooly
Mr Matthews
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Loades -GAD
Mr Jenkins - OPC

Mr Kuczys ) IR
Mr Hinton )
PS/IR

**STARTER 153: MINOR CHANGES**

The Financial Secretary was grateful for your minute of 9 January, which he discussed with you and others.

The Financial Secretary agrees with the Chancellor that the personal pensions rules should be changed so that the lump sum is limited to 25% of the total fund excluding the value of protected rights. He also agrees that the amendments recommended in paras 17 and 23 of your minute (allowing provisional approval of personal pension schemes to continue beyond February 1990, and removing the restriction on tax relief for investment income in pre-FA70 schemes) should be included in this year's Finance Bill if there is sufficient space. However, the other recommendations in paras 12, 18 and 21 of your minute are not of high enough priority for inclusion this year.

R.C.M.S.

R C M SATCHWELL
Private Secretary

CONFIDENTIAL

**Inland Revenue**

Business Tax Division
Somerset House

FROM: J H REED
DATE: 19 JANUARY 1989

1. MR McGIVERN
2. FINANCIAL SECRETARY

STARTER 206: CLOSE COMPANY LEGISLATION

At Monday's Overview meeting we undertook to do more work on the costings of the options for replacing close company apportionment. This note summarises our conclusions.

Investment income of individuals

2. By far the most important element of the costings is the view taken on the amount of investment income currently received by individuals which would be transferred to a close investment company - we assume a negligible effect on the tax yield from existing companies. Our starting point is the forecast statistics for individual higher-rate taxpayers in 1989-90 (we look at individuals because Independent Taxation will be in force from 1990-91). (The forecast is based on the 1986-87 survey of personal incomes projected to 1989-90 by Treasury economic forecasts and is therefore, when used in the detail we require, subject to a substantial margin of error.) The table gives details for individuals with investment income of more than £20,000.

| Investment income 1989-90 gross of tax | No of taxpayers ('000) | Total amount of investment income (£m) | Dividend income (%) |
|---|---|---|---|
| £20,000-£50,000 | 120 | 3,400 | 45 |
| £50,000-£100,000 | 21 | 1,400 | 45 |
| £100,000-£200,000 | 3.4 | 450 | 50 |
| £200,000-£500,000 | 1.1 | 300 | 50 |
| >£500,000 | 0.2 | 200 | 70 |

2.TXT

<u>Arguments for and against transferring income to a close investment company</u>

3. If the corporation tax rate applying to a close investment company ("CIC") is less than 40 per cent a higher rate taxpayer would save tax if he accumulated income, and realised capital gains, in a CIC. But there are potential tax charges on putting investments into a CIC and on realising the investment; these might outweigh the tax saving.

4. If an individual currently has investments which have an accrued capital gain the prospect of paying CGT if he transfers them to a CIC may deter him. The table shows that dividend income forms a very substantial part of total investment income, particularly where this exceeds £500,000. And it is likely that, despite the stock market crash, the great majority of these shares are showing an accrued gain. So, at least in the shorter-term, it is unlikely that much current dividend income would be transferred to a CIC.

5. In practice, the same is likely to be true of income from property. And for higher rate taxpayers bank and building society income liable at the composite rate is effectively taxable at less than 40 per cent (for 1989-90 the effective rate will be about 37.5 per cent), giving little incentive to transfer this to a CIC. Adding these sources of income to dividends, they account for about 80 per cent of the income shown in the table.

6. There is also a potential tax charge when someone wants to obtain cash from his investment. Even if this is not expected to happen for many years it is something which a taxpayer and his advisers would wish to consider before setting up a CIC.

7. If he takes the money out as a dividend, <u>at a time when he is still a higher-rate taxpayer</u>, the combined tax bills of the individual and the CIC will be greater than if the individual had owned the underlying investments directly. If instead he sells the shares in the investment company he will

normally be liable to higher-rate tax on the capital gain (which would reflect the accumulated income and capital gains of the company). The same would be true if he liquidated the company; and in addition, the CIC would also be taxable on any accrued capital gains on its investments.

8. There are some exit routes which would reduce the potential tax charges. One is to hold the shares in the CIC until death, when the accrued capital gain escapes tax. Another is to become non-resident before disposing of the shares. But there would remain a CGT liability on the company on any gain it realises on a disposal of its investments - while if the investments had been held directly this gain would have escaped tax as a result of the death of the individual or of his becoming non-resident. Of course, a well-advised taxpayer may seek to use a tax avoidance device to escape the CGT liability. But even if a taxpayer and his advisers think they know of a device which will work, there must be a risk that before he wishes to use the device, which is likely to be several years in the future, the device will have been blocked. And they may think that there is a risk that a future government would impose a penal tax regime on close investment companies.

9. Our view is that the potential tax charge on the realisation of the investment in the CIC will deter the vast majority of investors. Even if an investor sees a satisfactory way of mitigating the charge, for example by holding the shares until death or by becoming non-resident, he may be deterred by the need to lock-in his investment until then in order to avoid a heavy tax charge.

Effect of a 35 per cent rate

10. As Mr McGivern explained at the meeting, it is a matter of judgment how much a particular option would cost, and different people could quite reasonably come to different conclusions. But we think a fair assumption would be that about 10 per cent of the investment income of those individuals who have investment income in excess of £100,000 a

year might be transferred to CICs . Given the deterrent effect of the entry and exit charges it seems unlikely that much more than this would be transferred, and of course it might turn out that the transfer would be much smaller. But a 10 per cent transfer would cost about £5 million a year (10 per cent of £950 million at 5 per cent).

11. We would also expect some individuals with investment income of less than £100,000 a year to transfer some income to CICs. But clearly the proportion transferred would be much smaller. We think it is reasonable to assume, say, a further cost of about £5 million a year (for example, 2 per cent of £4.8 billion for those with income between £20,000 and £100,000 at 5 per cent), making a total of £10 million.

12. The costings in this note reflect a variety of possible circumstances and resulting tax charges. But we believe that the main effects are a reduction in income tax payments and a corresponding, although smaller, increase in corporation tax on income. There could also be effects on payments of tax on capital gains and of stamp duty, although we believe that the net effect of these would be negligible (the point being that entry and exit charges on capital gains would deter potential users of CICs unless, for some reason, they did not expect to pay these).

13. The £10 million is a long-term cost. The 1989-90 cost would be negligible. The 1990-91 cost would depend upon how rapidly people set up CICs. If, on average, everyone who would eventually set up a CIC did so in early 1990 the 1990-91 cost would be £5 million (this represents a loss of income tax with little or no counter-balancing increase in corporation tax in 1990-91). In practice we doubt that the take-up would be so rapid. But since the choice is between a cost of £5 million and a negligible cost, our advice would be to show a cost of £5 million in the Red Book. We would also recommend a footnote explaining that the costing is very sensitive to behavioural effects and so is particularly uncertain.

Distribution test

14. There are arguments for and against having a distribution test with a 35 per cent rate. The case for having one is that without one there could be an increased tax burden on existing companies which are currently liable at the small companies rate. With a 35 per cent rate, the combined tax bills of the company and the individual on distributed profits would be higher (at 48 per cent) than if the individual held the underlying investments directly. This is arguably not serious if it deters someone from setting up a CIC. But it is more of a problem for someone with an existing CIC, particularly since he may face a double charge to CGT if he liquidates the company.

15. The main objection to a distribution test is that it adds to the complexity of the legislation. This is inevitable but we propose to make the distribution test fairly simple, so we would not expect it to add substantially to the length of the legislation. The other argument against is that it could add to the tax cost. The current proposal is for a distribution test that would be satisfied if a property company distributed at least 70 per cent of its profits while for other CICs the requirement would be 85 per cent distribution. For a company liable at the small companies rate, and with higher-rate shareholders, this gives an effective tax rate (on the distributed plus retained profits) of 35.5 per cent for a property company and 37.75 per cent for other companies.

16. On the whole, we think that someone thinking of setting up a CIC would prefer to retain the profits in the company if the special rate of CT were 35 per cent. But with a property company some people might prefer to distribute 70 per cent of the profits - and so obtain an overall tax saving of 4.5%. So it is just possible that some people might be attracted into setting up a property company who would not do so in the absence of a distribution test. We do not believe that this effect would be sufficiently marked to cause us to increase our costing of £10 million a year. But we see a case for having a higher distribution requirement with a 35 per cent

rate than with a 40 per cent rate - the argument being that it is less serious if a CIC fails the distribution test. We suggest a requirement of 80 per cent for a property company and 90 per cent for other companies. This would make the effective tax rates 37 per cent and 38.5 per cent respectively.

Effect of a 40 per cent rate

17. We think that with a 40 per cent rate a distribution test is essential to prevent harsh results. And the proposed distribution requirements of 70 per cent and 85 per cent seem reasonable. As I have said, these produce effective tax rates of 35.5 per cent and 37.75 per cent. The 37.75 per cent rate is obviously, by itself, much less attractive to potential CIC users than a 35 per cent corporation tax rate. Against this, the exit route is less of a problem because, by definition, at least 70 per cent of the profits will already have been extracted as dividends. The remaining 30 per cent is potentially taxable, although this is less worrying for the investor in that, for a CIC liable at the small companies rate, the combined tax bills of the company and the individual would be only 40 per cent. A more serious problem is the potential double charge to CGT. This is particularly true of property companies and this is likely to outweigh the advantages of an effective tax rate of 35.5 per cent.

18. Overall, our judgment is that this option would cost less than a 35 per cent rate. We think that a reasonable costing would be £5 million a year in the longer-term, but with a negligible cost in 1990-91.

19. The argument against a 40 per cent rate is that it would be seen as clearly penal; and a higher rate than applies to multinationals. And no doubt there will be some genuine hard cases, particularly in the property field, where it may not be possible to satisfy the distribution test (perhaps because of exceptional expenditure for which substantial profits need to be retained). In its favour is that it reduces to almost

negligible amounts the potential cost; and in practice would virtually eliminate the use of CICs as a tax shelter.

Effect of a 37.5 per cent rate

20. We think that this would have to have the same distribution test as for a 40 per cent rate. We believe that a 37.5 per cent rate is too high for accumulation of profits within a company to be attractive to more than a handful of people. So most people setting up a CIC would be aiming to pass the distribution test. It follows that the cost would be broadly the same as for a 40 per cent rate and our view is that, after rounding, it would be identical.

21. The attraction of a 37.5 per cent rate over a 40 per cent rate would be that it looks less tough. This could also be seen as a disadvantage in that the Opposition might criticise it as a hand-out to the wealthy, although as we have indicated above in discussing the 35 per cent rate, we think that there would be virtually no justification for this criticism.

Conclusion

22. As we said, the costings are very difficult because of the importance of assessing the likely level of take-up. The figures we have given above may prove to be wrong - but we see no way that we can produce better estimates. If Ministers are content with these, we think that the crucial question is whether you think that a price of up to £10 million a year is worth paying for an attractive simplification measure. And of course whether you can defend this politically. If so, we would recommend a 35 per cent special rate of corporation tax. On balance, we would also recommend a distribution test. And we suggest distribution requirements of 80 per cent for property companies and 90 per cent for other companies.

23. If you find the £10 million cost too high, but a £5 million cost acceptable, then we would recommend a rate of 40 per cent or 37.5 per cent. In either case a distribution

requirement of 70 per cent for property companies and 85 per cent for other companies would seem reasonable.

24. Finally, as Mr Isaac pointed out at the meeting, the choice of a 35 per cent rate here would have no necessary implications for the taxation of the income and capital gains of trusts. The entry and exit charges are different and in particular there is not the same double charge to CGT. We shall be letting you have a further note about trusts before the Budget.

J H REED

EXTRACT FROM OVERVIEW DISCUSSION

Close Company Legislation

17. Following the tax reductions in last year's Budget, there was a strong case for a radical simplification of the close company provisions, along the lines suggested by the Financial Secretary. The options for the tax rate for close investment companies were 40 per cent with a distribution test; and 35 per cent without such a test. Further work was needed on the costs of these options, though that inevitably involved considerable judgement. The latest Revenue view was that the long-term costs might be £10 million with a 40 per cent rate and £20 million with a 35 per cent rate.

18. In discussion, the following points were made:

(i) introducing a 35 per cent rate might lead to criticism that a special lower tax band was being created for the very rich. This, however, ignored both entrance and exit charges, and the other costs of investing through a close investment company (eg the potential two-tier CGT charge);

(ii) a 40 per cent rate would mean introducing a new, higher CT rate, which had presentational disadvantages; and the distribution rules would reduce the simplifications, though not significantly;

(iii) most close investment companies were probably vehicles used by the wealthy to hold portfolio investments. The changes proposed could, however, have some effects on genuine property companies; special provisions for them might be needed.

19. It was agreed that the Financial Secretary would consider these two options further, based on further advice from the Revenue on costings and other issues, including what 'genuine' use was made of close investment companies. He would also consider the intermediate option of a 37½ per cent rate, with or without a distribution test.

ACSA

A C S ALLAN

16 January 1989

<u>Distribution</u>

Those present
Mr S Matthews
PS/IR
Mr P R H Allen - C&E

(note: all members of the permanent Overview cast receive the full minutes, even where they did not attend all the items).

CONFIDENTIAL

**Inland Revenue**

Business Tax Division
Somerset House

PPS / PSE
(Longer term business tax reform folder)

Note @ GW

From: E McGIVERN
Date: 19 January 1989

FINANCIAL SECRETARY

STARTER 206: CLOSE COMPANY LEGISLATION

1. Mr Reed's note below sets out the further work we promised to do on costings.

2. A brief summary of the possible costs of the various options is as follows:

| Tax rate (%) | Effect on tax receipts (£ million) 1989/90 | 1990/91 | Long-term |
|---|---|---|---|
| 35 | Neg | -5 | -10 |
| 37.5* | Neg | Neg | - 5 |
| 40 | Neg | Neg | - 5 |

* For the reason given in Mr Reed's note (paragraph 20), the cost of a 37.5 per cent rate of CT for these companies would in practice be much the same as for a 40 per cent rate.

3. As I explained at the meeting, the costing are highly uncertain and judgmental. The crucial question is how many

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cc PPS
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Hardcastle
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Mr Isaac
Mr McGivern
Mr Bush
Mr Cleave
Mr Corlett
Mr Campbell
Mr Gordon
Mr Eason
Mr Fitzpatrick
Mr Stewart
Mr Mace
Mr Cayley
Mr Reed
Mr Huffer
PS/IR

taxpayers would be likely to use CICs at any of the given CT rates; and how much investment income (or to be precise, the relevant assets) would they transfer to these companies. All we can do is make informed guesses.

4. Mr Reed's figures and assumptions reflect our considered views. For the vast majority of taxpayers, the possible entrance and exit charge (including the possible double CGT charge) and the present composite rate arrangements will kill the attractions of CICs as a tax shelter if apportionment is abolished.

5. I am reinforced in this view by what the professional advisers have been saying, ie that there is no need to put anything in the place of apportionment as the "exit" charge in getting money out of a CIC and the double CGT charge makes these companies unattractive for tax planning. (That, in my view, goes too far as the 15% potential saving (even if short-term) between the small companies rate of CT and the higher income tax rate would be a significant attraction to the very wealthy who would not mind tying up large amounts of capital in these companies). In addition, one of the professional publications recently carried an article saying, in effect, that with the new 1988 lower tax rates, CICs have had their day; and indeed that some investors should consider whether they ought not to wind-up the companies and extract the capital. I cannot see that advice changing with the introduction of the new regime you are considering.

Which rate - 35/37.5/40?

6. In view of the highly uncertain nature of the figures, this decision is pre-eminently one for political judgment. But my advice would be to go for 35%. It seems the "natural" rate once you decide to drop the small companies rate for CICs. It is, I believe, more easily defended if a genuine hard case arises - as I expect it inevitably will, either as a family property investment company or another (small) company which

fails to satisfy the trading company test and so falls with the new regime for CICs. And there is of course a limit to which we can fine-tune the simplified regime if we are to avoid complexity.

7. But we have to recognise that there could be presentational difficulties if the costings are challenged. Once the judgmental nature of the figures emerged, those bent on mischief would no doubt allege that they had been "fiddled" to disguise a hand out to the rich. That of course is nonsense but it would not stop the charge being made. And the necessary qualification about uncertainty in the Red Book, and indeed the fact that there is any cost at all, could attract detailed enquiries.

8. But as Mr Reed's note explains, there are significant tax costs in putting assets into and extracting money from a company which in our view would not make the potential 5% short-term saving worth the candle for the overwhelming majority of higher rate taxpayers. And many of the remainder could probably find more attractive shelters for their investments.

9. On balance, I would also include a distribution test with a 35% rate as it will help deflect criticism from existing companies. But I would start with 80% for property companies and 90% for others, because this would take the effective rates to 37% and 38.5% respectively (as compared with 40% if investments were held direct) and because you might find it helpful to have some room to manoeuvre in Committee.

10. If you conclude that the costs of a 35% rate - or more particularly, the judgements we have had to make in arriving at them - could not be defended politically, then I would recommend 40%. The remaining option of 37.5% runs the risk of satisfying no one: it would still be seen as "penal" by those at present paying the small companies rate and as a "hand-out" by those for whom nothing less than 40 will do. But again to

retain some flexibility, you might want to consider starting with slightly higher figures for the distribution test.

11. We are at your disposal if you would like a meeting.

E McGIVERN

FST

Subject to yr views, I would so much rather the simpler form of this simplification measure — viz a 35% rate & no distribution test. We cd always introduce a distributions tax as an [illegible] ~~[illegible]~~ if there [illegible] which really [illegible] concern about hard [illegible] by [illegible] cases. [illegible]

H.M. CUSTOMS AND EXCISE
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SE1 9PJ
01-620 1313

Tom B/L85

ECONOMIC SECRETARY

FROM: P G WILMOTT
DATE: 20 JANUARY 1989

Ch, This is a pirated copy which I forced C+E to send over. They will submit formally next week.

AF 24/1

Thanks. As Wilmott implies the point, which is to get

**BUDGET 1989: EXCISE DUTY - UNLEADED PETROL**

**INTRODUCTION**

1. I have just seen a copy of the 19 January scorecard. The picture on unleaded petrol is not wholly clear, and it is perhaps useful to start this submission by clarifying the options that are currently being considered. I understand them to be

(i) to increase the tax differential between leaded and unleaded by 0.7p a litre to give a pump price differential of 2p a litre.

(ii) to increase the tax differential by 1.1p a litre (this is our "5p a gallon" runner), giving a price differential of 2.4p a litre.

(iii) as (ii), but with an additional 1.1p a litre surcharge on 2 star leaded fuel.

These options correlate with those costed in the scorecard.

Circulation

PS/Chancellor
Mr Michie

CPS
Mr Jefferson Smith
Mr Gaw
Mr Allen
Mr Spackman
Ms French
Mr Vernon
Mr Warr

garages to clear supplying 2-star & turn the pump over to unleaded. N.

2. Against this background, I attach a note considering options for maximising the impact of a rise in the tax differential and dealing with other issues raised by the Chancellor at the overview meeting on 16 January. Our aim is to circulate it, with a brief covering note, for discussion at the next overview meeting. But given the upward revisions that our latest figures for unleaded petrol have caused us to make to our projections of market share, and the potentially confusing interaction of a range of different factors and options, you may like to discuss the matter with us first.

**SUMMARY**

3. The points made in the paper are:

a. **Differentials in other EC Member States.** There is no overriding need to aim for the highest differential in the EC (which would imply an extra 7p differential rather than 5p) - the presentational advantages of 5p are probably sufficient.

b. **2 Star Petrol.** We could cope with a differential tax on 2 star, at some cost. But the issue for Ministers is whether the small <u>extra</u> uptake of unleaded is worth it.

c. **A Government Information Campaign.** We recommend coordinating action with DoE, as the experts on publicity in this field, with some <u>limited</u> pre-Budget disclosure to them of the Chancellor's intentions.

d. **Litres v Gallons.** We recommend sticking to gallons for the Budget announcement, to maximise the impact.

P G WILMOTT

TAX DIFFERENTIALS AND TREATMENT IN OTHER MEMBER STATES OF THE EUROPEAN COMMUNITY

1. The attached table shows the current tax differentials in other Member States. Countries not listed make no tax distinction between leaded and unleaded petrol. We have no information immediately to hand on how these differentials translate into pump prices.

2. The United Kingdom is already towards the top of the tax differential league and a further increase in the differential of 5 pence a gallon would place us second only to Denmark (to take first place we would need to increase the rise in our differential to 7 pence a gallon.) Topping the Community league table has some attraction in presentational terms. But critics could point out that other EC countries were nonetheless ahead of us in other measures to stimulate uptake of unleaded petrol (eg greater filling station coverage, notably in the Netherlands, and tax reductions for new cars fitted with catalytic converters in Denmark, Germany and the Netherlands).

3. Increasing the differential from 5p to 7p a gallon is unlikely in our view significantly to affect the uptake of unleaded petrol. Presentationally "5p a gallon more in favour of unleaded petrol" is at least as attractive as "largest differential in the EC", and we see no overriding reason to go for the higher figure.

## GOVERNMENT INFORMATION CAMPAIGN

4. There is an obvious difficulty in preparing a campaign to maximise the impact of any increase in the tax differential in favour of unleaded petrol while preserving Budget secrecy. Although Customs and the Treasury will produce factual and other briefing material on this and other Budget matters in the usual way, we do not have the expertise or the resources to devise and run a full blown campaign targeted at the various groups in need of information and persuasion (motorists, garages and filling stations, car makers etc). Since promoting unleaded petrol is the primary responsibility of the Department of the Environment (they sponsor the Campaign for Lead Free Air, CLEAR, and chair the Unleaded Petrol Group which encourages and co-ordinates publicity) we suggest that that Department is best placed to take the lead. But this would involve widening the circle of those privy to Budget decisions.

5. However, we believe that DoE have contingency plans anyway to mount a fresh drive to coincide with the Budget, whatever action the Chancellor may or may not take. This could provide a way out of the confidentiality problem. The Chancellor could tell the Secretary of State that he was minded to give some additional encouragement to unleaded petrol without disclosing prematurely either the size of the new differential or, more important, his overall judgement on the oil duties. On this basis, a properly targeted campaign could be designed by DoE to achieve maximum impact after the Budget.

TWO STAR PETROL

6. The issue is whether a measure of tax discrimination against two star petrol is justified in order to hasten its decline and persuade users to switch to unleaded petrol.

7. The latest figures for the market share of two star petrol show clearly that it is in steady decline. From nearly 12 per cent of the market in 1985, two star has fallen to under 8 per cent in 1988 (based on eleven months' figures). If this downward trend continued at the same pace, two star would effectively disappear some time in 1993. But as sales dwindled overheads would climb and the economics of marketing the fuel would worsen rapidly. This would hasten its demise by possibly a year or more.

8. These projections assume no change in relative petrol duty rates. Increasing the price advantage of unleaded petrol by widening the duty differential, as proposed, by 5 pence would, we guess, bring the end of two star forward to perhaps 1990/91 and also encourage some switch from four star to unleaded.

9. It would be technically possible to introduce a separate duty rate for two star, in order to increase the incentive to switch to unleaded fuel. This would have administrative costs, and an added compliance burden for refiners. But if the outcome were worthwhile, we assume that Ministers would be prepared to accept these extra costs (indeed, the imposition of added compliance costs on the trade could be seen as part and parcel of the inducement to phase out two star). The essential question is, then, what extra benefits would accrue.

10. There are considerable uncertainties in attempting to forecast relative market shares with unleaded fuel expanding from such a narrow base, and with a variety of changes and influences all working at once.

And we think the take-up of unleaded may be improving faster than we thought earlier. But our best guess is that a surcharge of 5 pence on two star petrol, combined with a 5 pence cut in the unleaded duty, could cause a switch of some two further percentage points in the market share from two star to unleaded petrol and bring sales of two star effectively to a halt some time in 1990.

11. Given the already small part that two star plays in the petrol market, it is hard to claim that accelerating its disappearance is a central or essential part of the Government's strategy. There would be some extra uptake of unleaded fuel, but the jump could not be described as startling. Against the small gain for unleaded would be the short term administrative complications for us and the trade. We tend to discount the risk of criticism from two star users - virtually all these cars could take unleaded petrol without difficulty, and unleaded availability should increase as the supply of two star withers. The nub of the problem remains to persuade the bulk of motorists to give up using four star (currently 90% market share). We conclude that the judgement is essentially a tactical one, to be based on Ministers' views on the presentational aspects of the petrol package as a whole.

**LITRES VERSUS GALLONS: PRESENTATIONAL POINTS**

12. The Department of Trade and Industry's price marking order comes into force on 23 January 1989. This will authorise filling stations dispensing petrol in litres to display the price at the roadside in litres only rather than, as now, in litres and gallons.

13. Over time this will eliminate price displays of leaded four star in pence per gallon and enable the space thus released to be used to display the unleaded price. The ready comparison and consequent heightened awareness of the differential should encourage further take up of unleaded.

14. Given that the rest of the Community, except the Republic of Ireland, use litres, and given the increasing familiarity with the price in litres which the above Order will encourage, there is a *prima facie* case for expressing any Budget change in the unleaded petrol differential in litres too. But on Budget Day the effects of the Order will have hardly started and the British people have frequently demonstrated their deeply conservative attachment to Imperial measurement. And since 5p a gallon simply *sounds* more impressive than 1p a litre we advise against using litres in Budget publicity.

TAX DIFFERENTIALS IN EC MEMBER STATES

| MEMBER STATE | TAX DIFFERENTIAL (including VAT) GALLONS/pence | LITRES/pence |
|---|---|---|
| DENMARK | 17.54 | 3.86 |
| GERMANY | 12.67 | 2.79 |
| **UK** | **10.56** | **2.32** |
| NETHERLANDS | 9.93 | 2.18 |
| BELGIUM | 8.30 | 1.83 |
| LUXEMBOURG | 7.44 | 1.64 |
| GREECE | 4.24 | 0.93 |
| IRELAND | 3.72 | 0.82 |

Exchange rates as at 16 January 1989

CONFIDENTIAL

**Inland Revenue**

International Division
Somerset House

FROM: D I RICHARDSON

DATE: 20 JANUARY 1989

Mr 20/1

1. MR HOUGHTON
2. FINANCIAL SECRETARY

RESIDENCE - MINIMUM TAX

1. At the TCC meeting in November Mr Stitt and Mr Flight floated the possibility of introducing a minimum tax as an alternative to proceeding with the worldwide income approach outlined in the consultative document. The Chancellor has asked (Mr Taylor's minute of 3 January) for your views on the idea of a minimum tax. We have set out below what seem to be the main considerations.

Minimum tax

2. In principle, we can see three broad types of approach which could be described as a form of minimum tax:-

(a) A minimum proportionate charge. (That is, an individual's tax bill should not fall below a stated percentage of his original income.)

(b) A minimum flat-rate charge. (That is, an individual's tax bill should not fall below a stated absolute amount.)

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c PS/Chancellor
Mr Gilhooly
Miss Hay
Mrs Culpin

Mr Isaac
Mr Houghton
Mr Phalp
Mr Bryce
Mr Fraser
Mr Richardson
PS/IR

~~But~~ Although a flat-rate tax minimum sounds arbitrary & inequitable, it would in fact be welcomed by that section of the non-resident community who object to worldwide taxation. There is thus some attraction for a few people in the option. But perhaps this complication [illegible] best to await Mr R's promised further note.

(c) A minimum expenditure charge. (That is, an individual's tax bill should not fall below a stated percentage of the individual's expenditure in this country.)

3. The 'minimum tax' in the United States and Canada is, of course, of the type at (a) above. That is, the US/Canadian authorities require their taxpayers to report their total (worldwide) income; and the minimum tax then provides that the various tax reliefs and tax shelters available under their law should not reduce their total tax bill below a stated (minimum) percentage of total income. The underlying rationale is perhaps that, while a variety of reliefs and privileges may each be desirable considered in isolation, they can add up to altogether too much of a good thing, if piled one on top of the other. A minimum tax therefore involves taxpayers paying an amount of tax between the sum that would have been due if there were no tax shelters and the sum that is due with shelters.

4. As you will remember, the 'minimum tax' that we considered with Treasury Ministers a year or two ago would have been of the North American kind.

5. In the present context, a minimum tax would presumably be intended to provide a limit to the extent that the remittance basis could be used to reduce the tax bills of foreign domiciled residents below the tax bills of other residents.

6. If the remittance basis were strengthened by adopting a form of receipts basis it would also be for consideration whether a limit should be placed on the extent to which it similarly could be used to reduce tax bills. There is a risk that a receipts basis of the kind outlined in our notes of 22 December could at the end of the day amount to

a very complex provision for a fairly small yield. The degree of the risk will be clearer once the work we are currently carrying out on the form of a receipts basis is complete. But the potential for risk comes about because:

(i) as a technical matter, it is not yet clear whether a basis could be devised that was sufficiently watertight to catch all (or most) "receipts" allocated to consumption in the UK;

(ii) assuming such a basis could be devised, the yield would be dependent on where the boundary between capital expenditure (not taxable) and expenditure on consumption (taxable) was drawn. Clearly there are grey areas at the margin, such as works of art and jewellery. If it was felt necessary for the definition of capital expenditure to lean towards expenditure on consumption (and there may be pressure for this) the potential yield would be diminished; and

(iii) as a practical matter, it is not yet clear how effectively a receipts basis could be policed. We would likely have to depend heavily on an individual's word about the amount of his receipts and the manner in which those receipts were disposed of.

Assumptions

7. Four assumptions are common to the approaches we have identified:

i) That an individual's tax bill on his foreign income would be the higher of two sums. The first sum would be the tax due on the present basis (or, if introduced, a receipts basis); and the second sum would be the tax due on a new basis (the minimum tax).

ii) That UK income would be taxed in full as now.

iii) That an individual would have the option of electing to be taxed on worldwide income. We think this would be essential since, under at least some of the approaches considered, the minimum tax could exceed tax on worldwide income. To prevent manipulation the election would need to be irrevocable (or at least nearly irrevocable).

iv) That the minimum tax would only apply to residents with a foreign domicile.

8. We have at this stage only illustrated the various approaches in outline. If you were to find any of them attractive more work would need to be done on the detail. And a number of second order questions would need to be looked at, such as the interaction of a minimum tax with the rules for giving credit relief for foreign tax.

Approaches to a Minimum Tax

(a) A minimum proportionate charge

9. As we see it, a minimum proportionate charge, on North American lines, is not a serious starter in this context. By definition, it requires the taxpayer to declare his total worldwide income (or what amounts to the same thing for this purpose, his overseas income, to be added to his UK income). But that is precisely the point with which (we are told) the Greeks will not live.

10. We do not discuss this further.

(b) A minimum flat-rate charge

11. Mr Howard Flight suggested, at the TCC meeting, a minimum flat-rate charge. This would be the most radical of the various approaches. In effect, it would ignore an individual's foreign income and gains, and instead levy a fixed charge - if you like, a special rate of 'Community Charge' for resident foreign domiciliaries. The charge would apply if it exceeded the tax due on foreign income under the remittance basis (or, if introduced, a receipts basis).

12. A variant of this, if you favoured a receipts basis, would be to tax every taxpayer as if he had received a fixed flat-rate amount of income from abroad, regardless of the actual amount of receipts.

13. Such an approach would be:

- fairly straightforward to draft; and

- simple and predictable to operate for the Revenue and the taxpayer alike.

14. The problem, inevitably, is what level to fix for the 'foreign community charge'. A modest charge would yield relatively little revenue. A more sizeable charge could be set which made sense - and was seen generally to be reasonable and fair - for the very rich. But this could force large numbers of individuals - in particular the foreign executives working here - either on to the worldwide income basis, or out of the country altogether.

(c) A minimum expenditure charge

15. A further approach might be to have a scale of charges dependent on an individual's living expenses. (These might be estimated by looking at an individual's lifestyle - ownership of a yacht might suggest an income of £X, a house in Belgravia £Y, etc.) An approach of this kind is adopted in Switzerland for those not carrying on (and who have never carried on) a lucrative activity there.

16. This would help reduce the lack of equity, and possibly the arbitrariness of a single fixed charge. But the difficulties of estimating living expenses in this way would be formidable, and such an approach would lack the certainty and predictability that has been urged in the responses to the consultative document as being a vital component of any changes. It might also be regarded as coming pretty close to being a wealth tax.

17. If a receipts basis was introduced, a variant on a minimum expenditure charge might be to regard a percentage of receipts as being taxable irrespective of the character of the foreign source and of how the money was spent. The excluded categories of receipt outlined in our notes of 22 December would only apply in respect of receipts over and above the prescribed level. (An alternative would be to base a minimum tax on all receipts - ie with no exclusions - but apply a special low rate of tax).

18. This would:

- provide safeguards against a new receipts basis becoming a self-eliminating tax; and

- unlike a minimum flat-rate approach would never charge tax on a sum greater than that actually received in the UK.

19. But it would be:

- arbitrary nonetheless; and

- lead to hard cases where for instance an individual's receipts were derived entirely from capital and spent only on capital. (But an individual would have the option of being taxed on worldwide income).

Conclusion

20. The main problem with any form of minimum tax is the inevitable arbitrariness.

21. If for foreign domiciled taxpayers as a whole, a charge was secured that was more commensurate with the level of income enjoyed by them in the UK than is the case under the present remittance basis, an element of rough justice may well be acceptable. Indeed, a good deal of broad judgement may be inevitable in settling the tax liabilities of the very rich and internationally mobile. On the other hand there might be considerable difficulty in defending anything as arbitrary and inequitable as a minimum flat-rate charge.

22. Foreign domiciled residents range from students living on relatively small sums to Arab princes and others with immense fortunes. A minimum flat-rate charge applying to all foreign domiciled residents would seem arbitrary and inequitable in the extreme;

and we are not aware of any country that levies such a charge on foreigners.

23. A minimum expenditure charge based on estimated living expenses also looks problematic. Switzerland levies a variable charge based on living expenses, but compared with the wide range of foreign domiciliaries resident in the UK, the scope of the concession in Switzerland is limited to a relatively narrow group (foreign residents not carrying on a lucrative activity there). The practicalities of operating such an approach here would be considerable. And we would have thought that a tax on these lines could also have political sensitivities.

24. There may however be a case for a (different) form of minimum expenditure charge if a receipts basis were introduced. A receipts basis would be addressed to the same objective as the Swiss approach, but by a different route. In principle, the amount of income arising in this country, plus receipts from abroad, less net capital investment and remittances abroad - taken together - should equal consumption in this country. However, there is a worry with a receipts basis on the lines sketched out in our notes of 22 December, that the range of the excluded categories of receipts that may be necessary for the measure to achieve general support, coupled with difficulties in policing the excluded categories, may wipe out the prospect of significant tax yield. If a receipts basis were introduced there may be something to be said, therefore, for a "minimum expenditure" tax which provided that a percentage of receipts would always be taxable.

25. A minimum tax of this sort would still have rough edges. But they might be easier to handle than those of other approaches. The tax charge could never be greater than receipts and, since it would be based on a percentage

of an individual's receipts, it would also bear some correlation with an individual's circumstances. But there would be hard cases. And as with any minimum tax there would be the question of why have reliefs in the first place (in this case excluded categories of receipt) if they are to be overturned by a minimum tax. (The counter argument would be that each excluded category of receipt was acceptable in isolation, but not when exploited in excess with others).

26. Considerably more work would be necessary before we could put to you a firm proposal on these lines. It is however an approach that might merit a closer look and, subject to your views, we would propose to consider it in greater detail in the further note we are preparing about the form of a receipts basis.

27. We are, of course, at your disposal if you would find a discussion at this stage helpful.

D I RICHARDSON

Robert 03.23.1.89

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

bf. 26/1

FROM: FINANCIAL SECRETARY
DATE: 23 January 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call

HOUSING POLICY

£10-12 million

As you suggested, I have looked at Nick Ridley's idea of a tax relief for resident landlords who let out spare rooms, which the Economic Secretary and Judith Chaplin both favour.

I agree the objections to this idea are not overwhelming. When we looked at this last year, we decided against it on the grounds that an extension of BES was the better buy. But a new relief might increase the supply of rooms available, particularly at the lower end.

However, I do not believe that tax reliefs are in general a very effective way of encouraging people to do specific things, unless they are marketed vigorously, either by interested parties or by Government, (as BES, and to an increasing extent, reliefs for charities are). I don't think the publicity surrounding a Budget measure would last very long or have much impact in the medium term. There are also many snags for small landlords other than tax. I doubt if tax is a major consideration. Nick Ridley is himself not convinced that tax reliefs are the right way to go. There would be definitional problems, and we would face pressure for an extension of the relief to other areas.

FST → CHEX 23/1

That said, as Judith points out, any relief would not cost much, since if there were no relief, the allowable expenses would wipe out most of the income. If we went for a narrow definition for the relief of (say) up to 3 furnished rooms for periods of more than 30 days, the cost would be small enough to be acceptable. But I don't pretend to be wildly enthusiastic.

R.C.M.S.

pp NORMAN LAMONT

HOUSING POLICY

PS/EST
PS/CHEX
25/1

est.ld/hughes/25 Jan/FST

CONFIDENTIAL

ECONOMIC SECRETARY TO THE TREASURY

FROM: N D HUGHES
DATE: 25 JANUARY 1989

PS/CHANCELLOR

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call

**HOUSING POLICY**

The Economic Secretary has seen the Financial Secretary's note of 23 January.

2. He has commented that we should stick to a cash amount per week/month and not to number of rooms and days.

N D HUGHES
Assistant Private Secretary

cst.ps/4jm25.1/mins

CONFIDENTIAL

FROM: CHIEF SECRETARY
DATE: 25 January 1989

CHANCELLOR

cc: Financial Secretary
Paymaster General
Economic Secretary
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call

CST → CHEX 25/1

**TAX RELIEF FOR RESIDENT LANDLORDS**

You asked for views on this. I have seen the Financial Secretary's, the Economic Secretary's and Judith Chaplin's minutes.

2. On balance I think this is worth a try. I agree with Norman that tax may not be the major factor affecting whether people let rooms or not. On the other hand, people could well be deterred by the potential tax liability, and the complexity of calculating allowable expenses etc. Others may be stimulated by the Budget publicity.

3. If the Inland Revenue can produce a simple scheme, sufficiently narrowly defined to avoid abuse, my feeling is that we have little to lose if this fails and quite a lot to gain if it works.

John M.

JOHN MAJOR

cst.pas/mc/6.25.1

BUDGET CONFIDENTIAL

Bf 26/1 (for Prayers)

FROM: MARK CALL
DATE: 25 JANUARY 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mrs Chaplin
Mr Tyrie

CALL → CHEV 25/1

**TAX RELIEF FOR LETTING ROOMS**

The lodgers relief would have two advantages: 1) it would lead to a rapid increase in rented accommodation, 2) it would regularise the position of the (probably) large number of people who let rooms without declaring the income. I am not implying that this is a slippery slope into serious crime, but it would ease the consciences of otherwise law-abiding citizens.

2. Against it there is the increased difficulty in defining the borderline between lodgings and self-contained flats. On balance, I am in favour of the relief. I agree with Judith Chaplin that any presentational benefit from giving relief to lodgings would be lost if it were to be accompanied by a renewed zeal on the part of the Revenue as regards self-contained accommodation. The measure would be twisted by some to be represented as a snooper's charter.

MC

MARK CALL

cst.rj/docs/25.1.4

CONFIDENTIAL

FROM: A G TYRIE

DATE: 25 January 1989

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mrs Chaplin
Mr Call

TYRIE → CHEX 25/1

**HOUSING POLICY: TAX RELIEF FOR RESIDENT LANDLORDS**

I am no great enthusiast of this but not an intrepid opponent either. If pressed, having done the BES last year I'd probably do nothing this year.

2. First, I am pretty wary about levelling up the reliefs for renting as means of reducing the handouts to the owner occupied sector. I also think that it would be impossible to go back on this concession since, if it worked, reversing it would risk throwing people on to the street. It would also be a nasty little building block on which future DOE Ministers would construct further reliefs.

3. Secondly, I think the main deterrent to the growth of this market is people's fear that they would get stuck with unwanted tenants. The law now gives them a lot of protection. There is no statutory control over either the rent or security of tenure for new resident landlord lettings. (Existing tenants can still go to the rent tribunal for the fixing of a "reasonable rent".)

4. As people become more aware of the change in the law, and particularly as people become more confident that the law is not going to be overturned, I would expect to see an increase in this market. Any big increase in the number of lettings would be the result of the new Housing Act, not a fiscal incentive such as this.

5. Incidentally, this idea was first pedalled (as far as I know) by the mad Monckton in 1984 (around the time he claimed to have the yuppy disease!). If we did this we would undoubtedly be able to get some full page spreads in the Evening Standard saying how clever we (or he) had been!

pp RJ A G TYRIE

CONFIDENTIAL

P/R? P1

PAYMASTER GENERAL

FROM: MALCOLM BUCKLER
DATE: 25 January 1989

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Call

**HOUSING POLICY**

The Paymaster General has seen the papers on Mr Ridley's proposal of a tax relief for resident landlords who let out spare rooms.

The Paymaster has commented that he realises "rooms to rent" may be an idea whose time has come and he has no difficulty in recognising its topical attractiveness, but we did deliberately set our face against such a proposal when Dr Owen suggested it, and, at a time when the "main is flooding in", he is reluctant to give inches in the opposite intellectual direction. It would be helpful to dust down the arguments before we rush to a conclusion? On the advantages side, students after the demise of housing benefit become a new one.

PS/PMG
B/Ch
25/1

On a separate but related issue the Paymaster has asked while we have entered the coppice of Mr Ridley's suggestions, where do we stand on gifts of land to housing associations? The reason for his question is rural rather than urban, but also very topical.

MALCOLM BUCKLER
Private Secretary

chex.md/aa/45 BUDGET CONFIDENTIAL

**FROM: A C S ALLAN**
**DATE: 25 January 1989**

Pg

**MR CULPIN**

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Riley
Mrs Chaplin
PS/IR

**CT THRESHOLDS FOR SMALL COMPANIES**

The Chancellor would be grateful for a note on the following CT proposal, as a possible substitute for the existing proposal on raising small companies' thresholds:

(i) first £5,000 of profits tax free;

(ii) next £100,000 at 25%;

(iii) next £X at 37½%;

(iv) the remainder at 35%.

£X, as now, would be set so that the total tax on profits of £105,000 plus £X would be 35%. The purpose is to inject into CT a £5,000 tax free slice for small companies. The Inland Revenue may want to offer variants.

ACSA

**A C S ALLAN**

PS The purpose, of course, is to reject the CT ~~—~~ £5000 ~~—~~ tax-free slice for small companies

N

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The possible substitution for scrapping Item 7 (Cap Tax ~~—~~ thresholds)

Pl let me have a note on the following CT proposal:

1st £5,000 of profits tax free

next £100,000 @ 25%

next £x @ 37½%

remainder @ 35%

---

Note: £x, as now, wd be set so that total tax on profits of £105,000 + £x wd be 35%

---

IR may offer variants. ASAP

N

CLOSE COMPANIES

Robert/05.24.1.89

**BUDGET CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

**FROM: FINANCIAL SECRETARY**

**DATE: 25 January 1989**

**CHANCELLOR**

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Hardcastle
Mr Scholar
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Jenkins - OPC

Mr McGivern) IR
Mr Reed )
PS/IR

Ch, Discuss post-overview? - Yes
25
25/1

[any genuine cost?]

**STARTER 206: CLOSE COMPANY LEGISLATION**

I have discussed with officials your suggestion of a 35% rate of corporation tax for close investment companies with no distribution test. Andrew Tyrie and Eugene McGivern agree with you. But I must say that I am not wholly convinced. Nor are Robert Culpin and FP.

It seems to me that the key point is that we must publish the costs of this change. It is regrettable that a simplification measure should cost money, even if the long-term cost (£10 million with a 35% rate, £5 million with 40%) is very speculative and relatively small. But I would be very disinclined to go for a particular rate if another solved the problem equitably but at lower cost.

The distribution test would not add substantially to the length of the legislation. It is an alleviating provision which, if passed, puts companies back in the position they would have been under the old regime. For a 35% company, that can put the effective rate of tax up to 48%. But that is no more than it is now.

FST → CHEX 25/1

Taken together, that suggests to me that we should go for a 40% rate <u>with</u> a distribution test. The higher rate would cut the long-term cost, since non-distributed profits would be taxed more heavily than with a 35% rate. And it would signal very forcibly the end of the close investment company, a vehicle for which there appears to be no good reason.

There is the question of the effect on existing companies. But as I have said, there is no increase in their effective rate <u>if</u> they distribute (which is of course what we want them to do). It would, however, have an adverse effect on existing companies created for the purpose of rolling up gains until death. But arguably that is a device it is legitimate to hit.

There is also a presentational advantage in having a 40% rate. With a 35% rate, we would be attacked by the Labour Party as providing a "tax break for the well-off". As Mr McGivern's and Mr Reed's notes make clear, there is not much in that argument. But it makes it much easier to convince people of that if the rate is the same as the top rate of income tax and higher than that for ICI.

However, there is a difference of views. You may like to discuss.

NL

**NORMAN LAMONT**