PO-CH/NL/0704 PART A

2/2

gasmu.cg/minutes/1.22.9

FROM: SIR ANTHONY WILSON
DATE: 22 September 1988

CHANCELLOR
FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Sir P Middleton
Mr Anson
Mr Monck
Mr Culpin
Mr Burr
Mr Inglis
Miss Hay
Mr MacPherson
Mr Cropper
Mr Tyrie

Mr Beighton - IR
Mr Shaw - IR
PS/IR
Mr Fryett - C&E
PS/C&E

STATUTORY AUDIT FOR SMALL COMPANIES

Attached is a draft of a note for the Chancellor to send to the Prime Minister before the weekend as a counterpaper to the one put in by Lord Young preparatory to the E(A) meeting on Thursday, 29 September. I hope it meets the Chancellor's requirement that it should be "crisp and well-argued" and we have tried to emphasise the role of audit as a protection against financial fraud.

2. We are updating the background briefing sent to the Financial Secretary, (and copied to the Chancellor's Private Office), on 12 September to reflect the content of Lord Young's note and to cover the points made in the minute of 21 September from the Financial Secretary's Private Office. This updated briefing should be available later today.

3. I have been asked to attend the E(A) meeting on 29 September when statutory audit for small companies is discussed.

A WILSON

DRAFT

PRIME MINISTER

STATUTORY AUDIT OF SMALL COMPANIES ACCOUNTS

NOTE BY THE CHANCELLOR OF THE EXCHEQUER

In his minute of 19 September David Young ~~is proposing~~ proposes the abolition of the statutory audit for small companies, ~~preferably without any replacement or, as an alternative, its replacement by a compilation report signed by a competent person who need not be independent of the company.~~ I can agree that the audit requirement should be abolished for small companies, provided it ~~is replaced by~~ a compilation report, but given by an independent, properly qualified accountant.

2. ~~Following widespread consultation by the DTI with business and professional interests~~ David Young, Paul Channon and I examined the matter in May 1986. We then concluded that the statutory audit should be retained because of its valuable role as a safeguard against fraud. ~~In~~ The subsequent deregulation White Paper "Building Business...Not Barriers" ~~we said:~~ made this clear:

> "The Government have decided to retain the requirement for small companies to have their accounts audited. The consultation revealed no strong balance of opinion in favour of abolition. The Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate"

3. The ~~main~~ only new factor is that because of EC requirements for monitoring auditors, ~~to be reflected through~~ which will in the forthcoming Companies Bill, audit standards will be tightened up and ~~are likely to increase.~~ As a result the costs of the statutory audit will ~~This, combined with our desire to allow the full audit process to develop more effectively for larger~~

1

What does this mean?

I accept that, in these circumstances, it is right to try and find a less costly arrangement for small companies.

companies, means that we have to consider new arrangements for small ones. But I see no reason for departing from the substance of our previous approach based upon the involvement of an independent accountant, nor for relaxing our defences against fraud. My proposal for a compilation report signed by an independent accountant would provide some measure of deregulation - albeit less than David would like - but it would maintain a defence against fraud by directors of small companies. It would also help to maintain the financial credibility of the small company sector in the eyes of the public and business community which habitually has placed considerable reliance on audited accounts as evidence of the bona fides of small companies.

4. It is too risky to rely on an in-house accountant's adherence to his code of professional ethics when his livelihood depends on his doing what his directors instruct him to do. There is some concern in the profession that accountants who work in small companies are coming under increasing pressure from their employers to act in unethical ways in relation to their duties. A removal of the obligation to have at least some independent involvement in small companies' accounting may well increase such pressures further.

5. The limited involvement through a compilation report of an independent professional accountant would, in many cases, be the continuing basis for the wider financial advice and services which all, including the DTI, feel the small business sector requires increasingly.

6. There is also the risk to the Exchequer from David's proposal. The total yield of tax from small companies, including directors' PAYE and NIC, is £10 billion. The abolition of the audit will reduce the reliability of accounts. Every 1% reduction in their reliability would result in a loss to the Exchequer of £100 million - and American experience suggests that the loss could be as high as 5% overall. We can only keep this loss within reasonable bounds if we have an effective replacement.

7. It is true, as David says, that most other countries do not have a statutory audit for small companies. But this does not mean that regulation is less. Tax returns are very much more complicated; tax authorities employ more staff on investigating companies and are given greater and more intrusive powers. The closest comparison is with the United States where there are twice as many tax audits of companies using twice as many staff and where the tax return is between five and ten times as long. Even if we wanted to shift some of the auditing effort onto the Inland Revenue in this way, we would not be able to find the extra staff that we would need.

8. Provided we replace the statutory audit with a compilation report signed by an independent accountant, then I can agree with David that the limit should be set as high as the EC Directive allows, ie £2 million, which would benefit 95% of companies.

RECOMMENDATION

9. I recommend to colleagues acceptance of the option of abolishing the statutory audit requirement for small companies and replacing it with a compilation report signed by an independent professional accountant.

10. I am copying this note to David Young and Norman Fowler, to E(A) members, and to Sir Robin Butler.

NL

September 1988

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DRAFT

PRIME MINISTER

STATUTORY AUDIT OF SMALL COMPANIES ACCOUNTS

NOTE BY THE CHANCELLOR OF THE EXCHEQUER

In his minute of 19 September David Young is proposing the abolition of the statutory audit for small companies - preferably without any replacement, or, as an alternative, its replacement by a compilation report signed by a competent person who need not be independent of the company. I can agree that the audit requirement should be abolished for small companies, provided it is replaced by a compilation report, but given by an independent, properly qualified accountant.

2. Following widespread consultation by the DTI with business and professional interests David Young, Paul Channon and I examined the matter in May 1986. We then concluded that the statutory audit should be retained because of its valuable role as a safeguard against fraud. In the subsequent deregulation White Paper "Building Business...Not Barriers" we said:

> "The Government have decided to retain the requirement for small companies to have their accounts audited. The consultation revealed no strong balance of opinion in favour of abolition. The Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate"

3. The main new factor is that because of EC requirements for monitoring auditors, to be reflected through the forthcoming Companies Bill, audit standards will be tightened up and costs are likely to increase. This, combined with our desire to allow the full audit process to develop more effectively for larger

companies, means that we have to consider new arrangements for small ones. But I see no reason for departing from the substance of our previous approach based upon the involvement of an independent accountant, nor for relaxing our defences against fraud. My proposal for a compilation report signed by an independent accountant would provide some measure of deregulation - albeit less than David would like - but it would maintain a defence against fraud by directors of small companies. It would also help to maintain the financial credibility of the small company sector in the eyes of the public and business community which habitually has placed considerable reliance on audited accounts as evidence of the bona fides of small companies.

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5. The limited involvement through a compilation report of an independent professional accountant would, in many cases, be the continuing basis for the wider financial advice and services which all, including the DTI, feel the small business sector requires increasingly.

6. There is also the risk to the Exchequer from David's proposal. The total yield of tax from small companies, including directors' PAYE and NIC, is £10 billion. The abolition of the audit will reduce the reliability of accounts. Every 1% reduction in their reliability would result in a loss to the Exchequer of £100 million - and American experience suggests that the loss could be as high as 5% overall. We can only keep this loss within reasonable bounds if we have an effective replacement.

7. It is true, as David says, that most other countries do not have a statutory audit for small companies. But this does not mean that regulation is less. Tax returns are very much more complicated; tax authorities employ more staff on investigating companies and are given greater and more intrusive powers. The closest comparison is with the United States where there are twice as many tax audits of companies using twice as many staff and where the tax return is between five and ten times as long. Even if we wanted to shift some of the auditing effort onto the Inland Revenue in this way, we would not be able to find the extra staff that we would need.

8. Provided we replace the statutory audit with a compilation report signed by an independent accountant, then I can agree with David that the limit should be set as high as the EC Directive allows, ie £2 million, which would benefit 95% of companies.

RECOMMENDATION

9. I recommend to colleagues acceptance of the option of abolishing the statutory audit requirement for small companies and replacing it with a compilation report signed by an independent professional accountant.

10. I am copying this note to David Young and Norman Fowler, to E(A) members, and to Sir Robin Butler.

NL

September 1988

3. I have arranged for Mr Beighton at Somerset House to field any further questions or briefing requirements from lunchtime on Monday 26 September to mid afternoon on Wednesday 28 September, when I shall be in Guildford chairing the Government Accountancy Service Conference. Mr Inglis will also be away from the office during that period.

A WILSON

BRIEFING

gasmu.cg/minutes/2.22.9

BF 2/6/9

FROM: SIR ANTHONY WILSON
DATE: 22 September 1988

2819

CHANCELLOR
FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Sir P Middleton
Mr Anson
Mr Monck
Mr Culpin
Mr Burr
Mr Inglis
Miss Hay
Mr MacPherson
Mr Cropper
Mr Tyrie

Mr Beighton - IR
Mr Shaw - IR
PS/IR
Mr Fryett - C&E
PS/C&E

STATUTORY AUDIT FOR SMALL COMPANIES

I attach the updated briefing for the E(A) meeting on 29 September when the future audit requirement for small companies will be discussed. I apologise for the length of the briefing, but it has attached to it as Appendix 1 a summary of the Revenue effects of abolition with international comparisons, as Appendix 2 (for the Chancellor and Financial Secretary only) a copy of UK draft Pay and File corporation tax forms as they are expected to apply, and the current US corporation income tax return. It is suggested these might be taken to the E(A) meeting to show the volume of questions and information sought by the US Revenue authorities where no audit of accounts takes place. As Appendix 4 there is a summary of Treasury and Inland Revenue counter arguments to the points made in favour of audit abolition on the last pages of Lord Young's note to the Prime Minister.

2. The briefing now reflects the content of Lord Young's note and covers the points made in the minute of 21 September from the Financial Secretary's Private Office.

including the abolition of the statutory audit requirement for all small companies. The discussion paper was sent to over 40 representative organisations and copies were made available free on request to others. In all, more than 4,000 copies were issued, mostly to small companies and firms of accountants. Over 200 responses were made.

3. Views about audit were fairly evenly divided, though most of those who favoured abolition either wished to do so only in relation to shareholder-managed companies or to couple abolition with new rules governing the preparation of accounts. Many saw audit as the quid pro quo for limited liability, and some suggested a tightening up of the conditions for incorporation rather than abolition.

4. The audit was seen by many to be an important element in the management of companies. The statutory requirement does ensure that the smaller company obtains professional accountancy advice at least once a year. The majority of consultees thought it unlikely that small companies would use savings on audit to buy in financial advice.

5. The regular third party users of company accounts - banks, investors, venture capitalists and credit managers - were all strongly opposed to abolition as they regarded audited accounts as more reliable. Some were equally worried about the effect of abolition on the ability of small companies to compete for business. Local authorities, large firms and Government procurement agencies were all said to rely greatly on audited accounts in placing contracts.

6. The DTI officials concluded that abolition would not result in large savings for small companies, as any savings from abolition would be likely to be outweighed in many cases by additional costs of compliance, for instance for providing information to third party users including banks and the Inland Revenue. The Report by DTI officials on "Accounting and Auditing Requirements for Small Companies" noted:-

gasmu.cg/docs/1.7.9

FROM: SIR ANTHONY WILSON
DATE: 22 September 1988

CHANCELLOR
FINANCIAL SECRETARY

cc PS/Sir P Middleton
Mr Culpin
Mr Burr
Mr Inglis
Miss Hay
Mr Cropper
Mr Tyrie
Mr Beighton - IR
Mr Shaw - IR
PS/IR
Mr Fryett - C&E
PS/C&E

BRIEFING FOR THE CHANCELLOR PREPARATORY TO THE E(A) DISCUSSION OF THE FUTURE AUDIT REQUIREMENT FOR SMALL COMPANIES ON 29 SEPTEMBER

Background

In his minute to the Prime Minister dated 20 September Lord Young invites E(A) colleagues to agree that the statutory requirement for the accounts of small companies to be audited should be abolished. He recommends that this should be done outright with no alternative requirement, but suggests that an alternative would be a compilation report to be signed by any "competent person" whether or not independent of the company. A "competent person" is defined as having any form of accountancy or related qualification which the Secretary of State for Trade and Industry recognised as conferring the necessary level of competence.

Background to the previous ministerial decision not to abolish mandatory audit for small companies

2. The Government's 1985 deregulation White Paper "Burdens on Business" suggested removing the audit requirement from shareholder-managed small companies. The DTI published a discussion paper later in 1985 entitled "Accounting and Audit Requirements for Small Companies", which made sweeping proposals

"In practice, the evidence suggests that pure audit costs typically represent no more than 10-20% of the total accountancy bill and where the auditor also prepares the accounts may well be even less."

7. In the light of the DTI consultation, the abolition of the small company audit was discussed at the Chancellor's meeting of 14 May 1986 with Lord Young, Mr Channon and others. Mr Channon, then Secretary of State for Trade and Industry, supported the Chancellor's view that the audit requirement should be retained for all companies. The Government's decision was announced in the 1986 deregulation White Paper "Building Businesses.... Not Barriers", which said:

"The Government have decided to retain the requirement for small companies to have their accounts audited. The consultation revealed no strong balance of opinion in favour of abolition. The Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate."

DTI 1988 mini-consultation

8. Earlier this year the DTI wrote to the four accounting institutes and a small number of accountancy firms, to canvass their views on a number of possible alternatives to the audit. The results were mixed, but of 10 respondents, 7 thought it essential either that the statutory audit be retained, or that there should be some form of review by an independent professional.

DTI Position

9. The DTI now proposes that the statutory audit requirement should be abolished for small companies. It wishes to legislate for the change in the forthcoming Companies Bill and would accept

a "compilation report", signed by a professionally qualified accountant in place of an audit, but would prefer that there was no requirement for any sort of report. The DTI does not accept that a compilation report needs to be signed by a professional accountant who is independent of the company on which he reports. A company would only dispense with an audit with the prior approval of all its shareholders, and companies within the ambit of the Financial Services Act would continue to have a mandatory audit. Lord Young accepts that following abolition the directors of a company opting out should be required to sign a statement taking responsibility for the accounts and certifying subsequent tax computations. It is proposed that a "small company" for this purpose should be one with an annual turnover of less than £2 million - the level applied in the EC Directive.

Treasury/Inland Revenue Position

10. Treasury/Inland Revenue agree that the mandatory audit requirement for small companies should be replaced by a compilation report signed by an independent accountant. The incursion of an independent professionally qualified accountant into a smaller company's affairs should help to safeguard the Exchequer, whilst at the same time allowing the audit process for larger companies to develop unrestricted by the implications of having to apply the same procedures to smaller companies. Without this safeguard, part of the £10 billion tax from small companies (corporation tax and income tax and NIC on the directors) would be at risk. It is impossible to say how much, but the American experience (see Appendix 1, paragraph 7) suggests that the additional loss to the Exchequer could be as high as 5 per cent, that is £500 million.

The Issue

11. Both DTI and Treasury/Inland Revenue agree that the mandatory audit for small companies, other than those covered by the Financial Services Act, should be abolished, subject to safeguards for minority shareholders, and both would accept a compilation report as a substitute. A compilation report would

be a statement by a competent person (defined as any form of accountancy or related qualification which the Secretary of State DTI recognised as conferring the necessary level of competence) that the accounts have been prepared from and reflect the records and information supplied by the management, and conform to the layout and content requirements of the Companies Act. The point of disagreement now referred to E(A) is whether the competent person needs to be independent of the company, and whether any review of, or assurance on, the accounts needs to be given.

DTI General Arguments (1)

12. Companies which are large enough to employ their own internal professionally qualified accountants are well able to maintain proper books and records and produce accounts which comply with the Companies Act. To require such companies to have an independent report in such cases will lead to extra costs for no significant benefit. An independent compilation report, which is greatly reduced in scope compared with an audit, can add little, if any, further assurance where the accounts have been prepared by a competent accountant.

Treasury/IR counters

- It is essential to have a substitute for audit which the Government can hold out as meeting the objectives of fraud prevention which were publicly considered as very important in 1986. This cannot be achieved without the independence of the reporting accountant.

- It is too risky to rely on an in-house accountant's adherence to his code of professional ethics when his livelihood depends on his doing what his directors instruct him to do. There is now some concern in the profession that accountants who work in small companies are coming under increasing pressure from their employers to act in unethical ways in relation to their duties. A removal of the obligation to have at least some independent involvement in small companies' accounting may well increase such pressures further.

- It is important to maintain the financial credibility of the small company sector in the eyes of the public and business community which habitually has placed considerable reliance on audited accounts as evidence of the bona fides of small companies.

- The limited involvement through a compilation report of an independent professional accountant will in many cases be the basis of the wider financial advice which all, including the DTI, feel the small business sector requires increasingly.

- Independent accountants will detect at least some of the errors that are inevitably made in preparing accounts, notwithstanding the care taken by the preparer, and they will have the standing to challenge the accuracy of statements by the Directors which an in-house accountant would lack.

- The vast majority of small companies do not have their own in-house accounting expertise. For these companies there will be no additional deregulatory benefit in allowing the compilation report to be signed by any properly qualified accountant since they can only use an independent accountant. The effect of permitting the use of non-independent accountants, which will only be of benefit to a small minority of companies, would be to weaken severely the credibility of all small company accounts as third party users will not know whether or not the compilation report has been prepared by an independent accountant.

DTI General Arguments (2)

13. Most other major countries, including USA, Australia, West Germany, France and the Netherlands, do not have a mandatory

independent audit requirement for small companies. In these countries there is no obligation for small companies to involve an independent accountant in the preparation of accounts. Australia has recently removed the mandatory audit requirement for small companies.

Treasury/IR counters

- Most of these countries have never had a mandatory audit requirement for small companies and the general business climate has developed accordingly; in the UK there has been experience and an expectation of universal company audit for a long time. Change from a system which is used to universal mandatory audit, whatever its defects, to one based on voluntary compliance could create a vacuum in which malpractice could thrive and credibility would be strained unless at least a minimal independent professional association with accounts was maintained.

- Some countries, such as Denmark and Sweden, still have universal audit requirements.

- regulation for tax purposes is greater in most countries which do not have a mandatory audit requirement than is the case in the UK (see paragraph 16 and Appendix 1), resulting in higher compliance costs for companies and greater administrative costs and powers for Revenue authorities.

DTI General Arguments (3)

14. The Revenue accept unaudited accounts from unincorporated businesses without a statutory review by an independent professional, so why is this needed for companies?

Treasury/IR counters

- Exchequer is more at risk from small companies than from small unincorporated businesses because the companies are bigger, their affairs are more complex and they pay more tax.

- Revenue investigate between two and three times as high a proportion of unincorporated businesses as of companies because their accounts are more unreliable.

- Revenue could not find the extra staff, even if Ministers so wished, to investigate the same proportion of companies as of unincorporated businesses.

Treasury/IR Arguments for retaining the involvement of the independent accountant

15. As recently as 1986 the Government announced its intention to retain the audit as a defence against fraud. A decision now, unsupported by a more widespread consultation exercise than that carried out in 1987/88 by DTI which, in any case, did not reveal a majority in favour of abolition of the independence requirement, to abolish the mandatory audit for small companies and not to replace it with any form of independent professional accountancy involvement in the accounts preparation process, will cause significant presentational problems, particularly when contrasted with the increase in controls over investment businesses introduced by the Financial Services Act. The involvement of an independent professional in the preparation of accounts for small companies can, by contrast, be presented as a positive action as it will allow audit to develop more appropriately for larger companies, while retaining the vital involvement of a independent professional in the affairs of smaller companies. In another context, that of fraudulent RDGII claims, the PAC concluded in 1987-88; "We share the Department's (of Trade and Industry) views that independent accountants' reports constitute an important safeguard against fraud". Although this particular scheme has now been withdrawn, it does not invalidate these findings as to the efficiency of independent reivew.

16. The resources and powers of the Revenue authorities in most other countries are significantly greater than those in the UK.

In many countries (including most of those above) tax returns are made on detailed standard forms which cover many pages. The UK is virtually unique in relying on accounts as the main authoritative document for tax purposes. In a number of countries, including USA, Germany,the Netherlands and Australia, the Revenue have the authority and resources to undertake their own periodic detailed tax audits, and in Australia funding to the Revenue authorities has recently been increased to enhance the resources available to carry out tax audits. Even if the Inland Revenue were granted such powers by legislation, which in itself would be a controversial step, it lacks the resources to carry out tax audits and it would hardly be deregulatory to substitute one form of audit for another. In summary, the Inland Revenue is far more dependent on the reliability and accuracy of annual accounts than most of its counterparts overseas, and measures which reduce the degree of reliance placed on those accounts are likely to have a correspondingly greater impact on revenue collection. In the short to medium term it would be impossible for the Inland Revenue to obtain the staff resources necessary to exercise enhanced powers even if these were introduced in legislation. The Inland Revenue has prepared the attached annex which compares in more detail the UK position with that of other countries, particularly the USA.

Threshold for abolition

17. The DTI are proposing abolition up to the threshold allowed by the EC directive, that is up to a turnover of £2 million. This would affect 95 per cent of companies.

18. A threshold of £2 million for abolition is acceptable to the Treasury/Inland Revenue if the audit is replaced by a compilation report signed by an independent accountant.

19. However, if the compilation report or the independence of the accountant signing it were dropped, then only a lower threshold would be acceptable to avoid putting the Exchequer at risk to an unacceptable degree and creating a need for extra Revenue staff which could not be met.

20. For these reasons, it would not be acceptable to set the threshold for abolition without an independent compilation report above £250,000. This would still apply to 70 per cent of companies.

A WILSON

Inland Revenue

Compliance and
Collection Division
Somerset House

FROM: D L SHAW
DATE: 27 SEPTEMBER 1988

ADDITIONAL BRIEFING SHAW 27/9

1. MR BEIGHTON Not seen by.
2. FINANCIAL SECRETARY

STATUTORY AUDIT FOR SMALL COMPANIES

1. At your meeting of 27 September you asked for additional briefing on the following points.

DTI 1988 mini-consultation - majority of profession opposed to total abolition

2. Earlier this year the DTI wrote to the four accounting institutes and a small number of accountancy firms, to canvass their views on a number of possible alternatives to the audit. Seven out of the ten respondents, including three out of the four accounting institutes, thought it essential that there should be some form of review by an independent professional.

---

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Anson
Mr Monck
Mr Culpin
Mr Burr
Mr McPherson
Mr Inglis
Miss Hay
Mr Cropper
Mr Tyrie
Mr Fryett (C&E)
PS/C&E

Chairman
Mr Beighton
Mr Bush
Mr Roberts
Mr Page
Mr Shaw
PS/IR

3. The only institute in favour of total abolition was the Institute of Chartered Accountants of England and Wales. The Irish Chartered Accountants and the Certified Accountants thought that the present statutory audit by an independent professional should be retained. The Scottish Chartered Accountants thought that it should be replaced by a more limited review by an independent professional.

Compliance costs of the audit and of our proposal

4. In his note to you of 11 July, Sir Anthony Wilson guessed the likely savings under (1) a compilation report which may be completed in-house and (2) a compilation report by an independent professional, as a percentage of audit costs, as:

Turnover	Percentage saving	
£'1000	(1)	(2)
0-100	Nil	Nil
100-500	15	10
500-1000	35	25
1000-2000	80	60

5. The DTI report on the 1985 consultation probably provides the most recent and authoritative information available on costs of audit. The officials concluded:

> In practice, the evidence suggests that pure audit costs typically represent no more than 10 to 20 per cent of the total accountancy bill and where the auditor also prepares the accounts may well be even less.
>
> We can only guess at what small companies pay in audit fees but small company accounting bills range from a few hundred pounds to £2000 to £3000 and above. Even if pure audit costs are no more than 10 per cent of the total, the gross costs adds up to some £60 to £80

million. If one also includes the opportunity cost of management time spent with the auditor, the total figure rises to over £100 million.

6. The above figures show that the saving to a small company from the abolition of the audit would be in the range of nil to £300, rather than in the range of £2000 for the "larger small company" suggested in Lord Young's letter to the Prime Minister. In practice, both are probably correct. For most small companies the savings would be in the range of nil to £300. For a small number of larger small companies they could be as high as £2000, but this would be exceptional.

Audit is useless

7. The checks which the auditor has to make do help to uncover fraud.

8. Audit helps to ensure that good accounting practices are followed - which are in themselves a defence against error and fraud.

9. Audit provides the added psychological barrier for the potential fraudster that an independent professional is going to check his books and may find him out.

10. And even if audit provides no defence in practice, it is widely believed that it does. So its removal without adequate replacement would send a strong, and wrong, signal.

11. The 1985 DTI survey showed that all third-party users of company accounts - banks, investors, venture capitalists, credit managers; local authorities, large firms and Government agencies placing contracts; Inland Revenue and Customs and Excise - are strongly opposed to abolition as they regard audited accounts as more reliable. It does seem unlikely that they could all be wrong.

Is a compilation report by an independent professional accountant an adequate replacement for audit

12. A compilation report by an independent professional accountant retains the best features of the audit - the involvement of an independent professional - while doing away with the less important and more costly features such as crossing and ticking entries.

Proportion of companies by turnover

13. The latest figures that we have are:

Turnover	Percentage in band	Cumulative total
£'1000		
0-150	70	70
250-500	11	81
500-1m	8	89
1m-2m	6	95
2m +	5	100

14. These figures exclude dormant companies. The numbers are percentages of the total of live companies. There are approximately 670,000 live companies in all.

CIMA report

15. The Chartered Institute of Management Accountants have just produced a report on small companies reactions to their proposals for replacing the statutory audit by a certificate which would be broadly equivalent to an audit report except that it could be signed by an in-house accountant. You may be interested in the results of the survey in case it is quoted at E(A).

16. Although CIMA describe their report as a survey of small companies, this is not the case. It is a survey of large companies with turnovers greater than £2 million. The views of the companies surveyed and the conclusions are, therefore, largely irrelevant to the present debate.

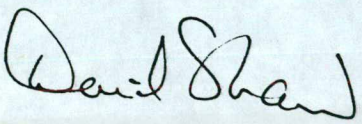
17. The CIMA proposal differs from all of those under consideration. For the overwhelming majority of small companies, it would be no different from the statutory audit. For those few larger small companies with in-house accountants, it would be less onerous than a statutory audit but more onerous than either of Lord Young's two proposals. It is difficult to say how it would compare with the Chancellor's proposal, it could prove either more or less onerous in practice.

18. CIMA sent quesionnaires to 1200 privately owned independent companies. 151 replied, that is 12.6 per cent. Only four of the respondents (3 per cent) were small companies - ie had turnovers below £2 million. A further 7 percent had turnovers between £2 and £5 million, 39 per cent between £5 and £10 million and 38 per cent more than £10 million. An overwhelming majority of the companies surveyed were therefore large companies with sophisticated accounting systems and full, in-house accounting expertise.

19. Although the overwhelming majority of the companies surveyed would have the expertise to sign an audit report in-house, and would thus save the bulk of their present audit costs under this proposal, only a narrow majority, 54 per cent of respondents, were in favour.

20. It is interesting to note that the respondents did not think that the Inland Revenue would be satisfied with accounts certified in-house. Only 24 per cent thought that the Inland Revenue would be. 49 per cent felt that the Inland Revenue would object strongly to accounts certified in-house. Furthermore the majority of respondents, 66 per cent of all respondents and 83 per cent of those expressing

an opinion, agreed that an independent audit should take place when there is a transfer of any part of a company's ownership. In other words, the majority of respondents believed that a report from an in-house accountant would not be credible to a purchaser of the business either.



D L SHAW

APPENDIX 1

REVENUE EFFECTS OF ABOLITION - INTERNATIONAL COMPARISONS

1. The experience of other countries is that unaudited accounts are less reliable for tax. This leads to:

a. increased risk to the Exchequer

b. increased compliance activity by Revenue

c. increased administrative costs

d. increased regulation for tax

e. increased compliance costs for companies.

2. The number of tax returns audited by the Revenue, the types of returns audited and the thoroughness of tax audit seems to vary substantially from one country to another, although precise numbers are hard to come by.

3. A number of countries aim to tax-audit every business either annually or once every few years. For instance Sweden tax-audits every business every year,

Denmark once every two years, Belgium once every three years and West Germany tax-audits all but the smallest businesses once every three or four years. At the other extreme Switzerland tax-audits businesses only where fraud is suspected.

4. It is almost impossible to form direct comparisons between the UK experience and our continental neighbours because the structure of our accounting and tax compliance systems is so different. In Sweden, for instance, accounting treatments are closely linked with tax law and the Revenue authorities assist businesses to complete their returns. In Denmark there is a system of independent licensed tax auditors that businesses may use if they choose.

5. The clearest comparison that can be made is with America since their accounting and tax compliance systems are most similar to our own, except that they have no statutory audit.

Comparison of UK and USA experience

6. In the USA

- Risk to the Exchequer is much higher (see 7).

- Especially for larger small companies (see 8).

- Companies are twice as likely to be audited by the Revenue (see 9).

- Revenue employ twice as many staff (per 1000 companies) on tax-audit (see 9).

- Tax audits are far more intrusive (see 10).

- Compliance burdens on companies are far higher (see 11).

7. The tax underdeclared by companies and recovered through Revenue compliance activities - tax-audit, examination of returns, etc - is 5 per cent of the total tax paid by companies in the UK, 10 per cent of the total in the USA.

8. We find that the risk to the Exchequer from unreliability of accounts decreases with company size, the Americans find that it increases. Thus we both investigate 1 per cent of the smallest companies (the bottom 50 per cent, turnover up to £150,000). But we investigate 0.5 per cent of larger small companies (the next 45 per cent, turnover between £150,000 and £2 million), the Americans tax audit 3.5 per cent. In other words, the increased risk to the Exchequer from the abolition of the audit is most serious for the larger small companies. These are precisely the companies that the DTI say would benefit most if "independence" were dropped.

9. We investigate 1 per cent of companies and employ 0.5 inspectors per 1000 companies on investigation. The Americans audit 2 per cent of companies and employ 1 tax agent per 1000 companies on audit.

10. In the UK, investigations are normally conducted by one Inspector and by correspondence and interview. Investigations are only started where the Inspector has reason to believe that the return is wrong. In the USA investigations are normally carried out at the taxpayer's premises and by a team of auditors. Taxpayers can be chosen for investigation at random.

11. I attach copies of the UK and USA company tax returns which illustrate very clearly the higher compliance burden on companies in the USA. You may find it useful to take these to E(A).

- Appendix 2 contains the experimental UK company return and notes for completing it designed for Pay and File. The final version will not be significantly different from this. As will be seen these are quite simple and straightforward.

- Appendix 3 contains the main returns that a larger small company would be required to complete in the USA. As will be seen they are substantially longer and more complex. At a rough count they require between 5 and 10 times as many entries. But in

addition, the American returns include cross references - I have highlighted some of these - to a further 83 different forms which the company may have to complete as well. The UK return is complete as it stands.

- In addition, companies in the USA have to provide substantially more (on average 20 times as much) information about payments for services, interest etc than in the UK.

Comparison of investigation rates with major trading nations

12. Lord Young states that the USA, Japan, Canada, West Germany and Australia are major trading nations that do not have a statutory audit requirement. France should be added to the list, as it does not have a statutory audit requirement for small companies.

13. In every case, regulation for tax is much greater than in the UK. Tax returns are longer and more complicated. The Revenue authorities tax-audit more companies, employ more audit staff and have greater powers. Tax audits are more intrusive.

14. The proportion of companies tax-audited by the Revenue authorities are (with separate figures for larger small companies - the ones most at risk - where these are available):

USA - 2 per cent of companies overall,
3.5 per cent of larger small companies.

Japan - 9 per cent of companies overall.

Canada - 2 per cent of companies overall,
4 per cent of larger small companies.

West Germany - Detailed figures are not available. All companies except the very smallest are tax audited once every 3 to 4 years.

(Definition of very smallest is not available, position is complicated by federal division of responsibility.)

Australia - 3 per cent of companies overall.

France - 4 per cent of companies overall.

UK - 1 per cent of companies overall,
0.5 per cent of larger small companies.

Inland Revenue
Corporation Tax

Reference - please complete

Corporation tax working sheet

This form should be handed to the person who prepares the company's tax computations.

This working sheet is not part of the company's tax return. It is for you to use when sending the accounts and tax computations to the Inspector of Taxes. It allows you to show

- the information you are sending to the Inspector
- how any losses arising or brought forward are being dealt with
- a calculation of the company's profits chargeable to tax and the tax due or the repayment claimed
- a breakdown of any figures of directors' remuneration included in the accounts.

Notes to help you fill in the form are enclosed. If you meet difficulties which are not covered in the notes, please contact your Inspector.

The statutory references shown on the form refer to the Income and Corporation Taxes Act 1970 unless otherwise stated.

Please show below the person to whom any queries about the entries on this form should be addressed.

Name .....**Reference**.....

Address .....

.....

.....

.....**Postcode**.....

Date .....

Company details Please complete in all cases

Company name

Company tax reference /

Accounting period for which working sheet is submitted to

1 Information supplied

Please show what accounts and supporting information are being provided by

- entering the period covered by the Accounts
- putting an "X" in the relevant box when information supporting any entry is attached

a Audited accounts with supporting accounts for the period *(e.g. trading accounts, detailed profit and loss account, etc.)* to

		Supporting entry at	"X"
b	Calculation of trade (Cases I and II) **profit** from the accounts figures	4.01	
c	Calculation of trade (Cases I and II) **loss** from the accounts figures	2.2a	
d	Capital allowances and balancing charges arising. *Please complete Section 6*		
e	Sources of non-trading income and the amount from each source	4.05 to 4.13	
f	Capital gains or losses. *Show each disposal giving rise to a gain or loss, losses brought forward, rollover relief claims, etc*	4.16 to 4.20	
g	Development gains or losses. *If a Development Land Tax charge, see guidance notes*	4.07 to 4.09	
h	Management expenses	4.27	
j	Charges	3.3g, 4.33	
k	Group relief: losses or other amounts surrendered or claimed	2.2e, 4.35	
l	Marginal small companies relief	5.70	
m	Double taxation relief	5.71	
n	Advance corporation tax	5.72	
p	Income tax set-off	5.77	
q	Other information. *Please specify*		

2 Trade losses of this period

Please use this section if the company has made trade losses during the period shown at 1a

1c refers	Trade (Cases I and II) **loss** of this period			2a
	Less amounts claimed against			
	profits of this period *S.177(2). Also enter at 4.26*	2b		
	profits of previous period *S.177(2), 3A and S.178. See point "A"*	2c		
	surplus franked investment income *S.254, S.255. See point "B"*	2d		
1k refers	amounts surrendered as group relief	2e		
	Total of losses utilised (2b to 2e)		▶	2f
	Unrelieved trade loss of this period (2a – 2f). *Also enter figure at 3f*			2g

- *Point A Show separately the period in which the loss is claimed and the amounts claimed for each period. If as a consequence a repayment is claimed, complete Section 7*
- *Point B Show separately the calculation of tax credit claimed and enter the amount of repayment in Section 7*

3 Unrelieved trade losses

Please use this section if the company has unrelieved trade losses brought forward to, or carried forward from, this accounting period

	Trade (Cases I and II) **losses** brought forward			3a
	Less amount set-off against			
	Cases I and II profit of this period *S.177(1). Also enter at 4.02*	3b		
	Other income of financial concerns *S.177(7). Also enter at 4.29*	3c		
	Total (3b + 3c)		▶	3d
	Unrelieved trade losses brought forward (3a – 3d)			3e
	Unrelieved trade loss of this period (from 2g)			3f
1j refers	Excess trade charges augmenting losses carried forward *S.177(8)*			3g
	Losses restored under *S.254, S.255*			3h
	Total trade (Case I and II) **losses** carried forward (3e to 3h)			3j

4 Calculation of profits chargeable to tax

Schedule D Cases I and II profit. *If a trade loss, use Section 2*	01			*1b refers From 3b*
Less set-off of losses brought forward under *S.177(1)*	02			
Net trade Cases I and II profit		▶	03	
Schedule D Case III			05	*1e and 1g refer*
Schedule D Cases IV and V			06	
Schedule D Case VI profits	07			
Less Case VI losses, including Case VI losses brought forward	08			
Net Case VI profits (07 – 08)		▶	09	
Income from which income tax deducted. *Enter gross amount*			10	
Income from which income tax not deducted by election			11	
Building Society interest etc. *Enter amount after grossing at basic rate*			12	
Schedule A (after set-off of surplus expenses brought forward)			13	
Chargeable gains:				
gross gains (after any indexation allowances)	16			*1f refers*
Less allowable losses including losses brought forward	17			
Total (16 – 17)	18			
Less S.93(2) FA 1972 reduction	19			
Net chargeable gains (18 – 19)		▶	20	
Total of entries 03 to 20			22	
Deductions:				
losses on unquoted shares *S.36 FA. 1981*	25			*1f refers*
trading losses *S.177(2)*	26			*From 2b*
management expenses *S.304*	27			*1h refers*
capital allowances against profits *S.254(6), S.74(3), CAA 1968*	28			*1d refers*
losses of financial concerns *S.177(7)*	29			*From 3c*
Total deductions (25 to 29)		▶	30	
Total (22 – 30)			32	
Less charges set against profits			33	*1j refers*
Total (32 – 33)			34	
Less group relief claimed			35	*1k refers*
Profits chargeable to Corporation tax (34 – 35)			37	

Now go to SECTION 5

5 Calculation of tax chargeable

	Financial years	rates of tax	amounts of profit	Tax £ p
Income *See "A" below*	51 19 at	52 % on	53	54
	55 19 at	56 % on	57	58
Chargeable gains *See "B" below*	59 19 at	60 % on	61	62
	63 19 at	64 % on	65	66
Totals (67 to agree box 37)	53+57+61+65 =	67	54 +58 +62+66 =	68

Less set-off of	£ p		
marginal small companies relief	70		*1l refers*
double taxation relief	71		*1m refers*
advance corporation tax (restricted if necessary *S.85 FA 72*)	72		*1n refers*
other adjustments. *Show nature at 85 below*	73		*1q refers*
Total set-offs (70 to 73)	▶	74	
Total (68 – 74)		76	
Less set-off of income tax (relating to income at boxes 10 and 12 above)		77	*1p refers*
Corporation tax payable (76 – 77)		78	*See "C" below*
Income tax repayable (77 – 76). *Carry forward to Section 7 overleaf*		80	

A Include chargeable gains where all profits charged at full rate of tax
B Show separately where tax is • on gains at full rate • on other profits at small companies rate
C If a payment has already been made on account of this tax and a repayment now arises see Section 7 overleaf

Nature of "other adjustments" shown at 73 above 85

6 Capital allowances and balancing charges

Please show how any capital allowances and balancing charges arising are reflected in your computations

	Balancing charges	Capital allowances	
Cases I and II	6a	6b	• *If 6b exceeds £25,000 see * below*
Others	6c	6d	

Please provide a further analysis where the figure of capital allowances at 6b exceeds £25,000

	Initial or first year allowances	Writing down or balancing allowances
Plant and machinery (including cars and ships)	6e	6f
Real property (e.g. buildings, agricultural allowances)	6g	6h
Others (mines, patents, etc.)	6j	6k

7 Repayments claimed

If repayment of any tax is being claimed, please

- show the amount claimed here ▶ 7a £ p
- send in a computation of how this amount has been calculated unless the figure is shown at item 5.80
- provide any vouchers available as evidence of payment of tax to be repaid

If the repayment is to be made to a **banker, agent** or **other person** resident in the UK please complete the following authority and have it signed by an officer of the company.

I, as ..... of .....
(enter status – Company Secretary, Treasurer, etc.)

authorise M .....
.....
.....
.....
.....Postcode .....

to receive on my behalf the amount due.

Signed .....

8 Directors' remuneration

Where you normally send a breakdown of directors' remuneration to the Inspector who handles the company's accounts, please complete the separate schedule enclosed for this purpose.

9 Additional information

- Unless the information has been given elsewhere in a covering letter or the Directors' Report, etc please show here anything which may lead to a better understanding of the accounts. For example, show changes in the company's activities during the period, trading policies, or the nature of unusual entries in the accounts, etc.
- Please describe here any information you are sending in which is provisional. Show
  - why it is provisional
  - when the figures will be finalised.

Inland Revenue
Corporation Tax

Please complete if known

PAYE District

PAYE Reference /

Analysis of directors' remuneration included in the company's accounts

Please use this form to show a breakdown of any figures of directors' remuneration reflected in the accounts.

(An analysis of the directors' benefits, expense payments, etc is not required on this form. Such information should be set out on form P11D which is the Return of payments etc to directors.)

Company name

Company tax reference /

Accounts for the period to

Name of director	Salary £	Fees £	Bonus £	Total £

Total

Add **Other items**
(eg benefit figures, employers NIC, pension contributions)

Directors' remuneration per accounts

For official use only

Accounts district use

Action in assessing district

"√"

Entered on P247 *(E4541)* ☐

Compared with relative end of year return for 19__ ☐

Dealt with by _____

Enquiries issued ☐

Date _____

No enquiries necessary ☐

Issuing district date stamp

Inland Revenue
Corporation Tax

Completion of Corporation Tax working sheet – CTWS

These notes are to help you complete the corporation tax working sheet.

They tell you what information is needed in support of the entries and explain how each section should be completed.

CT1(Ins) notes enclosed with the tax return give more details on how the various items on the working sheet should be calculated. If you want more information ask your tax office for booklets.

- IR 18 Corporation Tax
- CGT 8 Capital Gains Tax

If you need help in completing the working sheet your Inspector of Taxes will give you assistance.

1 General

1.1 Form's user

The working sheet should be used by the person who prepares the company's tax computations. If you are not that person, please pass the form on.

1.2 Non-statutory document - purpose

Unlike the tax return which you are required to complete, the working sheet is a non-statutory document. It is provided to assist in the computation of the company's corporation tax. It will enable you to show clearly which accounts you are providing and the information you are submitting in support of entries in your computations. The working sheet has been designed to be comprehensive. So, in most cases, you will fill in only some of the entries. Leave blank those which are not needed.

1.3 Rates and allowances

Corporation tax rates and allowances which you may find helpful when completing the working sheet are shown at the end of these notes.

1.4 Clubs and associations

Clubs and associations fall within the legal definition of a company. If you are preparing the tax computations of such an organisation you will have been sent a working sheet with the corporation tax return. If the club, etc is assessed only on its investment income, the number of entries needed on the working sheet is likely to be small, and so it may be of limited help to you.

If you do use the working sheet, after filling in the name, reference and accounting period details at the head of page 2 it is likely that you will need to complete only **Section 4** to show at item(s)

- **05-13** what income has been received
- **16-20** the net chargeable gain (if any) which has accrued
- **37** the total income which is assessable to tax
- **51-68** what tax arises on the income; the rate will normally be the special rate to small companies **except** for chargeable gains which are always charged at the full rate of tax
- **77-80** the tax to be paid, or repaid to the club, etc.

If you would like general information about the tax treatment of clubs, etc ask your tax office for leaflet **IR46 Clubs, Societies and Associations.**

2 Completing the form

Company details

In all cases please enter at the top of page 2 of the working sheet

- the name of the company
- its tax reference
- the accounting period for which tax is chargeable.

The **accounting period** is a Taxes Acts concept. It will usually be the period shown on the company's corporation tax return. In most cases it will coincide with the period for which the company makes up its accounts, but it may not. For example, an accounting period cannot be longer than twelve months. **Paragraphs 3.42** and **3.47** of the booklet **IR18** will tell you more about accounting periods.

If the company's accounts cover more than one accounting period send in a working sheet for each period. Show how the figures in the accounts are apportioned between each accounting period.

2.1 Section 1 Information supplied

Complete this section to indicate what material you are sending to your Inspector. He requires certain information to show how the company's profits have arisen and what deductions, etc you are setting against those profits.

If any information you are sending in is **provisional** point this out with a prominent note on the supporting computation **AND** in **Section 9** of the working sheet (page 4)

- enter the provisional figures
- explain why they are provisional and
- state when they will be finalised.

2.1.1 Accounts (item 1a)

Show the period covered by the accounts you are sending in. Your Inspector will want a copy of the company's audited accounts including the directors' report, etc. He will also need copies of any supporting accounts which show how the audited accounts have been compiled. Examples are a detailed profit and loss account or a trading account, etc.

2.1.2 Calculation of Trade (Cases I and II) results (items 1b and 1c)

Send in a computation showing what adjustments have been made to the accounts figures to arrive at the assessable trade profit or the allowable trade losses. Examples are those for depreciation, capital losses, etc.

If there is a **trade profit**

- enter the figure in **Section 4, item 01.**

If there is a **trade loss**

- enter the figure in **Section 2, item 2a**; complete Section 2 **before** showing any loss figures in Section 4; Section 2 helps you deal with losses correctly.

2.1.3 Capital allowances and balancing charges arising (item 1d)

If capital allowances or balancing charges arise

- send in a computation of amounts arising and/or disclaimed
- show how the allowances and charges are reflected in your computation; examples are amounts given against Case I income, Case VI profits, etc
- complete **Section 6** of the working sheet.

2.1.4 Sources of non-trading income (item 1e)

In support of **items 05-13** in **Section 4** please provide separate details of the types and amounts of any non-trade income. Examples are Case VI profits, Schedule A, etc.

2.1.5 Chargeable gains or losses (item 1f)

If the company disposed of assets giving rise to a capital gain or a related loss, show

- details of each disposed asset
- the amounts of each gain or loss arising
- how the figures entered at **item 16** and **17** in **Section 4** have been calculated. This will mean giving details of rollover claims, losses brought forward, etc.

2.1.6 Development gains or losses (item 1g)

If the company has disposed of an interest in land which gives rise to a development gain or related loss, show

- details of each disposed asset
- the amount of each gain or loss arising
- the aggregate amount of gain or loss
- how the figures entered at **items 07-09** in **Section 4** have been calculated (development gains are assessable under Case VI of Schedule D). Give details of rollover relief claims, losses brought forward, etc.

Apart from development gains which have been deferred by rollover relief claims, this charge was abolished for disposals occurring on or after 19 March 1985.

Development Land Tax
If you disposed of an interest in land with development value a charge to development land tax may arise. This charge was abolished for disposals occurring on or after 19 March 1985.

For information about the tax ask your tax office for leaflet **DLT 2 Development Land Tax or** contact the Development Land Tax Office, Corporation House, 73 Albert Road, Middlesbrough, Cleveland TS1 2RY.

2.1.7 Management expenses (item 1h)

Give details of how the amounts entered at **item 27** in **Section 4** have been calculated.

2.1.8 Charges (item 1j)

If the company has charges on income, give details of

- the total charges on income; only charges paid in the accounting period are eligible for relief (a form CT61(Z) should already have been submitted in respect of any charges paid under deduction of tax)
- the amount set off against total profits of this accounting period at **item 33** in **Section 4**
- the manner in which any excess charges have been treated; examples are
  - set off against surplus franked investment income
  - carried forward as management expenses if your company is an investment company
  - trade charges used to augment a trade loss (entry at **item 3g** in **Section 3**)
  - charges unrelieved and not otherwise set off.

2.1.9 Group relief (including consortium relief) (item 1k)

If the company is surrendering losses or other amounts as group relief show

- the total amount surrendered and how this has been calculated
- the names and tax references of the companies claiming the group relief
- the amounts surrendered to each company.

Where the amounts are **provisional** the claim should be listed in the order in which they are to take effect.

If the company is claiming amounts as group relief show

- the name of each surrendering company
- the surrendering company's tax reference
- the amounts claimed from that company
- the accounting periods in which the loss or excess arose.

The total claimed should equal the figure entered at **item 35** in **Section 4**. Where the amounts are **provisional** they should be listed in the order in which they are to take effect.

Remember to enclose a copy of the surrendering companies' consent to the claim.

2.1.10 Marginal small companies relief; Double taxation relief; Advance Corporation Tax; Income Tax set off (items 1l, 1m, 1n, 1p)

If one of these set-offs is being claimed, submit details of how the amounts shown at **items 70, 71, 72** or **77** in **Section 5** have been calculated. Where advance corporation tax at **item 72** arises from dividends paid during the period, a form CT61(Z) should already have been sent to the Revenue.

2.1.11 Other information (item 1q)

Enter on the form in the space provided in **Section 1** what other information you are submitting with the accounts and the computations. State the item in **Section 4** which this information supports.

2.2 Section 2 Trade losses of the period

Use this section to show the **trade losses** of the period.
Item 2a Enter the figure from the computations referred to at **Section 1, item 1c.**
Items 2b-2e Show how the losses are being relieved or set off, but first read **Point A** and **Point B** shown at the end of **Section 2** on the form.
Item 2f Enter the total of the losses which have been utilised **(2b + 2c + 2d + 2e).**
Item 2g Enter the amount of **unrelieved** trade losses for the period **(2a less 2f)** and then enter this figure at **Section 3, item 3f.**

2.3 Section 3 Unrelieved trade losses

Use this section if the company has unrelieved trade losses **brought forward** to or **carried forward** from the accounting period you are reporting.
Item 3a Enter the trade losses **brought forward** from earlier accounting periods.
Items 3b and 3c Show how any of these losses brought forward are to be set off.
Item 3d Enter the total of the losses set off **(3b + 3c).**
Item 3e Show the losses brought forward which are **not** being utilised **(3a less 3d).**
Item 3f Enter the unrelieved trade loss of this period (taken from **Section 2, item 2g).**
Items 3g and 3h Enter the losses which are not otherwise being set off.
Item 3j Enter the total trade (Cases I and II) loss to be carried forward for set off in future accounting periods **(3e + 3f + 3g + 3h).**

2.4 Section 4 Calculation of profits chargeable to tax

Use this section to show what profits are chargeable to tax and how that figure has been built up. If you enter a figure at any item in this Section, your Inspector needs supporting information. A cross reference to the information needed and described in **Section 1** is shown beside each item.

If there is more than one trade

- show the **aggregate** figure of profits at **item 01** and
- remember that **trade losses brought forward** can only be set off against profits of the trade **in which they arose.**

Where more than one trade suffers losses **Sections 2** and **3** may not provide an adequate record. You should then submit a separate statement showing the position for each trade.

At **item 19** calculate the **Section 93(2)** reduction by multiplying the amount of gains shown at **item 18** with the appropriate fractions set out in the Table at the end of these notes. Where different fractions are in force for different parts of the accounting period, time apportion the gain to the appropriate financial year. Reduce the amount for each financial year by the fraction in force for that part.

Where losses, deductions etc exceed the profits against which they can be set, restrict the amount entered in the computation to the figure which reduces the profits to **nil. Do not show negative figures** where losses etc exceed the profits. For example, if the amount of charges available for set-off is **9682** but the profits against which they can be set shown at **item 32** is **1641,** show the charges set against profits at **item 33** as **1641** and provide details of the excess charges separately (see note 2.1.8 above).

2.5 Section 5 Calculation of tax chargeable

Use this section to work out the amount of tax due on the profits you have shown at **Section 4, item 37.** If you are in any doubt about how to complete this Section you may find **Chapter 10** of the booklet **IR18** helpful.

Items 51-68 To complete these items

- decide whether all of the company's profits are chargeable at the full rate of tax; if they are not, the **chargeable gains (Section 4, item 20)** must always be chargeable at the full rate even though other profits **(Section 4, item 37** less **item 20)** may be chargeable at the **small companies rate**
- apportion the profits between the appropriate financial years where the accounting period straddles **31 March** and show the amounts chargeable in each financial year
- decide on the rate of tax to be charged by reference to the Table at the end of these notes
- calculate the tax arising on the profits chargeable for each financial year and show the amounts of tax at **items 54, 58, 62** and **66;** give the total of these at **item 68.**

Items 70-72 Details to help you calculate the amounts to be shown here are given in booklet **IR18.**

Item 72 Advance corporation tax cannot be set against tax arising on **chargeable gains.** The maximum available for set-off may be restricted by **Section 85 Finance Act 1972.** As a rough guide the maximum set-off will be the figure of profits (**excluding** any chargeable gains element) charged at the basic rate of income tax.

Item 73 If you make an entry at this item also enter a brief description of it in the space provided at **item 85.** Details of the adjustment should also be given as requested in the note at **Section 1, item 1q.**

2.6 Section 6 Capital allowances and balancing charges

Information is required about the capital allowances used in calculating the company's profits and losses. Where these allowances exceed £25,000 a breakdown is needed of the type of allowances which have arisen. This information is used in particular when Budget forecasts are made for the Chancellor of the Exchequer. These forecasts are needed when changes to the rates are considered. Your co-operation in providing this information on the working sheet will be appreciated.

2.7 Section 7 Repayments claimed

If you believe that a repayment is due to the company

- show the amount claimed
- show how that amount has been calculated (unless this is obvious from **Section 5**)
- send in any vouchers available as evidence of the payment of tax to be repaid
- complete and arrange for an officer of the company to sign the mandate on the form when you want the repayment to be made to anyone other than the company.

2.8 Section 8 Directors' remuneration

Your Inspector needs to know what directors' remuneration has been included in the accounts (whether it is described under this or some other heading). Sometimes this information is sent directly to the tax district which deals with the director's own tax affairs. For example, where Centre 1 is involved or where the in-house tax department of a large public company prepares the computations. But if, as in most cases, you usually send details of the directors' remuneration to the Inspector when you submit the accounts, please show the details on the **separate schedule** enclosed for this purpose.

2.9 Section 9 Additional information

Use the final part of the form to provide any other information which you feel may assist your Inspector in his examinations of the accounts, schedules and computations that you are sending in.

Also show here what provisional information you are sending in. Say why it is provisional and when the figures will be finalised.

3 Table of Corporation Tax rates and fractions

Financial year	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Rates %														
Rate of tax	52	52	52	52	52	52	52	52	52	52	50	45	40	35
Special rate for small companies	42	42	42	42	42	42	40	40	40	38	30	30	30	30
Special rate for co-operative societies, building societies, etc	40	40	40	40	40	40	40	40	40	40	40	40	-	-
Fraction by which chargeable gains to be reduced under S93 FA 1972														
Authorised unit trusts and approved investment trusts	37/52	71/104	69/104	69/104	21/26	21/26	21/26	-	-	-	-	-	-	-
Others	11/26	11/26	11/26	11/26	11/26	11/26	11/26	11/26	11/26	11/26	2/5	1/3	1/4	1/7
Relevant maximum amounts where no associated companies (£ thousands)														
Lower	25	25	30	40	50	60	70	80	90	100	100	100	100	100
Upper	40	40	50	65	85	100	130	200	225	500	500	500	500	500
S95(2) FA 1972 Fraction														
For using in calculating marginal small companies relief	1/6	1/6	3/20	4/25	1/7	3/20	7/50	2/25	2/25	7/200	1/20	3/80	1/40	1/80

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Form 1120 — U.S. Corporation Income Tax Return

Department of the Treasury
Internal Revenue Service

For calendar 1987 or tax year beginning _____, 1987, ending _____, 19____

▶ For Paperwork Reduction Act Notice, see page 1 of the instructions.

OMB No. 1545-0123

1987

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See the list in the instructions.)

Use IRS label. Otherwise please print or type.

Name

Number and street

City or town, state, and ZIP code

D Employer identification number

E Date incorporated

F Total assets (See Specific Instructions.) Dollars $ | Cents

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address

Income

1a	Gross receipts or sales _____ b Less returns and allowances _____ Balance ▶	1c	
2	Cost of goods sold and/or operations (Schedule A)	2	
3	Gross profit (line 1c less line 2)	3	
4	Dividends (Schedule C)	4	
5	Interest	5	
6	Gross rents	6	
7	Gross royalties	7	
8	Capital gain net income (attach separate Schedule D)	8	
9	Net gain or (loss) from Form 4797, line 18, Part II (attach Form 4797)	9	
10	Other income (see instructions—attach schedule)	10	
11	TOTAL income—Add lines 3 through 10 and enter here ▶	11	

Deductions (See instructions for limitations on deductions)

12	Compensation of officers (Schedule E)	12	
13a	Salaries and wages _____ b Less jobs credit _____ Balance ▶	13c	
14	Repairs	14	
15	Bad debts (see instructions)	15	
16	Rents	16	
17	Taxes	17	
18	Interest	18	
19	Contributions (see instructions for 10% limitation)	19	
20	Depreciation (attach Form 4562) 20	21b	
21	Less depreciation claimed in Schedule A and elsewhere on return 21a	22	
22	Depletion	23	
23	Advertising	24	
24	Pension, profit-sharing, etc., plans	25	
25	Employee benefit programs	26	
26	Other deductions (attach schedule)	27	
27	TOTAL deductions—Add lines 12 through 26 and enter here ▶	28	
28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)		
29	Less: a Net operating loss deduction (see instructions) 29a	29c	
	b Special deductions (Schedule C) 29b		

Tax and Payments

30	Taxable income (line 28 less line 29c)	30	
31	TOTAL TAX (Schedule J)	31	
32	Payments: a 1986 overpayment credited to 1987		
	b 1987 estimated tax payments		
	c Less 1987 refund applied for on Form 4466 ( )		
	d Tax deposited with Form 7004		
	e Credit from regulated investment companies (attach Form 2439)		
	f Credit for Federal tax on gasoline and special fuels (attach Form 4136)	32	
33	Enter any PENALTY for underpayment of estimated tax—check ▶ ☐ if Form 2220 is attached	33	
34	TAX DUE—If the total of lines 31 and 33 is larger than line 32, enter AMOUNT OWED	34	
35	OVERPAYMENT—If line 32 is larger than the total of lines 31 and 33, enter AMOUNT OVERPAID	35	
36	Enter amount of line 35 you want: Credited to 1988 estimated tax ▶ Refunded ▶	36	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer _____ Date _____ ▶ Title _____

Paid Preparer's Use Only

Preparer's signature ▶ _____ Date _____ Check if self-employed ☐ Preparer's social security number _____

Firm's name (or yours, if self-employed) and address ▶ _____ E.I. No. ▶ _____ ZIP code ▶ _____

Schedule A Cost of Goods Sold and/or Operations (See instructions for line 2, page 1.)

1 Inventory at beginning of year	1		
2 Purchases	2		
3 Cost of labor	3		
4a Additional section 263A costs (see instructions)	4a		
b Other costs (attach schedule)	4b		
5 Total—Add lines 1 through 4b	5		
6 Inventory at end of year	6		
7 Cost of goods sold and/or operations—Line 5 less line 6. Enter here and on line 2, page 1	7		

8a Check all methods used for valuing closing inventory:

(i) ☐ Cost (ii) ☐ Lower of cost or market as described in Regulations section 1.471-4 (see instructions)

(iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c) (see instructions)

(iv) ☐ Other (Specify method used and attach explanation.) ▶ _____

b Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) . . . . . ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 8c

d Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? ☐ Yes ☐ No

e Was there any change (other than for section 263A purposes) in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation . . . . . ☐ Yes ☐ No

Schedule C Dividends and Special Deductions (See Schedule C instructions.)

	(a) Dividends received	(b) %	(c) Special deductions: multiply (a) × (b)
1 Domestic corporations subject to section 243(a) deduction (other than debt-financed stock)		see instructions	
2 Debt-financed stock of domestic and foreign corporations (section 246A)		see instructions	
3 Certain preferred stock of public utilities		see instructions	
4 Foreign corporations and certain FSCs subject to section 245 deduction		see instructions	
5 Wholly owned foreign subsidiaries and FSCs subject to 100% deduction (sections 245(b) and (c))		100	
6 Total—Add lines 1 through 5. See instructions for limitation			
7 Affiliated groups subject to the 100% deduction (section 243(a)(3))		100	
8 Other dividends from foreign corporations not included in lines 4 and 5			
9 Income from controlled foreign corporations under subpart F (attach Forms 5471)			
10 Foreign dividend gross-up (section 78)			
11 IC-DISC or former DISC dividends not included in lines 1 and/or 2 (section 246(d))			
12 Other dividends			
13 Deduction for dividends paid on certain preferred stock of public utilities (see instructions)			
14 Total dividends—Add lines 1 through 12. Enter here and on line 4, page 1 ▶			
15 Total deductions—Add lines 6, 7, and 13. Enter here and on line 29b, page 1 ▶			

Schedule E Compensation of Officers (See instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a, plus lines 4 through 10, of page 1, Form 1120) are $150,000 or more.

(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
Total compensation of officers—Enter here and on line 12, page 1					

Schedule J Tax Computation (See instructions.)

1 Check if you are a member of a controlled group (see sections 1561 and 1563) . . . . . ▶ ☐

2 If line 1 is checked, see instructions. If your tax year includes June 30, 1987, complete both a and b below. Otherwise, complete only b.

a (i) $ _____ (ii) $ _____ (iii) $ _____ (iv) $ _____

b (i) $ _____ (ii) $ _____

3	Income tax (see instructions to figure the tax; enter this tax or alternative tax from Schedule D, whichever is less). Check if from Schedule D ▶ ☐		3
4a	Foreign tax credit (attach Form 1118)	4a	
b	Possessions tax credit (attach Form 5735)	b	
c	Orphan drug credit (attach Form 6765)	c	
d	Credit for fuel produced from a nonconventional source (see instructions)	d	
e	General business credit. Enter here and check which forms are attached ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586	e	
5	Total—Add lines 4a through 4e		5
6	Line 3 less line 5		6
7	Personal holding company tax (attach Schedule PH (Form 1120))		7
8	Tax from recomputing prior-year investment credit (attach Form 4255)		8
9a	Alternative minimum tax (see instructions—attach Form 4626)		9a
b	Environmental tax (see instructions—attach Form 4626)		9b
10	Total tax—Add lines 6 through 9b. Enter here and on line 31, page 1		10

Additional Information (See instruction F.)

		Yes	No
H	Did the corporation claim a deduction for expenses connected with:		
	(1) An entertainment facility (boat, resort, ranch, etc.)?		
	(2) Living accommodations (except employees on business)?		
	(3) Employees attending conventions or meetings outside the North American area? (See section 274(h).)		
	(4) Employees' families at conventions or meetings? If "Yes," were any of these conventions or meetings outside the North American area? (See section 274(h).)		
	(5) Employee or family vacations not reported on Form W-2?		
I	(1) Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: (a) name, address, and identifying number; (b) percentage owned; (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year; (d) highest amount owed by the corporation to such corporation during the year; and (e) highest amount owed to the corporation by such corporation during the year.		
	(2) Did any individual, partnership, corporation, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) If "Yes," complete (a) through (d)		
	(a) Attach a schedule showing name, address, and identifying number. Enter percentage owned ▶ _____		
	(b) Was the owner of such voting stock a person other than a U.S. person? (See instructions.) Note: *If "Yes," the corporation may have to file Form 5472.* If "Yes," enter owner's country ▶ _____		
	(c) Enter highest amount owed by the corporation to such owner during the year ▶ _____		
	(d) Enter highest amount owed to the corporation by such owner during the year ▶ _____		
	Note: *For purposes of I(1) and I(2), "highest amount owed" includes loans and accounts receivable/payable.*		

		Yes	No
J	Refer to the list in the instructions and state the principal: Business activity ▶ _____ Product or service ▶ _____		
K	Was the corporation a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 5471 for each such corporation.		
L	At any time during the tax year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See instruction F and filing requirements for form TD F 90-22.1.) If "Yes," enter name of foreign country ▶ _____		
M	Was the corporation the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not the corporation has any beneficial interest in it? If "Yes," the corporation may have to file Forms 3520, 3520-A, or 926.		
N	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.		
O	During this tax year did the corporation maintain any part of its accounting/tax records on a computerized system?		
P	Check method of accounting: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶ _____		
Q	Check this box if the corporation issued publicly offered debt instruments with original issue discount ☐ If so, the corporation may have to file Form 8281.		
R	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ _____		
S	If you are a member of a controlled group, enter the amount of taxable income for the entire group ▶ _____		

Schedule L Balance Sheets

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash				
2 Trade notes and accounts receivable				
a Less allowance for bad debts				
3 Inventories				
4 Federal and state government obligations				
5 Other current assets (attach schedule)				
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other depreciable assets				
a Less accumulated depreciation				
10 Depletable assets				
a Less accumulated depletion				
11 Land (net of any amortization)				
12 Intangible assets (amortizable only)				
a Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets				
Liabilities and Stockholders' Equity				
15 Accounts payable				
16 Mortgages, notes, bonds payable in less than 1 year				
17 Other current liabilities (attach schedule)				
18 Loans from stockholders				
19 Mortgages, notes, bonds payable in 1 year or more				
20 Other liabilities (attach schedule)				
21 Capital stock: a preferred stock				
b common stock				
22 Paid-in or capital surplus				
23 Retained earnings—Appropriated (attach schedule)				
24 Retained earnings—Unappropriated				
25 Less cost of treasury stock		( )		( )
26 Total liabilities and stockholders' equity				

Schedule M-1 Reconciliation of Income per Books With Income per Return

You are not required to complete this schedule if the total assets on line 14, column (d), of Schedule L are less than $25,000.

1 Net income per books		7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax		a Tax-exempt interest $	
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize)			
		8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (itemize)		a Depreciation $	
a Depreciation $		b Contributions carryover $	
b Contributions carryover $			
6 Total of lines 1 through 5		9 Total of lines 7 and 8	
		10 Income (line 28, page 1)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (line 24, Schedule L)

You are not required to complete this schedule if the total assets on line 14, column (d), of Schedule L are less than $25,000.

1 Balance at beginning of year		5 Distributions: a Cash	
2 Net income per books		b Stock	
3 Other increases (itemize)		c Property	
		6 Other decreases (itemize)	
4 Total of lines 1, 2, and 3		7 Total of lines 5 and 6	
		8 Balance at end of year (line 4 less line 7)	

1987

Department of the Treasury
Internal Revenue Service

Instructions for Forms 1120 and 1120-A

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Changes You Should Note

The Tax Reform Act of 1986 made several changes to the way corporations compute their taxable income and their tax liability. Many of these changes are contained in these instructions. For information on other changes, see **Publication 921**, Explanation of the Tax Reform Act of 1986 for Business.

Form 1120-A

If a corporation meets **all** the qualifications under General Instruction B, Who May File Form 1120-A, it can file **Form 1120-A**, U.S. Corporation Short-Form Income Tax Return, instead of **Form 1120**, U.S. Corporation Income Tax Return.

Form 1120-A is printed in a special colored ink to permit processing by optical character recognition (OCR) equipment. This equipment cannot process photocopies. Therefore, please file the original Form 1120-A, rather than a copy.

Voluntary Contributions To Reduce the Public Debt

Quite often inquiries are received about how voluntary contributions to reduce the public debt may be made. A corporation may contribute by enclosing a **separate** check, payable to "Bureau of the Public Debt," with the tax return. These amounts are tax deductible subject to the rules and limitations for charitable contributions. Please keep the contribution to reduce the public debt **separate** from any amount payable with the tax return. Tax remittances should be made payable to "Internal Revenue Service."

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

General Instructions

Note: In addition to those publications listed throughout these instructions, taxpayers may wish to get: **Publication 534**, Depreciation; **Publication 535**, Business Expenses; and **Publication 542**, Tax Information on Corporations.

A. Purpose of Form

In general, Form 1120 and Form 1120-A are used to report income, gains, losses, deductions, and credits of U.S. corporations.

B. Filing Form 1120 and Form 1120-A

Who Must File

Domestic corporations not required to file a special return (see below), must file Form 1120, unless they qualify to file Form 1120-A. All domestic corporations must file, whether or not they have any taxable income, unless exempt under section 501.

(Note: *If an organization more nearly resembles a corporation than a partnership or trust, it will be considered an association taxed as a corporation.)*

Who May File Form 1120-A

Form 1120-A may be filed by a corporation if it meets **all** of the following requirements:

- Its gross receipts (line 1a on page 1) must be under $250,000;
- Its total income (line 11 on page 1) must be under $250,000;
- Its total assets (line 11, column (b), Part II on page 2) must be under $250,000;
- It does not have any ownership in a foreign corporation;
- It does not have foreign shareholders who own, directly or indirectly, 50% or more of its stock;
- It is not a member of a controlled group of corporations (sections 1561 and 1563);
- It is not a personal holding company (sections 541 through 547);
- It is not a consolidated corporate return filer;
- It is not a corporation undergoing a dissolution or liquidation;
- It is not filing its final tax return;
- Its only dividend income is from domestic corporations (none of which represents debt-financed securities), and those dividends qualify for the 80% deduction.
- It has no nonrefundable tax credits other than the general business credit, which is the sum of the investment credit, jobs credit, alcohol fuel credit, research credit, and low-income housing credit.
- It is not required to file a special tax return as stated below under Special Returns for Certain Organizations.
- It is not subject to environmental tax under section 59A.

Form 1120-A Filers

To make it easier for us to process Form 1120-A, we ask all filers to:

- Keep all entries inside the entry boxes;
- Not use dollar signs;
- If possible, type or machine print all entries on the tax return; and
- File the original form instead of a copy.

Special Returns for Certain Organizations

Certain organizations, listed below, have to file special returns.

- Foreign corporations other than life and property and casualty insurance companies filing Forms 1120L and 1120-PC : File Form 1120F.
- Foreign sales corporations (section 922): File Form 1120-FSC.
- Life insurance companies (section 801): File Form 1120L.
- Property and casualty insurance companies (section 831): File Form 1120-PC.
- Farmers' cooperatives (section 1381): File Form 990-C.
- Exempt organizations with unrelated trade or business income: File Form 990-T.
- S corporations (section 1361): File Form 1120S.
- Interest Charge Domestic International Sales Corporations (section 992): File Form 1120-IC-DISC.
- Political organizations (section 527): File Form 1120-POL.
- Condominium management associations and residential real estate management associations who elect to be treated as homeowners associations under section 528: File Form 1120-H.
- Funds set up to pay for nuclear decommissioning costs (section 468A): File Form 1120-ND.
- Designated settlement funds (section 468B): File Form 1120-DF.
- Real estate investment trusts (section 856): File Form 1120-REIT.
- Entities electing under section 860D to be treated as real estate mortgage investment conduits (REMICS): File Form 1066.
- Regulated investment companies (section 851): File Form 1120-RIC.

When To File

In general, a corporation must file its income tax return by the 15th day of the 3rd month after the end of the tax year. A new corporation filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

Extension.—File Form 7004, Application for Automatic Extension of Time To File Corporation Income Tax Return, to request an automatic 6-month extension of time to file.

Period covered.—File the 1987 return for calendar year 1987 and fiscal years that begin in 1987 and end in 1988. For a fiscal year, fill in the tax year space at the top of the form.

Initial return, final return, and change in address.—If this is the corporation's first return, check the "Initial return" box in item G. If the corporation ceases to exist, check the "Final return" box in item G and do not file Form 1120-A; use Form 1120. Indicate a change in address by checking the appropriate box.

Where To File

Use the preaddressed envelope. If you do not use the envelope, file your return at the applicable IRS address listed below.

If the corporation's principal business, office, or agency is located in ▼	Use the following Internal Revenue Service Center address ▼
New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)	Holtsville, NY 00501
New York (all other counties), Connecticut, Maine, Massachusetts, Minnesota, New Hampshire, Rhode Island, Vermont	Andover, MA 05501
Alabama, Florida, Georgia, Mississippi, South Carolina	Atlanta, GA 39901
Kentucky, Michigan, Ohio, West Virginia	Cincinnati, OH 45999
Kansas, Louisiana, New Mexico, Oklahoma, Texas	Austin, TX 73301
Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming	Ogden, UT 84201
California (all other counties), Hawaii	Fresno, CA 93888
Illinois, Iowa, Missouri, Wisconsin	Kansas City, MO 64999
Arkansas, Indiana, North Carolina, Tennessee, Virginia	Memphis, TN 37501
Delaware, District of Columbia, Maryland, Pennsylvania	Philadelphia, PA 19255

Corporations having their principal place of business outside the United States or claiming a possessions tax credit (section 936) must file with the Internal Revenue Service Center, Philadelphia, PA 19255.

The separate income tax returns of a group of corporations located in several Service Center regions may be filed with the Service Center for the area in which the principal office of the managing corporation that keeps all the books and records is located.

Signature

The return must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as tax officer) authorized to sign. A receiver, trustee, or assignee must sign and date any return required to be filed on behalf of a corporation.

If a corporate officer filled in the corporate tax return, the Paid Preparer's space under "Signature of officer" should remain blank. If someone prepares the tax return and does not charge the corporation, that person should not sign the return. Certain others who prepare the tax return should not sign. For example, a regular, full-time employee of the corporation, such as a clerk, secretary, etc., does not have to sign.

Generally, anyone who is paid to prepare the tax return must sign it and fill in the other blanks in the Paid Preparer's Use Only area of the return.

The preparer required to sign the return MUST complete the required preparer information and:

- Sign it, by hand, in the space provided for the preparer's signature. (Signature stamps or labels are not acceptable.)
- Give a copy of the tax return to the taxpayer in addition to the copy filed with IRS.

Tax return preparers should be familiar with their responsibilities. See **Publication 1045,** Information for Tax Practitioners, for more details.

C. Figuring and Paying the Tax

1. Accounting

Accounting methods.—Taxable income must be computed using the method of accounting regularly used in keeping the corporation's books and records. In all cases, the method adopted must clearly reflect taxable income. (See section 446.)

Generally, corporations engaged in farming operations must use the accrual method of accounting. See section 447 for exceptions.

Unless the law specifically permits otherwise, the corporation may change the method of accounting used to report taxable income in earlier years (for income as a whole or for any material item) only by first getting consent on **Form 3115,** Application for Change in Accounting Method. Also see **Publication 538,** Accounting Periods and Methods.

Note: *The Tax Reform Act of 1986 changed several of the rules governing accounting methods:*

(1) *For tax years beginning after 1986, corporations (other than qualified personal service corporations), are generally required to use the accrual method of accounting if their annual average gross receipts are $5,000,000 or more. See section 448(c). A corporation changing to the accrual method because of this provision must complete a Form 3115 and attach it to Form 1120 for the year of change. The corporation must also show on a statement accompanying Form 3115 the period over which the section 481(a) adjustment will be taken into account and the basis for that conclusion. See section 448 and Regulations section 1.448-1T(g) and 1.448-1T(h) for more information. Include the amount reportable as income in 1987 under section 481(a) on line 10, page 1.*

(2) *For long-term contracts (except certain real property construction contracts), entered into after February 28, 1986, taxpayers must elect either the percentage of completion or the percentage of completion-capitalized cost method. See section 460 and Notice 87-61, 1987-38, I.R.B. 40, for more information.*

(3) *The reserve method of computing bad debts has been repealed for tax years beginning after 1986 for most taxpayers. See the instructions for line 15 for details.*

Change in accounting period.—Generally, before changing an accounting period, the Commissioner's approval must be obtained (Regulations section 1.442-1) by filing **Form 1128,** Application for Change in Accounting Period. Also see Publication 538.

Note: *For tax years beginning after 1986, personal service corporations as defined in section 441(i)(2) must adopt a calendar year unless the corporation can establish to the satisfaction of the Secretary that there is a business purpose for having a different tax year. See section 441.*

A corporation which is adopting a calendar year must file a short period return for its first taxable year beginning after 1986. These taxpayers should type or legibly print at the top of the first page of the return for the first required tax year "FILED UNDER SECTION 806 OF THE TAX REFORM ACT OF 1986."

Personal service corporations who wish to establish a business purpose for having a different tax year should see Rev. Rul. 87-57, 1987-28, I.R.B. 7, for more information. Also see Rev. Proc. 87-32, 1987-28, I.R.B. 14, for procedures to use in adopting, retaining, or changing the corporation's tax year. Personal service corporations who wish to adopt or retain a non-calendar tax year must file requests to do so on Form 1128 in accordance with the procedures outlined in Rev. Proc. 87-32 and Announcement 87-82, 1987-37, I.R.B. 30. Announcement 87-82 provides rules regarding extensions of time for these corporations to file Form 1128, and information on extensions of time for personal service corporations filing short period returns.

2. Rounding Off to Whole-Dollar Amounts

The corporation may show the money items on the return and accompanying schedules as whole-dollar amounts. To do so, drop any amount less than 50 cents and increase any amount from 50 cents through 99 cents to the next higher dollar.

3. Depositary Method of Tax Payment

The corporation must pay the tax due in full when the return is filed but no later than 2½ months after the end of the tax year.

Deposit corporation income tax payments (and estimated tax payments) with a Federal Tax Deposit Coupon (**Form 8109**). Be sure to darken the "1120" box on the coupon. Make these tax deposits with either a financial institution qualified as a depositary for Federal taxes or the Federal Reserve bank or branch servicing the geographic area where the corporation is located. Do not submit deposits directly to an IRS office; otherwise, the corporation may be subject to a failure to deposit penalty. Records of deposits will be sent to IRS for crediting to the corporation's account. See the instructions contained in the coupon book (Form 8109) for more information.

In order for us to better process your deposits, please write your employer identification number, type of tax paid, and the tax period to which the deposit applies on your check.

To get more deposit coupons, use the reorder form (**Form 8109A**) provided in the coupon book.

For more information concerning deposits, see **Publication 583,** Information for Business Taxpayers.

4. Backup Withholding

If a person receives certain payments and does not give the payer the correct employer identification number, the payer will

withhold taxes from those payments. This type of withholding is called "backup withholding." If the corporation has had any backup withholding withheld from payments, the corporation should show this amount in the blank space in the righthand column between lines 31 and 32, page 1, Form 1120, and label the amount as backup withholding. The corporation should then include the amount in the total for line 32. On Form 1120-A, include the amount of backup withholding in line 28, page 1, and write "backup withholding" and the amount in the margin.

5. Estimated Tax

A corporation must make estimated tax payments if it can expect its estimated tax (income tax minus credits) to be $40 or more. Use **Form 1120-W,** Corporation Estimated Tax, as a worksheet to compute estimated tax. Use the Payment Coupons (Forms 8109) in making deposits of estimated tax.

If a corporation is the beneficiary of a trust, and the trust makes a section 643(g) election to credit its estimated tax payments to its beneficiaries, include the corporation's share of the estimated tax payment in the total amount entered on line 32b, Form 1120. In the blank space to the left of the entry space for line 32b, write "Sec. 643(g)" and the amount attributable to it. On Form 1120-A, include the corporation's share of the section 643(g) payment on line 28b and identify it as shown above for Form 1120.

If the corporation overpaid estimated tax, it may be able to get a "quick refund" by filing **Form 4466,** Corporation Application for Quick Refund of Overpayment of Estimated Tax. The overpayment must be both: (1) at least 10% of expected income tax liability, and (2) at least $500. To apply, file Form 4466 within 2½ months after the end of the tax year and before the corporation files its tax return.

6. Timing Change in Deducting Accrued Expenses

Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year that all events have occurred that determine the liability, and the amount of the liability can be figured with reasonable accuracy. However, generally all the events that establish liability for the amount are treated as occurring only when economic performance takes place. There are exceptions for recurring items. See section 461(h).

7. Rule of 78's Not an Acceptable Method of Figuring Interest

Taxpayers are reminded that, generally, the Rule of 78's is not an acceptable method for computing interest income and expense. Anyone using the Rule of 78's should see Revenue Procedures 84-27, 84-28, 84-29 and 84-30, (which are in Cumulative Bulletin 1984-1) to change their method.

D. Interest and Penalties

Interest and penalty charges are described below. If a corporation files late or fails to pay the tax when due, it may be liable for penalties unless it can show that failure to file or pay was due to reasonable cause and not willful neglect.

1. Interest.—Interest is charged on taxes not paid by the due date, even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, gross valuation overstatements, and substantial understatements of tax from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

2. Late Filing of Return.—A corporation that fails to file its return when due (including extensions of time for filing) may be subject to a penalty of 5% a month or fraction of a month, up to a maximum of 25%, for each month the return is not filed. The penalty is imposed on the net amount due. The minimum penalty for failure to file a tax return within 60 days of the due date for filing (including extensions) is the lesser of the underpayment of tax or $100.

3. Late Payment of Tax.—Generally, the penalty for not paying tax when due is ½% of the unpaid amount, up to a maximum of 25%, for each month or fraction of a month the tax remains unpaid. The penalty is imposed on the net amount due.

4. Underpayment of Estimated Tax.—A corporation that fails to make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayment. To avoid the estimated tax penalty, the corporation must make estimated tax payments of a least 90% of the tax shown on the return. See section 6655.

If a corporation underpaid estimated tax, attach **Form 2220,** Underpayment of Estimated Tax by Corporations, to show either how the penalty was figured or the exceptions which apply. Also be sure to check the box on line 33, Form 1120 or line 29, Form 1120-A. If the corporation owes a penalty, enter the amount of the penalty on this line. Corporations using the annualization exception may be able to avoid penalties under section 6655 for installment payments due before July 1, 1987, by using the safe harbor provided in Regulations section 1.6655-2T.

5. Overstated Tax Deposits.—If deposits are overstated, the corporation may be subject to a penalty of 25% of the overstated deposit claim. See section 6656(b).

6. Other Penalties.—There are also penalties that can be imposed for negligence, substantial understatement of tax, and fraud. See sections 6653 and 6661.

E. Other Forms, Returns, Schedules, and Statements That May Be Required

1. Forms

The corporation may have to file any of the following:

Forms W-2 and W-3. Wage and Tax Statement; and Transmittal of Income and Tax Statements.

Form W-2P. Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments.

Form 966. Corporate Dissolution or Liquidation.

Form 1096. Annual Summary and Transmittal of U.S. Information Returns.

Form 1098. Mortgage Interest Statement. This form is used to report the receipt from any individual of $600 or more of mortgage interest in the course of the corporation's trade or business for any calendar year.

Forms 1099-A, B, DIV, INT, MISC, OID, PATR, and R. Information returns for reporting abandonments, acquisitions through foreclosure, proceeds from brokers, barter exchange, and real estate transactions, certain dividends and distributions, interest payments, payments for certain fishing boat crew members, medical and dental health care payments, direct sales of consumer goods for resale, miscellaneous income payments, nonemployee compensation, original issue discount, patronage dividends, and total distributions from profit-sharing plans, retirement plans, and individual retirement arrangements. Also use these returns to report amounts that were received as a nominee on behalf of another person.

For more information, see **Publication 916,** Information Returns.

Note: *Every corporation must file information returns if, in the course of its trade or business, it makes payments of rents, commissions, or other fixed or determinable income (see section 6041) totaling $600 or more to any one person during the calendar year.*

Form 5452. Corporate Report of Nontaxable Dividends.

Form 5498. Individual Retirement Arrangement Information. Use this form to report contributions (including rollover contributions) to an individual retirement arrangement (IRA) and the value of an IRA or simplified employee pension account.

Form 5713. International Boycott Report, for persons having operations in or related to "boycotting" countries. In addition, persons who participate in or cooperate with an international boycott may have to complete Schedule A or Schedule B and Schedule C of Form 5713 to compute their loss of the following items: the foreign tax credit, the deferral of earnings of a controlled foreign corporation, IC-DISC benefits, and FSC benefits.

Form 8264. Application for Registration of a Tax Shelter. It is used by tax shelter organizers to register tax shelters with the IRS, for the purpose of receiving a tax shelter registration number.

Form 8271. Investor Reporting of Tax Shelter Registration Number. It is used by taxpayers who have acquired an interest in a tax shelter, which is required to be registered, to report the tax shelter's registration number. Form 8271 must be attached to any tax return (including an application for tentative refund (Form 1139) and an amended return (Form 1120X)) on which a deduction, credit, loss, or other tax benefit attributable to a tax shelter is taken or any income attributable to a tax shelter is reported.

Form 8281. Information Return for Publicly Offered Original Issue Discount Instruments. This form is generally required to be filed by issuers of public offerings of debt instruments within 30 days of the issuance of the debt instrument.

Form 8300. Report of Cash Payments Over $10,000 Received in a Trade or Business. Generally, this form is used to report the receipt of more than $10,000 in cash or foreign currency in one transaction (or a series of related transactions).

Form 8582. Passive Activity Loss Limitations. It is used to figure the amount of passive activity loss allowed for the

current tax year and the loss to be reported on your tax return. Form 8582 applies to personal service corporations and closely held C corporations who have losses from passive activities.

2. Consolidated Return

The parent corporation of an affiliated group of corporations must attach **Form 851,** Affiliations Schedule, to the consolidated return. For the first year a consolidated return is filed, each subsidiary must attach **Form 1122,** Authorization and Consent of Subsidiary Corporation to be Included in a Consolidated Income Tax Return.

File supporting statements for each corporation included in the consolidated return. Use columns to show the following, both before and after adjustments:

- Items of gross income and deductions.
- A computation of taxable income.
- Balance sheets as of the beginning and end of the tax year.
- A reconciliation of income per books with income per return.
- A reconciliation of retained earnings.

Attach consolidated balance sheets and a reconciliation of consolidated retained earnings.

3. Statements

Stock ownership in foreign corporations.—Attach the required statement to Form 1120 if the corporation owned 5% or more in value of the outstanding stock of a foreign personal holding company and the corporation was required to include in its gross income any undistributed foreign personal holding company income from a foreign personal holding company. See section 551(c).

A corporation that controls a foreign corporation, or that is a 10%-or-more shareholder of a controlled foreign corporation, or acquires, disposes of, or owns 5% or more ownership in the outstanding stock of a foreign corporation, may have to file **Form 5471,** Information Return with Respect to a Foreign Corporation.

A domestic corporation or a foreign corporation that is engaged in a trade or business in the United States and is controlled by a foreign person may have to file **Form 5472,** Information Return of a Foreign-Owned Corporation.

Transfers to a corporation controlled by the transferor.—If a person receives stock or securities of a corporation in exchange for property, and no gain or loss is recognized under section 351, the person (transferor) and the transferee must attach to Form 1120 the information required by Regulations section 1.351-3.

4. Amended Return

Use **Form 1120X,** Amended U.S. Corporation Income Tax Return, to correct any error in a previously filed Form 1120 or Form 1120-A.

5. Financial Statements

A corporation is not required to complete Schedules M-1 and M-2 (Form 1120 only) if the corporation's total assets at the end of the tax year (line 14, column (d) of Schedule L, Form 1120) are less than $25,000.

6. Attachments

Attach **Form 4136,** Computation of Credit for Federal Tax on Gasoline and Special Fuels, after page 4, Form 1120, or page 2, Form 1120-A. Attach schedules in alphabetical order and other forms in numerical order after the Form 4136.

In order to process the return we ask that you complete every applicable entry space on Form 1120. Please do not attach statements and write "See attached" in lieu of completing the entry spaces on Form 1120.

If more space is needed on the forms or schedules, attach separate sheets indicating at the top of each attachment the form number or schedule letter of the form or schedule being continued. Also, show the same information called for on the form in the same order as on the printed forms. **Be sure to show totals on the printed forms.** Please use sheets that are the same size as the forms and schedules. Attach these separate sheets after all the schedules and forms. Also, put the corporation's name and employer identification number (EIN) on each sheet.

F. Additional Information

Be sure to answer questions H through S on page 3, Form 1120, or questions I through O on page 2, Form 1120-A. The instructions that follow are keyed to these questions.

1. Question I(2)(b), Form 1120 only

U.S. person.—The term "U.S. person" means:

1. A citizen or resident of the United States;
2. A domestic partnership;
3. A domestic corporation; or
4. Any estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)).

"Owner's country," for individuals, is the owner's country of residence. For all others, it is the country where incorporated, organized, created, or administered.

2. Question L, Form 1120, and Question M , Form 1120-A

Foreign financial accounts.—Check the Yes box if either a or b below applies to the corporation; otherwise, check the No box:

a. At any time during the year the corporation had an interest in or signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account); AND

- The combined value of the accounts was more than $10,000 at any time during the year; AND
- The account was NOT with a U.S. military banking facility operated by a U.S. financial institution.

b. The corporation owns more than 50% of the stock in any corporation that would answer "Yes" to item **a** above.

Get form **TD F 90-22.1,** Report of Foreign Bank and Financial Accounts, to see if the corporation is considered to have an interest in or signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account).

If "Yes" is checked for this question, file form TD F 90-22.1 by June 30, 1988, with the Department of the Treasury at the address shown on the form. Form TD F 90-22.1 is not a tax return, so do not file it with Form 1120.

Form TD F 90-22.1 may be obtained from IRS Forms Distribution Centers.

Also, if "Yes" is checked for this question, write the name of the foreign country or countries. Attach a separate sheet if more space is needed.

3. Question R, Form 1120, and Question K, Form 1120-A

Report any tax exempt interest received or accrued in the space provided. Include any exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company.

Specific Instructions

Employer identification number. If the employer identification number (EIN) on the label is wrong or if the corporation did not receive a label, enter the correct number at the top of the return. Also, filers of Form 1120-A should enter their EIN at the top of page 2 of the return.

A corporation that does not have an EIN should apply for one on **Form SS-4,** Application for Employer Identification Number. This form may be obtained from most IRS and Social Security Administration offices. Send Form SS-4 to the same Internal Revenue Service Center to which Form 1120 or Form 1120-A is mailed. If the EIN has not been received by the filing time for the corporation return, write "Applied for" in the space for the EIN.

For more information concerning an EIN, see Publication 583.

Total Assets. Enter the total assets of the corporation. If there are no assets at the end of the tax year, enter the total assets as of the beginning of the tax year.

Income

Note: *Generally, income from all sources, whether U.S. or foreign, must be included.*

Line 1

Gross receipts

Enter gross receipts or sales from all business operations except those that must be reported in lines 4 through 10. For reporting advance payments, see Regulations section 1.451-5. The rules for long-term contracts have been changed by the Tax Reform Act of 1986. See section 460 for more information.

Changes have also been made to the installment method. Effective for tax years beginning after 1986, the installment method is no longer available for any sale of personal property under a revolving credit plan.

The use of the installment method is limited by the proportionate disallowance rules of new section 453C for sales of real property held for sale to customers or the sale of personal property by a dealer after February 28, 1986. Additional income (in the case of sales of real property by dealers), or additional tax (in the case of sales of personal property by dealers) generated by the application of the proportionate disallowance rules is taken into account or treated as imposed ratably over a period of three years. See sections 811(c)(6) and 811(c)(7) of the Tax Reform Act of 1986 for more information. Dealers in personal property, see also the Instructions for Schedule J, Tax

Computation. The proportionate disallowance rules do not apply to certain sales by manufacturers to dealers. A seller may elect to have the proportionate disallowance rules not apply to certain sales of timeshares and residential lots. See section 453C for more information.

If the installment method is used, enter on line 1 the gross profit on collections from installment sales (real estate dealers enter this amount as modified by section 811(c)(6) of the Tax Reform Act of 1986) and carry the same amount to line 3. Attach a schedule showing the following for the current year and the three preceding years: a. gross sales, b. cost of goods sold, c. gross profits, d. percentage of gross profits to gross sales, e. amount collected, and f. gross profit on amount collected. Increase the amount collected by any allocable installment indebtedness required by section 453C.

After 1986, accrual basis taxpayers need not accrue certain amounts to be received from the performance of services which, on the basis of their experience, will not be collected (section 448(d)(5)). Corporations that fall under this provision should attach a schedule showing total gross receipts, amount not accrued as a result of the application of section 448(d)(5), the net amount accrued, and Form 3115. The net amount should be entered on line 1a. For more information and guidelines on this "non-accrual experience method," see Regulations section 1.448-2T.

Line 2

Cost of goods sold and/or operations

Both Form 1120 and Form 1120-A filers must enter their cost of goods sold and/or operations on line 2, page 1, of their respective forms. However, a Form 1120 filer must also complete Schedule A on page 2 of the form.

While there is not a similar schedule on Form 1120-A to compute this entry, the following worksheet is provided to help in figuring this amount.

Note: *If a corporation is using either Schedule A, Form 1120, or the following worksheet to figure cost of operations, where inventories are not an income-determining factor, it should do so by entering a zero on lines 1 and 6 of the schedule or worksheet.*

Form 1120 filers using Schedule A and Form 1120-A filers using the worksheet below should see the instructions below under Section 263A Uniform Capitalization Rules before completing Schedule A or the worksheet.

Worksheet (Form 1120-A)

1. Inventory at start of year (enter here and on page 2, Part II, line 3, Column (a), Form 1120-A) . . . . . _____
2. Purchases (enter here and on page 2, Item L(1)(a), Form 1120-A) . . . . . _____
3. Cost of labor (enter here and include in total on page 2, Item L(1)(c), Form 1120-A) _____
4a. Additional section 263A costs (enter here and on page 2, Item L(1)(b)) (see instructions) . . . . . _____
b. Other costs (enter here and include on page 2, Item L(1)(c)) . . . . . _____
5. Subtotal—Add lines 1 through 4b . . . . . _____
6. Inventory at end of year (enter here and on page 2, Part II, line 3, Column (b), Form 1120-A) . . . . . _____
7. Total Cost of goods sold and/or operations—Line 5 less line 6 (enter here and on page 1, line 2, Form 1120-A) . . . . _____

Inventory valuation methods. Inventories can be valued at: (1) cost; (2) cost or market value (whichever is lower); or (3) any other method that is approved by the Commissioner of Internal Revenue, and that conforms to the provisions of the applicable regulations cited below.

Taxpayers using erroneous valuation methods must change to a method permitted for Federal income tax purposes. Such a change should be made by filing Form 3115. For more information about the change, see Regulations section 1.446-1(e)(3) and Rev. Proc. 84-74, 1984-2 C.B. 738.

In line 8a of Schedule A, Form 1120 only, check the method(s) used for valuing inventories. Under "lower of cost or market," market generally applies to normal market conditions where there is a current bid price prevailing at the date the inventory is valued. When no regular open market exists or when quotations are nominal because of inactive market conditions, use fair market prices from the most reliable sales or purchase transactions that occurred near the date the inventory is valued. For more requirements, see Regulations section 1.471–4.

Inventory may be valued below cost when the merchandise is (1) unsalable at normal prices or (2) unusable in the normal way because the goods are "subnormal" (that is because of damage, imperfections, shop wear, etc.) within the meaning of Regulations section 1.471–2(c). Such goods may be valued at a current bona fide selling price, minus direct cost of disposition (but not less than scrap value) if such a price can be established. See Regulations section 1.471–2(c) for more requirements.

If this is the first year the "Last-in First-out" (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method provided in section 472, attach **Form 970**, Application To Use LIFO Inventory Method, or a statement with the information required by Form 970. Also check the LIFO box in line 8b of Schedule A, Form 1120 only. Enter the amount or percent of total closing inventories covered under section 472 in line 8c. Estimates are acceptable.

If the corporation changed or extended its inventory method to LIFO and had to "write up" its opening inventory to cost in the year of election, report the effect of this writeup as income (line 10, page 1) proportionately over a 3-year period that begins in the tax year you made this election. (Section 472(d))

Section 263A Uniform Capitalization Rules. The uniform capitalization rules of section 263A are discussed in general in the instructions for **Limitations on deductions** on page 6. See those instructions before proceeding.

Corporations subject to section 263A will be required to make adjustments to the cost of goods sold computation on Schedule A or on the worksheet used by Form 1120-A filers. To the extent that section 263A costs were not included in inventory in prior years, corporations must revalue their beginning inventory. Corporations may elect one of the simplified methods of accounting for section 263A costs provided in the regulations for purposes of both revaluing their inventory and accounting for costs in subsequent years. (See the instructions for Form 1120, Schedule A, line 4a.) Absent the election of a simplified method, taxpayers are required to allocate additional costs to be included in inventory under section 263A with the same degree of specificity as was required of inventoriable costs under prior law.

Schedule A, Form 1120

Line 1.—For tax years beginning after 1986, beginning inventory must be revalued as if the section 263A rules had been in effect for all prior periods. Enter the revalued beginning inventory on line 1. An adjustment to income is required under section 481(a). This adjustment should be included on page 1, line 10, "Other income" and separately identified on an attached schedule. The section 481 adjustment is taken into account over a period not to exceed 4 years. In addition, since the application of section 263A is considered to be a change in accounting method, corporations are required to complete Form 3115 to show their computation of the section 481(a) adjustment. Attach Form 3115 to Form 1120 or Form 1120-A. Be sure to use the 1987 revision of Form 3115. See the Regulations for more information on revaluing beginning inventory.

Line 4a.—An entry is required on this line only for corporations electing a simplified method of accounting. In the case of taxpayers electing the simplified production method, additional section 263A costs are generally those costs, other than interest, that were not capitalized or included in the inventory costs under the taxpayer's method of accounting immediately prior to the effective date in Regulations section 1.263A-1T, but that are now required to be capitalized under section 263A. In the case of taxpayers electing the simplified resale method, additional section 263A costs are generally those costs incurred with respect to the following categories: off-site storage or warehousing; purchasing; handling, processing, assembly and repackaging; and general and administrative costs (mixed service costs). Enter on line 4a the balance of section 263A costs paid or incurred during the taxable year not included on lines 2 and 3. See Regulations section 1.263A-1T for more information.

Line 4b.—Enter on line 4b any costs paid or incurred during the taxable year not entered on lines 2 through 4a.

Line 6.—See Regulations section 1.263A-1T for more information on computing the amount of additional section 263A costs to be capitalized and added to ending inventory.

Form 1120-A Filers

Form 1120-A filers should complete the inventory worksheet on this page. Before completing the worksheet, read the instructions for lines 1, 4a, and 6 of Schedule A, Form 1120 above. These instructions also apply to lines 1, 4a, and 6 of the worksheet, and explain adjustments

to be made as a result of the new section 263A uniform capitalization rules. In completing the worksheet, enter additional section 263A costs on line 4a only to the extent that: (1) The corporation elects one of the simplified methods discussed in the instructions for line 4a, Schedule A, (Form 1120), and (2) The costs are not included on line 2, "Purchases," or as part of the cost of labor on line 3 or in "Other costs" on line 4b.

Line 4

Dividends

Form 1120-A filers.—Because Form 1120-A can be filed by corporations that only received dividends from domestic corporations (which are not from debt-financed stock) which qualify for the 80% dividends-received deduction, they should enter the total of those dividends on line 4, page 1, Form 1120-A.

Form 1120 filers.—See the instructions for Schedule C, Form 1120.

Line 5

Interest

Enter taxable interest on U.S. obligations and on loans, notes, mortgages, bonds, bank deposits, corporate bonds, tax refunds, etc.

Do not offset interest income against interest expense.

Special rules apply to interest income from certain below-market rate loans. See section 7872 for more information.

Line 6

Gross rents

Enter the gross amount received for the rent of property. Deduct expenses such as repairs, interest, taxes, and depreciation in the proper lines for deductions.

Line 8

Capital gain net income

Every sale or exchange of a capital asset must be reported in detail on **Schedule D (Form 1120)**, Capital Gains and Losses, even though no gain or loss is indicated.

If the net long-term capital gain is more than the net short-term capital loss, or if there is only a net long-term capital gain, compute the alternative tax using Schedule D to see if it produces a smaller tax. Corporations whose tax years begin after June 30, 1987, are not eligible for alternative tax.

Line 9

Net gain or (loss)

Enter the net gain or (loss) from line 18, Part II, **Form 4797**, Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions.

Line 10

Other income

Enter any other taxable income not listed above, and explain its nature on an attached schedule. Examples of other income are recoveries of bad debts deducted in prior years under the specific charge-off method (also see instructions for line 15, Bad debts); the amount of credit for alcohol used as fuel (determined without regard to the limitation based on tax) that was entered on **Form 6478**, Credit for Alcohol Used as Fuel; and refunds of taxes deducted in prior years to the extent they reduced income subject to tax in the year deducted (see section 111). Do not offset current year's taxes with tax refunds.

If "other income" consists of only one item, explain what it is in parentheses on line 10.

Many changes made by the Tax Reform Act of 1986 result in a change in method of accounting for the corporation and require income adjustments under section 481(a). Include any section 481(a) adjustment on line 10, "Other income" and attach a schedule identifying the nature and amount of the adjustment.

Deductions

Limitations on deductions

1. Section 263A Uniform capitalization rules.—Many items that were deductible under prior law must now be capitalized or included in inventory under the new uniform capitalization rules of section 263A. The new rules require corporations to capitalize or include in inventory certain costs incurred in connection with the production of real and personal tangible property held in inventory or held for sale in the ordinary course of business. Tangible personal property produced by a taxpayer includes a film, sound recording, videotape, book, or similar property. The rules also apply to personal property (tangible and intangible) acquired for resale. Taxpayers subject to the rules are required to capitalize not only direct costs but an allocable portion of most indirect costs (including taxes) that relate to the assets produced or acquired for resale. Interest expense paid or incurred in the course of production must be capitalized and is governed by special rules. The uniform capitalization rules also apply to the production of property constructed or improved by a taxpayer for use in its trade or business or in an activity engaged in for profit.

Section 263A does not apply to personal property acquired for resale if the taxpayer's annual average gross receipts are $10,000,000 or less. It does not apply to timber or to property produced under a long-term contract. Special rules apply for farmers. The rules do not apply to property which is produced for use by the taxpayer if substantial construction has occurred before March 1, 1986.

The uniform capitalization rules are generally effective for costs and interest paid or incurred after December 31, 1986. With respect to inventory, the uniform capitalization rules apply to tax years beginning after 1986. Transitional rules are contained in section 803 of the Tax Reform Act of 1986.

In the case of inventory, some of the indirect costs which may not have been capitalized before the Tax Reform Act which must now be capitalized are administration expenses; taxes; depreciation; insurance costs; compensation paid to officers attributable to services; rework labor; and contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Current deductions may still be claimed for research and experimental costs under section 174, intangible drilling costs for oil and gas and geothermal property, and mining and exploration and development costs. Regulations section 1.263A-1T specifies other indirect costs that may be currently deducted and those that must be capitalized with respect to production or resale activities. For more information, see Regulations section 1.263A-1T.

2. Meals and entertainment.—For tax years after 1986, the amount deductible for business meals and entertainment is generally limited to 80% of the amount otherwise allowable. In addition, meals may not be lavish or extravagant; a bona-fide business discussion must occur during, immediately before, or immediately after the meal; and your employee must be present at the meal.

Special rules apply to deductions for tickets to entertainment activities. With the exception of certain charitable sporting events, the deduction for the cost of a ticket is limited to the face value of the ticket.

A limitation on the amount deductible for the rental of a luxury skybox will be phased in beginning in 1987 and will become fully effective in 1989. If the taxpayer rents a skybox in the same arena for more than one event, the deduction is disallowed to the extent that it exceeds the sum of the face value on non-luxury box seats for the seats in the box covered by the lease. This limitation is fully effective in 1989. In 1987, ⅓ of the excess cost of the skybox is disallowed. In 1988 tax years, ⅔ of the excess cost is disallowed. Both the limitation on tickets to entertainment activities and the limitation on skybox rentals is calculated before the application of the 20% reduction required by section 274(n). See Notice 87-23, 1987-9, I.R.B. 6, for more information on meals, entertainment, and travel expense.

3. Transactions between related taxpayers.—Generally, an accrual basis taxpayer may only deduct business expenses and interest owed to a related party in the year the payment is included in the income of the related party. See section 267 for limitation on deductions for unpaid expenses and interest.

4. Section 291 limitations.—Corporations may be required to adjust deductions for depletion of iron ore and coal, intangible drilling and exploration and development costs, bad debt deductions for financial institutions, and the amortizable basis of pollution control facilities. See section 291 to determine the amount of adjustment.

5. Golden parachute payments. —A portion of the payments made by a corporation to key personnel that exceeds their usual compensation may not be deductible. This occurs when the corporation has an agreement (golden parachute) with these key employees to pay them these excessive amounts if control of the corporation changes. See section 280G for changes to the golden parachute rules.

6. Business startup expenses.—Business startup expenses are required to be capitalized unless an election is made to amortize them over a period of 60 months. See section 195.

Line 12

Compensation of officers

Besides entering the total officers' compensation on line 12, Form 1120 filers must complete Schedule E on page 2 if their total receipts (line 1a, plus lines 4 through 10, of page 1, Form 1120) are $150,000 or more.

Complete Schedule E, columns (a) through (f), for all officers. The corporation determines who is an officer under the laws of the state where incorporated.

In a consolidated return, each member of an affiliated group must furnish this information.

Line 13

Salaries and wages

Enter on line 13a the amount of total salaries and wages paid or incurred for the tax year. Do not include salaries and wages deducted elsewhere on the return, such as contributions to a simplified employee pension.

Caution: If you provided taxable fringe benefits to your employees, such as personal use of a car, do not deduct as wages the amount allocated for depreciation and other expenses that you claimed on lines 20 and 26, Form 1120, or lines 20 and 22, Form 1120-A.

Enter on line 13b the amount of jobs credit from **Form 5884**, Jobs Credit.

The jobs credit has been extended through 1988.

Line 14

Repairs

Enter the cost of incidental repairs, such as labor and supplies, that do not add to the value of the property or appreciably prolong its life.

Line 15

Bad debts

Enter the total debts that became worthless in whole or in part during the tax year.

The reserve method of computing bad debts has been repealed for tax years beginning after 1986 for all taxpayers except small banks and thrift institutions. If a corporation maintained such a reserve for its last tax year beginning before 1987, it must change to the specific charge-off method in 1987. The corporation must include the balance remaining in the reserve in income ratably over a 4-year period. Include the amount reportable as income in 1987 on line 10, page 1, and attach a computation. The change from the reserve method to the specific charge-off method is treated as a change in accounting method and shall be considered as approved by the Commissioner. A small bank or thrift institution using the reserve method in 1987 should attach a schedule showing how it arrived at the current year's provision.

Line 17

Taxes

Enter taxes paid or accrued during the tax year, but do not include the following:

1. Federal income taxes;
2. Foreign or U.S. possession income taxes if a tax credit is claimed;
3. Taxes not imposed on the corporation; or
4. Taxes, including state or local sales taxes, that are paid or incurred in connection with an acquisition or disposition of property (such taxes must be treated as a part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition).

See section 164(d) for apportionment of taxes on real property between seller and purchaser.

If the corporation is liable for environmental tax under section 59A, see **Form 4626**, Alternative Minimum Tax—Corporations, for computation of the environmental tax deduction.

Line 18

Interest

Do not include interest on indebtedness incurred or continued to purchase or carry obligations on which the interest is wholly exempt from income tax. (For exceptions, see section 265(b).)

Mutual savings banks, building and loan associations, and cooperative banks can deduct the amounts paid or credited to the accounts of depositors as dividends, interest, or earnings. (See section 591.)

Generally, a cash basis taxpayer cannot deduct prepaid interest allocable to years following the current tax year. For example, a cash basis calendar year taxpayer who in 1987 prepaid interest allocable to any period after 1987 can deduct only the amount allocable to 1987. See **Publication 545**, Interest Expense.

Generally, the interest and carrying charges on straddles cannot be deducted and must be capitalized. (See section 263(g).)

Interest paid or incurred after 1986 that is allocable to certain property produced by a corporation for its own use or for sale must be capitalized. In addition, a corporation must also capitalize any interest on debt it incurred or continued in connection with an asset needed to produce the above property. See section 263A for definitions and more information.

Section 7872 contains special rules for the deductibility of foregone interest on certain below-market rate loans. See section 7872.

Line 19

Contributions

Enter contributions or gifts actually paid within the tax year to or for the use of charitable and governmental organizations described in section 170(c) and any unused contributions carried over from prior years.

The total amount claimed may not be more than 10% of taxable income (line 30, Form 1120, or line 26, Form 1120-A) computed without regard to the following:

1. Any deduction for contributions;
2. The special deductions in line 29b, Form 1120, or line 25b, Form 1120-A;
3. Deductions allowed under sections 249 and 250;
4. Any net operating loss carryback to the tax year under section 172; and
5. Any capital loss carryback to the tax year under section 1212(a)(1).

Charitable contributions over the 10% limitation may not be deducted for the tax year but may be carried over to the next 5 tax years.

A contribution carryover is not allowed, however, to the extent that it increases a net operating loss carryover. See section 170(d)(2)(B).

Corporations on the accrual basis may elect to deduct contributions paid by the 15th day of the 3rd month after the end of the tax year if the contributions are authorized by the board of directors during the tax year. Attach to the return a declaration, signed by an officer, stating that the resolution authorizing the contributions was adopted by the board of directors during the tax year. Also attach a copy of the resolution.

If a contribution is in property other than money and the total claimed value of all property contributed exceeds $500, corporations (except closely held and personal service corporations) shall attach a schedule describing the kind of property contributed and the method used in determining its fair market value.

Closely held corporations and personal service corporations must complete **Form 8283**, Noncash Charitable Contributions, and attach it to their returns.

Also, a corporation must keep records, as required by the regulations for section 170, for all of its charitable contributions.

If the corporation made a "qualified conservation contribution" under section 170(h), also include the fair market value of the underlying property before and after the donation, as well as the type of legal interest contributed, and describe the conservation purpose furthered by the donation.

If a contribution carryover is included, show the amount and how it was determined.

Special rule for contributions of certain property. For a charitable contribution of property, the corporation must reduce the contribution by the sum of:

1. The ordinary income, short-term capital gain that would have resulted if the property were sold at its fair market value; and
2. For contributions made in tax years beginning after 1986, all of the long-term capital gain that would have resulted if the property were sold at its fair market value.

The reduction for the long-term capital gain applies to:

1. Contributions of tangible personal property for use by an exempt organization for a purpose or function unrelated to the basis for its exemption; and
2. Contributions of any property (except stock for which market quotations are readily available—see section 170(e)(5)) to or for the use of certain private foundations. (See section 170(e) and Regulations section 1.170A-4.)

For special rules for contributions of inventory and other property to certain organizations, see section 170(e)(3) and Regulations section 1.170A-4A.

Charitable contributions of scientific property used for research. A corporation (other than a personal holding company or a personal service organization) can receive a larger deduction for contributing scientific property used for research to an institution of higher education. For further information, see section 170(e).

Line 20

Depreciation

Besides depreciation, include in line 20 the part of the cost that the corporation elected to expense for certain recovery property placed in service during tax year 1987. For property placed in service after December

31, 1986, the amount the taxpayer may expense under section 179 has been raised from $5,000 to $10,000.

The deduction for amortization of trademark and trade name expenses has been repealed for expenses paid or incurred after 1986. See the instructions for Form 4562 for more information on changes to the rules for depreciation brought about by the Tax Reform Act of 1986.

Line 22, Form 1120 only

Depletion

See sections 613 and 613A for percentage depletion rates applicable to natural deposits. Also, see section 291 for the limitation on the depletion deduction for iron ore and coal (including lignite). The reduction in a corporation's depletion deduction for iron ore or coal (including lignite) has been increased from 15% to 20% for tax years beginning after 1986. (See section 291.)

Foreign intangible drilling costs and foreign exploration and development costs paid or incurred after 1986 must either be added to the corporation's basis for cost depletion purposes or be deducted ratably over a 10-year period. See sections 263(i), 616, and 617 for more information.

Attach **Form T (Timber)**, Forest Industries Schedules, if a deduction for depletion of timber is taken.

Line 24, Form 1120 only

Pension, profit-sharing, etc., plans

Employers who maintain a pension, profit-sharing, or other funded deferred compensation plan, whether or not qualified under the Internal Revenue Code and whether or not a deduction is claimed for the current tax year, generally are required to file one of the forms described below. There are penalties for failure to file these forms on time.

In addition, there is a new penalty for overstating the pension plan deduction for returns filed after October 22, 1986. See new section 6659A.

Form 5500.—Complete this form for each plan with 100 or more participants.

Form 5500-C or 5500-R.—Complete the applicable form for each plan with fewer than 100 participants.

Form 5500EZ.—Complete this form for a one-participant plan.

Line 25, Form 1120 only

Employee benefit programs

Enter the amount of contributions to employee benefit programs (for example, insurance, health and welfare programs) that are not an incidental part of a pension, profit-sharing, etc., plan included on line 24.

Line 26, Form 1120, and Line 22, Form 1120-A

Other deductions

Include in this line the deduction taken for amortization of pollution control facilities, organization expenses, etc. See Form 4562.

A corporation may deduct dividends it pays in cash on stock held by an employee stock ownership plan. However, a deduction may only be taken if, according to the plan, the dividends are:

1. Paid in cash directly to the plan participants; or

2. Paid to the plan, which distributes them in cash to the plan participants no later than 90 days after the end of the plan year in which the dividends are paid. (See section 404(k).) For other deductions which may be allowed, see section 404(k)(2)(C).

Generally, a deduction may not be taken for the amount of any item or part thereof allocable to a class of exempt income. (See section 265(b) for exceptions.)

Generally, a corporation can deduct all ordinary and necessary travel and entertainment expenses paid or incurred in its trade or business, subject to certain limitations. (See the discussion of "Meals and entertainment" in the **Limitations on deductions** section earlier in these instructions.) However, it cannot deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) that is used for an activity that is usually considered entertainment, amusement, or recreation. (**Note:** *The corporation may be able to deduct the expense if the amount is treated as compensation and reported on Form W-2 for an employee or on Form 1099-MISC for an independent contractor.*)

See **Publication 463**, Travel, Entertainment, and Gift Expenses, for more details.

Note: *Do not deduct penalties imposed on corporations such as those included in General Instruction D.*

Form 1120-A filers.—These filers should also include on line 22 of Form 1120-A the expenses described above for lines 22, 24, and 25 of Form 1120 and any other deductible expense not discussed above.

Line 28, Form 1120, and Line 24, Form 1120-A

Taxable income before NOL deduction and special deductions—"At risk" rules and passive activity loss limitations.

Special "at risk" rules under section 465 generally apply to closely held corporations (section 465(a)(1)(B)) engaged in any activity as a trade or business, or for the production of income. Such corporations may have to adjust the amount on line 28, Form 1120, or line 24, Form 1120-A. (See below.) However, the "at risk" rules do not apply to: (1) holding real property (other than mineral property) placed in service by the taxpayer before 1987; (2) equipment leasing under sections 465(c)(4), (5), and (6); and (3) any qualifying business of a qualified corporation under section 465(c)(7).

If the "at risk" rules apply, adjust amount on this line for section 465(d) losses. These losses are limited to the amount for which such corporation is "at risk" for each separate activity at the close of the tax year. If the corporation is involved in one or more activities, one or more of which incurs a loss for the year, report the losses for each activity separately. Attach **Form 6198**, Computation of Deductible Loss From an Activity Described in Section 465 (c), showing the amount at risk and gross income and deductions for the activities with the losses.

If the corporation sells or otherwise disposes of an asset or its interest (either total or partial) in an activity to which the "at risk" rules apply, determine the net profit or loss from the activity by combining the gain or loss on the sale or disposition with the profit or loss from the activity. If the corporation has a net loss, it may be limited because of the "at risk" rules.

Treat any loss from an activity not allowed for the tax year as a deduction allocable to the activity in the next tax year.

Passive activity loss limitations.

The passive loss rules of section 469 apply to closely held C corporations and personal service corporations. Corporations subject to the passive loss rules must complete Form 8582, Passive Activity Loss Limitations, to compute their allowable passive activity loss. Before completing Form 8582, see Regulations section 1.163-8T, which provides rules for allocating interest expense among activities. If a passive activity is also subject to the at-risk rules of section 465, the at-risk rules apply before the passive loss rules apply. For more information, see section 469 and **Publication 925**, Passive Activity and At-Risk Rules. A corporation subject to the passive activity loss limitations may also be required to adjust credits attributable to passive activities on **Form 8582-CR**, Passive Activity Credit Limitations.

Special Instructions for Form 8582.—Corporations subject to the passive loss rules should complete the following sections of Form 8582: Part I (only lines 2a through 2g, and 3) and if applicable, all of Part III. Also complete the applicable worksheets in the Instructions for Form 8582. Special rules apply to closely held corporations (see below).

In completing worksheets 2, 4, and 5 in the Instructions for Form 8582, enter net income or (loss) from each separate activity in the appropriate column of these worksheets. Also, show the net gain or loss for each transaction reportable on Schedule D or Form 4797 as a separate activity in these worksheets.

If line 3 of Form 8582 is net income, all of the corporation's passive activity losses are allowed. Complete Form 1120 (or 1120-A) and related forms and schedules in the regular manner, disregarding the passive activity loss limitation rules.

If line 3 is a loss, enter -0- on line 9 and complete lines 10 through 19 of Form 8582. Use worksheets 4 and 5 in the Form 8582 instructions to figure the allowed and unallowed amount of each loss. From column (c) of worksheet 5, enter the allowed portion of any Schedule D or Form 4797 loss on Schedule D or Form 4797.

If the corporation's passive losses consist only of Schedule D and/or Form 4797 losses, no adjustment to line 28 of Form 1120, or line 24 of Form 1120-A is necessary. If the corporation's passive losses are limited to **(a)** both Schedule D and/or Form 4797 losses **and** losses on "other passive activities," or **(b)** just losses on "other passive activities," the amount of the unallowed loss(es) for "other passive activities" is the amount in column (c) of worksheet 4. Add the total of these unallowed "other passive activity loss(es)" and increase the taxable income (or reduce the loss—which may result in taxable income if the adjustment is significant) shown on line 28, Form 1120, or line 24, Form 1120-A by this amount.

Write the amount of the adjustment in the space to the left of line 27, Form 1120, or line 23, Form 1120-A, and label as PALA (Passive Activity Loss Adjustment).

Closely held corporations.—Closely held corporations can use "net active income" to offset any loss on Form 8582, line 2g. Net active income is your taxable income for the taxable year determined without regard to any income, expenses, gain, or loss from a passive activity and any item of gross income, expenses, gain or loss under section 469 (e)(1)(A). Closely held C corporations should combine the loss, if any, on line 2g with net active income and enter the result on line 3. The net active income should also be added in on line 18, Form 8582, along with any other income entered on lines 2a and 2d.

Line 29a, Form 1120, and Line 25a, Form 1120-A

Net operating loss deduction

The "net operating loss deduction" is the amount of the net operating loss carryovers and carrybacks that can be deducted in the tax year. See section 172(a). If this deduction is taken, explain its computation on an attached schedule.

Effective January 1, 1987, section 382 limits the amount of taxable income against which net operating loss carryforwards may be applied after an ownership change occurs with respect to a loss corporation. The limitation is described in section 382(b) and generally applies when one or more 5% shareholders increase their ownership in a corporation by more than 50 percentage points. See Regulations section 1.382-2T(a)(2)(ii), which requires that a loss corporation file an information statement with its income tax return for each taxable year that it is a loss corporation. Also see section 382 and Regulations sections 1.382-1T and 1.382-2T for other rules and definitions.

Note: The rule allowing financial institutions to carry their net operating losses back 10 years and forward 5 years is generally repealed for tax years after 1986. For taxable years beginning after 1986, most financial institutions may carry net operating losses back 3 years and forward 15 years. A special 10-year carryback provision applies to certain commercial banks that compute their deduction for bad debts using the specific charge-off method. See section 172(b)(1)(L) for more information.

Generally, a corporation may carry a net operating loss back to each of the 3 years preceding the year of the loss and carry it over to each of the 15 years following the year of the loss. A corporation may carry back 10 years the part of the net operating loss attributable to a product liability loss. (See section 172(b)(1)(I).) See Regulations section 1.172-13(c) for the required statement that must be attached to Form 1120 when claiming the 10 year-carryback on product liability losses.

There is also an available election to carry a net operating loss over to just each of the 15 years following the year of the loss. The election may be made by attaching a statement to a return that is filed on time (including extensions). The election is irrevocable. Section 172(b)(1) describes types of losses for which the 15-year carryforward period does not apply.

After applying the net operating loss to the first tax year to which it may be carried, the portion of the loss the corporation may carry to each of the remaining tax years is the excess, if any, of the loss over the sum of the modified taxable income for each of the prior tax years to which the corporation may carry the loss. (See section 172(b).)

If there is a carryback of a net operating loss, net capital loss, or an unused credit, file **Form 1139**, Corporation Application for Tentative Refund, within 12 months after the close of the tax year for a "quick refund" of taxes. (See section 6411.)

See section 172 for special rules, limitations, and definitions pertaining to net operating loss carrybacks and carryovers. Also see **Publication 536**, Net Operating Losses.

Line 29b, Form 1120, and Line 25b, Form 1120-A

Special deductions

Form 1120 filers.— See the instructions for Schedule C, line 6, column (c) below.

Form 1120-A filers.—Enter 80% of line 4, page 1, on line 25b for dividends received in 1987.

However, this deduction may not be more than 80% of line 24, page 1. For this purpose, compute line 24 without regard to any adjustment under section 1059, and without regard to any capital loss carryback to the tax year under section 1212(a)(1).

In a year in which a net operating loss occurs, this 80% limitation does not apply, even if the loss is created by the dividends-received deduction. (See sections 172(d) and 246(b).)

Line 32e, Form 1120, and Line 28e, Form 1120-A

Credit for overpaid windfall profit tax

A corporation that has overpaid its windfall profit tax may claim a credit on its income tax return. Use **Form 6249**, Computation of Overpaid Windfall Profit Tax, to figure the credit. Include the amount of the credit in the total for this line. Write in the margin, next to the entry on this line, the amount of the credit and identify it as "Overpaid Windfall Profit Tax."

Schedule C Form 1120 Only

Dividends and Special Deductions

Line 1, Column (a)

Enter dividends (except those received on debt-financed stock acquired after July 18, 1984—see section 246A and line 2, column (a)) that are received from domestic corporations subject to income tax and that are subject to the deduction under section 243(a)(1). Include on this line taxable distributions from an IC-DISC or former DISC that are designated as being eligible for the section 243(a)(1) deduction and certain dividends of Federal Home Loan Banks. (See section 246(a)(2).)

Small business investment companies must enter dividends received from domestic corporations subject to income tax even though a deduction is allowed for the entire amount of such dividends in line 1, column (c). For dividends received from a regulated investment company, see section 854 for the amount subject to the section 243(a)(1) deduction.

So-called dividends or earnings received from mutual savings banks, etc., are really interest. Do not treat them as dividends.

Line 2, Column (a)

Enter dividends on debt-financed stock (acquired after July 18, 1984) that are received from domestic and foreign corporations subject to income tax and that would otherwise be subject to the dividends-received deduction under sections 243(a)(1) or 245(a). Generally, debt-financed stock is stock that the corporation acquired and, in doing so, incurred a debt (for example, it borrowed money to buy the stock).

Line 3, Column (a)

Enter dividends received on the preferred stock of a public utility that is subject to income tax and is allowed the deduction provided in section 247 for dividends paid.

Line 4, Column (a)

Enter dividends that are received from foreign corporations and that qualify for the deduction under section 245(a). Also enter on line 4, column (a), dividends received from a FSC that are attributable to qualified interest and carrying charges and that qualify for the deduction provided in section 245(c)(1)(B).

Line 5, Column (a)

Enter dividends that are received from wholly owned foreign subsidiaries and from FSCs that are attributable to export sales income, and that are eligible for the 100% deduction provided in sections 245(b) and (c)(1)(A), respectively.

In general, the deduction under section 245(b) applies to dividends paid out of the earnings and profits of a foreign corporation for a tax year during which:

1. All of its outstanding stock is owned (directly or indirectly) by the domestic corporation receiving the dividends, and
2. All of its gross income from all sources is effectively connected with the conduct of a trade or business within the U.S.

Line 1, Columns (b) and (c)

The dividends-received deduction percentage for dividends received after December 31, 1986, is 80%. Multiply the dividends received by 80% to determine the dividends-received deduction.

A small business investment company operating under the Small Business Investment Act of 1958 may deduct 100% of dividends received from domestic corporations subject to income tax. (See section 243(a)(2).)

Line 2, Columns (b) and (c)

The dividends-received deduction for dividends received on debt-financed stock is explained in section 246A. This section applies both to dividends received from debt-financed stock of domestic and foreign corporations acquired after July 18, 1984.

stock are not entitled to the full 80% dividends-received deduction. The 80% deduction is reduced by a percentage that is related to the amount of debt incurred to acquire the stock. See section 246A. Also see section 245(a) before making this computation for an additional limitation which applies to dividends received from foreign corporations. A schedule showing how the amount on line 2, column (c) was figured must be attached to Form 1120.

Line 3, Columns (b) and (c)

For dividends on certain preferred stock of public utilities received after December 31, 1986, but before July 1,1987, the dividends-received deduction percentage is 55.652%. For those dividends received after June 30, 1987, the dividends-received deduction percentage is 47.059%.

Multiply the dividends received in each period by the proper percentage to determine the correct dividends-received deduction.

Line 4, Columns (b) and (c)

The dividends-received deduction percentage for dividends received from foreign corporations entitled to the dividends-received deduction under section 245(a) and section 245(c)(1)(B) for certain FSCs is 80% for dividends received after December 31, 1986. To qualify for the section 245(a) deduction, the corporation must own at least 10% of the stock of the foreign corporation by vote and value. The deduction is computed on the U.S. source portion of the dividends.

Line 6, Column (c)

Limitation on dividends-received deduction. Line 6 of column (c) may not be more than 80% of the difference between line 28, page 1, Form 1120, and line 7 of column (c). For this purpose, compute line 28 (Form 1120) without regard to any adjustment under section 1059 and without regard to any capital loss carryback to the tax year under section 1212(a)(1).

In a year in which a net operating loss occurs, this 80% limitation does not apply even if the loss is created by the dividends-received deduction. (See sections 172(d) and 246(b).)

For a small business investment company, the dividends-received deduction of 100% included in line 6 of column (c) is not subject to the overall limitation. The 100% dividends-received deduction under section 245(c)(1) for dividends received from a FSC included in line 6 of column (c) is not subject to the overall 80% limitation.

Certain financial institutions to which section 593(a) applies should see section 596 for the special limitation on the dividends-received deduction.

Line 7, Columns (a) and (c)

Enter only those dividends that are subject to the elective provisions of section 243(b) and that are entitled to the 100% dividends-received deduction under section 243(a)(3). Corporations making this election are subject to the provisions of section 1561.

Line 8, Column (a)

Enter foreign dividends not reportable on lines 4 and 5 of column (a). Exclude

taxed in the current year or in prior years under subpart F (sections 951 through 964).

Line 9, Column (a)

Include income constructively received from controlled foreign corporations under subpart F. This amount should equal the total of amounts reported on Schedule J, Form(s) 5471.

Line 10, Column (a)

Include gross-up for taxes deemed paid under sections 902 and 960.

Line 11, Column (a)

Enter taxable distributions from an IC-DISC or former DISC that are designated as not being eligible for the 80% deduction.

No deduction is allowed under section 243 for a dividend from an IC-DISC or former DISC (as defined in section 992(a)) to the extent the dividend:

1. Is paid out of the corporation's accumulated IC-DISC income or previously taxed income, or
2. Is a deemed distribution under section 995(b)(1).

Line 12, Column (a)

Include the following:

1. Dividends (other than capital gain dividends and exempt-interest dividends) that are received from regulated investment companies and that are not subject to the deduction.
2. Dividends from tax-exempt organizations.
3. Dividends (other than capital gain dividends) received from a real estate investment trust which, for the tax year of the trust in which the dividends are paid, qualify under sections 856 through 860.
4. Dividends not eligible for a dividends-received deduction because of the holding period of the stock or an obligation to make corresponding payments with respect to similar stock.

Two situations in which the dividends-received deduction will not be allowed on any share of stock are:

(1) If the corporation held it 45 days or less (see section 246(c)(1)(A)), or

(2) To the extent the corporation is under an obligation to make related payments for substantially similar or related property.

5. Any other taxable dividend income not properly reported above (including distributions under section 936(h)(4)). If patronage dividends or per-unit retain allocations are included in Schedule C, line 12, column (a), identify the total of these amounts in a schedule attached to Form 1120.

Line 13, Column (c)

Deduction for dividends paid on certain preferred stock of public utilities. Section 247 allows public utilities a deduction of 30.435% (for dividends received before July 1, 1987) or 41.176% (for dividends received after June 30, 1987), of the lesser of:

1. Dividends paid on their preferred stock during the tax year, or
2. Taxable income computed without regard to this deduction.

In a year in which a net operating loss occurs, compute the deduction without regard to section 247(a)(1)(B). (See section 172(d).)

Tax Computation

Line 1, Part I, Form 1120-A
Line 3, Schedule J, Form 1120.

Any corporation that files Form 1120 or 1120-A should compute its tax on its taxable income using Schedules A and B of the Tax Computation Worksheet on page 12. Members of a controlled group, see the instructions below for lines 1 and 2 under heading B before proceeding to page 12. If the corporation is a dealer in personal property and is using the installment method in 1987, it should see section 811(c)(7) of the Tax Reform Act of 1986 to figure the ratable portion of tax attributable to section 453C to be included in line 3 of Schedule J, or line 1 of Part I, Form 1120-A. Write in the space to the left of line 3, Schedule J, or line 1, Part I, Form 1120-A, "Sec. 453C tax computation." Attach a schedule showing the computation.

Additional Tax

The Tax Computation Worksheet includes the computation of an additional 5% tax on the excess of a corporation's taxable income over a specified amount. The "specified amount" was changed, effective July 1, 1987, from $1,000,000 to $100,000. The maximum amount of the additional tax (previously $20,250) has been changed to $11,750 effective July 1, 1987.

Alternative Tax

If the tax year of the corporation begins before July 1, 1987, and the corporation has a net capital gain on line 10, Schedule D (Form 1120), the alternative tax computation may apply. To compute the alternative tax, complete Schedules A and B of the Tax Computation Worksheet on page 12 as instructed, and enter the amount from line 34, Schedule B, on line 12, Part IV, Schedule D (Form 1120). Complete the rest of Part IV, Schedule D (Form 1120), and enter the lesser of the alternative tax or the tax figured by the regular method on line 3, Schedule J, Form 1120, or line 1, Part I, Form 1120-A.

A. Form 1120-A, Part I, Page 2 Line 2

General business credit. This credit is made up of the sum of the following credits:

Investment credit. The investment credit was generally repealed for property placed in service after 1985. See **Form 3468**, Computation of Investment Credit, for exceptions.

Jobs credit. The jobs credit, if elected, is allowed for hiring members of targeted groups during the tax year. See **Form 5884**, Jobs Credit, for definitions, special rules, and limitations.

Do not take an expense deduction for the part of the wages or salaries paid or incurred, which is equal to the amount of the jobs credit (determined without regard to the limitation based on the tax (section 38(c))).

Alcohol fuel credit. A corporation may be able to take a credit for alcohol used as fuel. Use **Form 6478**, Credit for Alcohol Used As Fuel, to figure the credit.

The *credit for increasing research activities* is part of the general business credit. See **Form 6765.** Also, a *low-income*

housing credit is part of the general business credit for expenditures made after 1986. See section 42 and **Form 8586,** Low-Income Housing Credit.

Form 3800, *General Business Credit.* Enter on the appropriate line of the corporate tax return the amount of the credit from Form 3800, and check the boxes indicating which forms are attached to the return. If the corporation is claiming only one of the above credits, you do not have to complete Form 3800. Instead, check the appropriate box and attach the form for which the credit is being taken. However, if the corporation has a carryforward or carryback of any of these credits (or a carryforward of an ESOP credit), it must use Form 3800. For more information, see **Publication 572,** General Business Credit.

Line 4

Tax from recomputing prior-year investment credit. If property is disposed of or ceases to be qualified property before the end of the life-years used in computing the regular or energy investment credit, there may be a recapture of the credit. See **Form 4255,** Recapture of Investment Credit.

Line 5

Alternative minimum tax. Attach **Form 4626,** Alternative Minimum Tax—Corporations, if the taxable income plus adjustments and tax preference items of the corporation exceed $40,000. See Form 4626 for details.

B. Form 1120, Schedule J

Lines 1 and 2

Members of a controlled group, as defined in section 1563, with tax years that begin before July 1, 1987 are entitled to only one $25,000 amount in each taxable income bracket on line 2a. Members of a controlled group that have tax years that end after June 30, 1987, are entitled to one $50,000 amount and one $25,000 amount (in that order) in each taxable income bracket on line 2b.

When a controlled group adopts or later amends an apportionment plan, each member must attach to its tax return a copy of its consent to this plan. The copy (or an attached statement) must show the part of the amount in each taxable income bracket apportioned to that member. There are other requirements as well. See Regulations section 1.1561-3(b) for the requirements and for the time and manner of making the consent.

Equal Apportionment Plan. If no apportionment plan is adopted, the members of the controlled group must divide the amount in each taxable income bracket among themselves. For example, controlled group AB consists of corporation A and corporation B, both corporations with tax years which include July 1, 1987. They do not elect an apportionment plan. Therefore, corporation A is entitled to $12,500 (one-half of $25,000) in each taxable income bracket on line 2a. Corporation B is also entitled to $12,500 in each taxable income bracket. Each income bracket on line 2b is also equally divided.

Unequal Apportionment Plan. Members of a controlled group may elect an unequal apportionment plan and divide the taxable income brackets as they wish. There is no need for consistency between taxable income brackets. Any member of the controlled group may be entitled to all, some, or none of the taxable income bracket. However, the total amount for all members of the controlled group cannot be more than the total amount in each taxable income bracket.

Each member of a controlled group must answer Question S in the Additional Information section of Form 1120.

Note: *Members of a controlled group of corporations are treated as one corporation for purposes of figuring the applicability of the additional 5% tax. If the additional tax applies, each member of the group must attach to its tax return a schedule that shows the taxable income of the entire group as well as how its portion of the additional tax was figured.*

Line 3

Bank holding companies. Section 6158 provides that a bank holding company may elect to pay in installments the tax attributable to the sale of certain assets whose divestiture is certified by the Board of Governors of the Federal Reserve System. If the bank holding company chooses this election, attach a statement showing the tax computation and the amount of the installment paid with this return. Also, in the right-hand margin next to line 3, Schedule J, enter the amount of the installment payment followed by the words "computed under section 6158." If an election under section 1103(g) or (h) applies, enter the words "section 1103(g) election" or "section 1103(h) election," as the case may be.

Mutual savings bank conducting life insurance business. The tax under section 594 consists of the sum of: (1) a partial tax computed on Form 1120 on the taxable income of the bank determined without regard to income or deductions allocable to the life insurance department, and (2) a partial tax on the taxable income computed on Form 1120L of the life insurance department. Enter the combined tax on line 3 of Schedule J, Form 1120. Attach Form 1120L as a schedule and identify it as such.

Line 4a

Foreign tax credit. See **Form 1118,** Computation of Foreign Tax Credit—Corporations, for an explanation of when a corporation can take this credit for payment of income tax to a foreign country.

Line 4b

Possessions tax credit. See **Form 5712,** Election To be Treated as a Possessions Corporation Under Section 936, for rules on how to elect to claim the possessions tax credit (section 936). Compute the credit on **Form 5735,** Computation of Possessions Corporation Tax Credit Allowed Under Section 936.

Line 4c

Orphan drug credit. See section 28 and **Form 6765,** Credit for Increasing Research Activities (or for claiming the orphan drug credit), for an explanation of when a corporation can take this credit, as well as how it is figured.

Line 4d

Credit for fuel produced from a nonconventional source. A credit is allowed for the sale of qualified fuels produced from a nonconventional source. Section 29 contains a definition of qualified fuels, provisions for figuring the credit, and other special rules. Attach a separate schedule to the return showing the computation of the credit.

Line 4e

General business credit. See the earlier instructions for Form 1120-A, line 2, under the heading **Tax Computation.**

Line 7

Personal holding company tax. A corporation is taxed as a personal holding company under section 542 if:

- At least 60% of its adjusted ordinary gross income, defined in section 543(b)(2), for the tax year is personal holding company income as defined in section 543(a), and
- At any time during the last half of the tax year more than 50% in value of its outstanding stock is owned, directly or indirectly, by not more than 5 individuals.

Use **Schedule PH (Form 1120),** Computation of U.S. Personal Holding Company Tax, to figure this tax.

Line 8

Tax from recomputing prior-year investment credit. See the earlier instructions for Form 1120-A, Line 4, under the heading **Tax Computation.**

Line 9a

Alternative minimum tax. Attach Form 4626, Alternative Minimum Tax—Corporations, if the taxable income plus adjustments and tax preference items of the corporation exceeds $40,000. See Form 4626.

Line 9b

Environmental tax. The Superfund Amendments and Reauthorization Act of 1986 added new section 59A, which requires that corporations pay an environmental tax. The environmental tax is 0.12 per cent of modified alternative minimum taxable income of the corporation in excess of $2,000,000. See Form 4626 for computation of environmental tax.

Schedule M-2 (Form 1120 Only)

Unappropriated Retained Earnings

Line 5

Distributions under the Bank Holding Company Act. If an election under section 1103(g) or (h) applies to a section 1101 distribution, the bank holding company making the distribution must enter the words "section 1103(g) election" or "section 1103(h) election," as the case may be, in the right-hand margin next to line 5, Schedule M-2, Form 1120.

Schedules A and B Tax Computation Worksheet

Effective July 1, 1987, the tax rates for corporations were reduced. The new rates of tax are:

15% on the first $50,000 of income;
25% on the next $25,000 of income; and
34% on any amount over $75,000.

Also, an additional tax of 5% is applied against income in excess of $100,000. The maximum amount of this additional tax is $11,750.

Corporations with tax years beginning after June 30, 1987, should complete Schedule B only.

Schedule A Tax Computed for Period Before July 1, 1987

1	Taxable income (line 30, Form 1120, or line 26, Form 1120-A)	
2	Net capital gain (If the alternative tax applies, enter net capital gain from line 10, Schedule D (Form 1120). If the alternative tax does not apply, enter zero. See instructions.)	
3	Subtract line 2 from line 1	
4	Enter the lesser of line 3 or $25,000 (members of a controlled group, see instructions)	
5	Subtract line 4 from line 3	
6	Enter the lesser of line 5 or $25,000 (members of a controlled group, see instructions)	
7	Subtract line 6 from line 5	
8	Enter the lesser of line 7 or $25,000 (members of a controlled group, see instructions)	
9	Subtract line 8 from line 7	
10	Enter the lesser of line 9 or $25,000 (members of a controlled group, see instructions)	
11	Subtract line 10 from line 9	
12	Multiply line 4 times 15%	
13	Multiply line 6 times 18%	
14	Multiply line 8 times 30%	
15	Multiply line 10 times 40%	
16	Multiply line 11 times 46%	
17	Additional tax. If line 3 is greater than $1,000,000, enter the lesser of: (a) 5% of the excess of line 3 over $1,000,000 or (b) $20,250 (members of a controlled group, see instructions)	
18	Add amounts on lines 12 through 17	

Schedule B Tax Computed for Period After June 30, 1987

19	Taxable income (line 30, Form 1120, or line 26, Form 1120-A)	
20	Net capital gain (If the alternative tax applies, enter net capital gain from line 10, Schedule D (Form 1120). If the alternative tax does not apply, enter zero. See instructions.)	
21	Subtract line 20 from line 19	
22	Enter the lesser of line 21 or $50,000 (members of a controlled group, see instructions)	
23	Subtract line 22 from line 21	
24	Enter the lesser of line 23 or $25,000 (members of a controlled group, see instructions)	
25	Subtract line 24 from line 23	
26	Multiply line 22 times 15%	
27	Multiply line 24 times 25%	
28	Multiply line 25 times 34%	
29	Additional tax. If line 21 is more than $100,000, enter the lesser of: (a) 5% of the excess of line 21 over $100,000 or (b) $11,750 (members of a controlled group, see instructions)	
30	Add lines 26 through 29. (If only Schedule B was completed, skip lines 31 through 34. Enter the amount from line 30 on line 3, Schedule J, Form 1120, or on line 1, Part I, Form 1120-A.)	
31	Enter amount from line 18, Schedule A (Above)	
32	Line 31 × (number of days in tax year before 7-1-87 / number of days in tax year)	
33	Line 30 × (number of days in tax year after 6-30-87 / number of days in tax year)	
34	Tax liability before credits. Add amounts on lines 32 and 33. Enter here and on line 3, Schedule J, Form 1120, or on line 1, Part I, Form 1120-A. If alternative tax applies, enter on line 12, Schedule D (Form 1120)	

Instructions for Schedules A and B, Tax Computation Worksheet

Net Capital Gain and Alternative Tax (Lines 2 and 20).—In general, the alternative tax is the sum of (a) a tax computed on taxable income reduced by the net capital gain using the applicable tax brackets and tax rates, and (b) a tax of 34% of the net capital gain.

For tax years beginning on or after July 1, 1987, the alternative tax computation does not apply. If a corporation's tax year begins before July 1, 1987, and the corporation has a net capital gain, both computations (the regular tax computation and the alternative tax computation) should be made to determine which results in the lower tax.

The alternative tax is computed by using Schedules A and B of the tax computation worksheet and Part IV of Schedule D (Form 1120). If the alternative tax is less than the regular tax computed on taxable income using the applicable tax brackets and tax rates, then the corporation may enter the alternative tax from Schedule D in Part I, line 1, page 2, Form 1120-A, or line 3, Schedule J, Form 1120, and check the block for alternative tax.

Lines 4, 6, 8, 10, 22 and 24.—Members of a controlled group must enter their portion of each taxable income bracket. See the instructions for Schedule J (Form 1120) for rules regarding how controlled groups (as defined in section 1563) may divide these amounts.

Line 17.—If the total taxable income of the controlled group of corporations is more than $1,000,000, each member should enter its portion of the additional tax on line 17 as explained in the instructions for Schedule J (Form 1120).

Line 29.—If total taxable income of the controlled group of corporations is more than $100,000, each member should enter its portion of the additional tax on line 29. See section 1561 for rules on determining each member's share of the additional tax.

SCHEDULE D (Form 1120)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

To be filed with Forms 1120, 1120-A, 1120-IC-DISC, 1120F, 1120-FSC, 1120-H, 1120L, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 990-C, and certain Forms 990-T

OMB No. 1545-0123

1987

Name

Employer identification number

Part I Short-term Capital Gains and Losses—Assets Held Six Months or Less (One year or less if acquired after 12/31/87)

(a) Kind of property and description (Example, 100 shares of "Z" Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Cost or other basis, plus expense of sale	(f) Gain or loss ((d) less (e))
1					

2	Short-term capital gain from installment sales from Form 6252, line 23 or 31	2	
3	Unused capital loss carryover (attach computation)	3	( )
4	Net short-term capital gain or (loss)	4	

Part II Long-term Capital Gains and Losses—Assets Held More Than Six Months (More than one year if acquired after 12/31/87)

5					

6	Enter gain from Form 4797, line 7 or 9	6	
7	Long-term capital gain from installment sales from Form 6252, line 23 or 31	7	
8	Net long-term capital gain or (loss)	8	

Part III Summary of Parts I and II

9	Enter excess of net short-term capital gain (line 4) over net long-term capital loss (line 8)	9	
10	Net capital gain. Enter excess of net long-term capital gain (line 8) over net short-term capital loss (line 4)	10	
11	Total of lines 9 and 10. Enter here and on Form 1120, line 8, page 1; or the proper line on other returns *Note: If losses exceed gains, see instructions on capital losses for explanation of capital loss carrybacks.*	11	

Part IV Alternative Tax Computation (If your tax year begins after June 30, 1987, do not complete Part IV. Forms 1120-H, 1120-IC-DISC, and 1120-RIC filers also omit Part IV.)

12	Partial tax. a Form 1120—Enter the amount from line 34, Schedule B, Tax Computation Worksheet, in the instructions for Forms 1120 and 1120-A. b Others—See the tax computation instructions for applicable return	12	
13	Enter 34% of line 10 (Form 1120-REIT filers, see instructions)	13	
14	Alternative tax—total of lines 12 and 13. If less than amount of tax figured by regular method, enter here and on Form 1120, Schedule J, line 3; or the proper line on other returns. Also check box for Schedule D.	14	

Instructions

(Section references are to the Internal Revenue Code unless otherwise noted.)

New Law Changes.—The alternative tax has been repealed for tax years beginning after June 30, 1987. See Parts III and IV below for more information about alternative tax.

The Tax Reform Act of 1986 changed some of the rules governing corporate distributions. Generally, gain (but not loss) is recognized on a nonliquidating distribution of appreciated property to the extent that the property's fair market value exceeds its adjusted basis. Certain exceptions to the gain recognition rule that were contained in section 311 have been repealed. See section 311 for more information. For liquidations completed after 1986, gain or loss is generally recognized by a corporation upon the liquidating distribution of property as if it had sold the property at its fair market value. An exception to this rule applies for liquidations of certain subsidiaries. See sections 336 and 337 for more information and other exceptions to the general rules. In addition, the special nonrecognition rules governing 12-month liquidations have been repealed. However, Section 633(d) of the Tax Reform Act of 1986 provides a transition rule for certain qualified small corporations that completely liquidate before January 1, 1989. These corporations should get **Form 964-A**, Computation of Gain or Loss Recognized by Qualified Corporations on Complete Liquidation, to compute their gain or loss before completing Schedule D.

Purpose of Form

This Schedule D should be used by a taxpayer whose tax year begins in 1987 and who files either Forms 1120, 1120-A, 1120-IC-DISC, 1120F, 1120-FSC, 1120-H, 1120L, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 990-C, or certain Forms 990-T, to report sales or exchanges of capital assets. Sales or exchanges of property other than capital assets, including property used in a trade or business, involuntary conversions (other than casualties or thefts), gain from the disposition of interest in oil, gas, or geothermal property, and the section 291 adjustment to section 1250 gains should be reported on **Form 4797**, Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business

and Involuntary Conversions. See the instructions for Form 4797 for more information.

If property is involuntarily converted because of a casualty or theft, use **Form 4684**, Casualties and Thefts.

Parts I and II

Generally, a corporation should report sales and exchanges, including "like-kind" exchanges, even though there is no gain or loss. No loss is allowed for a wash sale of stock or securities or from a transaction between related persons (sections 1091 and 267).

In Part I, report the sale or exchange of capital assets held 6 months or less. In Part II, report the sale or exchange of capital assets held more than 6 months. For property acquired after December 31, 1987, the holding period has been changed to 1 year.

What Are Capital Assets.—Each item of property the corporation held (whether or not connected with its trade or business) is a capital asset except:

1. Assets that can be inventoried or property held mainly for sale to customers.
2. Depreciable or real property used in the trade or business.
3. Certain copyrights; literary, musical, or artistic compositions; letters or memorandums; or similar property.
4. Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in 1 above.
5. A U.S. Government publication (including the Congressional Record) received from the Government or any of its agencies in a manner other than by buying it at the price offered for public sale, which is held by a taxpayer who received the publication or by a second taxpayer in whose hands the basis of the publication is determined, for purposes of determining gain from a sale or exchange, by referring to its basis in the hands of the first taxpayer.

Exchange of "like-kind" property.—Report the exchange of "like-kind" property on Schedule D or on Form 4797, whichever applies. The corporation must report it even though no gain or loss is recognized when business or investment property is exchanged for property of "like-kind." (This does not include stock-in-trade or other property held primarily for sale. It also does not include stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness. Generally it does not include exchanges of partnership interests. See section 1031.)

If Schedule D is used, identify in column (a) the property disposed of. Enter the date it was acquired in column (b), and the date it was exchanged in column (c). Write "like-kind exchange" in column (d). Enter the cost or other basis in column (e). Enter zero in column (f).

Special Rules for the Treatment of Certain Gains and Losses

Note: *For more information, get Publication 544, Sales and Other Dispositions of Assets, and Publication 542, Tax Information on Corporations.*

● **Gains and losses from passive activities.**—For tax years beginning after 1986, a closely held or personal service corporation that has a gain or loss which relates to a passive activity (section 469) may be required to complete **Form 8582**, Passive Activity Loss Limitations, before completing Schedule D.

A capital gain on the sale or exchange of an entire interest in a passive activity in a fully taxable disposition to an unrelated party is reported on Schedule D. The gain (reduced by any current year operating loss from that activity) is also included on Form 8582 if the corporation has other passive activity losses.

Capital losses from a fully taxable disposition of an entire interest in a passive activity to an unrelated party are allowed in full under the passive activity loss rules, but may be subject to the capital loss limitations. Enter the loss on Schedule D, but do not enter it on Form 8582.

Capital gains and losses from a disposition of less than an entire interest in a passive activity are treated the same as any other passive activity gain or loss. The gain is entered on Schedule D and also on Form 8582 as passive activity income if the corporation has other passive activity losses. The loss is not entered on Schedule D until the passive activity loss allowed is figured on Form 8582.

Report the allowed losses computed on worksheet 5 of the Form 8582 instructions as separate short-term or long-term losses in column (f) of Schedule D. Include in the description for column (a) "Loss from Form 8582." Complete any remaining columns according to the column headings.

● **Gains and losses on section 1256 contracts and straddles.**—Use **Form 6781**, Gains and Losses From Section 1256 Contracts and Straddles, to report gains and losses from section 1256 contracts and straddles.

● **Gain or loss on certain short-term Federal, state, and municipal obligations.**—Such obligations are treated as capital assets in determining gain or loss. On any gain realized, a portion is treated as ordinary income and the balance is considered as a short-term capital gain. See section 1271.

● **Gain from installment sales.**—If a corporation has a gain this year from the sale of real property or a casual sale of personal property other than inventory and is to receive any payment in a later year, it must use the installment method (unless it elects not to) and file **Form 6252**, Computation of Installment Sale Income. Also use Form 6252 if a payment is received this year from a sale made in an earlier year on the installment basis.

The corporation may elect out of the installment method by doing the following on a timely filed return (including extensions):

1. Report the full amount of the sale on Schedule D.
2. If the corporation received a note or other obligation and is reporting it at less than face value (including all contingent obligations), state that fact in the margin and give the percentage of valuation.

For tax years beginning after 1986, the installment method may not be used for sales of stock or securities (or certain other property described in the regulations) traded on an established securities market. See section 453(k).

● **Gain or loss on an option to buy or sell property.**—See sections 1032 and 1234 for the rules that apply to a purchaser or grantor of an option.

● **Gain or loss from a short sale of property.**—Report the gain or loss to the extent that the property used to close the short sale is considered a capital asset in the hands of the taxpayer.

● **Gains and losses of foreign corporations from the disposition of investment in United States real property.**—Foreign corporations are required to report gains and losses from the disposition of U.S. real property interests. See section 897 for details.

● **Gains on certain insurance property.**—Form 1120L filers with gains on property held on December 31, 1958, and certain substituted property acquired after 1958 should see section 818(c).

● **Loss from the sale or exchange of capital assets of an insurance company taxable under section 831.**—Under the provisions of section 834 (c)(6), the capital losses of a property and casualty insurance company are deductible to the extent that the assets were sold to meet abnormal insurance losses or to provide for the payment of dividend and similar distributions to policyholders.

● **Loss from securities that are capital assets that become worthless during the year.**—Except for securities held by a bank, treat the loss as a capital loss as of the last day of the tax year. (See section 582 for the rules on the treatment of securities held by a bank.)

● **Nonrecognition of gain on sale of stock to an ESOP.**—See section 1042 for rules under which a taxpayer may elect not to recognize gain from the sale of certain stock to an employee stock ownership plan (ESOP).

● **Disposition of market discount bonds.**—See section 1276 for rules on the disposition of any market discount bonds that were issued after July 18, 1984.

How To Determine the Cost or Other Basis of the Property

In determining gain or loss, the basis of property will generally be its cost (section 1012). The exceptions to the general rule are provided in sections contained in subchapters C, K, O, and P of the Code. For example, if the corporation acquired the property by dividend, liquidation of a corporation, transfer from a shareholder, reorganization, contribution or gift, bequest, bankruptcy, tax-free exchange, involuntary conversion, certain asset acquisitions, or wash sale of stock, see sections 301 (or 1059), 334, 362 (or 358), 1014, 1015, 372 (or 374), 1031, 1033, 1060, and 1091, respectively. Attach an explanation if the corporation uses a basis other than actual cash cost of the property.

If the corporation is allowed a charitable contribution deduction because it sold property to a charitable organization, figure the adjusted basis for determining gain from the sale by dividing the amount realized by the fair market value and multiplying that result by the adjusted basis.

Capital losses.—The amount of capital losses allowed may not be more than capital gains. A net capital loss may be carried back 3 years and forward 5 years as a short-term capital loss. Carry back a capital loss to the extent it does not increase or produce a net operating loss in the tax year to which it is carried. Foreign expropriation capital losses may not be carried back, but may be carried forward 10 years instead of 5. A net capital loss for a regulated investment company may be carried forward 8 years instead of 5.

At-risk limitations (section 465).—If the corporation sold or exchanged an asset used in an activity to which the at-risk rules apply, combine the gain or loss on the sale or exchange with the profit or loss from the activity. If the result is a net loss from the activity, it may be subject to the at-risk rules. The at-risk rules now apply to the holding of real property placed in service after 1986.

Part III—Summary of Parts I and II

If the net long-term capital gain is more than the net short-term capital loss, there is a net capital gain. If the corporation's tax year begins before July 1, 1987, and there is a net capital gain, the corporation may want to complete Part IV to determine if the resulting alternative tax is less than the tax figured using the regular method.

Part IV—Alternative Tax Computation

Form 1120L and Form 1120-REIT filers should see the instructions for those forms before figuring alternative tax.

In figuring the alternative tax, do not refigure deductions limited by the amount of taxable income (such as contributions and the special deductions in Schedule C of Form 1120).

Certain dairy farmers see section 406 of the Tax Reform Act of 1986.

If the alternative tax amount on line 14 is less than the tax figured by the regular method, enter the amount of alternative tax on Form 1120, Schedule J, line 3; or the proper line on other returns. Also check the box for Schedule D.

SCHEDULE PH (Form 1120)

Department of the Treasury
Internal Revenue Service

Computation of U.S. Personal Holding Company Tax

▶ Attach to your tax return.

OMB No. 1545-0123

1987

Name

Employer identification number

Part I—Computation of Undistributed Personal Holding Company Income

Additions

1	Taxable income before net operating loss deduction and special deductions (Form 1120, line 28—see instructions for line 1)	1	
2	Contributions deducted in figuring line 1 (Form 1120, line 19)	2	
3	Excess expenses and depreciation under section 545(b)(6) (Schedule A, line 2)	3	
4	Total—Add lines 1 through 3	4	

Deductions

5	Federal and foreign income, war profits, and excess profits taxes not deducted in figuring line 1 (attach schedule)		5	
6	Contributions deductible under section 545(b)(2) (see line 6 instructions for limitation)		6	
7	Net operating loss for the preceding tax year (deductible under section 545(b)(4))		7	
8a	Net capital gain (from separate Schedule D (Form 1120), line 10)	8a		
b	Less: Income tax on this net capital gain (see section 545(b)(5)—attach computation)	8b	8c	
9	Amounts used or irrevocably set aside to pay or retire qualified indebtedness (see instructions for line 9)		9	
10	Deduction for dividends paid (other than dividends paid after the end of the tax year (Schedule B, line 5))		10	
11	Total—Add lines 5 through 10		11	
12	Subtract line 11 from line 4		12	
13	Dividends paid after the end of the tax year (other than deficiency dividends defined in section 547(d)) but not more than the smaller of line 12 or 20% of Schedule B, line 1		13	
14	Undistributed personal holding company income—Subtract line 13 from line 12. (Foreign corporations—see instructions for line 14.)		14	

Tax

15	Personal holding company tax (enter 38.5% of line 14 here and on: Schedule J (Form 1120), line 7; or the proper line of the appropriate tax return)	15	

Part II—Information Required Under Section 6501(f).

If the information on income and stock ownership is not submitted with the corporation's return, the limitation period for assessment and collection of personal holding company tax is 6 years.

Personal Holding Company Income

1	Dividends		1	
2a	Interest	2a		
b	Less: Amount excluded under section 543(b)(2)(C) (attach schedule)	2b	2c	
3	Royalties (other than mineral, oil, gas, or copyright royalties)		3	
4	Annuities		4	
5a	Rents	5a		
b	Less: Adjustments described in section 543(b)(2)(A) (attach schedule)	5b	5c	
6a	Mineral, oil, and gas royalties	6a		
b	Less: Adjustments described in section 543(b)(2)(B) (attach schedule)	6b	6c	
7	Copyright royalties (see instructions for an exception for certain computer software royalties)		7	
8	Produced film rents		8	
9	Compensation received for use of corporation property by shareholder		9	
10	Amounts received under personal service contracts and from their sale		10	
11	Amounts received from estates and trusts		11	
12	Total personal holding company income—Add lines 1 through 11		12	

Stock Ownership Enter the names and addresses of the individuals who together owned directly or indirectly at any time during the last half of the tax year more than 50% in value of the outstanding stock of the corporation.

(a) Name	(b) Address	Highest percentage of shares owned during last half of tax year	
		(c) Preferred	(d) Common
		%	%
		%	%
		%	%
		%	%
		%	%

Schedule A **Excess of Expenses and Depreciation Over Income From Property Not Allowable Under Section 545(b)(6) (See instruction for line 3.)**

	(a) Kind of property	(b) Date acquired	(c) Cost or other basis	(d) Depreciation	(e) Repairs, insurance, and other expenses (section 162) (attach schedule)	(f) Total of columns (d) and (e)	(g) Income from rent or other compensation	(h) Excess (col. (f) less col. (g))
1								

2 Total excess of expenses and depreciation over rent or other compensation. Enter here and on line 3, page 1. **Note:** *Attach a statement showing the names and addresses of persons from whom rent or other compensation was received for the use of, or the right to use, each property.*

Schedule B **Deduction for Dividends Paid (See instruction for line 10.)**

1	Taxable dividends paid (do not include dividends considered as paid in the preceding tax year under section 563, or deficiency dividends as defined in section 547)	1	
2	Consent dividends (attach Forms 972 and 973)	2	
3	Taxable distributions—Add lines 1 and 2	3	
4	Dividend carryover from first and second preceding tax years (attach computation)	4	
5	Deduction for dividends paid—Add lines 3 and 4. Enter here and on line 10, page 1	5	

General Instructions

(References are to the Internal Revenue Code unless otherwise noted.)

Purpose of Form

This schedule is used to figure personal holding company tax.

Tax Reform Act of 1986

The Tax Reform Act of 1986 lowered the tax rates for tax years that begin in 1987 and for later tax years. For tax years beginning in 1987, the tax rate for personal holding companies is decreased to 38.5%. For tax years beginning after 1987, the tax rate is decreased to 28%.

Who Must File

Every personal holding company must have this schedule attached to its income tax return.

Definitions

Personal Holding Company.—A corporation is a personal holding company if:

- At least 60% of its adjusted ordinary gross income, defined in section 543(b)(2), for the tax year is personal holding company income as defined in section 543(a); **and**
- At any time during the last half of the tax year more than 50% in value of its outstanding stock is owned, directly or indirectly, by not more than 5 individuals.

For exceptions to the term "personal holding company," see section 542(c).

Certain personal holding companies may elect to be treated as a regulated investment company and be taxed at the highest corporate rate on their undistributed taxable income. For definitions, limitations, and procedures, see sections 851 and 852 and the instructions for **Form 1120-RIC,** U.S. Income Tax Return for Regulated Investment Companies.

Individual.—An organization described in section 401(a), 501(c)(17), or 509(a), or a part of a trust permanently set aside or to be used exclusively for the purpose described in section 642(c) is also considered an individual. See section 542(a)(2).

Foreign Corporations Must File a Return.—If a foreign corporation that is a personal holding company does not file Schedule PH as required, the corporation will be charged a penalty. The penalty is 10% of the corporation's Federal income taxes (including the personal holding company tax) and is in addition to any other penalties charged the corporation. See section 6683.

Note: *For a foreign corporation all of whose outstanding stock during the last half of the tax year is owned directly or indirectly by nonresident alien individuals, taxable income for section 545(a) is only income received under a contract for personal services as described in section 543(a)(7). This income must be reduced by deductions for that income, and have special adjustments made to the income, as provided in section 545(b).*

In determining net capital gains under section 545(b)(5), see section 545(b)(7), which provides that only gains and losses which are effectively connected with the conduct of a trade or business within the U.S. and are not exempt from tax under treaty shall be taken into account.

Specific Instructions

These instructions are numbered to correspond with the line numbers on page 1 of Schedule PH (Form 1120). Other line items on the form are self-explanatory.

Part I
Additions

Line 1—Taxable income before net operating loss deduction.—Enter the amount shown on Form 1120, page 1, line 28. If you figured the income on line 28 using section 443(b) (placing the income on an annual basis), refigure it without that section.

If you are a foreign corporation (whether or not engaged in a trade or business within the United States) that qualifies as a personal holding company under section 542 but not as a foreign personal holding company under section 552, enter on line 1 the amount figured under section 861 and not under section 881(a).

Line 2—Contributions.—See instructions for Form 1120.

Line 3—Expenses and depreciation.—If the corporation earned rent or other compensation for the use of, or right to use, property that was less than the total allowable expenses and depreciation, complete Schedule A and enter the excess on line 3.

You must make this adjustment unless you establish, according to section 545(b)(6), that the rent or other compensation the corporation received was the highest obtainable. If none was received, you must show that none was obtainable. The property must be held in the course of a business carried on for profit. There must be a reasonable expectation that the property's operation would result in a profit, or that the property was necessary to conduct the business.

The burden of proof is on the corporation. For a corporation with excess deductions you must, instead of completing Schedule A, attach a statement reporting the deductions with the complete facts, circumstances, and arguments to support them. The statement must include the information required by Regulations section 1.545-2(h)(2).

Deductions

Line 5—Federal and foreign income, war profits, and excess profits taxes.—Attach a schedule showing the kind of tax, the tax year, and the amount. Under section 545(b)(1), the company can deduct Federal income taxes accrued during the tax year, but not the accumulated earnings tax under section 531 or the personal holding company tax under section 541.

The foreign tax credit is not allowed against personal holding company tax. A deduction is allowed, however, for income, war profits, and excess profits taxes accrued (or considered paid under sections 902(a) or 960(a)(1)) during the tax year to foreign countries and U.S. possessions. This is true if the corporation claims a credit for the taxes in figuring its income tax.

Line 6—Contributions.—Section 545(b)(2) provides a different limitation for charitable contributions for figuring the personal holding company tax than the 10% limitation used in determining the corporate income tax. The limitations on charitable deductions of individuals apply, but are applied to the taxable income to which the 10% limitation applied. However, figure taxable income without deducting the amount disallowed under section 545(b)(6), (excess expenses and depreciation).

The contribution carryover under section 170(d) is not allowed when figuring personal holding company tax.

Line 7—Net operating loss.—Section 545(b)(4) provides that instead of the net operating loss deduction provided in section 172, a deduction is allowed for the net operating loss (as defined in section 172(c)) for the preceding tax year figured without the deductions provided in Part VIII (except section 248) of Subchapter B.

Line 9—Amounts used or irrevocably set aside.—Subject to the limitations in section 545(c), section 545(c)(1) allows a deduction for amounts used, or irrevocably set aside, to the extent reasonable, to pay or retire qualified indebtedness as defined in section 545(c)(3). This deduction applies only to corporations described in section 545(c)(2).

Any corporation taking this deduction must provide detailed information and any necessary computation showing it is a corporation described in section 545(c)(2)(A). To the extent that it succeeds to the deduction by section 381(c)(15), it must submit detailed information showing that the distributor or transferor corporation was a corporation described in section 545(c)(2)(A).

A corporation succeeding to the deduction must adjust its qualified indebtedness to take this indebtedness into account.

The corporation must establish that the amount reported as a deduction is reasonable. Attach a statement giving a description of the indebtedness, date incurred or assumed, date due, and plan for payment or retirement of the obligations (indicating date and method of adoption). If the plan is covered by a mandatory sinking fund agreement or similar arrangement, include a copy of the indenture or agreement by which the fund was established and under which it is maintained.

The statement must also include:

- Amount of indebtedness on January 1, 1964; **and**
- Total amounts used or irrevocably set aside to pay or retire the indebtedness in earlier tax years beginning on and after January 1, 1964; **and**
- Amount actually used during the tax year to pay or retire the indebtedness; **and**
- Amount irrevocably set aside during the tax year to pay or retire the indebtedness but not actually used during the tax year for that purpose.

Also, the statement must indicate if the deduction claimed represents:

- An amount actually used during the tax year to pay or retire the indebtedness; **or**
- An amount irrevocably set aside during the tax year to pay or retire the indebtedness; **or**
- A combination of the two.

If the amount reported as a deduction on line 9 represents an amount irrevocably set aside, and not used to pay or retire the indebtedness, attach a statement explaining the circumstances and method by which it was irrevocably set aside.

The corporation must also provide a schedule for amounts described in section 545(c)(5) that reduce the amounts used or irrevocably set aside to pay or retire qualified indebtedness.

Section 545(c)(4) allows corporations to elect to treat as nondeductible certain amounts used or irrevocably set aside to pay or retire qualified indebtedness that are otherwise deductible under section 545(c)(1). See Regulations section 1.545-3(e) for time and manner of making the election.

Line 10—Deduction for dividends paid.—Enter this deduction from Schedule B. The rules in section 562 apply in determining the deduction for dividends paid.

Line 13—Dividends paid after the end of the tax year.—Enter on line 13, and not in Schedule B, the dividends paid after the end of the tax year and before the 16th day of the third month following the end of the tax year if the corporation elects to have the dividends considered as paid during that tax year.

Do not include on line 10 or line 13 deficiency dividends paid under section 547.

Line 14—Undistributed personal holding company income of certain foreign corporations.—If 10% or less in value of the outstanding stock of a foreign corporation is owned (see section 958(a)) during the last half of the tax year by U.S. persons, undistributed personal holding company income is determined by multiplying the undistributed personal holding company income (determined without this instruction) by the percentage in value of the corporation's outstanding stock. This percentage is figured by using the greatest percentage in value of its outstanding stock owned by the U.S. persons on any one day during the period.

Part II
Personal Holding Company Income

Line 7—Exception.—Computer software royalties are not considered personal holding company income if the personal holding company satisfies these five conditions. First, the income must be received during the tax year in connection with the licensing of computer software. Second, the company must be in the active business of developing, manufacturing, or producing computer software. Third, the computer software royalty income must constitute at least 50% of the company's ordinary gross income for the tax year. Fourth, the expenses allowed under sections 162, 174, and 195 relating to computer software royalty income must be at least 25% of the company's ordinary gross income. Fifth, the sum of the dividends paid under section 562, and dividends considered paid under section 563(c), and consent dividends under section 565 must equal or exceed the amount, if any, by which personal holding company income for the tax year exceeds 10% of the company's ordinary gross income. See section 543(d).

Form **3468**

Department of the Treasury
Internal Revenue Service (L)

Computation of Investment Credit

▶ Attach to your tax return.

▶ Schedule B (Business Energy Investment Credit) on back.

OMB No. 1545-0155

1987

Attachment Sequence No. 24

Name(s) as shown on return

Identifying number

Part I Elections (Check the box(es) below that apply to you (See Instruction D).)

A I elect to increase my qualified investment by all qualified progress expenditures (QPE) made this and all later tax years . . . . . ☐
Enter total qualified progress expenditures included in column (4), Part II ▶ . . . . . .

B I claim full credit on certain ships under section 46(g)(3) (See **Instruction B** for details) . . . . . ☐

Part II Qualified Investment (Certain Transition Property, QPE Property, and Qualified Timber Property)

1 Recovery Property		Line	(1) Class of Property	(2) Cost or Other Basis	(3) Applicable Percentage	(4) Qualified Investment (Column 2 x column 3)
Regular Percentage	New Property	(a)	3-year		60	
		(b)	Other		100	
	Used Property	(c)	3-year		60	
		(d)	Other		100	

2	Nonrecovery property—Enter total qualified investment (See instructions for line 2)	2	
3	**Total qualified investment in 10% property**—Add lines 1(a) through 1(d), column (4), and line 2 (See instructions for special limits)	3	
4	Regular credit—(See instructions for line 4 for amount to enter)	4	
5	Qualified rehabilitation expenditures (enter qualified investment and multiply by percentage shown):		
a	**Transition Property** and **Certain Projects placed in service after 12-31-86:**		
	(i) 30-year-old buildings . . . . . ____ × 10%	5a(*i*)	
	(ii) 40-year-old buildings . . . . . ____ × 13%	5a(*ii*)	
	(iii) Certified historic structures (attach NPS certificate) . . . . . ____ × 25%	5a(*iii*)	
b	**Rehabilitation Property** (not shown above) **placed in service after 12-31-86:**		
	(i) Pre-1936 buildings . . . . . ____ × 10%	5b(*i*)	
	(ii) Certified historic structures (attach NPS certificate) . . . . . ____ × 20%	5b(*ii*)	
6	Credit from cooperatives—Enter regular investment credit from cooperatives	6	
7	Business energy investment credit—From line 6 of Schedule B (see back of this form)	7	
8	Current year investment credit—Add line 4 through line 7.	8	

Note: If you have a 1987 jobs credit (Form 5884), credit for alcohol used as fuel (Form 6478), research credit (Form 6765), or low-income housing credit (Form 8586) in addition to your 1987 investment credit, or if you have a carryback or carryforward of any general business credit, stop here and go to Form 3800, General Business Credit, to claim your 1987 investment credit. If you have only a 1987 investment credit (which may include business energy investment credit), you may continue with lines 9 through 16 to claim your credit.

Part III Tax Liability Limitations

9a	Individuals—From Form 1040, enter amount from line 43		
b	Corporations—From Form 1120, Schedule J, enter tax from line 3 (or Form 1120-A, Part I, line 1)		
c	Other filers—Enter income tax before credits from return	9	
10a	Individuals—From Form 1040, enter credit from line 44, plus any orphan drug and nonconventional source fuel credits included on line 46		
b	Corporations—From Form 1120, Schedule J, enter credits from lines 4(a) through 4(d) (Form 1120-A filers, enter zero)		
c	Other filers—See instructions for line 10c	10	
11	Income tax liability as adjusted (subtract line 10 from line 9)	11	
12	Tentative minimum tax—		
a	Individuals—From Form 6251, enter amount from line 17		
b	Corporations—From Form 4626, enter amount from line 19		
c	Estates and Trusts—From Form 8656, enter amount from line 20	12	
13	Excess of income tax liability over tentative minimum tax—Subtract line 12 from line 11	13	
14a	Enter smaller of line 11 or $25,000 (See instructions for line 14)	14a	
b	If line 11 is more than $25,000—Enter 75% of the excess	14b	
15	Add lines 14a and 14b	15	
16	Total allowed credit—Enter the smallest of line 8, line 13, or line 15 (corporations, see instructions)—This is your **General Business Credit** for 1987. Enter here and on Form 1040, line 45; Form 1120, Schedule J, line 4(e); Form 1120-A, Part I, line 2; or the proper line of other returns	16	

For Paperwork Reduction Act Notice, see separate instructions.

Form **3468** (1987)

Schedule B.—Business Energy Investment Credit

1 Enter on lines 1(a) through 1(e) your qualified investment in business energy property.

Type of Property	Line	(1) Class of Property or Life Years	(2) Code	(3) Basis	(4) Applicable Percentage	(5) Qualified Investment (Column 3 x column 4)
Recovery	(a)	3-year			60	
	(b)	Other			100	
Nonrecovery	(c)	3 or more but less than 5			33 ⅓	
	(d)	5 or more but less than 7			66 ⅔	
	(e)	7 or more			100	

2	Total qualified investment—Add lines 1(a) through 1(e), column (5)	2
3	Multiply the portion of the line 2 amount attributable to the following types of property by the applicable percentages:	
a	Solar energy property (12%)	3a
b	Biomass and geothermal property (10%)	3b
c	Ocean thermal property (15%)	3c
4	Certain other property (See instructions below for special limits):	
a	Certain long-term section 46(b)(2)(A)(i) projects underway by 12-31-82 (10%)	4a
b	Hydroelectric generating property placed in service during the year (if docketed with the Federal Energy Regulatory Commission by 12-31-85) (11%)	4b
5	Cooperative credit—Enter business energy investment credit from cooperatives	5
6	Tentative business energy investment credit—Add lines 3a through 5. Enter here and on line 7 of page 1	6

Instructions for Schedule B (Form 3468)

Energy property must meet the same requirements as regular investment credit property, except that the provisions of sections 48(a)(1) and 48(a)(3) do not apply. See the separate Instructions for Form 3468 for definitions and rules regarding regular investment credit property.

Energy property must be acquired new. See sections 46(b)(2) and 48(l)(1) through (17) for details.

See section 48(l)(17) for special rules on public utility property, and section 48(l)(11) (as amended by the Crude Oil Windfall Profit Tax Act of 1980) for special rules on property financed by Industrial Development Bonds.

Specific Instructions

One Credit Only.—If property qualifies as more than one kind of energy property, you may take only one credit for the property.

Line 1—Type of Property.— For definition of recovery and nonrecovery property, see the separate Instructions for Form 3468.

Line 1—Column (2).—Use the code letters from the following list to indicate the kind of property for which you are claiming a credit. If you enter more than one kind of property on a line, enter the code letter for each kind of property in column (2) and the code letter and dollar amount of each kind of property in the right hand margin.

The code letters are:

a. Biomass property
b. Hydroelectric generating property
c. Solar equipment (but not passive solar equipment)
d. Ocean thermal equipment
e. Geothermal equipment

See sections 48(l)(4) and 48(l)(3)(A)(viii) and (ix) for definitions and special rules that apply to these kinds of property.

Line 4.—The section 48(q)(4) election to take a reduced credit instead of adjusting the basis of the energy property on line 4 is not available for property placed in service after 1985, and you must reduce the basis for depreciation by the full amount of the credit claimed.

If the installed capacity of hydroelectric generating property is more than 25 megawatts, the 11% energy credit is allowed for only part of the qualified investment. See section 48(l)(13)(C).

On the dotted line for line 4b, enter the megawatt capacity of the generator as shown on the nameplate of the generator.

If your tax year begins before and ends after July 1, 1987, the energy credit(s) on lines 4a and 4b must be reduced by a percentage figured from the following formula:

$$35\% \times \frac{\text{number of months in your tax year after June 1987}}{\text{total number of months in your tax year}}$$

Enter the reduced credit on lines 4a and 4b. Although this reduction may not be used in the current year or carried back to a prior year, it may be carried forward to your next tax year under the following rules.

If you are able to use **all** of the reduced credit in the current year, then none of the reduction may be carried to any other year.

If you are able to use **only a portion** of the reduced credit in the current year because you are limited by the tax liability limitations, then you may carry forward to your next year the unused portion of the reduced credit and a corresponding portion of the reduction. If, for example, you are able to use half of the reduced credit in 1987, then you may carry forward the other half of the reduced credit and half of the reduction.

If you are **not** able to use **any** of the reduced credit because of the tax liability limitations, then you may carry forward to your next year the entire credit (both the reduced credit and the reduction).

For tax years beginning after June 30, 1987, you must reduce the energy credit(s) on lines 4a and 4b by the full 35%. Enter the reduced credit. (This reduction may not be carried to any other year.)

1987

Department of the Treasury
Internal Revenue Service

Instructions for Form 3468

Computation of Investment Credit

(Section references are to the Internal Revenue Code unless otherwise noted.)

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Items You Should Note

The Tax Reform Act of 1986 repealed the investment credit for most taxpayers. In general, for property placed in service after December 31, 1985, you cannot claim any investment credit unless the property is:

- Transition property, as defined in the Specific Instructions for lines 1(a)–1(d);
- Qualified progress expenditure property, as defined in General Instructions D(1) under "Elections," and the Specific Instructions for lines 1(a)–1(d);
- Qualified timber property;
- Certain rehabilitation property; or
- Business energy property.

For most taxpayers, this means you may no longer claim any investment credit for property such as automobiles, delivery trucks, office equipment, farm equipment, etc., unless it was transition property on December 31, 1985, or it falls into one of the other categories above.

The Tax Reform Act of 1986 changed the alternative minimum tax rules for the general business credits. This will require an additional tax liability limitation computation on lines 12 and 13.

If you have credits from passive activities, see **Form 8582-CR**, Passive Activity Credit Limitations, before completing Form 3468.

General Business Credit.—The general business credit consists of the investment credit (Form 3468), jobs credit (Form 5884), credit for alcohol used as fuel (Form 6478), research credit (Form 6765), and low-income housing credit (Form 8586). If you have more than one of these credits for 1987, or a carryback or carryforward of any of these credits, you must summarize them on **Form 3800**, General Business Credit. If you have only a 1987 investment credit, you do not have to file Form 3800 this year.

General Instructions

A. Purpose of Form.—Use Form 3468 to claim a regular, rehabilitation, or business energy investment credit or to make certain elections.

Caution: *You may have to refigure the credit and recapture all or a portion of it if:*

- you dispose of the property before the end of the property class life or life years;
- you change the use of the property;
- the business use of the property decreases so that it no longer qualifies (in whole or in part) as investment credit property;
- you reduce your proportionate interest in a partnership or other "pass-through" entity that had claimed a credit; or
- you returned leased property (on which you had taken a credit) to the lessor before the end of the recapture period or useful life.

For more information, see **Form 4255**, Recapture of Investment Credit.

A partnership or S corporation should complete only the following lines, to figure the cost or basis of property to pass through to the individual partners or shareholders:

- the Part I elections,
- columns (2) of line 1 and the line 2 worksheet,
- the qualified investment on line 5, and
- columns (2) and (3) for line 1, Schedule B (you should also tell the partner, etc., how much of the column (3) basis to enter on lines 3 or 4).

Attach the completed form to the partnership or S corporation return to show the total cost or basis that is passed through.

If you are a partner, beneficiary, shareholder in an S corporation, or lessee, use Form 3468 to figure the credit based on your share of the investment by the partnership, estate, trust, S corporation, or lessor.

For more details on investment credit, see **Publication 572**, General Business Credit, and regulations under sections 46 and 48.

B. How to Figure the Credit.—For recovery property, the class of property determines the percentage qualifying for investment credit. For nonrecovery property, the useful life of the property for investment credit must be the same as the useful life for depreciation or amortization.

See section 48 for special rules on movie and television films, sound recordings, and sale-leasebacks.

See section 46(e) for limitations on the investment credit for mutual savings institutions, regulated investment companies, and real estate investment trusts.

Generally, you may only take half of the regular credit for certain vessels. See sections 46(g)(1) through (6). If you claim the full credit, check box B in Part I of Form 3468.

C. Investment Credit Property.—You may take investment credit for property placed in service only if it qualifies as one of the items listed above under "Items You Should Note."

The property must be used in a trade or business and be either recovery property or other depreciable property with a life of 3 years or more. Enter only the business part if property is for both business and personal use.

Exceptions.—Investment credit generally does not apply to property that is:

(1) Used mainly outside the U.S.

(2) Used by a tax-exempt organization (other than a section 521 farmers' cooperative) unless the property is used mainly in an unrelated trade or business.

(3) Used by governmental units and foreign persons and entities.

(4) Used for lodging or for furnishing the lodging (see section 48(a)(3) for exceptions, *i.e.*, hotel or motel furnishings).

(5) Amortized or depreciated under section 167(k), 184, or 188.

(6) Acquired or constructed with "excluded cost-sharing payments" from grants under any program listed in section 126(a) or by grants under the Energy Security Act.

D. Elections.—

(1) Qualified Progress Expenditures.—You may elect under section 46(d) to increase your qualified investment for the year by qualified progress expenditures. This permits you to claim investment credit on a long-term construction project before it is completed and placed in service. Check box A in Part I. The election applies to all progress expenditure property for the tax year it is made and all later tax years.

In general, "progress expenditure property" means property which is being constructed by or for you and (1) construction began before 1986 (or you had a binding contract on 12-31-85 to begin construction), (2) the property has a normal construction period of two years or more, and (3) it is reasonable to believe that it will be new section 38 property when it is placed in service.

(2) Election for Leased Property.—If you lease property to someone else, you may elect to treat all or part of your investment in new property as if it were made by the person who is leasing it from you. Lessors and lessees should see section 48(d) and regulations for rules on making this election. For limitations, see sections 46(e)(3) and 48(d)(6).

E. At-Risk Limitation for Individuals and Closely Held Corporations.—The cost or basis of property for investment credit purposes may be limited if you borrowed against the property and are protected against loss, or if you borrowed money from a person who is related or who has other than a creditor interest in the business activity. The cost or basis must be reduced by the amount of this "nonqualified nonrecourse financing" related to the property as of the close of the tax year in which it is placed in service. See Publication 572 and sections 46(c)(8) and 465 for details. If there is an increase during a later year of this nonqualified nonrecourse financing, you may have to refigure the credit on Form 4255.

Specific Instructions

Part II.—Qualified Investment

Lines 1(a)–1(d). Recovery Property.—In general, the Tax Reform Act of 1986 repeals the regular investment tax credit for property placed in service after December 31, 1985. The only properties for which you can now claim a regular credit are (1) transition property, (2) qualified progress expenditure (QPE) property, and (3) qualified timber property.

Transition Property.—There are several types of transition property that may be placed in service after 1985 and still be eligible for the regular credit in that year:

- Binding contract on 12-31-85: Property that is constructed, reconstructed, or acquired under a written contract that was binding on December 31, 1985.
- Construction in progress on 12-31-85: Property that is constructed or reconstructed if at least 5% of the cost, or $1 million, had been incurred or committed by December 31, 1985.
- Equipped building or plant facility in progress on 12-31-85: If construction had begun pursuant to a written specific plan and more than one-half the cost had been incurred or committed by December 31, 1985.
- Specific projects listed in the Act.

Transition property must be placed in service before the date shown in the following table. Otherwise, no credit will be allowed.

Property class life (years)	Must be placed in service before
3 or more but less than 5	July 1, 1986
5 or more but less than 7	January 1, 1987
7 or more but less than 20	January 1, 1989
20 or more	January 1, 1991

The section 48(q)(4) election to take a reduced credit instead of adjusting the basis of property is not available for transition property. You must reduce the basis for depreciation by the full amount of the credit claimed.

QPE Property.—The regular credit may be claimed on QPEs so long as it is reasonable to expect that the property will be transition property when placed in service before the date shown in the table above. For any year that the reasonable expectations change, or if the property is not placed in service before the date shown, all post-1985 QPEs must be recaptured.

The election to take a reduced credit instead of adjusting the basis of QPE property is no longer available. Although you do not have to amend prior years, for periods after 1985 you must reduce the depreciable basis of QPE property by the full amount of the credit claimed, even if you made a section 48(q)(4) election in a prior year.

Qualified Timber Property.—The regular credit may be claimed in 1987 for the portion of the adjusted basis of qualified timber property that is treated as section 38 property under section 48(a)(1)(F). For timber property you must reduce the amortizable basis by one-half of the credit taken.

Enter the basis of recovery property in column (2). This is generally the cost of the property reduced by any personal-use factor and by any portion that was expensed under section 179. It includes all items properly included in the depreciable basis, such as installation and freight costs. Recovery property is tangible personal property used in a trade or business or held for the production of income, and depreciated under the Accelerated Cost Recovery System (ACRS). See sections 46(c)(7), 168 and 280F.

Line 2. Nonrecovery Property.—Compute your qualified investment using the worksheet format at the bottom of this page. Nonrecovery property includes:

- property you elect to depreciate using a method not expressed in terms of years;
- property you elect to amortize (*e.g.*, leasehold improvements);
- property transferred or acquired merely to bring the property under ACRS;
- property acquired in certain nonrecognition transactions;
- certain property used outside the U.S.;
- public utility property if you do not use the normalization method of accounting. See section 168(e) for further details.

Enter the amortizable basis in forestation and reforestation expenditures on line 2(c) of the worksheet. See section 48(a)(1)(F). See section 46(c)(5) for rules for certain pollution control facilities.

Lines 1(a) and 1(b) of form; lines 2(a), 2(b), and 2(c) of worksheet. Qualified Progress Expenditures.—Enter on the proper line the amount of qualified progress expenditures made in the tax year.

Do not take any qualified progress expenditures for the year the property is placed in service or for the year for which recapture is required for the property. The credit allowed for the year the property is placed in service is based on the entire qualified investment reduced by the progress expenditures included as qualified investment in earlier years. See section 46(d) for more information.

Line 2 Nonrecovery Property Worksheet	Line	(1) Life Years	(2) Basis or Cost	(3) Applicable Percentage	(4) Qualified Investment (Column 2 x column 3)
New	(a)	3 or more/less than 5		33⅓	
	(b)	5 or more/less than 7		66⅔	
	(c)	7 or more		100	
Used	(d)	3 or more/less than 5		33⅓	
	(e)	5 or more/less than 7		66⅔	
	(f)	7 or more		100	
Total—Add lines (a) through (f) and enter on line 2 of Form 3468				2	

Lines 1(c) and 1(d) of form; lines 2(d), 2(e), and 2(f) of worksheet. Used Property Dollar Limitation.—In general, you may not take into account more than $125,000 of the cost of used property in any one year. This does not include the basis of any property traded in unless the trade-in caused the recapture of all or part of an investment credit allowed earlier or a reduction in an investment credit carryback or carryforward. Determine the $125,000 amount before applying the percentages based on the class of property or useful life. Enter the cost (subject to the dollar limitation) of used property placed in service during the year. Property inherited, received as a gift, or acquired from certain related persons does not qualify for the investment credit.

If a husband and wife file separate returns, each may claim up to $62,500. If one of them has *no* qualifying used property, the other may claim up to $125,000.

The $125,000 limitation applies to a partnership, S corporation, estate, or trust. The $125,000 must be divided among the estate or trust and its beneficiaries based on the income of the estate or trust allocable to each. A $125,000 limitation also applies to each partner, shareholder, or beneficiary. Controlled corporate groups must divide the limitation among all component members. See section 48(c) and related regulations.

Line 4.—The credit for qualified timber property included in line 3 is 10%. The credit for transition property and QPE property included in line 3 depends on your tax year. If your tax year begins before and ends after July 1, 1987, the regular 10% credit for transition and QPE property must be reduced by a percentage figured from the following formula:

$$35\% \times \frac{\text{number of months in your tax year after June 1987}}{\text{total number of months in your tax year}}$$

Example: Your 1987 calendar tax year shows a qualified investment in transition or QPE property on line 3 of $100,000. Since six months of the twelve (6/12) are after June 1987, you must reduce your regular credit of $10,000 (10% x $100,000) by 17.5% (35% x 6/12). The credit reduction is $1,750 ($10,000 x .175), and the reduced credit of $8,250 ($10,000 – $1,750) would be entered on line 4.

Although this reduction ($1,750 in the example) may not be used in the current year or carried back to a prior year, it may be carried forward to your next tax year under the following rules.

If you are able to use **all** of the reduced credit ($8,250 in the example) in the current year, then none of the $1,750 reduction may be carried to any other year.

If you are able to use only a **portion** of the reduced credit in the current year because you are limited by the tax liability limitations, then you may carry forward to your next year the unused portion of the reduced credit and a corresponding portion of the reduction. If, under the example, you are able to use half of the $8,250 reduced credit in 1987, then you may carry forward the other half of the reduced credit and half of the $1,750 reduction.

If you are **not** able to use **any** of the reduced credit because of the tax liability limitations, then you may carry forward to your next year the entire credit (both the reduced credit and the reduction).

For tax years beginning after June 30, 1987, you must reduce the regular 10% credit for transition and QPE property (but not for qualified timber property) by the full 35%. Enter the reduced credit on line 4. (This reduction may not be carried to any other year.)

Lines 5a and 5b. Rehabilitation Expenditures.—The Tax Reform Act of 1986 generally changed the rules for claiming the rehabilitation portion of the investment credit for property placed in service after December 31, 1986, in tax years ending after that date.

You may take a credit for certain capital costs incurred for additions or improvements to qualified existing buildings and for rehabilitation of certified historic structures. The expenditures must be added to the basis of the building and depreciated by the straight-line method and must be incurred in connection with the rehabilitation of a qualified rehabilitated building. The applicable percentage for qualified rehabilitation expenditures is 100%.

The increase in depreciable basis resulting from the expenditures must be decreased by the allowed credit.

For filers placing property in service in 1987, the expenditures must be for either:

(1) nonresidential real property,

(2) residential rental property, or

(3) real property that has a class life of more than 12½ years.

See section 48(g) for other details and section 251(d) of the Act for transitional rules applicable to line 5a.

If you are claiming a credit for a certified historic structure, you must attach a copy of your request for final certification from the National Park Service (NPS Form 10-168c). (Do not do this if the credit is a flow-through from a partnership, S corporation, estate or trust because that entity will attach a copy to its return. Instead, write "$ _____ FROM PARTNERSHIP" (or "S CORP.," etc.) on the dotted line to the left of the entry column.)

Lines 3, 5, and 14a Limitations.—Mutual savings institutions, regulated investment companies, and real estate investment trusts are subject to special limitations for the amounts to be entered on lines 3, 5, and 14a. See regulations section 1.46-4.

Line 6. Credit from Cooperative.—Section 1381(a) cooperative organizations may claim investment credit. If the cooperative cannot use any of the credit because of the tax liability limitation, the unused credit must be allocated to the patrons of the cooperative. The recapture provisions of section 47 apply as if the cooperative had kept the credit and not allocated it. Patrons should enter their regular investment credit from a cooperative on line 6.

Carryback and Carryforward of Unused Credits.—If you cannot use part of the credit because of the tax liability limitations or the operation of the alternative minimum tax, you may carry it back 3 years, then forward 15 years. Use Form 3800.

Line 10c. Other Filers.—Before you can claim the investment credit against your income tax liability, you must reduce this tax liability by the credits listed below:

- Personal credits (child and dependent care credit, credit for elderly or disabled, residential energy credit carryforward, and the credit for interest on certain home mortgages)
- Foreign tax credit
- Possessions corporation tax credit
- Orphan drug credit
- Nonconventional source fuel credit

Line 14. Limitation.—If the tax liability on line 11 is $25,000 or less, your investment credit is limited to that tax liability. If the tax liability is more than $25,000, your credit is limited to $25,000 plus 75% of the excess.

If a husband and wife file separate returns, each must use $12,500 instead of $25,000. But if one of them has *no* investment credit, then the other may use the entire $25,000.

Controlled corporate groups must divide the $25,000 among all component members.

Estates and trusts must determine the percentage of total income allocable to the estate or trust itself, and apply the percentage to the $25,000 limit on line 14a.

Line 16.—If you are a "C" corporation with regular investment credit on line 4, your total allowed credit to be entered on line 16 will be figured differently than the instructions on the form direct. See Publication 572 for the amount to enter. If you figure your credit under this limitation, write "SEC 38(c)(3)" in the margin next to your entry on line 16.

Form **3800**

Department of the Treasury
Internal Revenue Service

General Business Credit

► Attach to your tax return.

OMB No. 1545-0895

1987

Attachment Sequence No. 25

Name(s) as shown on return

Identifying number

Part I Tentative Credit

1	Investment credit (Form 3468, line 8)	1	
2	Jobs credit (Form 5884, line 7)	2	
3	Credit for alcohol used as fuel (Form 6478, line 11)	3	
4	Credit for increasing research activities (Form 6765, line 25)	4	
5	Low-income housing credit (Form 8586, line 8)	5	
6	**Current year general business credit**—Add lines 1 through 5	6	
7	Carryforward of general business credit (or investment (see instructions), WIN, jobs, alcohol fuel, research, ESOP, or low-income housing credits)	7	
8	Carryback of general business credit to 1987	8	
9	Tentative general business credit—Add lines 6, 7, and 8	9	

Part II Tax Liability Limitations

10a	Individuals—From Form 1040, enter amount from line 43		
b	Corporations—From Form 1120, Schedule J, enter tax from line 3 (or Form 1120-A, Part I, line 1)		
c	Other filers—Enter income tax before credits from return	10	
11a	Individuals—From Form 1040, enter credit from line 44, plus any orphan drug and nonconventional source fuel credits included on line 46		
b	Corporations—From Form 1120, Schedule J, enter credits from lines 4(a) through 4(d) (Form 1120-A filers, enter zero)		
c	Other filers—See instructions for line 11c	11	
12	Income tax liability as adjusted—Subtract line 11 from line 10	12	
13	Tentative minimum tax—		
a	Individuals—From Form 6251, enter amount from line 17		
b	Corporations—From Form 4626, enter amount from line 19		
c	Estates and Trusts—From Form 8656, enter amount from line 20	13	
14	Excess of income tax liability over tentative minimum tax—Subtract line 13 from line 12	14	
15a	Enter smaller of line 12 or $25,000 (see instructions for line 15)	15a	
b	If line 12 is more than $25,000—Enter 75% of the excess	15b	
16	Add lines 15a and 15b	16	
17	General business credit—Enter smallest of line 9, line 14, or line 16 (corporations, see instructions) here and on Form 1040, line 45; Form 1120, Schedule J, line 4(e); Form 1120-A, Part I, line 2; or the proper line on other returns	17	

General Instructions

(Section references are to the Internal Revenue Code.)

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Changes You Should Note.—The Tax Reform Act of 1986 changed the alternative minimum tax rules for the general business credits. This will require an additional tax liability limitation computation on lines 13 and 14. The Act also repealed the Employee Stock Ownership Plan (ESOP) credit as of 12-31-86.

If you have credits from passive activities, see **Form 8582-CR**, Passive Activity Credit Limitations, before completing Form 3800.

Purpose of Form.—The general business credit consists of the investment credit (Form 3468), jobs credit (Form 5884), alcohol fuel credit (Form 6478), research credit (Form 6765), and low-income housing credit (Form 8586). If you have more than one of these credits, or a carryback or carryforward of any of these credits, you must attach the appropriate credit forms and summarize them here on Form 3800. *If you have only one of these credits for 1987, you do not have to file Form 3800. Instead, use only that particular form to claim the credit.* For example, if you have only a 1987 investment credit, you may use Form 3468 to claim your credit. You do not have to file Form 3800 in this case.

You do not have to take the jobs or alcohol fuel credits if you do not wish to.

For more information on the investment credit, see **Form 3468**, Computation of Investment Credit, or **Publication 572**, General Business Credit.

For more information on the jobs credit, see **Form 5884**, Jobs Credit, or Publication 572.

For more information on the alcohol fuel credit, see **Form 6478**, Credit for Alcohol Used as Fuel.

For more information on the research credit, see **Form 6765**, Credit for Increasing Research Activities (or for claiming the orphan drug credit), or Publication 572.

For more information on the low-income housing credit, see **Form 8586**, Low-Income Housing Credit, or Publication 572.

Carryback and Carryforward of Unused Credit.—If you cannot use part or all of the credit on line 6 because of the tax liability limitations, you may carry any excess back to each

(Continued on back)

of the 3 preceding tax years, beginning with the earliest. If you have an unused credit after carryback, it may be carried forward to each of the 15 years after the year of the credit. In general, credits unused after 15 years may be deducted in the 16th year (or earlier if the taxpayer dies or goes out of business). Unused ESOP credits are deductible in the 15th year if unused by that time. **Note:** *Generally, only half the unused investment credit is deductible. If you had originally made a section 48(q)(4) election to take a reduced credit instead of adjusting the basis of the property, then none is deductible.*

Although the investment, jobs, alcohol fuel, research, and low-income housing credits are aggregated as the general business credit, you may want to keep separate records of these credits to ensure that no credits or deductions are lost.

Specific Instructions

Line 7.—All carryforwards of unused investment, jobs, WIN, alcohol fuel, research, ESOP, and low-income housing credits are added together and become a business credit carryforward to 1987.

Note: *Carryforward of regular investment credit for filers with tax years beginning before and ending after July 1, 1987.*—Under section 49(c) you must reduce the portion of the business credit carryforward attributable to the section 46(a)(1) regular investment credit (other than for qualified timber property) by a percentage figured from the following formula:

$$35\% \times \frac{\text{number of months in your tax year after June 1987}}{\text{total number of months in your tax year}}$$

Enter the reduced credit on line 7. Although this reduction may not be used in the current year or carried back to a prior year, it may be carried forward to your next tax year under the following rules .

If you are able to use **all** of the reduced credit in the current year, then none of the reduction may be carried to any other year.

If you are able to use only **a portion** of the reduced credit in the current year because you are limited by the tax liability limitations, then you may carry forward to your next year the unused portion of the reduced credit and a corresponding portion of the reduction. If, for example, you are able to use half of the reduced credit in 1987, then you may carry forward the other half of the reduced credit and half of the reduction.

If you are **not** able to use **any** of the reduced credit because of the tax liability limitations, then you may carry forward to your next year the entire credit (both the reduced credit and the reduction).

Carryforward of regular investment credit for filers with years beginning after June 30, 1987.—You must reduce the portion of the business credit carryforward attributable to the section 46(a)(1) regular investment credit (other than for qualified timber property) by the full 35%. Enter the reduced credit on line 7. *(This reduction may not be carried to any other year.)*

Line 8.—Leave blank in 1987. Use only in subsequent years to carry back unused credits arising in those later years.

Line 11c—Other filers.—Before you can claim the general business credit against your income tax liability, you must reduce this tax liability by the following credits:

- Personal credits (child and dependent care credit, credit for elderly or disabled, residential energy credit carryforward, and the credit for interest on certain home mortgages)
- Foreign tax credit
- Possessions corporation tax credit
- Orphan drug credit
- Nonconventional source fuel credit

Line 15.—If your adjusted tax liability (line 12) is $25,000 or less, your general business credit is limited to that liability. If the tax liability is more than $25,000, your credit is limited to $25,000 plus 75% of the excess.

If a husband and wife file separate returns, each must use $12,500 instead of $25,000. But if one of them has no credit, then the other may use the entire $25,000.

Controlled corporate groups must divide the $25,000 among all component members. See section 38(c)(4)(B).

Estates and trusts must first determine what percentage of the total income is allocable to the estate or trust itself, then apply that same percentage to the $25,000 amount on line 15a.

See section 38(c)(4)(C) for limitations on the credit for mutual savings institutions, regulated investment companies, and real estate investment trusts.

Line 17.—If you are a "C" corporation with regular investment credit included in line 1, your total allowed credit to be entered on line 17 will be figured differently than the instructions on the form direct. See Publication 572 for the amount to enter. If you figure your credit under this limitation, write "SEC 38(c)(3)" in the margin next to your entry on line 17.

Form **4136**

Department of the Treasury
Internal Revenue Service (L)

Computation of Credit for Federal Tax on Gasoline and Special Fuels

(And Credit for Purchase of Qualified Diesel-Powered Highway Vehicles)

▶ Attach this form to your income tax return.

OMB No. 1545-0162

1987

Attachment Sequence No. 26

Name (as shown on your income tax return) | Social security or employer identification number

Type of Use	Gasoline and Gasohol, Diesel Fuel, and Other Special Motor Fuels (a) Number of gallons used	(b) Rate of tax	(c) Multiply column (a) by column (b) (except line 1)
1 Qualified diesel-powered highway vehicles (See instructions below.)			$
2 Nonhighway:			
a Farm (for farming purposes):			
(i) Gasoline, gasoline/alcohol mixture		.03/.0333/.09*	
(ii) Diesel fuel, diesel/alcohol mixture		.09/.15*	$
(iii) Special fuels, special fuels/alcohol mixture		.03/.045/.09*	
b Commercial fishing vessel (See instructions.):			
(i) Gasoline, gasoline/alcohol mixture		.03/.0333/.09*	
(ii) Diesel fuel, diesel/alcohol mixture		.09/.15*	$
(iii) Special fuels, special fuels/alcohol mixture		.03/.045/.09*	
c Off-highway business (specify)			
(i) Gasoline, gasoline/alcohol mixture		.03/.0333/.09*	
(ii) Diesel fuel, diesel/alcohol mixture		.09/.15*	$
(iii) Special fuels, special fuels/alcohol mixture		.03/.045/.09*	
3a Intercity, local, and school buses (See instructions.)		.03/.0333/.09/.12*	
b Qualified local and school buses (See instructions.)		.15	$
c Gasoline used for certain exempt purposes		.03/.09*	
4 Gasoline/alcohol mixture (gasohol)		.0566	$
5a Qualified methanol and ethanol		.06	
b Diesel/alcohol mixture		.06	$
c Special fuels/alcohol mixture		.06	
6 Qualified taxicab		.04	$
7 Additional tax on fuels (See instructions.)		.001/.0005	$
Aviation Fuel:			
8 Farm (for farming purposes)		.03/.09/.12/.14*	$
9 Aviation (Applies only to commercial or certain helicopter uses as defined in instructions.)		.03/.09/.12/.14*	$
10 Total income tax credit claimed (add lines 1 through 9). Enter here and on Form 1040, line 59; Form 1120, line 32f; Form 1120-A, line 28f; Form 1120S, line 23b; Form 1041, line 30b; or the proper line of other returns			$

* Use rate paid or allowable rate if less.

Instructions

(Section references are to the Internal Revenue Code.)

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Purpose of Form.—File this form if you claim credit for Federal excise tax on gasoline and gasohol, diesel fuel, and other special fuels used for certain types of business uses or the credit for diesel-powered highway vehicles. Figure the credit by multiplying the number of gallons used by the rate of Federal excise tax paid or the allowable rate if less. See the instructions for your particular use of fuel to determine the applicable rate of tax.

An individual, estate, trust, or corporation may file this form, but a partnership may not. However, a partnership must attach to **Form 1065**, U.S. Partnership Return of Income, a statement showing how many gallons of the fuels are allocated to each partner, the types of use, and the applicable tax rate as shown on this form.

Refund Instead of Credit.—If you paid excise tax of at least $1,000 ($200 for gasoline/alcohol mixture and $50 for gasoline, diesel fuel, or special fuels used in a qualified taxicab) on gasoline for nonhighway use (including use for commercial fishing vessels) and intercity, local, or school bus use in any one of the first three quarters of the tax year, you may file for a refund of the tax instead of a credit.

If you paid excise tax of at least $1,000 (include in the $1,000 the credit for purchase of a qualified diesel-powered highway vehicle) on special fuels for a nontaxable use, intercity, local or school bus use (including a qualified local bus), certain aircraft museums use, and certain helicopter use in any one of the first three quarters of the tax year, you may file for a refund.

To claim the refund, file **Form 843**, Claim, before the end of the quarter following the one for which you are claiming the refund. Show separate computations for a claim on gasoline, special fuels, and alcohol mixtures. You may use Form 4136 as a worksheet to show your computations and attach it to the Form 843 you file.

You must claim a credit, rather than a refund, for any tax paid during the fourth quarter, and for any tax under $1,000 ($200 for gasoline/alcohol mixture and $50 for gasoline, diesel fuel, or special fuels used in a qualified taxicab) for any fuel used in the first three quarters. You must also claim the credit rather than a refund for tax paid on gasoline, special fuels, or alcohol mixtures used on a farm for farming purposes.

Do not claim a credit on Form 4136 for any amount that you previously claimed as a refund.

Year To Include the Credit or Refund in Income.—When you claim a credit or refund, you must include that credit or refund in your gross income to the extent that it reduced your income tax. The year you include it depends on your method of accounting. This rule does not apply to the credit claimed on line 1 for qualified diesel-powered highway vehicles.

Cash Method.—If you use the cash method, include the credit in gross income on your return for the year you claim the credit. If you file an amended return, or if you file a claim for credit or refund (and claim the credit for the tax), include the refund that results from the credit in your gross income for the tax year you receive it.

Accrual Method.—If you use the accrual method, figure the credit or refund due at the close of your tax year. Include it in income even if you have not filed a claim for refund.

Credit for Purchase of Qualified Diesel-Powered Highway Vehicles.—If you purchased a diesel-powered highway vehicle for a use other than resale and you are the first purchaser, you may claim a credit of $102 for an automobile and $198 for a light truck or van. A **qualified diesel-powered highway vehicle** is any diesel-powered highway vehicle that has at least 4 wheels, has a gross vehicle weight rating of 10,000 pounds or less, and is registered for highway use in the United States under the laws of any state. Enter the credit on line 1 of Form 4136. If you purchased more than one vehicle that qualifies for the credit, enter the total of the credits on line 1.

(Continued on next page)

What Gasoline To Include.—

Farm Use.—You may claim a credit for gasoline used for farming in a trade or business farm in the U.S. The credit for gasoline is 9¢ a gallon and 3¢ a gallon for gasohol. If gasoline was purchased for blending with alcohol, the credit is 2⅓¢ (.0333) a gallon. (See instructions for ...tion fuel used for farming.) Such farms include the following: stock, dairy, poultry, fur-bearing animals, truck farms, plantations, ranches, nurseries, ranges, greenhouses, and orchards. See **Publication 225**, Farmer's Tax Guide, for information on who may claim a credit for farming purposes.

Commercial Fishing Vessel Use.—You may claim a credit for tax paid on gasoline and a gasoline/alcohol mixture (gasohol) used in a commercial fishing vessel. The credit for gasoline is 9¢ a gallon and 3¢ a gallon for gasohol. If gasoline was purchased for blending with alcohol, the credit is 3⅓¢ (.0333) a gallon. A **commercial fishing vessel** is one used in the fisheries or whaling business and used:

- Exclusively for catching shrimp and other types of aquatic life for sale commercially as bait; or
- On specific trips exclusively for catching fish, shrimp, or other aquatic life to be sold commercially.

Off-Highway Business Uses.—You may claim a credit for tax paid on gasoline and a gasoline/alcohol mixture (gasohol) used for off-highway business purposes. The credit for gasoline is 9¢ a gallon and 3¢ a gallon for gasohol. If gasoline was purchased for blending with alcohol, the credit is 3⅓¢ (.0333) a gallon. Off-highway business use does not include gasoline used in a motorboat that is not a commercial fishing vessel, or in a highway vehicle that either must be registered for highway use or is owned by the U.S. and used on the highway.

Intercity, Local, or School Bus Uses.—If you are the ultimate purchaser of gasoline or a gasoline/alcohol mixture (gasohol) for a bus that provides transportation (1) to the general public for a fee, or (2) to students and school employees, you may claim a credit for tax paid on gasoline used for this service of 9¢ a gallon and 3¢ a gallon for gasohol. If gasoline was purchased for blending with alcohol, the credit is 3⅓¢ (.0333) a gallon.

If you provide transportation on intercity and local buses on nonscheduled irregular routes, you may take the credit only if the seating capacity of the bus is at least 20 adults, not including the driver.

Exempt Uses.—Effective January 1, 1988, you may claim a credit for gasoline or gasoline/alcohol mixture that is exported, used by a state or local government, used by a nonprofit educational organization, or used as supplies for vessels or aircraft. The credit for gasoline is 9¢ a gallon and 3¢ a gallon for gasoline/alcohol mixture. See **Publication 510**, Excise Taxes for 1988, for more information.

Gasoline Mixed With Alcohol.—You may claim a credit for tax paid on gasoline that you used to produce a gasoline/alcohol mixture that was sold or used in your trade or business. The credit is 5⅔¢ (.0566) a gallon if you paid 9¢ a gallon.

Qualified Taxicab Use.—The ultimate purchaser may claim a credit for tax paid on gasoline (or diesel fuel) used in a qualified taxicab providing qualified taxicab service in the amount of 4¢ a gallon.

A **qualified taxicab** is a land vehicle that holds fewer than 10 adults including the driver. For 1978 and later model years, the vehicle model must have a fuel economy rating better than the average fuel economy standard for the model year (18 mpg for 1978 models, 19 mpg for 1979, 20 mpg for 1980, 22 mpg for 1981, 24 mpg for 1982, 26 mpg for 1983, 27 mpg for 1984 and 27½ mpg for 1985 and later years). A taxicab is qualified if the vehicle received or could have received an exemption from the fuel economy standard for the model year. Fuel economy standards do not apply for vehicles acquired before 1979.

Qualified taxicab service means furnishing nonscheduled land transportation for a fixed fee in a qualified taxicab. The driver must be properly licensed as a taxicab driver and must be able to furnish ride-sharing.

Aviation Fuel—*Farming, Commercial, or Helicopter Uses.*—You may claim a credit for tax paid on aviation gasoline used in farming, commercial, or certain helicopter aviation uses of 9¢ or 12¢ a gallon, whichever is paid. Also, you may claim a credit for tax paid on gasohol of 3¢ a gallon.

For the definition of farm use, see Publication 225.

Commercial aviation is the use of an aircraft in a business of carrying people or property by air for pay. The use of an aircraft may be considered noncommercial aviation if the aircraft has a maximum certificated takeoff weight of 6,000 pounds or less and is not operated on an established line, or is owned or leased by a member of an affiliated group and is not available for hire to nonmembers.

Helicopter uses are:

(a) Transporting individuals, equipment, or supplies in the exploration for, or the development or removal of, hard minerals, oil, or gas; or

(b) Planting, cultivating, cutting, transporting, or caring for trees (including logging operations), but only if the helicopter does not take off from, or land at, a facility eligible for assistance under the Airport and Airway Development Act of 1970, or otherwise use services provided under the Airport and Airway Improvement Act of 1982 during such use.

What Special Fuels To Include.—

(a) Diesel Fuel.—This fuel is a liquid that is (1) sold for use in a diesel-powered highway vehicle, or (2) used for fuel in a diesel-powered highway vehicle unless there was a taxable sale of the fuel under (1).

(b) Special Motor Fuels.—These fuels include benzol, benzene, naphtha, liquefied petroleum gas, casing head and natural gasoline and other liquids, except kerosene, gas oil, fuel oil, diesel fuel, or any product taxable under section 4081. Special motor fuels must be (1) sold for use as a fuel in a motor vehicle or motorboat, or (2) used for fuel in a motor vehicle or motorboat. (This use is not taxable if there was a taxable sale of the fuel under (1).)

(c) Qualified Methanol and Ethanol Fuels.—These fuels include any liquid 85% of which consists of alcohol produced other than from petroleum or natural gas. The allowable credit is 6¢ a gallon. Claim the credit on line 5a.

(d) Diesel Fuel Mixed With Alcohol.—You may claim a credit for tax paid on diesel fuel that is later used in a mixture of diesel fuel and alcohol if it is at least 10% alcohol. The allowable credit is 6¢ a gallon.

(e) Special Fuels Mixed With Alcohol.—You may claim a credit for tax paid on special fuels that are later used in a mixture of a special fuel and alcohol if it is at least 10% alcohol. The allowable credit is 6¢ a gallon.

Uses of Special Fuels.—

Farm Use.—You may claim a credit for tax paid on diesel fuel of 15¢ a gallon and for tax paid on diesel fuel mixed with alcohol of 9¢ a gallon. You may claim a credit for tax paid on special motor fuels of 9¢ a gallon and 3¢ a gallon for special fuels mixed with alcohol. If 85% of the special fuel consists of alcohol produced from natural gas, you may claim a credit for the tax paid of 9¢ or 4½¢ a gallon. Also, you may claim a credit for qualified methanol and ethanol of 3¢. Enter the credit for methanol and ethanol under special fuels on line 2a(iii). For the definition of farm use, see Publication 225.

Commercial Fishing Vessel Use.—You may claim a credit for tax paid on diesel fuel of 15¢ a gallon and 9¢ a gallon for diesel fuel mixed with alcohol. You may claim a credit for tax paid on special motor fuels of 9¢ a gallon and 3¢ a gallon for special fuels mixed with alcohol. If 85% of the special fuel consists of alcohol produced from natural gas, you may claim a credit for the tax paid of 9¢ or 4½¢ a gallon. Also, you may claim a credit for qualified methanol and ethanol of 3¢. Enter the credit for methanol and ethanol under special fuels on line 2b(iii). For the definition of commercial fishing vessel use, see *Commercial Fishing Vessel Use*, under *What Gasoline To Include*.

Bus Uses.—Generally, you may claim a credit for tax paid on diesel fuel of 12¢ a gallon for intercity and local bus use. You may claim a credit of 15¢ a gallon for tax paid on diesel fuel if the fuel is used in a qualified local bus or school bus. A **qualified local bus** is any local bus that seats at least 20 adults (not including the driver), that transports the general public along regular scheduled routes, and that is under contract (or receives more than a nominal subsidy) from any state or local government to furnish such transportation. You may claim a credit for tax paid on special motor fuels of 9¢ a gallon. For the definition of intercity, local, and school bus uses, see *Intercity, Local, or School Bus Uses*, under *What Gasoline To Include*.

Farming, Commercial, or Helicopter* Aviation *Uses.—You may claim a credit for tax paid on fuels of 14¢ a gallon that were for farming, commercial, or helicopter aviation uses. See instructions for the definitions of commercial or helicopter aviation uses under *What Gasoline To Include*. See Publication 225 for definition of farming use.

Other Nontaxable Uses—Diesel and* Special *Motor Fuel.—These fuels may qualify for a credit in any of the following cases:

- You resold the fuel.
- You used the fuel for a nontaxable purpose.
- You used the fuel for a purpose that was not the one you bought it for. (This other purpose must make a lower tax rate apply.)

If any of these three conditions exist, claim as a credit the figure you get by subtracting (a) the tax that applies to the actual use of the fuel from (b) the tax imposed by section 4041 on the fuel sold to you. Enter the net amount of credit on line 2c(ii) or (iii), Form 4136, for off-highway business credit.

Additional Tax on Fuels (Leaking Underground Storage Tank Taxes).—You may claim a credit of 1/10 of 1¢ (.001) a gallon for tax paid on gasoline or gasohol used in intercity, local, or school buses, on a farm or in farming aviation, in commercial fishing vessels, and in helicopter aviation described in *Helicopter uses* and all commercial aviation. You may also claim a credit for tax paid on diesel fuel and special motor fuels of 1/10 of 1¢ (.001) a gallon for use on a farm, in farming aviation, in commercial fishing vessels, in qualified local buses and school buses, and in helicopter aviation described in *Helicopter uses*. The amount of credit for qualified ethanol and methanol is 1/20 of 1¢ (.0005) a gallon.

What Fuels Not To Include.—Fuels lost through spillage, accident, or shrinkage are not considered used and do not qualify for credit or refund.

Additional Information.—**Publication 225**, Farmer's Tax Guide, and **Publication 378**, Fuel Tax Credits, are available from the Internal Revenue Service.

Form **4255**
(Rev. June 1986)
Department of the Treasury
Internal Revenue Service

Recapture of Investment Credit
(Including Energy Investment Credit)
▶ Attach to your income tax return.

OMB No. 1545-0166
Expires 8-31-88

Attachment Sequence No. **65**

Name(s) as shown on return | Identifying number

Properties	Kind of property—State whether recovery or nonrecovery (see the Instructions for Form 3468 for definitions). If energy property, show type. Also indicate if rehabilitation expenditure property.
A	
B	
C	
D	
E	

Original Investment Credit

Computation Steps: (see Specific Instructions)	Properties A	B	C	D	E
1 Original rate of credit					
2 Date property was placed in service					
3 Cost or other basis					
4 Original estimated useful life or class of property					
5 Applicable percentage					
6 Original qualified investment (line 3 times line 5)					
7 Original credit (line 1 times line 6)					
8 Date property ceased to be qualified investment credit property					
9 Number of full years between the date on line 2 and the date on line 8					

Computation of Recapture Tax

10 Recapture percentage (from instructions)						
11 Tentative recapture tax (line 7 times line 10)						
12 Add line 11, columns A through E						
13 Enter tax from property ceasing to be at risk, or for which there was an increase in nonqualified nonrecourse financing (attach separate computation)						
14 Total—Add lines 12 and 13						
15 Portion of original credit (line 7) not used to offset tax in any year, **plus** any carryback and carryforward of credits you can now apply to the original credit year because you have freed up tax liability in the amount of the tax recaptured (Do not enter more than line 14—see instructions)						
16 Total increase in tax—Subtract line 15 from line 14. Enter here and on the proper line of your tax return.						

General Instructions

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Purpose of Form.—Use Form 4255 to figure the increase in tax for the recapture of investment credit for regular and energy property. You must refigure the credit if you took it in an earlier year, but disposed of the property before the end of the recapture period or the useful life you used to figure the original credit. You must also refigure the credit if you returned leased property (on which you had taken a credit) to the lessor before the end of the recapture period or useful life.

You must refigure the credit if you changed the use of property so that it no longer qualifies as regular or energy investment credit property. For example, you must refigure the credit if you change the use of property from business use to personal use, or if there is any decrease in the percentage of business use of investment credit property. See sections 47(a)(3) and 47(a)(5)(C) for information on recapture for progress expenditure property. Also, see the instructions

:13 regarding recapture if property ceases
risk, or if there is an increase in
lified, nonrecourse financing related to
at-risk property placed in service after
.

ertain "listed property" (i.e., transportation
y, entertainment, recreation or amusement
ty, or certain home computer equipment)
in service after June 18, 1984, ceases to be
nore than 50% for business, you may have to
ure investment credit taken on the property.
ction 280F for details.

election to be treated as an S corporation
not automatically trigger recapture of
ment credit taken before the election was
ive. However, the S corporation is liable for
:capture of investment credit taken before
ection.

property on which you took both regular and
y investment credit ceases to be energy
: property, but still qualifies as regular
tment credit property, you need only
ure the energy investment credit. However,
took both credits, and you dispose of the
erty, or the property ceases to be both
gy and regular investment credit property,
nust refigure both credits.

you are an S corporation, a partnership, or
state or trust that allocated any or all of the
stment credit to the beneficiaries, you must
your shareholders, partners, or beneficiaries
nformation they need to refigure the credit.
regulations sections 1.47-4, 1.47-5 and
'-6.

Partners, shareholders and beneficiaries.—If
Schedule K-1 shows that you must recapture
stment credit taken in an earlier year, you will
d your retained copy of the original Form 3468
omplete lines 1 through 9 of this Form 4255.

cial Rules.—If you took a credit on the
kinds of property, see the sections listed
ow before you complete Form 4255:

Property	Section
ion picture films and video tapes	47(a)(8)
is	46(g)(4)
mmuter highway vehicles	47(a)(4)

If you took any nonconventional source fuel
dit, see section 29(b)(4).

If, before the end of the recapture period, you
pose of recovery property placed in service
er 1982 (or the business use percentage
creases), increase the basis of this property by
% of the recapture amount unless you
ginally made the section 48(q)(4) election to
ke a reduced credit instead of reducing the
sis of the property.

For more information, see **Publication 572,**
vestment Credit.

pecific Instructions

ote: *Do not figure the recapture tax on lines 1 rough 12 for property ceasing to be at risk, or if ere is an increase in nonqualified nonrecourse nancing related to certain at-risk property aced in service after July 18, 1984. Figure the capture tax for these properties on separate chedules and enter the recapture tax on line 13. clude any unused credit for these properties on ne 15.*

ines A through E.—Describe the property for hich you must refigure the credit.

Fill in lines 1 through 11 for each property on hich you are refiguring the credit. Use a
e column for each item. If you must
ecapture both the energy investment credit and
he regular investment credit for the same item,
se a separate column for each credit. If you
eed more columns, use additional Forms 4255,
r other schedules with all the information shown
n Form 4255. Enter the total from the separate
sheets on line 12.

Line 1.—Enter the rate you used to figure the original credit from the tables below:

Regular Investment Property

Qualifying property acquired or constructed and placed in service	10%

Be sure to include any ESOP credit, or other credits listed under the special rules above.

See section 46(b)(4) for the rates for qualified rehabilitation expenditures made after 1981.

Energy Investment Property

Alternative energy property, specially defined energy property, recycling equipment, shale oil equipment, equipment for producing natural gas from geopressured brine, cogeneration equipment, and intercity buses	10%
Qualified hydroelectric generating equipment	11%
Solar and wind equipment acquired or constructed before 1980	10%
Solar and wind equipment, ocean thermal equipment, and geothermal equipment acquired or constructed after 1979	15%

Line 2.—For both recovery and nonrecovery property, enter the first day of the first month, and the year, that the property was available for service.

Line 3.—Enter the cost or other basis that you used to figure the original credit.

Line 4.—Enter the estimated useful life that you used to figure the original credit for nonrecovery property. Enter the class of property for recovery property.

Line 5.—Enter the applicable percentage that you used to figure the original qualified investment from the tables below:

Nonrecovery Property

Original estimated useful life	Applicable percentage
3 or more but less than 5 years	33⅓%
5 or more but less than 7 years	66⅔%
7 or more years	100%

Recovery Property

Class of property	Applicable percentage
3-year	60%
Other	100%

Section 48(q) Election Recovery Property

(Placed in service after 12/31/82)

Class of property	Applicable percentage
3-year	40%
Other	80%

Line 8.—Generally, this will be the date you disposed of the property. See regulations section 1.47-1(c) for more information.

Line 9.—Do not enter partial years. If the property was held less than 12 months, enter zero.

Line 10.—Enter the recapture percentage from the following tables:

Nonrecovery Property

If number of full years on line 9 of Form 4255 is:	The recapture percentage for property with an original useful life of: 3 or more but less than 5 years is	5 or more but less than 7 years is	7 or more years is
0	100	100	100
1	100	100	100
2	100	100	100
3	0	50	66.6
4	0	50	66.6
5	0	0	33.3
6	0	0	33.3

Recovery Property

If number of full years on line 9 of Form 4255 is:	The recapture percentage for: 3-year property is	Other than 3-year property is
0	100	100
1	66	80
2	33	60
3	0	40
4	0	20

Decrease in Business Use.—If you take investment credit for property and the percentage of business use in a later year falls below the percentage for the year placed in service, you are treated as having disposed of part of the property and may have to recapture part of the investment credit.

For example, if you are a calendar-year taxpayer who bought a $21,000 automobile in August 1984 and used it 90% for business, your investment credit for 1984 would have been $900 (90% of the $1,000 limit for automobiles placed in service from June 19, 1984, through April 2, 1985). If business use in 1985 fell to 60%, you are treated as having disposed of one-third ((90 – 60) ÷ 90) of the automobile on January 1, 1985 (since business use is computed on a tax-year basis and a decrease in business use is deemed to take place on the first day of the tax year). Multiply the recapture percentage from the table above (100%) by one-third and enter the result (33.3%) on line 10 of the form.

Line 12.—If you have used more than one Form 4255, or separate sheets to list additional items on which you figured an increase in tax, write on the dotted line "Tax from attached, $ _____." Include the amount in the total for line 12.

Line 13.—For certain taxpayers, the basis or cost of property placed in service after February 18, 1981, is limited to the amount the taxpayer is at risk for the property at year end. For property placed in service after July 18, 1984, the basis or cost must be reduced by the amount of any "nonqualified, nonrecourse financing" related to the property at year end. If property ceases to be at risk in a later year, or if there is an increase in nonqualified, nonrecourse financing, recapture may be required. See section 47(d) for details. Attach a separate computation schedule to figure the recapture tax and enter the total tax on line 13.

Line 15.—If you did not use all the credit you originally figured, either in the year you figured it or in a carryback or carryforward year, you do not have to recapture the amount of the credit you did not use. In refiguring the credit for the original credit year, be sure to take into account any carryforwards from previous years, plus any carrybacks arising within the 3 taxable years after the original credit year that are now allowed because the recapture and recomputation of the original credit made available some additional tax liability in that year. See regulations section 1.47-1(d), Revenue Ruling 72-221, and Publication 572 for more information.

Figure the unused portion on a separate sheet and enter it on this line. Do not enter more than the recapture tax on line 14.

Reminder: Be sure to adjust your *current* unused credit to reflect any unused portion of the original credit that was recaptured on this form.

Form **4562**

Department of the Treasury
Internal Revenue Service (L)

Depreciation and Amortization

▶ See separate instructions.
▶ Attach this form to your return.

OMB No. 1545-0172
1987
Attachment Sequence No. 67

Name(s) as shown on return | Identifying number

Business or activity to which this form relates

Part I **Depreciation** (Do not use this part for automobiles, certain other vehicles, computers, and property used for entertainment, recreation, or amusement. Instead, use Part III.)

Section A.—Election To Expense Depreciable Assets Placed in Service During This Tax Year (Section 179)

(a) Description of property	(b) Date placed in service	(c) Cost	(d) Expense deduction
1			

2 Listed property—Enter total from Part III, Section A, column (h) 2
3 Total (add lines 1 and 2, but do not enter more than $10,000) 3
4 Enter the amount, if any, by which the cost of all section 179 property placed in service during this tax year is more than $200,000 4
5 Subtract line 4 from line 3. If result is less than zero, enter zero. (See instructions for other limitations) . . 5

Section B.—Depreciation

(a) Class of property	(b) Date placed in service	(c) Basis for depreciation (Business use only—see instructions)	(d) Recovery period	(e) Method of figuring depreciation	(f) Deduction
6 Accelerated Cost Recovery System (ACRS) (see instructions): *For assets placed in service* **ONLY** *during tax year beginning in 1987*					
a 3-year property					
b 5-year property					
c 7-year property					
d 10-year property					
e 15-year property					
f 20-year property					
g Residential rental property					
h Nonresidential real property					

7 Listed property—Enter total from Part III, Section A, column (g) 7
8 ACRS deduction for assets placed in service prior to 1987 (see instructions) 8

Section C.—Other Depreciation

9 Property subject to section 168(f)(1) election (see instructions) 9
10 Other depreciation (see instructions) 10

Section D.—Summary

11 Total (add deductions on lines 5 through 10). Enter here and on the Depreciation line of your return (Partnerships and S corporations—Do NOT include any amounts entered on line 5.) 11
12 For assets above placed in service during the current year, enter the portion of the basis attributable to additional section 263A costs. (See instructions for who must use.) . . 12

Part II **Amortization**

(a) Description of property	(b) Date acquired	(c) Cost or other basis	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
1 Amortization for property placed in service **only** during tax year beginning in 1987					
2 Amortization for property placed in service prior to 1987					

3 Total. Enter here and on Other Deductions or Other Expenses line of your return 3

See Paperwork Reduction Act Notice on page 1 of the separate instructions.

Part III **Automobiles, Certain Other Vehicles, Computers, and Property Used for Entertainment, Recreation, or Amusement (Listed Property).**

If you are using the standard mileage rate or deducting vehicle lease expense, complete columns (a) through (d) of Section A, all of Section B, and Section C if applicable.

Section A.—Depreciation (If automobiles and other listed property placed in service after June 18, 1984, are used 50% or less in a trade or business, the Section 179 deduction is not allowed and depreciation must be taken using the straight line method over 5 years. For other limitations, see instructions.)

Do you have evidence to support the business use claimed? ☐ Yes ☐ No If yes, is the evidence written? ☐ Yes ☐ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business use percentage (%)	(d) Cost or other basis (see instructions for leased property)	(e) Basis for depreciation (Business use only—see instructions)	(f) Depreciation method and recovery period	(g) Depreciation deduction	(h) Section 179 expense

Total (Enter here and on line 2, page 1.) . . . . . .

Total (Enter here and on line 7, page 1.) . . . . . .

Section B.—Information Regarding Use of Vehicles

Complete this section as follows, if you deduct expenses for vehicles:

- *Always complete this section for vehicles used by a sole proprietor, partner, or other more than 5% owner or related person.*
- *If you provided vehicles to employees, first answer the questions in Section C to see if you meet an exception to completing this section for those items.*

	Vehicle 1		Vehicle 2		Vehicle 3		Vehicle 4		Vehicle 5		Vehicle 6	
1 Total miles driven during the year . . .												
2 Total business miles driven during the year												
3 Total commuting miles driven during the year												
4 Total other personal (noncommuting) miles driven												
	Yes	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
5 Was the vehicle available for personal use during off-duty hours?												
6 Was the vehicle used primarily by a more than 5% owner or related person? . . .												
7 Is another vehicle available for personal use?												

Section C.—Questions for Employers Who Provide Vehicles for Use by Employees.

(Answer these questions to determine if you meet an exception to completing Section B. **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.)*

	Yes	**No**
8 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
9 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
10 Do you treat all use of vehicles by employees as personal use?		
11 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
12 Do you meet the requirements concerning fleet vehicles or qualified automobile demonstration use (see instructions)?		

Note: *If your answer to 8, 9, 10, 11, or 12 is "Yes," you need not complete Section B for the covered vehicles.*

Department of the Treasury
Internal Revenue Service

87
ructions for Form 4562
:iation and Amortization

eferences are to the Internal Revenue Code, unless otherwise noted.)

ork Reduction Act

r this information to carry out the Revenue laws of the United States. it to ensure that taxpayers are ng with these laws and to allow us to nd collect the right amount of tax. required to give us this information.

s You Should Note

ent legislation changed the way you your deduction for depreciation and ction 179 deduction for property d in service after 12/31/86. Figure allowable deduction in Part I, Sections d B.

ate and local sales taxes paid on the hase of an asset are no longer uctible but can be added to the basis of asset and depreciated.

Many other items that were deductible der prior law must now be capitalized or luded in inventory costs. See the structions for line 12.

All taxpayers claiming any type of eduction for any listed property (such as obiles, computers, and property used poses of entertainment, recreation and amusement) are required to complete Part III on page 2, regardless of when such property was placed in service.

- As an alternative to depreciating a vehicle, self-employed individuals may elect to use the standard mileage allowance if two or more vehicles are not used at the same time. For more information, see **Publication 917**, Business Use of a Car.
- All details of depreciation should be retained as part of your permanent books and records. See **Publication 534**, Depreciation, for example of how to keep depreciation records.

Purpose of Form

Use Form 4562 to claim your deduction for depreciation and amortization, to make the election to expense recovery property, and to provide information concerning the business use of automobiles and other listed property.

In using this form, a taxpayer should prepare and submit a separate Form 4562 for each business or activity in the return.

For more information about depreciation, the election to expense newly acquired recovery property, and leased listed property, see Publication 534 and Publication 917. For more information about amortization (including depreciation/amortization of leasehold expenses), see **Publication 535**, Business Expenses.

Line-by-Line Instructions

Part I.—Depreciation

Depreciation is an amount you can deduct each year for assets, except land, you acquire to use in your business or hold to produce income. (Land is never depreciable.) Depreciation starts when you first start using the property in your business. It ends when you take the property out of service, deduct all of your depreciable cost, or no longer use the property in your business.

Complete Section A of Part III on page 2, instead of Part I, for depreciation of all listed property, regardless of when such property was placed in service.

If any "listed property" placed in service after June 18, 1984, was used more than 50% in a trade or business in the year it was placed in service, and used 50% or less in a later year, part of the depreciation, section 179 deduction, and investment credit may have to be recaptured in the later year. Figure the amount of depreciation and section 179 deduction to be recaptured on **Form 4797**, Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions. Figure the amount of investment credit to be recaptured on **Form 4255**, Recapture of Investment Credit.

Section A.—Election to Expense Depreciable Assets.—You may choose to expense part of the cost of depreciable personal property used in your trade or business and certain other property described in Publication 534. To do so, you must have purchased (as defined in section 179(d)(2)) the property and placed it in service during the 1987 tax year. If you take this deduction, the amount on which you figure your depreciation or amortization deduction must be reduced by the section 179 expense.

Note: *The following do not qualify as section 179 property: (1) property that is used 50% or less in your trade or business; and (2) property held for the production of income (section 212 property).*

An estate or trust may not elect to expense property. A partnership or S corporation may choose to expense and pass through to its partners or shareholders a maximum of $10,000. Partners or shareholders add their share of the partnership or S corporation amount to their own section 179 expense they choose to take, and deduct the combined amount up to the limit. See Publication 534 for more information.

Line 1.—

Column (a).—Enter the class of property (that is, 3-year, 5-year, etc.) for which you make the election and a brief description of the item.

Column (b).—Enter the month and year you placed the property in service.

Column (c).—Enter the property's cost. Omit any undepreciated basis on assets you traded in. For information about basis, see **Publication 551**, Basis of Assets.

Column (d).—Enter the part of the cost you choose to expense. You can choose to expense part of the cost of an asset and depreciate the rest of it.

Line 2.—If you choose to claim a section 179 expense deduction for automobiles and other listed property, complete Section A, Part III. See "Limitations for automobiles" under Section A, Part III.

Line 5.—If you are married filing separately, each spouse is limited to one-half of the allowable amount unless you elect to allocate the section 179 expense in a different manner.

The amount on line 5 is further limited to the total taxable income from your trade or business (an amount disallowed under this rule is treated as cost of section 179 property next year).

Section B.—Depreciation.—

Note: *Lines 6a through 6h should be completed for assets, other than automobiles and other listed property, placed in service only during the tax year beginning in 1987.*

Column (a).—

Types of Property.—Property is classified as follows:

3-Year Property.—This is property with a class life of 4 years or less. It includes a race horse which is more than 2 years old at the time it is placed in service, and any other horse which is more than 12 years old at the time it is placed in service.

5-Year Property.—This is property with a class life of more than 4, but less than 10 years. It includes an automobile or light general purpose truck; semiconductor manufacturing equipment; computer based telephone central office switching equipment; qualified technological equipment; property used in connection with research and experimentation; and certain energy property specified in section 168(e)(3)(B)(vi).

7-Year Property.—This is property with a class life of 10 years or more, but less than 16 years. It includes railroad track; a single purpose agricultural or horticultural structure; and any property not having a class life and not otherwise classified.

10-Year Property.—This is property with a class life of 16 years or more, but less than 20 years.

15-Year Property.—This is property with a class life of 20 years or more, but less than 25 years. It includes a municipal wastewater treatment plant and any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications of information.

20-Year Property.—This is property with a class life of 25 or more years. It includes municipal sewers.

Residential Rental Property.—This is a building in which 80 percent or more of the total rent is from dwelling units.

Nonresidential Real Property.—This is real property, other than residential rental property, which has a class life of at least 27.5 years.

See **Publication 534**, Depreciation, for more information on class lives.

Column (b).—For lines 6g and 6h, enter the month and year you placed the property in service.

Column (c).—Enter the basis for depreciation of the assets you placed in

service in the current tax year. To find the basis for depreciation, multiply the cost or other basis of the property by the percent of business use. From that result, subtract any section 179 expense deduction and any applicable investment credit.

Certain taxpayers are not subject to the new depreciation rules for property placed in service after 12-31-86. See the note in the instructions for line 8 below.

Column (d).—Enter your recovery period. This is usually the number of years that corresponds to the class of property in column (a). For example, for 3-year property the recovery period is 3 years; for 5-year property the recovery period is 5 years, etc. For residential rental property, your recovery period is 27½ years and nonresidential real property, 31½ years.

If you use the alternative depreciation system, enter your recovery period or class life (for real property, enter 40).

Column (e).—Enter your method of figuring depreciation and convention by writing "DDB," "150% DB," or "SL," for depreciation method, and "½," "$^1/_{12}$," or "¼," for half-year, mid-month, or mid-quarter conventions, respectively.

Column (f).—Figure your depreciation deduction according to the instructions given below.

How To Figure Depreciation

The following instructions apply to figuring depreciation for line 6, column (f). Also read the instructions below under Mid-Quarter Convention for information on when that convention must be used.

3-year property, 5-year property, 7-year property, and 10-year property.—For this property, use the 200% declining balance method, switching to straight-line for the first year in which that method would result in a higher deduction. You may use optional Table 2(a) on page 4 to figure your depreciation. Apply the percentage shown in the table to the original basis each year. The table reflects the switch to the straight-line method. Also see "Mid-Quarter Convention" below for special rule.

See Publication 534 for a more detailed method for computing depreciation.

15-year property and 20-year property.— Use the 150% declining balance method, switching to straight-line for the first year in which that method results in a higher deduction. You may use optional Table 2(a) on page 4 to figure your depreciation. Apply the percentage shown in the table to the original basis each year. The table reflects the switch to the straight-line method. Also see "Mid-Quarter Convention" below for special rule.

See Publication 534 for a more detailed method for computing depreciation.

Nonresidential Real Property and Residential Rental Property.—For this property you must use the straight-line method and apply the mid-month convention. You may use optional Tables 2(b) or 2(c) on page 4 to figure your depreciation. Apply the percentage shown in the table to the original basis each year.

See Publication 534 for a more detailed method for computing depreciation.

Mid-Quarter Convention.—If more than 40% of the total cost or other basis of all property placed in service during the tax year was placed in service during the last 3 months of that year, you must use the "mid-quarter convention" for all property placed in service during the year (lines 6a–6f). This rule does not apply to nonresidential real property and residential rental property (lines 6g and 6h). The mid-quarter convention treats property which is placed in service or disposed of during a quarter as being placed in service or disposed of during the middle of the quarter.

To use the mid-quarter convention, figure depreciation for each asset using Table 2(a) on page 4. Multiply that result by 2 (because Table 2(a) is based on the half-year convention) and then multiply by the number of full quarters that the property was in service, plus one-half a quarter for the quarter in which the property was placed in service. Then divide that result by 4.

Filers with 2nd year depreciation of property placed in service after 12/31/86 should take a full year's depreciation as shown in the table. For additional information see **Publication 534**, Depreciation.

Alternative Depreciation System.—Instead of the methods discussed above, you may elect to use the straight-line method of figuring depreciation for one or more classes of property. If elected, this method must be used for all property in the same class that is placed in service during the tax year. However, the election for nonresidential real property and residential rental property may be made separately for each property.

To figure depreciation under this method, divide the basis for depreciation by the class life, and use the same conventions as explained above. If personal property does not have a class life, use 12 years. For certain exceptions, see section 168(g)(3)(B). For nonresidential real property and residential rental property, divide the basis for depreciation by 40, and use the mid-month convention.

The alternative depreciation system must be used for the following: any tangible property used mostly outside the United States; any tax-exempt use property; any tax-exempt bond financed property; and any imported property covered by an Executive Order of the President of the United States.

You may also elect to use the straight-line method over the recovery period (instead of the class life), using the same conventions as discussed above. If elected, this method must also be used for all property in the same class that is placed in service during the tax year.

Caution: *Pending legislation would allow you to use 150% DB instead of 200% DB or straight line depreciation over the class life of the property for property other than residential rental or nonresidential real property.*

Line 8.—ACRS deduction for assets placed in service prior to 1987.—Unless you use an alternate percentage, multiply your basis for depreciation by the applicable percentage as follows:

3-year property-1st year (25%), 2nd year (38%), 3rd year (37%);

5-year property-1st year (15%), 2nd year (22%), 3rd through 5th year (21%);

10-year property-1st year (8%), 2nd year (14%), 3rd year (12%), 4th through 6th year (10%), 7th through 10th year (9%);

15-year public utility property-1st year (5%), 2nd year (10%), 3rd year (9%), 4th year (8%), 5th and 6th year (7%), 7th through 15th year (6%);

Low-income housing, 15-year, 18-year, and 19-year real property-Use the tables on page 4 of the instructions for 15-, 18-, and 19-year real property, and the table in Publication 534 for low-income housing.

If you elected an alternate percentage for any property listed above, use the straight-line method over the recovery period you chose in the prior year. See Publication 534 for more information.

The basis and amounts claimed for depreciation in prior years should be part of your permanent books and records. No attachment is necessary.

Note: *Certain taxpayers placing property in service in the current year are covered by transitional rules and should figure their depreciation using the rules for assets placed in service before 1/1/87. This includes property under a binding contract or under construction on March 1, 1986, and certain other transition property. These taxpayers must reduce their basis by the full investment credit. Use line 6, Part I, modifying the column (a) headings if necessary. See sections 203 and 204 of the Tax Reform Act of 1986, and Publication 534 for more information.*

Section C.—Other Depreciation.—Use Section C for property, other than automobiles and other listed property, you do not amortize, expense, or use ACRS to depreciate. This includes:

- Property placed in service before January 1, 1981;
- Certain public utility property, which does not meet certain normalization requirements;
- Certain property acquired from related persons;
- Property acquired in certain nonrecognition transactions; and
- Certain sound recordings, movies, and videotapes.

Line 9.—Report property that you elect, under section 168(f)(1), to depreciate by the units-of-production method or any other method not based on a term of years (other than the retirement-replacement-betterment method).

On a separate sheet, attach: (1) a description of the property and what depreciation method you elect that excludes the property from ACRS; and (2) the depreciable basis (cost or other basis reduced, if applicable, by salvage value, investment credit, and the section 179 expense).

Enter the depreciation deduction in column (f).

Line 10.—Enter the total amount of depreciation attributable to assets, other than automobiles and other listed property, acquired before January 1, 1981 (pre-ACRS), or property that cannot otherwise be depreciated under ACRS. This amount should be calculated from your permanent books and records. **No attachment is necessary.** For a sample worksheet, see Publication 534.

Include any amounts attributable to the Class Life Asset Depreciation Range (CLADR) system. If you previously elected the CLADR system, you must continue to use it to depreciate assets left in your vintage accounts. You must continue to meet recordkeeping requirements.

If you elect CLADR for assets that do not qualify for ACRS, attach a statement that specifies the items that still apply to those listed in Regulations section 1.167(a)-11(f)(2).

Line 12—New Section 263A Uniform Capitalization Rules.—Under the Tax Reform Act of 1986 many items that were deductible under prior law must now be capitalized. If you produce property for use in your business then you should fill in line 12. Otherwise leave it blank.

Part II.—Amortization

Each year you may elect to deduct part of certain capital expenses over a fixed period. If you amortize property, the part you amortize does not qualify for the election to expense recovery property or depreciation.

Line 1.—Complete line 1 only for property placed in service during your tax year beginning in 1987.

Column (a).—Describe the property you are amortizing. Amortizable property includes—

- Pollution control facilities (section 169, limited by section 291 for corporations).
- Bond premiums (section 171).
- Amounts paid for research or experiments (section 174).
- Business start-up expenditures (section 195).
- Qualified forestation and reforestation costs (section 194).
- Organizational expenses for a corporation (section 248) or partnership (section 709).
- Optional write-off of certain tax preferences over the period specified in section 59(e).

Note: *Generally you may no longer amortize trademark or trade name expenditures or railroad grading and tunnel bore expenditures made after December 31, 1986.*

Column (b).—Enter the date you acquired or completed the property or spent the amount you are amortizing.

Column (c).—Enter the total amount you are amortizing. See the applicable Code section for limits on the amortizable amount.

Column (d).—Enter the Code section under which you amortize the property.

Attach any other information the Code and Regulations may require in order to make a valid election. For additional information, see Publication 535.

Line 2.—Enter the amount of amortization attributable to property placed in service before 1987.

Part III.— Automobiles and Other Listed Property

All taxpayers claiming any type of deduction for automobiles and other listed property, regardless of the tax year such property was placed in service, must provide the information requested in Part III. Listed property includes, but is not limited to:

- Passenger automobiles weighing 6,000 pounds or less.
- Any other property used as a means of transportation if the nature of the property lends itself to personal use, such as motorcycles, pick-up trucks, etc.
- Any property of a type generally used for purposes of entertainment, recreation, or amusement (such as photographic, phonographic, communication, and video recording equipment).
- Computers or peripheral equipment.

Listed property does not include photographic, phonographic, communication, or video equipment used exclusively in a taxpayer's trade or business or regular business establishment. It does not include any computer or peripheral equipment used exclusively at a regular business establishment and owned or leased by the person operating such establishment.

Listed property does not include an ambulance, hearse, or a vehicle used for transporting persons or property for hire.

Section A.—Depreciation

Column (a).—List on a property-by-property basis all of your listed property in the following order:

(1) Automobiles and other vehicles ;
(2) Other listed property (computers and peripheral equipment, etc.);

In column (a), list the make and model of automobiles, and give a general description of listed property.

If you have more than five vehicles used 100% in your trade or business, you may group them by tax year. Otherwise, list all vehicles separately.

Column (b).—Enter the date the property was placed in service. This is the date you first start using the property for any purpose, whether personal or business.

Column (c).—Enter the percentage of business use. For automobiles and other "vehicles," this is determined by dividing the number of miles the vehicle is driven for purposes of a trade or business during the year by the total number of miles the vehicle is driven for any purpose. Treat vehicles used by employees (who are not more than 5% owners) as being used 100% in your trade or business if the value of personal use is included in the employees' gross income or the employees reimburse the employer for the personal use.

If the employer reports the amount of personal use of the vehicle in the employee's gross income, and withholds the appropriate taxes, for purposes of this form the employer is to enter "100%" for the percentage of business use. For more information see Publication 917. For listed property (such as computers or video equipment), allocate the use on a basis of the most appropriate unit of time the property is actually used. See Temp. Regs. 1.280F-6T.

If you have property that is used solely for personal use that is converted to business use during the tax year, figure the percent of business use only for the number of months the property is used in your business. Multiply that percentage by the number of months the property is used in your business, and divide the result by 12.

Column (d).—Enter the property's actual cost. For leased property, enter the lease payment for the year.

Column (e).— Multiply column (d) by the percentage in column (c). From that result, subtract any section 179 expense and one-half of investment credit taken before 1986 (unless you took the reduced credit). For automobiles and other listed property placed in service after 1985 (i.e., "transition property") reduce the depreciable basis by the entire investment credit.

Column (f).—Enter the method of figuring your depreciation deduction. If you are using the prescribed method explained on page 2, enter "PRE." If you elect an alternate percentage, or if the business percentage is 50% or less, enter "S/L."

Also, enter your recovery period. See the instructions to Part I, Section B, Column (d) for property used more than 50% in your trade or business. For listed property placed in service after 12/31/86, and used 50% or less in your trade or business, you must use the alternative depreciation system. Enter 5 years for automobiles and computers. If placed in service before 1/1/87, enter 5 years for automobiles and 12 years for computers.

Column (g).— If column (c) shows more than 50% use in a trade or business, multiply column (e) by the applicable percentages given in the instructions for Section B, Part I, line 8 for property placed in service before 1/1/87 or from Table 2(a) on page 4 for property placed in service after 12/31/86. Treat automobiles as 5-year property (3-year property if placed in service before 1/1/87) and computers as 5-year property.

If column (c) shows 50% or less use in a trade or business, and the property was placed in service after 12/31/86, figure column (g) by dividing column (e) by column (f) and using the same half-year or mid-quarter conventions as discussed on page 2 of the instructions. If placed in service before 1/1/87 and after June 18, 1984, multiply column (e) by 20% for automobiles and 9% for computers.

For property used 50% or less in a qualified trade or business, no section 179 expense deduction is allowed.

Enter zero, if the property placed in service before 1/1/87 was disposed of during the year.

Limitations for automobiles.—When calculating your depreciation plus section 179 expense deduction for automobiles for the first tax year in the recovery period, your deduction is limited to $2,560.

For succeeding tax years in the recovery period the deduction is limited to $6,000 if placed in service after June 18, 1984, but before January 1, 1985; $6,200 if placed in service after December 31, 1984, and before April 3, 1985; $4,800 if placed in service after April 2, 1985, and before January 1, 1987; and $4,100 for the second tax year in the recovery period if placed in service after December 31, 1986.

Note: *These limitations are further reduced when the percentage of business use (column (c)) is less than 100%. For example, if an automobile is placed in service in 1987 and is used 60 percent for business, then the first year depreciation plus section 179 expense deduction is limited to 60 percent of $2,560, which is $1,536.*

For leased automobiles, see Publication 917 and Temporary Regulations 1.280F-5T, for amounts to be included in gross income.

Column (h).—Enter the amount you choose to expense for property used more than 50% in a qualified business use (subject to limitations noted above).

Section B.—Information Regarding Use of Vehicles

The information requested in Questions 1 through 7 is to be completed for each vehicle identified in Section A.

Employees are to provide their employers with the information requested in Questions 1 through 7 for each automobile or vehicle provided for his or her use.

Employers providing more than five vehicles to their employees, who are not more than 5% owners or related persons, are not required to complete Questions 1 through 7 for such vehicles. Instead, they are to obtain this information from their employees, check "Yes" to Question 11, and retain the information received as part of their permanent records.

Section C.—Questions For Employers Who Provide Vehicles For Use By Employees

For employers providing vehicles to their employees, a written policy statement regarding the use of such vehicles, if initiated and kept by the employer, will relieve the employee of keeping a separate set of records for substantiation requirements.

There are two types of written policy statements that will satisfy the employer's substantiation requirements under section 274(d). The first type which prohibits personal use, including commuting, must meet the following conditions:

- The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business;
- When the vehicle is not used in the employer's trade or business, it is kept on the employer's business premises, unless it is temporarily located elsewhere, for example, for maintenance or because of a mechanical failure;
- No employee using the vehicle lives at the employer's business premises;
- No employee may use the vehicle for personal purposes, other than de minimis personal use (such as a stop for lunch between two business deliveries); and
- The employer reasonably believes that, other than de minimis use, no employee uses the vehicle for any personal purpose.

The second type prohibits personal use, except for commuting. This is NOT available if the employee using the vehicle for commuting is an officer, director, or 1% or more owner. This type of written policy statement must meet the following conditions:

- The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;
- For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle;
- The employer establishes a written policy under which the employee may not use the vehicle for personal purposes, other than commuting or de minimis personal use (such as a stop for a personal errand between a business delivery and the employee's home);
- The employer reasonably believes that, except for de minimis use, the employee does not use the vehicle for any personal purpose other than commuting; and
- The employer accounts for the commuting use by including an appropriate amount in the employee's gross income.

For both written policy statements there must be evidence that would enable the IRS to determine whether the use of the vehicle meets the conditions stated above.

An automobile is considered to have qualified demonstration use if the employer maintains a written policy statement prohibiting its use by individuals other than full-time automobile salesmen, prohibiting its use for personal vacation trips, prohibiting storage of personal possessions in the automobile, and limiting the total mileage outside the salesmen's normal working hours.

Table 1.—Property Placed in Service Before 1-1-87 (mid-month convention)

15-year real property.—Property placed in service 1/1/80–3/15/84.

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1st	12%	11%	10%	9%	8%	7%	6%	5%	4%	3%	2%	1%
2nd	10%	10%	11%	11%	11%	11%	11%	11%	11%	11%	11%	12%
3rd	9%	9%	9%	9%	10%	10%	10%	10%	10%	10%	10%	10%
4th	8%	8%	8%	8%	8%	8%	9%	9%	9%	9%	9%	9%
5th	7%	7%	7%	7%	7%	7%	8%	8%	8%	8%	8%	8%
6th	6%	6%	6%	6%	7%	7%	7%	7%	7%	7%	7%	7%
7th	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
8th	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%

18-year real property.—Property placed in service 3/16/84–5/8/85.

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1st	9%	9%	8%	7%	6%	5%	4%	4%	3%	2%	1%	0.4%
2nd	9%	9%	9%	9%	9%	9%	9%	9%	9%	10%	10%	10%
3rd	8%	8%	8%	8%	8%	8%	8%	8%	9%	9%	9%	9%
4th	7%	7%	7%	7%	7%	8%	8%	8%	8%	8%	8%	8%
5th	7%	7%	7%	7%	7%	7%	7%	7%	7%	7%	7%	7%

19-year real property.—Property placed in service 5/9/85–12/31/86.

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1st	8.8%	8.1%	7.3%	6.5%	5.8%	5.0%	4.2%	3.5%	2.7%	1.9%	1.1%	0.4%
2nd	8.4%	8.5%	8.5%	8.6%	8.7%	8.8%	8.8%	8.9%	9.0%	9.0%	9.1%	9.2%
3rd	7.6%	7.7%	7.7%	7.8%	7.9%	7.9%	8.0%	8.1%	8.1%	8.2%	8.3%	8.3%
4th	6.9%	7.0%	7.0%	7.1%	7.1%	7.2%	7.3%	7.3%	7.4%	7.4%	7.5%	7.6%

Property Placed in Service After 12-31-86

Table 2(a).—3-year, 5-year, 7-year, 10-year, 15-year, and 20-year property (Half-year convention)

Year	Depreciation rate for recovery period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
2	44.45%	32.00%	24.49%	18.00%	9.50%	7.219%
3	14.81%	19.20%	17.49%	14.40%	8.55%	6.677%

Table 2(b).—Residential Rental Property (27.5-year) (Mid-month convention)

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.455	0.152%
2	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636%
3	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636%

Table 2(c).—Nonresidential Real Property (31.5-year) (Mid-month convention)

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042	2.778	2.513	2.249	1.984	1.720	1.455	1.190	0.926	0.661	0.397	0.132%
2	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175%
3	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175%

Form **4626**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax—Corporations (including environmental tax)

▶ See separate instructions.
▶ Attach to Forms 1120, 1120-A, etc.

OMB No. 1545-0175

1987

Name as shown on tax return

Employer identification number

1	Taxable income before net operating loss deduction		1
2	**Adjustments:** (see instructions)		
a	Depreciation of property placed in service after 1986	2a	
b	Mining exploration and development costs paid or incurred after 1986	2b	
c	Long-term contracts entered into after 2/28/86	2c	
d	Pollution control facilities placed in service after 1986	2d	
e	Installment sales of certain property	2e	
f	Circulation expenses (personal holding companies only)	2f	
g	Merchant marine capital construction funds	2g	
h	Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only)	2h	
i	Basis adjustment	2i	
j	Certain loss limitations	2j	
k	Tax shelter farm loss (personal service corporations only)	2k	
l	Passive activity loss (closely held corporations and personal service corporations only)	2l	
m	Total adjustments (combine lines 2(a) through 2(l))		2m
3	**Tax preference items:**		
a	Accelerated depreciation of real property placed in service before 1987	3a	
b	Accelerated depreciation of leased personal property placed in service before 1987 (personal holding companies only)	3b	
c	Amortization of certified pollution control facilities placed in service before 1987	3c	
d	Appreciated property charitable deduction	3d	
e	Tax-exempt interest from private activity bonds issued after August 7, 1986	3e	
f	Intangible drilling costs	3f	
g	Depletion	3g	
h	Reserves for losses on bad debts of financial institutions	3h	
i	Total tax preference items (add lines 3(a) through 3(h))		3i
4	Combine lines 1, 2(m), and 3(i)		4
5	Adjusted net book income of corporation	5	
6	If line 5 is more than line 4, enter difference; otherwise enter zero	6	
7	Multiply line 6 by 50% (.5)		7
8	Add line 4 and line 7		8
9	Alternative tax net operating loss deduction. (Do not enter more than 90% of line 8.)		9
10	Alternative minimum taxable income (subtract line 9 from line 8)		10
11	Enter $40,000 (Controlled corporations, see instructions.)		11
12	Enter $150,000 (Controlled corporations, see instructions.)		12
13	Subtract line 12 from line 10. If zero or less, enter zero		13
14	Multiply line 13 by 25% (.25)		14
15	Exemption. Subtract line 14 from line 11. If zero or less, enter zero		15
16	Subtract line 15 from line 10. If zero or less, enter zero		16
17	Multiply line 16 by 20% (.2)		17
18	Alternative minimum tax foreign tax credit		18
19	Tentative minimum tax (subtract line 18 from line 17)		19
20	Income tax before credits minus foreign tax credit		20
21	Alternative minimum tax (subtract line 20 from line 19). Enter on your tax return on the line identified as alternative minimum tax		21
22	Environmental tax (subtract $2,000,000 from line 8, and multiply the result, if any, by .12% (.0012)). Enter on your tax return on the line identified as environmental tax (Controlled corporations, see instructions.)		22

For Paperwork Reduction Act, see separate instructions.

Form **4626** (1987)

1987

Department of the Treasury
Internal Revenue Service

Instructions for Form 4626

Alternative Minimum Tax—Corporations

(Section references are to the Internal Revenue Code.)

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Changes You Should Note.—The Tax Reform Act of 1986 created an alternative minimum tax for corporations, similar to the one for individuals. This alternative minimum tax replaces the minimum tax.

Who Must File.—File this form if your taxable income plus your adjustments and tax preference items total more than $40,000. For more information, see **Publication 542,** Tax Information on Corporations.

Environmental Tax.—Figure your environmental tax as follows:

Step 1: Complete your tax return without the environmental tax deduction, through Taxable income before NOL deduction. (Form 1120, line 28 minus line 29b)

Step 2: Using the result in step 1, complete Form 4626 through line 8, skip lines 9 through 21, and figure your environmental tax on line 22.

Step 3: Using the result in step 2, complete your tax return through Taxable income before NOL deduction. Then figure your alternative minimum tax on Form 4626, by completing lines 1 through 21.

Short Period Return.—If this is a short period return, use the formula in section 443(d) to determine your alternative minimum taxable income and alternative minimum tax.

Puerto Rico and Possession Tax Credit.—If the corporation is allowed a credit under section 936, alternative minimum taxable income does not include taxable income from sources outside the United States from an active trade or business in a possession of the U.S., and qualified possession source investment income referred to in section 936.

Regulated investment companies, real estate investment trusts, and common trust funds, see section 59(d).

Beneficiaries of estates and trusts.—If the corporation is a beneficiary, enter the difference between the distribution included in income for purposes of the regular tax and the amount included on Schedule K-1 (Form 1041), line 7. Include in the total on Form 4626, line 2(m).

Line-by-Line Instructions

Line 1.—Enter your taxable income before net operating loss deduction. For example, Form 1120 filers, this is line 28 minus line 29(b).

Line 2a—Depreciation of property placed in service after 1986, or after 7/31/86 if election was made.—Refigure your depreciation as follows: For property other than real property and property on which the straight line method was used, use the 150% declining balance method, switching to straight line for the 1st tax year when that method gives a better result. Use the class life (instead of the recovery period) and the same conventions as you used on Form 4562. See **Publication 534,** Depreciation, for class lives. For personal property having no class life, use 12 years. For residential rental and nonresidential real property, use the straight line method over 40 years. Determine your depreciation adjustment by subtracting your recomputed depreciation from the depreciation you took on Form 4562. Enter the difference on line 2(a).

Note: *If depreciation is included in your inventory, refigure the inventory based on the depreciation adjustment discussed above.*

Line 2b—Mining exploration and development costs paid or incurred after 1986.—With respect to each mine or other natural deposit (other than an oil, gas, or geothermal well) refigure your expenses (before the 30% reduction under section 291(b)) by amortizing them over ten years beginning with the year in which the expenses were made. Figure your adjustment by subtracting the refigured amount from the deduction you took under section 616(a) or 617(a) after the 30% reduction. If you had a loss with respect to those expenses, see section 56(a)(2)(B).

Line 2c.—If you entered into a long-term contract after 2/28/86, determine your taxable income from such contract under the percentage of completion method of accounting as modified by section 460(b), and using your alternative minimum tax adjustments and tax preference items. Determine the difference between that result and the result you got on the contract when figuring your regular tax, and enter the difference on this line. If the refigured taxable income is less than the result when determining your regular tax, enter the difference as a negative amount.

Line 2d.—For any certified pollution control facility placed in service after 1986, figure your entry for this line in the same manner you figured line 2(a) without reducing your basis by 20% under section 291(a)(5), but use the straight line method of depreciation instead of 150% declining balance..

Line 2e—Installment sales of certain property.—In the case of any disposition after 3/1/86 of property which is inventory or stock in trade, or other disposition if an obligation arising from such disposition would be an applicable installment obligation under section 453C, determine the income from such disposition without using the installment method. Include a sale of rental property after 8/16/86 with a combined sales price of more than $150,000 from one sale. Your adjustment will be the difference between this result and the result you obtained when figuring your regular tax. If this result is less than the result you obtained when figuring your regular tax, enter the difference as a negative amount. This adjustment does not apply to property for which you made an election under section 453C(e)(4).

Line 2f—*Personal holding companies only.*—For circulation expenses paid or incurred after 1986, refigure your deduction by amortizing such expenses over three years beginning with the year the expenses were made. Figure your adjustment by subtracting this refigured amount from the deduction you took under section 173. Enter the difference on line 2(f). If you had a loss with respect to those expenses, see section 56(b)(2)(B).

Line 2g.—In the case of a capital construction fund established under section 607 of the Merchant Marine Act of 1936, section 7518(c)(1)(A), (B), and (C) will not apply to any amount deposited in such fund after 1986 or any earnings on amounts in such fund after 1986. In addition, no reduction in basis should be made under section 7518(f) with respect to the withdrawal from the fund of any amount described in the preceding sentence.

Line 2h.—The section 833(b) deduction is not allowed.

Line 2i.—Basis adjustment.—If you disposed of property during the year, refigure your gain or loss from such sale taking into consideration your alternative minimum tax adjustments on lines 2(a), (b), (d), and (f). Enter the difference between the gain or loss reported on your tax return for purposes of the regular tax and your recomputed gain or loss. If the recomputed gain is less, or the loss is more, enter the difference as a negative amount.

Line 2j—Certain loss limitations.—Refigure your allowable losses from at-risk activities and basis limitations applicable to partnerships, taking into account your alternative minimum tax adjustments and tax preference items. See sections 59(h), 465, and 704(d). Enter the difference between the loss reported on your tax return for purposes of the regular tax and your recomputed loss, as a negative amount on line 2(j) if the recomputed loss is more than the loss reported for purposes of the regular tax.

Line 2k.—*Personal service corporations only,* figure the amount of any disallowed loss from a tax shelter farm activity as defined in section 464(c) and any other farm activity which is a passive activity under section 469(d). Enter on this line the difference between the amount of such disallowed losses and the amount of losses from these activities which are disallowed for regular tax purposes, such as under the passive activity loss rules. In figuring the amount of the loss, take into consideration your alternative minimum tax adjustments and tax preference items. Any loss entered on this line shall be treated as a deduction allocable to such activity in the first succeeding year.

Line 2l.—*Closely held corporations and personal service corporations only,* refigure your allowable passive activity loss taking into consideration your alternative minimum tax adjustments and your tax preference items from passive activities. Refigure this loss on Form 8582, but do not complete lines 10 through 15, relating to the phase in of the disallowance. Enter on line 2(l) the difference between your recomputed loss and the loss obtained when figuring your regular tax. If the recomputed allowable loss is more than the allowable loss for purposes of the regular tax, enter as a negative amount. For purposes of this line, do not take into consideration any losses from tax shelter farm activities.

Note: *If you are insolvent at the end of the tax year, reduce (but not below zero) lines 2(k) and 2(l) by that amount. Insolvent means the excess of liabilities over fair market value of assets.*

Line 3a—Accelerated depreciation of real property placed in service before 1987.— Enter on this line (never less than zero) the difference between the depreciation taken for this property in determining the regular tax and depreciation as refigured using the straight line method. Figure this amount separately for each property. For 15, 18, or 19-year real property, or low income housing, use the straight line method over 15, 18, or 19 years, using the half-year convention and no salvage value.

Line 3b—Accelerated depreciation of leased personal property placed in service before 1987 (or before 8/1/86 if election was made).—*Personal holding companies only,* for leased personal property, other than recovery property, enter the difference (never less than zero) between the depreciation taken for this property in determining your regular tax and depreciation as refigured using the straight line method. Figure this amount separately for each property.

For leased recovery property, other than 15, 18, or 19-year real property, or low income housing, enter the amount by which your depreciation deduction determined for your regular tax is more than the deduction allowable using the straight line method, with a half-year convention, no salvage value, and the following recovery period: 3-year property (5 years), 5-year property (8 years), 10-year property (15 years), and 15-year public utility property (22 years).

Note: *If the recovery period actually used is longer than the recovery period in 3(a) or 3(b), do not complete those lines with respect to that recovery property.*

Line 3c.—For any certified pollution control facility placed in service before 1987 (or before 8/1/86 if election was made), enter the amount by which the amortization allowable under section 169 is more than the depreciation deduction otherwise allowable. Before figuring this tax preference item, reduce the amortizable basis by 20%. Include only 59 $^{5}/_{6}$% (71.6% if placed in service in 1983 or 1984; 100% before 1983) as a tax preference item.

Line 3d—Appreciated property charitable deduction.—Enter the amount by which your contribution deduction for capital gain and section 1231 property would be reduced if such property was taken into account at its cost or other basis, rather than fair market value. Do not include property for which you made an election under section 170(b)(1)(c)(iii).

Line 3e—Tax-exempt interest.—Enter your interest on private activity bonds issued after August 7, 1986, reduced by any deduction attributable to it. Private activity bonds are bonds where more than 10% of the proceeds are to be used for any private business use and the private security or payment test of section 141(b)(2) is met. A bond is also considered a private activity bond if it meets the private loan financing test of section 141(c). See section 57(a)(5) for more information.

Line 3f—Intangible drilling costs.—Enter the amount by which your excess intangible drilling costs are more than 65% of your net income from oil, gas, and geothermal properties.

Figure excess intangible drilling costs as follows: From the intangible drilling and development costs allowable under section 263(c) or 291(b) (except costs in drilling a nonproductive well), subtract the amount that would have been allowable if you had capitalized these costs and either amortized them over the 120 months that started when production began, or treated them according to any election you made under section 57(b)(2).

Your net income from oil, gas, and geothermal properties is your gross income from them, minus the deductions allocable to them, except for excess intangible drilling costs and nonproductive well costs.

Figure the line 3f amount separately for oil and gas properties which are not geothermal deposits and for oil and gas properties which are geothermal deposits.

Line 3g—Depletion.—In the case of mines, wells, and other natural deposits, enter the amount by which your deduction for depletion under section 611 is more than the adjusted basis of the property at the end of your tax year. Figure the adjusted basis without regard to the depletion deduction and figure the excess separately for each property. See section 291(a)(2) for reduction in amount allowable as a deduction in the case of iron ore and coal.

Line 3h—Reserves for losses on bad debts of financial institutions.—In the case of a financial institution, enter the excess of the deduction allowable (after reducing by 20% under section 291(a)(3)) for a reasonable addition to a reserve for bad debts over the amount that would have been allowable had the institution maintained its bad debt reserve for all tax years based on actual experience.

Line 5—Adjusted net book income of corporation.—This is the net income or loss of the corporation as set forth on the applicable financial statement as defined in section 56(f)(3), disregarding any Federal income taxes, and foreign income taxes if a foreign tax credit is claimed. See section 56(f)(2) for adjustments for related corporations, statements covering different periods, cooperatives, dividends from 936 corporations, Alaska native corporations, and omission or duplication of any item. This line does not apply to an S corporation, regulated investment company, real estate investment trust, or REMIC. See regulation section 1.56-1T for more information.

Line 9—Alternative tax net operating loss deduction.—For 1987, this will be your net operating loss deduction. However, if the minimum tax was deferred in a prior year, reduce your net operating loss carryovers to this year by your tax preference items for the year the tax was deferred.

Lines 11 and 12.—Controlled corporations should see section 1561 for a limitation on the alternative minimum tax exemption.

Line 18—Alternative minimum tax foreign tax credit.—This is your foreign tax credit with the following adjustments:

(a) Using Form 1118, substitute alternative minimum taxable income from sources outside the United States for taxable income from sources outside the United States.

In figuring alternative minimum taxable income from sources outside the United States, use your taxable income, adjustments, and tax preference items from those sources.

(b) Your alternative minimum tax foreign tax credit cannot be more than the amount on Form 4626, line 17 less 10% of the amount that would be on that line if Form 4626 was refigured using zero on line 9.

Line 19.—If the corporation has an investment credit attributable to the regular percentage under section 46(a)(1), see section 38(c)(3) for limitation on the credit allowed against the tentative minimum tax.

Line 20.—Form 1120 filers, Schedule J (Form 1120), line 3 less line 4(a). Do not include any section 667(b) tax (Form 4970) on line 20.

Line 22.—Controlled corporations should see section 1561 for a limitation on the environmental tax exemption.

Note: *At the time this form was developed, Congress was considering legislation to allow the Possessions Tax Credit to be subtracted from regular tax in determining the alternative minimum tax.*

APPENDIX 4

SPECIFIC COUNTERS TO DTI ARGUMENTS FOR AUDIT ABOLITION

1. Audit is one of many statutory requirements which cumulatively represent a substantial burden on business. If freed from the mandatory audit requirement many companies would choose other more relevant services from the profession.

- Company law, of which audit is a part, was identified as thirteenth out of eighteen burdens in the DTI's 1985 report "Burdens on Business". It is thus not perceived as a major burden and, indeed, was discussed in that report under the heading "The least frequent burden on small firms". The proposal for an independent compilation report would lighten this slight burden further. We are not aware of any evidence to show that small companies would use other accounting services to a greater extent if freed from the audit burden, and this was also the view of the majority of respondents to the 1985 DTI consultations. Indeed if the mandatory association with an independent professional were relaxed, some companies might use the services less.

2. Statutory audit of small company accounts is not a requirement of EC law. Our failure to take up existing derogations may weaken our position when we seek to oppose further burdensome company law proposals.

- The introduction of a compilation report in place of the audit for small companies will take advantage of the permitted derogations under the Fourth Company Law Directive..

3. The UK is one of the few major trading nations to impose a statutory audit on small companies.

- Most other countries have never had a mandatory audit requirement and the general business climate has developed accordingly; in the UK there has been the experience and expectation of universal company audit for a long time. To replace a long standing system with one based on voluntary compliance could create a dangerous vacuum in which credibility could be strained and malpractice could thrive. [Australia is one country which has recently relaxed the universal audit requirement and although it has recently announced an increase in funding for tax audits, it is not thought that this is connected to the abolition of the statutory audit.]

- Regulation for tax purposes is greater in most countries which do not have a mandatory audit than is the case in the UK.

4. If those dealing with a company require an audit, it is a matter for their commercial judgement.

- Many small companies do not know in advance who they may wish to deal with and whether those third parties will require an independent view on their accounts. Audits are always difficult and sometimes impossible to carry out when not planned properly in advance. If companies are not obliged to maintain accounts which are credible to third parties, they may be unable to enter into business relationships as they wish.

5. Abolition of the audit requirement will not relieve companies and their directors from the requirement to produce accounts showing a true and fair view. An additional declaration will be required from directors that accounts have been properly drawn up.

- In the absence of independent professional involvement, the major enforcement against fraud and error in the preparation of accounts will be lost. The additional declaration is merely an explicit statement of directors' existing responsibilities and is likely to add little to the credibility of accounts.

6. The abolition of the audit requirement will reduce company costs. These costs are likely to increase with the increase in regulation of auditors by the EC.

- A properly constructed framework for preparing compilation reports should also result in cost savings for companies. Since the proposed compilation report is not an audit, the possible increase in audit costs brought about by EC requirements should be avoided.

- The evidence of the 1985 DTI consultation showed that audit costs typically represent 10-20% of the total accountancy bill for small companies and possibly even less where the auditor also prepares the accounts.

7. The small business lobby now generally favours the abolition of the statutory audit.

- The seven bodies mentioned in Lord Young's note reached a collective (not individual) decision on the audit abolition proposed. Their views at the time of the 1985 consultation were mixed.

- No widescale consultation exercise has been carried out since 1986. We are not aware of any evidence to suggest that the majority of those opposing abolition at that time have subsequently changed their views.

CONFI

PARKINSON → PM 27/9

CH/EXCHEQUER
REC. 27 SEP 1988
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Prime Minister

STATUTORY AUDIT OF SMALL COMPANIES ACCOUNTS

I have seen David Young's minute of 19 September and Nigel Lawson's of 23 September, which are to be discussed at E(A) later this week.

I fully agree with David Young's drive to reduce the regulatory burden on small companies but I believe that in this case the benefit they receive may be more theoretical than real. I strongly suspect, for example, that the Inland Revenue are likely in practice to require rather more of the company than a document certified by the Directors alone. I also suspect that a very large proportion of such companies will have to produce independently authorised information for their bankers and, possibly, other major creditors. I am therefore in favour of the Chancellor's proposal that we should introduce an independently prepared and obiligatory compilation report in place of the statutory audit.

I am copying this to members of E(A).

C. P.

SECRETARY OF STATE FOR ENERGY

27 September 1988

CHEX → PM 23/9

chex.md/mw/29

CONFIDENTIAL

Br 28/9

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

STATUTORY AUDIT OF SMALL COMPANIES ACCOUNTS

In his minute of 19 September David Young proposes the abolition of the statutory audit for small companies. I can agree to this only if the present requirement is replaced by an obligatory compilation report, prepared by an independent, properly qualified accountant.

2. This is not the first time this issue has been raised. David Young, Paul Channon and I examined it fully in May 1986. We then concluded that the statutory audit should be retained because of its valuable role as a safeguard against fraud. The subsequent deregulation White Paper "Building Business..not Barriers" made this clear:

> "The Government have decided to retain the requirement for small companies to have their accounts audited. The consultation revealed no strong balance of opinion in favour of abolition. The Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate"

3. The only new factor to have emerged since then is the new EC requirements for monitoring auditors, which will be reflected in the forthcoming Companies Bill. As a result, audit standards will be tightened up and the cost of the statutory audit is likely to increase. I accept that, in these circumstances, it is right to try and find a less costly arrangement for small companies. But this in no way removes the need to involve an independent accountant in scrutinising the accounts of companies with a turnover of under £2 million, and to maintain our defences against

financial fraud. My suggestion of a compilation report signed by an independent accountant would achieve just this. It would provide a worthwhile measure of deregulation while maintaining a defence against fraud by directors of small companies. It would also help to maintain the financial credibility of the small company sector in the eyes of the public and in particular the business community which has always relied on audited accounts as evidence of the bona fides of small companies.

4. We simply cannot afford to rely on an in-house accountant's adherence to his code of professional ethics, when his livelihood depends on his doing what his directors instruct him to do. There is already concern in the profession that accountants who work in small companies are coming under pressure from their employers to act in unethical ways in relation to their duties. Removal of the obligation to have at least some independent involvement in small companies' accounting must increase such pressures further. Recent cases have served only to underline the importance of this issue.

5. We also need to recognise the risk to the Exchequer from David's proposal. The total yield of tax from small companies, including directors' PAYE and NIC, is £10 billion. The abolition of the audit will undoubtedly reduce the reliability of accounts. Every 1 per cent reduction in their reliability could result in a loss to the Exchequer of £100 million - and American experience suggests that the loss could be as high as 5 per cent overall. We can only keep this loss within reasonable bounds if we have an effective replacement.

6. It is true, as David says, that most other countries do not have a statutory audit for small companies. But this does not mean that regulation overseas is any less. Tax returns are very much more complicated; tax authorities employ more staff on investigating companies and are given greater and more intrusive

powers. For example the United States, where there is no statutory audit, undertakes twice as many tax audits of companies using twice as many staff - and their tax return is between 5 and 10 times as long. Even if we wanted to shift some of the private sector auditing effort on to the Inland Revenue in this way, we would not be able to find the extra Civil Servants we would need.

7. In short, provided we replace the statutory audit for small companies with a compilation report signed by an independent professional accountant, I can agree with David that the limit should be set as high as the EC directive allows, ie £2 million, which would benefit 95 per cent of all companies.

8. I am copying this note to David Young and Norman Fowler, to other E(A) members and to Sir Robin Butler.

Moir Wallace

pp N.L.
23 September 1988

Approved by the Chancellor and signed in his absence

L YOUNG → PM 19/9

dti

the department for Enterprise

CH/EXCHEQUER

REC.	19SEP1988
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19/9

CH/ There is not, as far as I am aware, any diary problem with X – so I'm afraid it looks like E(A) first thing day after you return from Berlin. Sorry!

PRIME MINISTER

STATUTORY AUDIT OF SMALL COMPANIES ACCOUNTS

I have looked again at the case for abolition of the statutory audit of small companies accounts in the context of the deregulation initiative. I remain strongly of the view that the requirement should be abolished. Treasury colleagues now agree that abolition is acceptable, but wish to see an alternative requirement put in place which, in my view, would reimpose the burden of audit under another name. The position is set out in the attached note. nipw.

E(A) is obviously the appropriate forum to resolve this issue. But if we cannot arrange discussion at an E(A) meeting where those mainly concerned are present, I believe that the issue could be resolved at a meeting chaired by you. The colleagues most concerned are Nigel Lawson and Norman Fowler.

We need to take an early decision in order to report the outcome in our forthcoming deregulation White Paper and, if legislative change is agreed, to include this in the Companies Bill at its introduction.

I am copying this minute and my note to Nigel Lawson and Norman Fowler, to E(A) Members and to Sir Robin Butler.

N.R.T.

pp DY

19 September 1988

DEPARTMENT OF TRADE AND INDUSTRY

the Enterprise initiative

LQ5AHW

chex.ps/aa/24 **MANAGEMENT IN CONFIDENCE**

FROM: A C S ALLAN
DATE: 24 November 1988

SIR A WILSON

cc **PS/Chief Secretary**
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Beastall

EXTERNAL AUDITORS OF THE NATIONAL AUDIT OFFICE

The Chancellor was grateful for your minute of 21 November, and noted that you will be discussing with the PAC the representation for the external audit of the National Audit Office.

A C S ALLAN

STATUTORY AUDIT OF SMALL COMPANIES ACCOUNTS
NOTE BY THE SECRETARY OF STATE FOR TRADE AND INDUSTRY

INTRODUCTION

1. We have previously discussed the issue of abolition of statutory audit of small company accounts in the context of the deregulation initiative. At that time colleagues felt, on balance, that statutory audit should be maintained as a first defence against fraud.

2. I have looked again at the case for abolition with Treasury colleagues in the light of my responsibilities for corporate affairs. I remain of the view that the imposition of statutory audit of small companies is an unnecessary burden upon them. Treasury colleagues now also agree that this is a burden which can be removed. There remain differences between us as to whether or how it should be replaced with an alternative requirement; and so I have brought the issue before colleagues for resolution. We need to take a decision swiftly in order to bring forward any agreed changes in the Companies Bill to be introduced this Autumn.

3. The basic issues for colleagues can be set out as follows:-

i) Should we abolish the statutory requirement for small company accounts to be audited?

I believe that the statutory audit requirements should be abolished for small companies (using the EC definition of companies with a turnover of up to £2m) and that no alternative requirement should be put in its place. I accept that in these circumstances directors of a company opting out should be required to sign a statement taking responsibility for the accounts and certifying subsequent tax computations.

Those companies wishing to opt out of audit would need the unanimous agreement of their shareholders. Those companies which did not wish to opt out or whose shareholders did not wish this, would have audited accounts as now. Financial Services companies would not be able to opt out; special requirements for these companies already exist under the Financial Services Act.

ii) If we abolish the statutory audit requirement, should anything be put in its place?

I do not believe that we should put in place an alternative requirement which will, inevitably, require new bureaucratic processes and create new problems of definition. The Treasury believe that an alternative requirement should be imposed with a view to protecting the Exchequer from any

potential loss of revenue. The Financial Secretary to the Treasury and Parliamentary Under Secretary of State for Corporate Affairs have discussed a range of suggestions for a less burdensome alternative to audit and reached some common ground. In such a case a small company would either:

- have their accounts audited as now

or

- have a compilation report prepared to accompany their accounts.

A compilation report would be a statement by a competent person (defined as any form of accountancy or related qualification which the Secretary of State DTI recognises as conferring the necessary level of competence) that the accounts have been prepared from and reflect the records and information supplied by the management, and conform to the layout and content requirements of the Companies Act.

The issue remains whether the competent person need be independent of the company, and whether any review of or assurance on the accounts need to given.

iii) If a compilation report is agreed, should this require the involvement of an independent professional accountant?

I believe that a company opting for a compilation report should be able to have the report prepared and signed by anyone competent to do so whether an in-house accountant if the company employs someone with such expertise, or an outside accountant if they do not. Treasury colleagues argue that some form of attestation of the accounts by an independent professional is essential. Such a requirement, in my view, simply replaces one burden with another which will impose costly professional fees.

4. I invite colleagues to agree that the statutory requirement for the accounts of small companies to be audited be abolished. This should be done either:

- outright with no alternative requirement. This is my recommendation

or

- with a compilation report replacement which can be signed by any competent person, whether or not independent of the company.

MN5ACJ

5. Audit is one among many statutory requirements which cumulatively represent a substantial burden on small companies. Removal of the audit requirement is not a panacea on its own - it needs to be accompanied by a range of other reforms. Audit is, however, an expensive professional service and would be much better entered into - as many companies would undoubtedly choose - voluntarily, as a commercial decision. Many small companies may, in place of audit, choose to make greater use of other more relevant services from the accountancy profession.

6. Statutory audit of small company accounts is not a requirement of EC law; the 4th Company Law Directive already provides a derogation for this purpose. The UK is seeking further exemptions from the 4th Directive for small companies. The EC (including the Small and Medium Enterprises Task Force set up following the Prime Minister's initiative on deregulation) is, not surprisingly, unconvinced by an approach which seeks reform while retaining a requirement which can be dispensed with. There is no doubt that our failure to take up existing derogations weakens our negotiating position when we seek to oppose the further burdensome company law proposals flowing from the Commission.

7. The UK is one of the few major trading nations to impose a statutory audit at all, let alone on small companies. The USA, Japan, Canada, West Germany and Australia do not.

8. There are many reasons why small companies need to maintain adequate accounting and management information systems, for example, to meet statutory accounting disclosure requirements, for business planning, seeking finance, chasing for payment, assessing VAT and other tax liabilities. If those who deal with the company require an audit (as banks may, if that is part of their appraisal system) that should be a matter for their commercial judgement, and the company would be undertaking an audit voluntarily, in its own commercial interest.

9. Abolition of statutory audit does <u>not</u> dispense with the requirement to produce accounts giving a <u>true and fair view</u>. The directors of a company will still be responsible for maintaining proper accounting records and preparing accounts in accordance with the law. In addition, I have agreed that there should be an <u>additional</u> declaration by directors (see paragraph 3).

10. Cost savings have been identified, if statutory audit were abolished, for those companies which choose to take advantage and opt out. Cost savings will vary according to the size/standing of accountancy practice used and the complexity of a company's affairs but might be in the range

of £2000 for the "larger small company". The EC is likely to toughen the regulation of auditors which could, in future, lead to greater costs to companies obliged to have an audit.

11. The small business lobby now generally favours the abolition of statutory audit. This includes the Institute of Directors, Association of British Chambers of Commerce, National Chamber of Trade, Forum of Private Business, National Federation of Self-Employed, Union of Independent Companies and Association of Independent Businesses. In addition, several of the accountancy bodies, including the Institute of Chartered Accountants of England and Wales, also urge abolition.

dti

the department for Enterprise

As regards classes of company, I agree your points. Other than the financial services sector to which the FSA applies and any special considerations for incorporated charities (on which we shall need to involve the Home Office), the option to dispense with audit should be available to all companies within the definition of small in the Companies Act. The level for this will continue to be the maximum level currently permitted by the fourth directive. There are no inmediate plans to alter this, and we will consult the Treasury about whether any increases which may be proposed should apply to the threshold for small company audit.

I am copying this letter to John Cope.

Yours sincerely

pp Andrew Hey

FRANCIS MAUDE

(Approved by the Minister and signed in his absence)

JCGAFC

the Enterprise

dti

the department for Enterprise

ECONOMIC SECRETARY
REC'D 02 SEP 1988

PPS/PS

The Hon. Francis Maude MP
Parliamentary Under Secretary of State for
Corporate Affairs

2 SEP 1988

CONFIDENTIAL
Peter Lilley Esq MP
Economic Secretary to the
Treasury
Parliament Street
LONDON
SW1P 3AG

Department of
Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

FINANCIAL SECRETARY
REC. 2 SEP 1988

Sir A. Wilson
PPS, CST, PMG, EST
Sir P. Middleton
Mr. Anson Mr. Monck
Mr. Scholar Mr. Burgner
Mrs. Lomax Mr. Culpin
Mr. Clapper Mr. Tyrie

MAUDE → EST 26/8

Direct line 215 4417
Our ref
Your ref
Date 26 August 1988

Dear Mr. Lilley,

STATUTORY AUDIT FOR SMALL COMPANIES

Thank you for your letter of 12 August. I am glad that we are much closer on an alternative to audit for small companies.

I would of course still prefer to abolish the statutory audit requirement outright and leave the development of any alternative statement to the market. But, as you know from my letter of 26 July, if we are to impose a compilation report I cannot agree that the reporting accountant must be independent of the client company. I will now put in hand the preparation of a paper for E(A) seeking approval for one of the options I can accept.

On the other points in your letter, I am content that we can reach agreement, with the possible exception of timing. I see no reason to wait until 1992 at the earliest to give companies the opportunity to opt out of audit. If directors are to be required explicitly to sign the company's tax returns, as the company secretary now does, there is clearly no need to wait for Pay and File to effect this.

I agree that DTI should lead on the form and content of the compilation report, liaising with your officials. It is entirely appropriate, as you say, for the Inland Revenue to discuss the form of certificates for tax purposes with Professional bodies.

I also agree that dispensing with audit should only be with the agreement of all shareholders.

cc: PS/IR
PS/C+E
Mr. Beighton IR.

the Enterprise

JCGAFC

53/2/cd/3773/044

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MR BURGNER MRS LOMAX
MR CULPIN MR BURR
MR MACPHERSON MR GRATELEY
MR INGLISS MR CALL
MR CROPPER MR TYRIE
IR - MR BELGHTON MR SHAW
C&E - MR FRYETT PS/CST
PS/IR.

Treasury Chambers, Parliament Street, SWIP 3AG

The Hon Francis Maude MP
Parliamentary Under-Secretary of State for Corporate Affairs
Department of Trade and Industry
1 Victoria Street
LONDON SW1

12 August 1988

Dear Minister,

STATUTORY AUDIT FOR SMALL COMPANIES

EST → MAUDE 12/8

Thank you for your letter of 26 July to Norman Lamont. I am replying in his absence. I am sorry that you feel the arrangements for independent compilation reports described in Norman Lamont's letter of 14 July as an alternative to audit for smaller companies would not yield worthwhile savings.

We are all agreed that an alternative to audit should not be turned into an audit by any other name, either by statutory requirements or by the accounting profession's implementation of them, and I see no difficulty in using a phrase such as "I report" or "I confirm" instead of "I certify". I also agree that we need to consider carefully the rest of the suggested wording for the compilation report with the benefit of legal advice to make sure that we don't reimpose an obligation for the independent accountant to undertake an audit-type evaluation. Nevertheless, we have to recognise that what we should be asking that accountant to sign would commit him to a judgement that certain requirements had been met without extending this to a confirmation of the accuracy of the figures themselves.

In relation to your second point I believe that there is really very little at issue between us. The present position is that a Company Secretary has to certify the accuracy of his company's tax returns, so that the only formal change proposed is that from a duty placed on a company secretary to one placed on its directors. As the company secretary is effectively the servant of the directors this cannot be an onerous change. There can be no question of moving to a situation where no-one would take responsibility for the accuracy of the tax returns and computations.

I agree with you that we should not leave the development of an appropriate form of words and guidance on procedures to be followed

when preparing a compilation report to the professional accountancy and legal bodies alone. It would be appropriate for the Inland Revenue to discuss the form of certificates for tax purposes with the representative professional bodies following on from their contacts in recent years in connection with Keith. The development of the scope and form of the Compilation Report would be an exercise where DTI should be in the lead, but I would expect a substantial input from the Treasury and the Revenue.

As regards timing, Norman said in his letter to you of 14 July that it would not be possible for the Revenue to administer the certification for tax until Pay and File is in place. Although a form of certification is at present required by law, it is rarely given properly by companies in practice, so reliance has to be placed on the auditor's certificate. This is one of the main weaknesses of the present tax system - one that Pay and File has been designed specifically to correct. It would leave the Revenue very exposed if the statutory audit requirement was removed before these new administrative controls were in place, and regrettably, that will not be until 1992 at the earliest.

You question which classes of company should be affected by the option to have a compilation report rather than an audit. Special requirements exist already for companies to which the Financial Services Act applies, and at some stage it may be necessary to consider the case of incorporated charities. But they would be dealt with if and when legislation comes forward. We have already agreed, I think, that agreement of all the holders of all classes of share capital should be obtained in order to dispense with the audit requirement, but before accepting that the threshold for the option should be the small company definition in the Companies Act, we need to know at what level you intend to set this in future.

Finally, I come to the most difficult outstanding issue between us - status of the accountant who may provide the compilation report. I agree that the competence of the individual could be defined by reference to his holding an appropriate professional accountancy qualification recognised by the Secretary of State.

His independence of the company on which he is reporting is, however, paramount in our view. You rightly say that many of the larger small companies will employ accountants who are well able competent to prepare accounts from them which meet Companies Act requirements. But despite that we cannot agree that an independent accountant's report would add little, if any, further reassurance to the Inland Revenue in such cases. In a nutshell it is too risky to rely on an in-house accountant's adherence to his code of professional ethics when his livelihood is going to depend on doing what his Directors ask him to do. There is also the important consideration of maintaining the financial credibility of the smaller company sector.

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In conclusion I repeat what Norman said in his letter to you of 14 July; his proposals give significantly less protection to the Exchequer and to the position of the Revenue Departments than audit now does, but on balance, as they stood they represented a risk we should be prepared to take. Removal from those proposals of the requirement that the reporting accountant should be independent of his client company accentuates the risk to an unacceptable extent. If you cannot agree, therefore, I am sure that the matter should go to E(A) for a decision.

Like you, I am copying this letter to John Cope in view of his responsibilities for small firms and his earlier interest in this matter.

Yours sincerely,

Guy Westhead

pp PETER LILLEY

(approved by the Minister and signed in his absence)

28 JUL 1988

dti
the department for Enterprise

The Hon. Francis Maude MP
Parliamentary Under Secretary of State for
Corporate Affairs

CONFIDENTIAL
The Rt Hon Norman Lamont MP
Financial Secretary
HM Treasury
Parliament Street
LONDON SW1

The FST will need to discuss (MISys) comments on this.

Department of
Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

FINANCIAL SECRETARY
REC. 28 JUL 1988
ACTION Sir A. Wilson
COPIES TO PS/Chancellor
Mr. Culpin Mr. Burn
Mr. Macpherson
Mr. Bradley Mr. Ingliss
Mr. Cropper Mr. Tyrie

Direct line 215 4417
Our ref
Your ref
Date 26 July 1988

Dear Norman,

STATUTORY AUDIT FOR SMALL COMPANIES

Thank you for your letter of 14 July. I am glad that you share my view that for many small companies there are services which accountants have to offer that are more productive than complying with the statutory audit requirement. I am pleased too that you see the compliance report which I suggested as a possible alternative to audit. However the arrangements, as described in your letter, are too far away from the kind of compilation report I proposed to give worthwhile savings for small companies in place of audit.

First, I am concerned that any report attached to the accounts should not be turned into audit by any other name. The use of the words "I certify that" risks doing just that. What we need is a statement; a certificate could be taken to imply a level of assurance which goes further than is intended. I would therefore want to omit any use of the word 'certify'. We also need to look carefully with the benefit of legal advice at the rest of the wording to ensure that by references such as "content ..... requirements of the Companies Act" we do not reimpose an obligation for the accountant to undertake an evaluation of the kind found in audit.

Secondly, I am concerned at your suggestion of a directors' statement certifying the accounts and tax computation. I would be prepared to see the directors' statement on the accounts themselves expressed in terms that make clear that the directors take responsibility for the accounts and other information supplied, which would include their use, as the basis of the tax computations. But in many cases it would be unreasonable to require non-tax experts to certify the

cc: Mr. Beighton
PS/C+E
PS/IR.

J05ELC

the Enterprise initiative

computation itself.

Thirdly, I do not think that we can simply leave it for the accountants and solicitors to develop the appropriate form of words and guidance on procedures etc. We must ourselves make clear what the nature of the statements by directors and by accountants should be: otherwise again there is a risk that parts of the profession may seek to reintroduce audit-type requirements, which would defeat the purpose.

Your letter mentions timing. Whatever is introduced will naturally take some time before it comes properly into effect, since it could only apply to accounting years which follow the legislation. I cannot see, however, that it need be delayed until Pay and File is introduced which, as you say, means 1992 at the earliest. This would simply make small companies suspect that we were relaxing nothing until we had something equally demanding to put in its place. I fear that this would rebound to the ultimate disadvantage of Pay and File, as well as dissipating any credit we stand to gain from abolition of audit. I would therefore want the new arrangements to be brought into effect once the relevant legislation - including any needed in a Finance Bill - were in place.

There is then a question of the classes of company to which this should apply. Other than for companies in the financial services sector, for which special requirements exist under the Financial Services Act, the abolition of statutory audit should apply to all companies which come within the small company definition under the Companies Act and trust that you can agree that.

This leaves what I suspect may be the most difficult issue and that is the status of the accountant who may provide the accountant's report. In many cases, perhaps especially the very small company without in-house accounting expertise, I would expect companies to continue to involve an outside accountant in some way in the preparation of their accounts, the submission of the tax computation etc. But I do not believe it would be right to require that in every case the accountant signing the report should be independent. Clearly the accountant needs to be the competent, which could be defined by reference to holding of any appropriate qualification (as defined by the Secretary of State) Many of the larger small companies, however - for whom, as you rightly say, the benefits of our proposals could be significant - will themselves employ an accountant, well able to ensure that proper records of account are maintained and well able to prepare accounts to meet Companies Act and tax requirements. To require an independent accountant's report in these cases would sacrifice most of the benefit of the proposal to no good

purpose. Without an audit, the provision of an independent accountant's report on the lines suggested in your letter would add little, if any, further reassurance for the Inland Revenue in cases where the accounts themselves had been prepared by a competent accountant: but it would add to the costs of the company. I cannot therefore agree to your suggestion that we require independence.

I hope you are able to agree these changes to your proposal. If not, then I fear that we shall still need to take this matter to E(A) for a decision.

I am copying this letter to John Cope in view of his responsibilities for small firms and his earlier interest in this matter.

FRANCIS MAUDE

41/2915

CONFIDENTIAL

cc: PS/Chancellor,
Sir P. Middleton,
Sir A. Wilson,
Mr Culpin, Mr Burr
Mr MacPherson,
Mr Bradley, Mr Inglis,
Mr Cropper, Mr Tyrie,
Mr Beighton IR,
Mr Shaw IR, PS/IR,
Mr Fryatt C+E, PS/C+E.

Treasury Chambers, Parliament Street, SW1P 3AG

The Hon Francis Maude
Parliamentary Under Secretary of State
Department of Trade and Industry
1 Victoria Street
London SW1H OET

14 July 1988

Dear Minister,

STATUTORY AUDIT FOR SMALL COMPANIES

When we last discussed statutory audit for small companies I said that I would write to you about your proposals for a compilation report as an optional alternative.

We have always believed that an independent professionally qualified accountant should be involved in some form of accounts attestation in order to protect the Exchequer from a potentially serious loss of tax revenue. I do, however, share your desire to reduce the burden on small businesses wherever this can be done safely, and broadly agree with your proposals for a compilation report, provided it is signed by an independent professionally qualified accountant.

I suggest that the compilation report should be viewed in the overall context of the accounts and tax returns. If the role of the independent accountant is to be significantly reduced it is very important that the directors are made fully aware of their responsibilities. I propose, therefore, that we consider the compilation report by an independent accountant and reports by the directors on both the accounts and the tax returns together. The pattern of reports would therefore be as follows:-

Accounts

(i) Directors' statement

(ii) Independent accountants' report

Tax return

(iii) Directors' statement.

The general terms in which these might be expressed are discussed below. I would emphasise that neither of the proposed directors' reports poses any additional burden. They are no more than explicit confirmation of matters for which the directors are already responsible, but in the absence of an audit report the mere signature of the accounts by the directors would not communicate anything to the user about what they purport to be. However, they would have a desirable "demonstration effect", bringing home to businessmen their statutory duties.

Accounts - Directors' Statement

The directors of a company would sign a statement to confirm the following:-

(i) that the company has kept proper accounting records throughout the period covered by the accounts in accordance with S.221 of the Companies Act 1985;

(ii) that the accounts have been properly prepared from these records in accordance with the requirements of the Companies Act 1985;

(iii) that the accounts show a true and fair view of the financial position and results for the accounting period.

Such a statement would, as far as possible, be expressed in layman's terms to bring home to directors their existing responsibilities for record keeping and accounts preparation under the Companies Act. It imposes no additional burdens upon them.

Accounts - Independent Accountant's report

The accountant, who should be independent of the company and professionally qualified, would sign a report along the following lines:-

> "I certify that the accompanying accounts of XYZ Ltd as at 31 December 19XX have been compiled from the records kept by and information supplied by the directors and are in accordance with the content and layout requirements of the Companies Act.
>
> I have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them."

This contains some minor changes to the form of wording you proposed, but the overall emphasis is still that the independent accountant's work is restricted to compilation of the accounts or a check on the compilation where they are prepared in-house. The changes are twofold. First, to make the statement appropriate either to an independent accountant who has compiled the accounts himself or who is checking the in-house compilation

by someone else, and, second, to tie together the references to the records used to prepare the accounts and the records on which the directors have issued their statement.

Tax - Directors' Statement

The directors will be required to provide proper certificates for tax purposes covering the accounts and the tax computation. This would require Finance Bill legislation, and the precise form of the certificate would have to be worked out with the bodies representing businesses and the legal and accounting professions.

Compliance Costs

The effect on compliance costs will obviously vary for individual companies depending on the extent of their in-house accounting expertise, but generally we believe that relief of the regulatory burden is likely to be greater for the larger small companies. The savings will depend to a considerable extent on the guidance developed by the accounting profession to its members about the scope of a compilation report. But, assuming that its scope is not extended, and your Department is in a position to influence this, substantial savings should be possible on 'pure audit' costs which, for small companies, are often only a small proportion of the total accountancy bill.

Timing

It would be necessary to ensure that the new compilation report regime was not implemented until the accountancy profession has developed guidance on the scope of the work to be undertaken. It would be necessary for the DTI to set deadlines for this. And it would not be possible for the Revenue to administer the certification for tax until Pay and File is in place. This could not be before 1992 at the earliest when the necessary computer systems will be in place. This does mean that 1992 would be the earliest date for changing over from statutory audits to a new system.

Summary

I believe that the above proposals may achieve significant deregulatory benefits in relation to the audit burden, particularly in so far as the larger small companies are concerned. They would achieve a break from the confusing use of the word 'audit' in relation to smaller companies. The relief for the very small companies will be less because many of them will continue to rely on independent professional accountants to prepare their accounts as they have done in the past; such work will, however, be necessary in the future as the basis of the more positive business advice instead of unproductive audits which we all hope will be forthcoming from the accounting profession for smaller companies.

CONFIDENTIAL

This is the second set of proposals which we have made to help with the deregulatory drive to ease the burdens on business in the audit area. The proposals offer significantly less protection to the Exchequer and to the position of the Revenue departments than does the present audit, or did the limited review we earlier proposed, but I believe that on balance they represent a risk we should be prepared to take. I hope, therefore, that you will be prepared to accept these proposals and we can then settle the classes of companies to which they may apply.

Yours sincerely,

Robert Sutherland

pp. NORMAN LAMONT

(Approved by the Financial Secretary and signed in his absence)

4376/84/JRF

CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 12 July 1988

CHANCELLOR

STATUTORY AUDIT

I have held a series of meetings on this and it has proved extremely difficult to get any agreement.

The Revenue View

2. The Revenue have not wavered from their strongly-held view that the standard of unincorporated business accounts is significantly lower than that of company accounts. Often the problem is not fraud, but inadequate or sketchy accounts, caused by ignorance or incompetence. Roughly 20% of unincorporated accounts need to be adjusted by the Revenue because of simple errors or misunderstandings of what the law requires.

3. By coincidence I recently came across an unincorporated business where huge tax arrears had built up as a result of wholly inadequate record-keeping. This is precisely the sort of situation where - in the Revenue's eyes - an audit might have revealed what was going on.

4. The Revenue argue that even if the audit were replaced by something along the lines I have been looking at, there would be a real risk to the Exchequer. Even a 1% leakage through reduced reliability of small company accounts would cost the Exchequer £100m.

5. As a result of this risk - which they cannot quantify - there is no doubt that the Revenue would only contemplate agreement to any relaxation of the audit requirement if it

were accompanied by a substantial increase in the proportion of company accounts investigated. It they investigated the same proportion of company accounts as they do unincorporated business accounts that would mean an extra 570 Inspectors. Of course even if we were prepared to contemplate such an increase in Revenue manpower, there is no conceivable way in which we could recruit so many new Inspectors.

Appraisal

6. My view is that the Revenue exaggerate the importance of the audit. It may be true that company accounts are more reliable. But that could be because of:

i. The obligations placed on directors by company law (as Andrew Tyrie believes); or

ii. The incursion of an independent person into the affairs of the company (as Sir Anthony Wilson believes).

7. But whatever the reality, it is clear that relaxing the audit will be perceived by the Revenue, and, more importantly, by the PAC as a threat to the Exchequer and an invitation to fraud. I think we will be able to resist the pressure to increase manpower. But there will certainly be pressure.

The Way Forward

8. My dicussions on this subject have convinced me of one thing - that we need to introduce a distinction between the type of audit faced by large and small companies. It is clearly desirable that the audit for large companies should be allowed to develop in line with European law, without being held back by the difficulties of applying the full rigours of auditing standards to smaller companies - both the accounting profession and the small business world would agree on that.

9. Taking this, together with my view that the Revenue are exaggerating the importance of the audit, I firmly believe that we should offer the DTI a relaxation. I do not believe we can accept the DTI stance of complete deregulation, but I do think that we need to be seen to be taking a positive approach.

10. I would therefore propose to write to Francis Maude offering him the alternative approach as described in Sir Anthony Wilson's minute of 11 July.

The Proposal

11. The half-way house I suggest builds on the DTI's suggestion of a 'compilation report'. But this would be signed not by the directors as Maude proposes - but by an independent accountant. In addition there would be two directors' statements:

i. That proper records had been kept and that the accounts had been properly prepared and showed a "true and fair view".

ii. That the tax computations submitted to the Revenue were accurate and had been properly prepared.

12. The directors' statements should not impose any additional burdens since they would merely make explicit responsibilities that directors already have. We would need to ensure that when the detail was worked up, the accounting bodies (and the Revenue) did not try to develop the tax certificate into a tax audit. Finance Bill legislation would be required.

13. Sir Anthony believes that this proposal would bring significant deregulatory benefits to the larger small companies. For companies with turnovers between £1-2m the savings might be something of the order of 50% of their current audit costs.

14. I am less sure myself about the extent of the deregulation. Ian Davidson whose advice I have sought was pretty sceptical. He thought that auditors do little more now than what the compilation report would require. Thus he did not envisage large reductions in the auditors' fees. Even if it were a major deregulation, it would be politically quite awkward to trumpet this given the PAC concerns we can expect.

DTI Response

15. The proposal we have worked up:

a. Is our second attempt to meet the DTI half-way;

b. Represents some easing of the burden, particularly for the larger small companies;

c. Offers a split between the way small and large companies will be 'audited' in the future.

16. Nevertheless, I believe that the DTI will reject it. They see no case whatsoever for the involvement of an independent accountant. Equally, I cannot recommend to you that we go any further to meet them. The Revenue regard this proposal as very much second best to the original 'limited review' suggestion we put to Maude and which was rejected out of hand. I doubt we could get the agreement of Sir Anthony to anything less than what is now on the table.

Conclusion

17. The current proposal has the backing of Messrs Cropper, Tyrie, and Wilson and has been accepted by the Revenue. Rather than go further I would prefer the DTI to take it to E(A). I am sure most of our colleagues will see the case for retaining some sort of independent check. And, having offered two alternatives in the face of the DTI's blanket stance I think we can win E(A)'s backing.

9.11

NORMAN LAMONT

059JRF42.2

PERSONAL

FROM: FINANCIAL SECRETARY
DATE: 28 September 1988

CHANCELLOR

STATUTORY AUDIT OF SMALL COMPANIES

In preparation for tomorrow's E(A) meeting, I have spoken to Cecil Parkinson, John Wakeham and Paul Channon.

Cecil has a bilateral tomorrow, and so will not be present. But he has written to the Prime Minister supporting our line. Both John and Paul will be there, and have agreed to speak in our favour. Paul will emphasise that he has not changed the view he took when at the DTI that audit is a necessary defence against fraud.

NORMAN LAMONT

EXTERNAL AUDITORS OF THE NATIONAL AUDIT OFFICE.

gasmu.cg/minutes/2.21.11

BF next PEM Internal

MANAGEMENT IN CONFIDENCE

FROM: SIR ANTHONY WILSON
DATE: 21 November 1988

PPS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Sir P Middleton
Mr Anson
Mr H Phillips
Mr Beastall

EXTERNAL AUDITORS OF THE NATIONAL AUDIT OFFICE

I have been asked by the Secretary of the Public Accounts Commission to advise its members on how to proceed with the representation for the external audit of the National Audit Office. Spicer and Pegler (now Spicer and Oppenheim) were appointed early in 1984 for a five year term, which ends in the spring of 1989. The PAC intends to discuss the appointment of a suitable firm at a meeting in the House on 6 December and has asked me to attend. It wishes to discuss with me, apparently, which firms ought to be approached to take part in a representation exercise, and it also wants my advice on the detailed procedure to be followed by the Commission this time.

Ch

PEM Internal ?

(Spicer & Pegler diffs presumably re Barlow Clowes)

A WILSON

Inland Revenue

Compliance and
Collection Division
Somerset House

FROM: D L SHAW
DATE: 8 DECEMBER 1988

1. MR ROBERTS
2. FINANCIAL SECRETARY

ABOLITION OF THE SMALL COMPANY AUDIT AND REDUCTIONS IN THEIR ACCOUNTING REQUIREMENTS

1. We are sorry to have to trouble you with this subject again, but the European Commission and the DTI have put it back on the agenda. We are concerned that the DTI proposals may not be acceptable to Treasury Ministers and need a steer from you on the line to take. If we are to meet the timetable set by the DTI, we will, I am afraid, need a decision early in the week beginning 12 December.

---

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Miss Hay
Mr Finlinson (C&E)
PS/C&E

Chairman
Mr Beighton
Mr Isaac
Mr Painter
Mr Rogers
Mr Bush
Mr Cherry
Mr Deacon
Mr Houghton
Mr Roberts
Mr Cleave
Mr Page
Mr Shaw
Mr Sutcliffe
PS/IR

EC proposal

2. The DTI have just informed us that the EC have published a proposed Directive which would:

- oblige member States to abolish the statutory audit for small companies and substantially reduce their accounting requirements,

- allow member States virtually to abolish the accounting requirements for small proprietorial companies.

3. We understand that the DTI have already submitted an explanatory memorandum to the British Parliament on the proposal, although we have yet to see a copy. We understand that the European Parliament have been asked to comment on the proposals by the end of 1988 and that the Council of Ministers are to consider the proposal in March 1989.

DTI proposal

4. The DTI have agreed with their Ministers that they should undertake public consultation as soon as possible before the opening of Council Working Party discussions, which may start as early as next Spring. The DTI tell us that they plan to agree a final draft of the consultative document with Mr Maude very soon, and certainly before Christmas. The DTI state that in advance of the outcome of the consultations, their Ministers take the view that they should adopt a neutral stance in the consultative document.

Inland Revenue view

5. We do not think that it would be appropriate to adopt a neutral stance in the consultative document.

6. We believe that the consultative paper should reflect the opposition of the Government to the abolition of the statutory audit for small companies. As you know, the

Government has examined the case for abolition and rejected it twice in recent years, most recently at E(A) on 29 September 1988. The Government's decision was announced publicly by Mr Maude on 20 October 1988. We do not think that there is any room for neutrality on abolition.

7. The position is much the same on the accounting requirements of small companies. These determine the information to be supplied in company accounts. When you introduced Pay and File for companies, you decided that the Revenue should continue to rely on the Companies Act accounts for the information it needs; and made this explicit in the legislation in 1987. Other member States obtain the information that they need for tax separately under their tax legislation and by way of large and complicated tax returns. This does, of course, mean that we need more information in the statutory accounts of small companies than other member States. We have looked at the question of how much more with the DTI and the Treasury twice in the last three years to see how far it can be reduced subject to the needs of the Inland Revenue. Mr Maude wrote to you on 12 July 1988 agreeing the position reached. He said that he had hoped it would be possible to move further, but was not seeking to pursue the point at this stage. The agreed package of reductions is to be introduced under the Companies Bill in this Session.

8. The EC proposals would go further than this and remove a good deal of the information that we need from small company accounts, and possibly all the information that we need for small proprietorial companies. This clearly goes against the decisions taken by the Government on the contents of the next Companies Bill and has far-reaching consequences for the Taxes Acts. If the EC proposals were followed in our legislation, the reliance on Companies Act accounts for Pay and File would have to go. As in other member States, tax legislation and more complicated returns would be needed to ensure that we receive the information that we need. When this was looked at in the run up to Pay

and File, both we and the representative bodies concluded that this approach would lead to an increase in the overall regulatory burden rather than a decrease. We do not think that it would be proper to present the Commission's proposal without bringing out the decisions that the Government has taken on the accounting requirements of small companies and the consequences for Pay and File and Taxes regulations if the requirements are reduced further.

Other Government Departments

9. The DTI have not, as far as we know, consulted other Government Departments apart from the Inland Revenue. We have copied the proposals to the Government Accountancy Service and Customs and Excise. The Government Accountancy Service shares our surprise at the DTI proposals for a neutral stance in view of the decisions that the Government has taken so recently.

Conclusions

10. We should like a steer from you on the line to take. We recommend that we should tell DTI officials that we have discussed this with our Ministers and that they consider that it would not be appropriate to take a neutral stance in the consultative paper. In particular the paper should:

- reflect the Government's opposition to the abolition of the audit for small companies,

- reflect the decisions the Government has already taken and is now implementing to reduce the accounting requirements of small companies as far as possible whilst meeting Inland Revenue needs,

- draw out the consequences of reducing them further (ie removing the reliance of Pay and File on Companies Act accounts, increasing regulations for tax, introducing new and more complex tax

returns), and in particular that it is likely that this would lead to greater regulation overall rather than to deregulation.

11. If you approve this line, we would add that in view of the decisions that the Government has taken on the audit and accounting requirements for small companies, the Government would be opposed to all the main proposals unless derogations are added allowing member States to decide which should be applied. In particular, the Government would be opposed to the abolition of the statutory audit for small companies and to mandatory reductions in their accounting requirements.

David Shaw

D L SHAW

Inland Revenue

Compliance and
Collection Division
Somerset House

Ch/ I have already minuted
our yr comments on Shaw's
earlier minute. But now see X in attached EM
para 16 – DTI merit a serious ticking off

FROM: D L SHAW
DATE: 9 DECEMBER 1988

1. MR ROBERTS – (Not seen, Mr Roberts is in Bristol today 9/12)
2. FINANCIAL SECRETARY

S67 1612

ABOLITION OF THE SMALL COMPANY AUDIT AND REDUCTIONS IN THEIR ACCOUNTING REQUIREMENTS

Note: Mr Maude's office robuked!

1. At the end of your meeting on Keith yesterday afternoon, we told you about proposals from the European Commission which would oblige member States to abolish the statutory audit for small companies and substantially reduce their accounting requirements. These proposals would, if implemented, go against the Government's own recent decisions.

DTI letter to Inland Revenue

2. We first heard of these proposals earlier this week, in a letter from the DTI. We promptly informed your private office. We also copied the DTI letter to the Government Accountancy Service and Customs and Excise, neither of whom had been approached directly by the DTI.

---

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Culpin
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Miss Hay
Mr Finlinson (C&E)
PS/C&E

Chairman
Mr Beighton
Mr Isaac
Mr Painter
Mr Rogers
Mr Bush
Mr Cherry
Mr Deacon
Mr Houghton
Mr Roberts
Mr Cleave
Mr Page
Mr Shaw
Mr Sutcliffe
PS/IR

3. The copy of the proposed Directive from the EC, enclosed with the letter from the DTI, is dated 14 October 1988. The DTI say in their letter that they have agreed with their Ministers that they should undertake public consultation as soon as possible, and in advance of the outcome of such consultation their Ministers take the view that they should adopt a neutral stance, both in their Explanatory Memorandum to Parliament and in the consultative document.

4. We do not think that it would be appropriate to adopt a neutral stance in the consultative paper. We said, yesterday, that a submission was already on its way to you explaining our concerns and seeking a steer on the line to take (Mr Shaw to Financial Secretary, 8 December).

Explanatory Memorandum

5. Shortly before your meeting yesterday, we received a copy of the Explanatory Memorandum submitted to Parliament by the DTI earlier this week. We have sent a copy already to your Private Office, and attach a further copy herewith. We are advised by the DTI that there were no consultations between the DTI and other Government Departments, either at official or Ministerial level, on the contents on the Memorandum.

6. The Memorandum is largely neutral. However, at the start of paragraph 16 it states that the Government welcomes these proposals because of their underlying deregulatory purpose. You took the view, yesterday, that "welcomes" might not be appropriate.

7. Furthermore, paragraph 18 suggests that the proposal is deregulatory in nature and is expected to reduce administrative costs. This statement could be misleading. The proposal would, if implemented, lead to an increase in regulation on the tax side which

might outweigh the benefit of deregulation on the company side. This is explained more fully in paragraphs 7 and 8 of my submission of 8 December.

Number of companies affected

8. You asked how many companies would be affected by the proposals. At present, approximately 600,000, or 95 per cent, of companies come within the small company definition and would be affected. The proposals would, inter alia, enlarge this category still further.

9. The DTI suggests that the sub-category of "closely held" (or "proprietorial") small companies, for whom requirements could be reduced still further, would include about 40 per cent of companies.

DTI involvement in EC proposals

10. We have, at your request, asked the DTI about their involvement in this. They tell us:

- that the proposals have their origins in discussions, involving the DTI, on the extension of the requirements for small companies to partnerships, which have stalled in the face of UK and German opposition.

- that the present proposals are the Commission's own ideas, and the DTI were not involved in their development.

- that the DTI have been expecting the proposed Directive "for months" and had "a good idea of its contents".

- that the DTI received the proposed Directive informally "about a week ago" and finally brought us into the picture this week.

- that there was no consultation at either official or Ministerial level before the publication of the Explanatory Memorandum.

7. The DTI mentioned also that their Ministers are very keen on the proposals, except that they would like to see more discretion given to member States over the obligations they impose on small companies than is proposed.

D L SHAW

9253/88
COM(88)292 Final

DRAFT INSTRUMENT 9253/88 OF 14 OCTOBER 1988 CONCERNING A PROPOSED COUNCIL DIRECTIVE AMENDING DIRECTIVE 78/660/EEC ON ANNUAL ACCOUNTS AND DIRECTIVE 83/349/EEC ON CONSOLIDATED ACCOUNTS WITH RESPECT TO THE EXEMPTIONS FOR SMALL AND MEDIUM-SIZED COMPANIES AND TO THE DRAWING UP AND PUBLICATION OF ACCOUNTS IN ECU

SUBMITTED BY THE DEPARTMENT OF TRADE AND INDUSTRY
5 DECEMBER 1988

SUBJECT MATTER

1 The European Community Fourth Company Law Directive (78/660/EEC), adopted in 1978, harmonised the rules relating to the drawing up, publication and auditing of accounts of limited liability companies throughout the Community. The Directive allowed Member States to grant exemptions to small and medium-sized companies as defined by Articles 11 and 27 of the Directive. The thresholds defining small and medium-sized companies, which Member States may not exceed, relate to the balance sheet total, net turnover and number of employees.

2 The Fourth Directive allows Member States to permit small companies to draw up an abridged balance sheet, abridged profit and loss account and abridged notes to the accounts; publish an abridged balance sheet; and exempt them from publication of the profit and loss account and directors' report. Member States may also exempt small companies from publishing their audit report, or from the requirement to have their accounts audited.

3 Medium-sized companies are required to draw-up a full balance sheet, but Member States may allow an abridged version to be published. In addition the Directive permits Member States to allow medium-sized companies to draw up and file an abridged profit and loss account, and notes to the accounts.

4 The general thrust of the new proposal is both to extend the derogations currently available to small and medium-sized companies and to make them mandatory on Member States, so as to allow for greater harmonisation of the treatment of such companies throughout the Community. The most significant changes proposed include:

(a) making the exemptions allowed for small companies compulsory, instead of being offered as a Member State option. The simplified requirements would then be an option available to all small companies in the Community. In addition Article 2 of the proposed directive makes the disclosure requirements for small companies imposed by the Fourth Directive the maximum that Member States may require;

(b) allowing Member States to vary the existing financial thresholds defining small and medium-sized companies by plus or minus 50 per cent of the current maximum;

(c) completely exempting small "closely held" companies which do not belong to a group, are managed by their shareholders, and whose shares are not freely transferable, from the scope of the Fourth Directive, thus leaving Member States free to set their own regime for such companies (which must not go beyond the requirements of the Fourth Directive as applied to small companies and as amended by the current proposal);

(d) providing the opportunity for all small companies, and an option for Member States to allow medium-sized companies, to keep the accounting documents that must be published available for public inspection at their registered office rather than requiring them to be filed at a central registry as at present;

(e) exempting all small companies from preparing a directors' report, provided that information on important events and purchase of own shares is disclosed in a note to the accounts;

(f) allowing Member States to exempt all single director companies from disclosing information on loans to directors and directors' remuneration in the notes to the accounts;

(g) providing for all companies to draw up and publish accounts in European Currency Units (ECU) if they so wish. An amendment to the Seventh Company Law Directive (83/349/EEC) would make this option available for companies' consolidated accounts.

MINISTERIAL RESPONSIBILITY

5 The Secretary of State for Trade and Industry has responsibility for the subject matter of the proposal as it affects Great Britain. The Secretary of State for Northern Ireland has equivalent responsibility for Northern Ireland.

LEGAL AND PROCEDURAL ISSUES

Legal basis

6 The proposed directive is based upon Article 54 of the Treaty of Rome.

Co-operation procedure

7 The co-operation procedure is applicable.

Voting procedure

8 The Council is required to act by qualified majority.

Impact on United Kingdom law

9 The EC Fourth Company Law Directive was implemented in Great Britain by the Companies Act 1981, later consolidated in the Companies Act 1985. In Northern Ireland the relevant legislation is contained within the Companies (Northern Ireland) Order 1986. References below are to the relevant legislation in Great Britain but in each case there is a comparable provision in Northern Ireland law.

10 Sections 247-250 of and Schedule 8 to the Companies Act 1985 deal with the exemptions currently available to small and medium-sized companies. While UK legislation has taken advantage of many of the optional exemptions currently available for small and medium-sized companies under the Fourth Directive, such companies are still required to draw up and circulate full accounts to shareholders. In addition the UK has retained the statutory audit requirement for small companies.

11 The UK has however taken advantage of the maximum thresholds defining small and medium-sized companies allowed by the Directive. These are currently set by section 248 of the Companies Act 1985 (as amended by the Companies (Modified Accounts) Amendment Regulations 1986 - SI 1986 No 1865) and are for:

(a) Small companies
- net turnover not more than £2 million;
- balance sheet total not more than £975,000;
- average number of employees not more than 50.

(b) Medium-sized companies
- net turnover not more than £8 million
- balance sheet total not more than £3.9 million
- average number of employees not more than 250.

12 The proposed directive would allow the UK to vary the financial thresholds by plus or minus 50 per cent, and to set the maximum employee threshold for small companies at 25.

13 The proposal to make existing exemptions mandatory would require sections 247-250 of and Schedule 8 to the Companies Act 1985 to be amended in order to allow small and medium-sized companies to take advantage of a number of options for exemptions currently allowed by the Fourth Directive, but which UK legislation has not made available. Legislation would also be necessary to provide for the proposed exemption from the scope of the Fourth Directive of "small closed companies" and the establishment of an alternative domestic regime.

14 These changes, together with the proposals for additional exemptions, could be implemented in Great Britain by secondary legislation under section 2(2) of the European Communities Act 1972 and sections 251 and 256 of the Companies Act 1985.

Separate legislation would be required to implement the changes in Northern Ireland.

15 The proposal to allow all companies to prepare and publish accounts in ECU could be implemented by secondary legislation under section 256 of the Companies Act 1985.

POLICY IMPLICATIONS

16 The Government welcomes these proposals because of their underlying deregulatory purpose. However, careful consideration will need to be given to the proposal to make all existing and proposed exemptions for small companies mandatory. This proposal will obviously have implications for the decision, recently reconfirmed by the Government, not to exercise the option to exempt small companies from the statutory audit. The mandatory approach may also make it more difficult for individual Member States to accept both the directive as a whole and individual exemptions and therefore, by impairing the prospects of agreement on a worthwhile package of deregulatory measures, could defeat the directive's ultimate objective. Consideration will also have to be given to the implications of the proposal to allow companies to make their accounts available at their registered office rather than file them at a central registry and the proposed exemption of small closed companies entirely from the scope of the Fourth Directive.

17 Before reaching a view on the approach to be adopted in the negotiations on this draft directive, the Government will wish to assess the implications and potential consequences of the proposals, and it therefore intends to consult widely as soon as possible.

FINANCIAL IMPLICATIONS

18 Unclear, but the proposal is deregulatory in nature and should not impose direct financial burdens on business. Rather, it is expected to reduce administrative costs.

TIMETABLE

19 The European Parliament and Economic and Social Committee have been asked to give their opinions by the end of 1988, and the Council to reach a common position by the end of March 1989. This looks over-optimistic, as the current Presidency do not intend to discuss the proposal, and we understand that negotiations are unlikely to begin before spring 1989.

THE HON FRANCIS MAUDE MP
Parliamentary Under Secretary of
State for Corporate Affairs

REPORTS OF THE PAC.

chex.u1/ds.ph/2 UNCLASSIFIED

FROM: D I SPARKES
DATE: 9 JANUARY 1989

BF ~~Feb~~ next PEM bilateral

PS/SIR P MIDDLETON

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Anson
Mr Phillips
Mr Beastall
Mrs Case
Mr Culpin
Miss Peirson
Mr Robson
Mr Gieve
Mr Shore

TREASURY MINUTE IN REPLY TO THE 43rd to 48th REPORTS OF THE PAC 1987-88

The Chancellor has seen Mr Beastall's minute of 6 January to the Financial Secretary.

2. He has noted the MOD defence of the Waltham Abbey and Enfield sales on the basis that "obtaining planning permissions before inviting offers could involve nugatory time and effort, and delay the wider benefits of privatisation". He would welcome Sir P Middleton's views on this point.

D.I.S.

DUNCAN SPARKES

toa.tr/jdrs/min4.6.1

Returns due to reach X @ next Health mtg. 2.1 SW St. George for Ports! Views of Y. M.

FROM: J S BEASTALL
DATE: 6 January 1989

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Phillips
Mrs Case
Mr Culpin
Miss Peirson
Mr Robson
Mr Gieve
Mr Shore

[NB the last is Royal Ordnance]

TREASURY MINUTE IN REPLY TO THE 43rd to 48th REPORTS OF THE PAC 1987-88

We now have the material for responding to another batch of PAC Reports which were published in November. Subject to clearance from No 10, we propose that a Treasury Minute should be laid before Parliament in your name on Tuesday 17 January for publication on Wednesday 18 January.

2. I attach a set of the replies proposed. These have all been agreed with the relevant Treasury expenditure divisions and, except for the reply to the 47th report on MoD's Major Projects Statement, have also been approved by the Accounting Officers concerned. The reply to the 44th report (Quality of service to the Public at DHSS local offices) has not yet been finally cleared by DSS Ministers.* With each draft reply is a copy of the conclusions from the relevant PAC report.

3. For your convenience, these are preceded by a brief summary of each report and proposed reply.

4. I would be grateful to know if you are content for us to go ahead with publication of this Treasury Minute as proposed.

JSB

J S BEASTALL

*We expect these clearances very shortly.

ANNEX A

FORTY-THIRD REPORT: IBA PROGRAMME CONTRACTORS' PAYMENTS

Expressed serious concern that both of the last two changes in levy arrangements have largely failed to secure their intended objectives, particularly as regards levy yield. Noted an expected shortfall of £38 million in the first two years of the new levy arrangements and criticised Home Office for a serious error of judgement. Recommended that the levy arrangements be reviewed and that measures of programme contractors' efficiency be developed.

REPLY

Points out that the 1986 changes were mainly aimed at lowering the combined marginal rate of levy and corporation tax, to encourage cost-consciousness and efficiency. Some evidence of improvement since then and financial indicators developed to monitor progress. For 1990-92, the levy will be based on a combination of revenue and profits, intended to produce a yield equivalent to that which would have been secured under the pre-1986 system.

FORTY-FOURTH REPORT: QUALITY OF SERVICE TO THE PUBLIC AT DHSS LOCAL OFFICES

Judged that defects in key management arrangements had contributed to poor local office performance. Recommended expanded performance targets and an effective reporting system to secure improvement from the failing offices. Expected the Department to give high priority to a staffing review and alternative complementing approach. Recommended continued development of improved methods of communication and monitoring of the effectiveness of information and advice activities.

REPLY

DSS says that service is improving and recent benefit changes have made things simpler for public and staff. Trials have begun of a new staff complementing system and a new reporting system is being

established to ensure improvement of the poorest-performing offices. Improved publicity material has been issued and local line management is being made accountable for performance as revealed by customer reaction sampling.

FORTY-FIFTH REPORT: MATTERS RELATING TO INLAND REVENUE AND CUSTOMS AND EXCISE

Expressed concern at deterioration in IR's collection performance in 1987 and the high level of erroneous PAYE charges. Called for concentrated efforts to stem the outflow of trained IR staff. Criticised C&E for failing to take the precaution of a period of parallel running when implementing the new Departmental Accounting System in January 1987, which led to late rendering of accounts and qualification of the C&AG's certificate.

REPLY

IR says that the 1987 collection problem was largely due to technical accounting changes. The erroneous PAYE charges were reduced by two-thirds in 1987 and are expected to fall further. The Exit London programme is moving IR work to provincial locations and use is being made of the added flexibility provided by new Civil Service pay agreements. A new scheme for Cadet Inspector recruitment in London has gone well so far.

C&E says that the decision not to have a period of parallel running was taken in the light of its consultant's advice and resource problems. Revised guidelines have been prepared for future new computer systems.

FORTY-SIXTH REPORT: MANAGEMENT OF THE FAMILY PRACTITIONER SERVICES (FPS)

Line to take: we agree! Instead!

Called for planning of the FPS to be integrated with that of the hospital and community health services. A unified management structure with the health authorities should also be considered. Noted the lack of an information strategy for FPS and inadequate use of performance indicators. Essential for Family Practitioner

Committees (FPCs) to monitor the use of GPs' deputising services, provide appropriate health care for the homeless and rootless, and target expenditure on GPs' premises which are below standard.

REPLY

DH has issued guidance to FPCs to strengthen planning and accountability. The Corporate Management Programme for the NHS in Wales points to full integration of the FPCs in planning. DH will devise an information strategy for the FPS this year. DH and WO will consider action for homeless and rootless people in the light of two pilot schemes in London, and will require FPCs to target money on practice premises where the need is greatest.

FORTY-SEVENTH REPORT: MAJOR DEFENCE PROJECTS

Expected MoD to establish quickly a management information system which could generate information for an improved Annual Statement reflecting the benefits of current procurement initiatives. Asked for information on the outcome of MoD's investigation into the strong correlation between cost increases at the development stage and decreases at the procurement stage. Called upon MoD to seek clauses in future contracts which would facilitate redress for performance deficiencies, and make careful scrutiny of BAe's costs for the ALARM contract. Also called for a sustained and marked improvement in MoD project management.

REPLY

Indicates that improved Procurement Executive financial information systems are being developed and that some improvements are intended in future Statements. MoD will keep the PAC informed of results from its investigation of variations between projected and achieved costs. It will aim to secure contract terms defining specification and delivery requirements under which redress can be sought. It made a very careful assessment of BAe's fixed price ALARM costs to ensure that they were reasonable. Steps have also been taken to improve project management.

FORTY-EIGHTH REPORT: SALE OF ROYAL ORDNANCE PLC (RO)

Concluded that part of the compensation payment to RO Crown Service Pension Scheme must be regarded as a cost of privatisation, and that agreement between MoD and BAe on continuation of the ALARM contract was made under pressure of the RO sale timetable. Expressed concern that MoD did not explore the possibility of redevelopment at Waltham Abbey and Enfield. Recommendation that in future planning permissions likely to increase values be obtained before offers are invited.

REPLY

Treasury acknowledges that some element of the ROCSPS compensation payment could be regarded as a cost of privatisation. MoD did not allow BAe the financial information to bid for RO until there was a satisfactory agreement on ALARM. Waltham Abbey and Enfield were valued for RO by a firm of surveyors on the basis of market value in existing use. MoD obtained an alternative use valuation which was lower, after taking account of decontamination costs. Obtaining planning permissions before inviting offers could involve nugatory time and effort, and delay the wider benefits of privatisation.

BF 27/10

BF2

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Chan has seen
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with Khan.

Treasury Minute on the Twenty-seventh, Twenty-ninth to Thirty-sixth and Forty-first Reports from the Committee of Public Accounts 1987–88

Presented to Parliament by the Financial Secretary to the Treasury by Command of Her Majesty October 1988

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TREASURY MINUTE DATED 26 OCTOBER 1988 ON THE TWENTY-SEVENTH, TWENTY-NINTH TO THIRTY-SIXTH AND FORTY-FIRST REPORTS FROM THE COMMITTEE OF PUBLIC ACCOUNTS, SESSION 1987–88

Twenty-seventh Report Ordnance Survey

Objectives and Management of Ordnance Survey

1. The Treasury and Ordnance Survey (OS) note the conclusions and recommendations of the Committee.

Planning

2. OS shares the Committee's belief in the importance of corporate planning and is pleased that the Committee recognises that steps have been taken by OS to improve strategic management in recent years. OS brought in consultants to advise on the information needed to plan and control the full range of OS's operations. Current planning methods are based on their recommendations further developed by OS to provide a framework for the pursuit of goals whilst properly balancing trading and public interest responsibilities. The OS Corporate Plan sets out clearly what the Secretary of State for the Environment has agreed the Department should achieve. As a published document it does not review the reasons behind these policy decisions but it evolves from a detailed evaluation of current and alternative activities with the best options being chosen for the Corporate Plan. OS's long-term planning is guided by its Mission Statement supported by Strategy Documents for the main Departmental activities. These are developed annually to produce the Corporate Plan and the Detailed Plan of production and revenue earning activities, which are all approved and monitored by the Management Board. OS believes that these now provide the firm framework that they and the Committee seek. OS will, however, continue its efforts for further improvements where possible. Current examples include improving performance indicators and developing further project management techniques.

Digital mapping

3. OS agrees that the progress of all technical, financial and commercial aspects of the digital mapping programme should be closely monitored and digital mapping is one of the four Key Success Factors which are reviewed by the OS Management Board. Following the Committee's recommendation, the frequency of this review has been increased and a co-ordinated report on all digital mapping activities is now presented to each Board meeting.

4. During 1987–88 OS considered in detail the reorganisation of the Department's management structure to assign responsibility for all digital activities to one individual, but decided that such a structure would not be the most effective. Digital activities do not stand alone; they are one of the major techniques contributing to the majority of OS products and they span most product and Cost Centre boundaries. Digital costs are therefore controlled, as are all other costs, through monthly financial management reports which are reconciled with the Departmental Vote. Overall responsibility for all Department-wide activities, including digital mapping, is with the Director General.

5. Time and cost targets for the digitising of Large Scale maps were agreed by Ministers in 1984. Their achievement is controlled through the co-ordination of the OS Corporate Plan and the Public Expenditure Survey. However, improvements by OS in both techniques and commercial arrangements indicate that this major task will be completed well ahead of schedule and within budget.

Financial management

6. OS shares the Committee's view on the need for forceful financial management. The Trading Accounts for 1986–87 were published in March 1988. The 1987–88 Trading Accounts were passed to NAO for audit on 12 September 1988. The Department understands that NAO hopes to arrange publication through the House of Commons in December 1988.

7. OS has comprehensive financial management systems based on recommendations by consultants who undertook reviews during 1981 and 1985 to propose improvements to financial information and to review the format and design of Trading Accounts. OS's systems meet the four principles endorsed by the Prime Minister following the 1986 Multi-Departmental Review of Budgeting, and provide the information required by the OS Management Board and by Vote accounting. Nevertheless, OS will continue its efforts to improve them and is considering, for instance, a different product breakdown for the monthly reports that are considered by the Management Board.

8. OS has a good record for the achievement of financial targets set by Ministers, but the recent Mission Statement produced by the OS Management Board acknowledges that more can be achieved and has set a long-term target of 100 per cent cost recovery across the Department. More demanding revenue targets currently being agreed by Treasury and DOE Ministers will work towards that goal whilst at the same time striking a proper balance between commercial and public interests.

Marketing

9. OS welcomes the Committee's comments about its progress in marketing. OS aims for a minimum of a 10 per cent surplus on its commercial work after covering all overheads and interest on capital. Some products will exceed their target but, as with any commercial venture, others will be less successful. OS aims to eliminate these, thus increasing overall margins, whilst continuing to meet the needs of users. OS values the Committee's understanding of its conflicting roles and will pursue a still more competitive and flexible approach to marketing, whilst maintaining its public interest role and continuing to avoid unfair competition.

10. OS welcomes the Committee's comments on its strengths. It will continue initiatives to improve its financial management, including work on performance monitors, revised reports to the OS Management Board, and advice to managers on project appraisal. OS aims to develop its sales by improving its marketing and the range of its products still further, especially in the Large Scale market which offers the greatest scope for improved cost recovery.

Twenty-ninth Report
Ministry of Defence

EH 101 Anglo-Italian Helicopter Project

11. The Treasury and the Ministry of Defence (MOD) note the conclusions and recommendations of the Committee.

International collaborative arrangements

12. The MOD recognises that there are difficulties in obtaining information about cost and worksharing at the lower levels of equipment sub-contracting, but is resolved to achieve a fair balance between the partner nations through the allocation of work and selection of common equipment at higher levels. Sufficient information, down to the second level of sub-contracting, is obtained from Westland and Agusta to allow accurate assessments to be made of each country's share of the common development costs, thus ensuring that the balance of work is adequately monitored.

Contractual provisions

13. The MOD is not satisfied with the lack of an absolute limit on development costs, and negotiations are in hand with Westland Helicopters Limited aimed at setting a maximum price, so reinforcing the existing target incentive to achieve programme targets to cost and time.

14. It is MOD policy to make a prime contractor responsible for the overall performance of integrated weapon systems wherever possible. This was not possible at the start of the EH 101 development programme for the reasons given in the C&AG's Memorandum (paragraph 4.6). However, now that the programme has been under way for several years, the MOD is looking again at the scope for appointing a prime contractor. Studies are in hand to produce a specification for an integrated weapon system, which will provide a basis for achieving this objective.

15. The MOD will not commit production funding unless sufficient progress has been made in development to provide the necessary confidence to proceed. However, in order to maintain the currently planned in-service date for the helicopter, preliminary production investment funding for tooling, long lead and other items will be necessary before all elements of the development programme have been completed. The aim will be to identify and minimise all development risk areas before launching production but, as is the case with most major defence procurement programmes, there will inevitably be some overlap between the latter stages of development and the work-up to production if momentum is to be maintained.

Financial appraisal of contractors

16. The MOD assesses the financial viability of potential contractors before they are added to the Defence Contractors List, and keeps under regular review the accounts of the major suppliers, with whom over 75 per cent of the procurement budget is spent. Other contractors' accounts are reviewed as necessary. Machinery exists which allows the Department of Trade and Industry (DTI) to contribute to these appraisals.

17. With regard to the EH 101 development contract, the ability of Westland Helicopters to undertake the work involved was kept under review in the usual way. MOD was also in regular and close contact with the DTI. At the time the development contract was placed the DTI and MOD, although aware that the company had short-term difficulties, had no reason to doubt Westland's long-

term viability. The MOD's assessment of a company's business prospects must necessarily be based in part on the company's own forecasts of costs and revenue on other programmes it is undertaking, as well as its dependence on MOD orders. The enquiries that MOD made of the company to supplement the DTI's Industrial Development Unit report covered both technical and financial matters, and the MOD had received sufficient assurances by March 1984 to have confidence in placing the contract. The further information received up to June 1984 did not alter that assessment.

18. The difficulties that the company made known to the Government six months later (essentially concerning revised forecasts of sales on the W30 programme) could not have been foreseen by the MOD and there was no warning of them during the contractual negotiations for EH 101; nor did the scale of the problem become fully apparent until the following year. The MOD is satisfied that adequate monitoring was carried out to minimise the risks associated with placing this large development contract. The nature of the world helicopter market and Westland's position in it carry some element of risk that the company could find itself in difficulties when demand falls, but such a fall in demand was not apparent at the time.

Thirtieth Report
HM Customs and Excise
Intervention Board for Agricultural Produce
Ministry of Agriculture, Fisheries and Food

External Trade Measures for Agricultural Produce

19. The Treasury, Customs and Excise (C&E), the Intervention Board for Agricultural Produce (IBAP) and the Ministry of Agriculture, Fisheries and Food (MAFF) note the conclusions and recommendations of the Committee.

Operation of controls by Customs and Excise

20. The Committee accepts that in operating controls over Common Agricultural Policy (CAP) transactions C&E must respond to local risks and patterns of trade. Enquiries conducted by C&E have revealed that the reported disparity in the standards of examination was largely a reflection of variations in the volume, nature, value or frequency of CAP trade at the ports concerned. However, the Department will continue to monitor standards of examination and investigate instances where established target levels are not achieved.

21. The Customs operational planning system was established nationally on 1 April 1988. It provides information for each operational unit about the levels of activity and the resources deployed. The Excise operational planning system is currently being tested before full introduction in April 1989. The Department's planning systems will continue to be developed in such a way as to ensure that, so far as possible, staff resources are deployed in areas where there is the greatest risk.

22. The Committee recognises that C&E has to strike the right balance between insisting on adequate examination facilities and not unduly impeding trade. The Department has concluded its review of examination facilities throughout the country. Some deficiencies have already been remedied. In March it opened discussions with the trade through the Joint Customs Consultative Committee. A formal statement of intent to operate a more rigorous policy in requiring the provision of adequate facilities was issued as a press release in September.

23. The Committee recognises that CAP trade is only a small part of C&E's business and notes the determination of C&E to improve the expertise of customs officers engaged in controlling it. The Committee also notes that C&E has recently been heavily engaged in training in preparation for the new tariff classification system and in drug preventive work. The Department has, however, already taken a range of measures to instruct officers and to disseminate information relating to freight control, including CAP trade. These are now being stepped up. For some time it has been the practice to nominate CAP liaison officers in each of the Customs Collections. The preparation of revised CAP training modules for new entrant staff has now also been completed and a revised CAP training course was conducted on a pilot basis in May 1988. This has been followed by a period of intensive training for instructors in preparation for the launch in the autumn of a programme of refresher training for all officers currently dealing with CAP trade. The revised training modules will be incorporated into the updated freight training course for new entrants being introduced later in 1988.

Operation of controls by the Intervention Board for Agricultural Produce

24. C&E and IBAP are agreed that C&E will provide evidence about the levels of

Customs examinations of goods so that IBAP can discharge its Vote responsibility.

25. Despite further delays and technical problems with the development of software for the export refund computer system, normal payment times have been restored for most commodity sectors. Although much still remains to be done plans are well advanced to ensure that an efficient and reliable computer system is available as quickly as possible. The need to concentrate resources on the refund system has prevented progress on the computerised licensing system, work on which has accordingly been deferred until 1989; but the timely issue of licences has been restored.

26. In view of the additional costs to exporters, Ministers authorised the Intervention Board to pay compensation on any export refunds paid in 1988 more than two months after the receipt by the Board or Customs and Excise of sufficient supporting documents. Such payments will start in October.

Complexity and Risk of Fraud

27. Efforts to secure improved control of expenditure under the CAP and tougher action against fraud in co-operation with the European Commission have been maintained. MAFF has continued vigorously to press the Commission to take tougher measures where they find that a member state has applied inadequate controls or has failed to report irregularities, and has suggested that they might make more active use of disallowance of CAP expenditure. MAFF will be monitoring Commission action through the clearance of accounts procedure.

28. Contact with the new Commission anti-fraud unit was established when its head was invited to the UK for meetings with the Paymaster General and Departments in June. It was made clear to the head of the unit that he could expect strong support from the UK for his work and that the UK would give sympathetic consideration to any new Commission proposals for cost-effective measures to combat fraud.

29. Following their visit to the UK in March 1988 to examine UK arrangements for reporting CAP irregularities, the Commission wrote to say that they had been impressed by UK procedures. The results of the Community-wide review are expected to be discussed by the Irregularities Group of the European Agricultural Guidance and Guarantee Fund (EAGGF) later this year. The Departments' aim will be to secure a practical and effective system and to gain assurances that the Commission will take the measures necessary to ensure that all member states will comply with it.

30. The Departments agree with the Committee that irregularity and fraud in other member states are matters of serious concern to the UK. The Departments therefore attach great importance to the establishment of uniformly rigorous standards of control and reporting throughout the Community. The Departments consider that the current initiatives in this field are likely to lead to improved effectiveness but recognise that the pressure for improvement needs to be kept up. They will therefore monitor developments closely and will press for further action wherever necessary.

31. A balance has to be struck between the simplification of CAP legislation and the need to ensure that the necessary control mechanisms are in place to protect EAGGF money and to prevent distortions in trade. Moreover, CAP negotiations often result in compromises and these sometimes entail administrative complications. Nevertheless, MAFF will continue to look for every opportunity to simplify CAP legislation and to avoid unnecessarily bureaucratic arrangements.

Thirty-first Report
Ministry of Defence
Property Services Agency

Naval Warship and Weapons Procurement

32. The Treasury, the Ministry of Defence (MOD) and the Property Services Agency (PSA) note the conclusions and recommendations of the Committee.

Torpedo programme

33. The MOD welcomes the Committee's acknowledgement of the improvements made in the overall torpedo programme and their support for the current SPEARFISH competition.

Design and procurement of warships

34. The MOD holds regular meetings with shipbuilders, one objective of which is to ensure that, within established guidelines, the industry is well informed on the Ministry's policy and the likely pattern of future MOD requirements for ships and submarines. The aim is to ensure that shipbuilders have information that is as full and reliable as possible upon which to judge their future workload and prospects in a competitive market.

35. The MOD confirms that its strategy is to maintain sufficient shipbuilding capacity to meet likely future defence requirements and a competitive base. These twin objectives are always taken into account in the placing of individual ship and submarine orders.

36. The MOD shares the Committee's concern at the slow progress in developing computerised command systems for the Type 22 and 23 Frigates. These command system projects have recently been reviewed with the aim of bringing the two programmes to completion at the earliest possible date. Where appropriate in this process the MOD has realigned requirements to take account of available technology and development work has been incentivised to the maximum extent possible.

Control and management of the Trident programme

37. The MOD welcomes the Committee's acknowledgement that financial control and project management appear generally to be operating effectively and that real reductions have been made in programme costs.

38. The contingency provision is regularly monitored with a major review at least once a year, following the re-costing of the MOD's long-term programme. Its use is closely controlled through the system of project management, which involves formal project reviews every four months, as well as the process of review referred to above.

39. The error in the estimate of US expenditure arose because the MOD did not appreciate that, contrary to normal US practice, the US Strategic Systems Program (SSP) Office had already allowed in their figures for inflation during the contract period. They refer to this as *constant* contract dollars, whereas the MOD, intending to exclude inflation, requested *constant* dollar estimates. No such misunderstanding will occur in future because the UK now clearly understands the US SSP costing conventions.

40. The Committee acknowledges the constraints on competition which result from there being currently only one nuclear submarine contractor. However, there is a firm requirement that competition should be sought for sub-contracts

wherever practicable and that the MOD's agreement should be required where the contractor does not propose to do this. Against this background, much of the hull section and missile tube steelwork has been competitively sub-contracted. For shore-based equipment to train operators and maintainers, feasibility studies and production contracts have been placed by competition. Procurement and contracting responsibility for the US Strategic Weapons System, including the missiles, has been placed with the US SSP Office. Competition is sought where feasible, but contractors have already been selected for most of the US programme and second-sourcing is not considered economic. However, the UK benefits from the advantageous prices which the US authorities originally obtained from their contractors and also from economies of scale through being included with the US programme. Competition has been used for the elements of the Tactical Weapons System where technical and programme considerations allow. Competitive tendering has been used for all main contracts in the Trident Works Programme and also for sub-contracts nominated by PSA where alternative suppliers were available.

41. The MOD and PSA note the Committee's observations on the cost of the Trident Works Programme. However, the 1981 figure was known to represent only PSA's original broad estimate. As the Committee notes, there has been no real increase in the total Works cost (including contingency) since a firm budget was set in 1984 and PSA remains confident that the Works programme will be completed within this budget. The large contingency provision was necessary to provide for the many uncertainties that lay ahead. However, it can only be drawn upon by joint agreement between PSA and the MOD. They confirm that it is carefully controlled and will not be used to accommodate avoidable cost increases.

42. The MOD's and PSA's works control procedures are continuing to work well. PSA still expects the Trident facilities to be completed in time to meet the MOD's requirement.

43. The MOD and PSA note the importance attached by the Committee to foreseeing the need for specialist expertise. The PSA has given the Trident Works Programme top priority. In general, sufficient specialist expertise is available either in-house or in the many consultants' firms involved in the project. The Construction Programme Co-ordinator has been appointed to give the Agency the benefit of a contractor's expertise on issues like industrial relations and large-scale site management. There have been problems, reflecting national manpower shortage in some disciplines, but not to the extent of putting any aspect of the project at risk. In some fields, such as seismic design for nuclear safety, there is a very limited pool of expertise in the country and the Agency is taking its full share of that.

44. As the Committee recognises in paragraphs 38 and 39 of the report, the MOD in concert with PSA has already taken a number of measures since 1986 to improve the management and control of the AWE Capital Works programme. The main measure is the introduction of a single experienced contractor, working under commercial incentives, to provide comprehensive management co-ordination and other services for the remaining stages of the construction and fitting out of the new facilities at AWE Aldermaston, including those needed for Trident. Following competition, the contract was awarded to the National Nuclear Corporation Ltd on 8 June 1988. Against this background the relevant projects formerly managed by PSA have been transferred to MOD management. The MOD notes also the Committee's concern about reliance on the use of existing facilities which need to be replaced. The Department is satisfied that although they are approaching the end of their life, the old facilities can be used to meet the early part of the warhead production programme, until the new facilities are ready.

45. The staffing of the AWE Trident programme will be kept under constant review and appropriate action will be taken as necessary.

46. The Treasury and the Land Registry note the conclusions and recommendations of the Committee.

Backlog

47. The Land Registry shares the Committee's concern at the growth in the backlog of unprocessed work. The volume of applications received by the Registry has increased by 66 per cent in the three years since 1985, reflecting the exceptional and rapid growth in conveyancing, both residential and commercial, together with associated mortgage transactions. This rapid growth made it difficult to revise resource requirements and to recruit and train suitable new staff fast enough to keep pace, even though the Treasury agreed significant increases in resources in successive expenditure rounds and also additional resources in July 1987 to meet a further surge in demand. During 1987 the Land Registry worked with the Treasury to devise alternative resource control measures, based on unit costs, to permit exemption from the normal gross control over departmental running costs. These new measures were introduced from 1 April 1988 and are permitting the Registry to adjust more quickly to changing levels of demand. The development of the Land Registry's financing regime remains under discussion to ensure that it facilitates and promotes efficient financial management and the effective delivery of registration services at minimum cost to the public.

48. The Land Registry has processed record volumes of applications over successive years. Output in the first four months of 1988–89 is at an all-time high and is 24 per cent higher than in the corresponding period last year and 64 per cent higher than the level achieved three years ago. The Registry is recruiting and training new staff in order to improve output further so as to overhaul the record levels of business and reduce the backlog of cases as quickly as possible.

Productivity and standards of service

49. The Land Registry agrees with the Committee that improving productivity should be given high priority. Productivity measured by units of output processed per post employed (ie the basis assessed by the Committee) has improved in each year since 1985–86 despite the massive growth in business and the consequent pressure on experienced staff that this growth has meant. The Registry has drawn up targets for steady improvements in productivity and unit costs for each of the next three years.

50. The Land Registry notes that the Committee welcomes the measures it has already taken to move work elsewhere and, in accordance with the Government's policy on location of work, is reviewing even more radically what activities can be moved from the South-East. Firm plans are being developed for further transfers of responsibility for registration in certain London Boroughs and south-eastern counties in 1989.

51. The Land Registry's targets for productivity, unit costs, output, quality and processing times continue to form an integral part of its forward plans. The Registry has taken steps to set even more demanding targets as part of the improved resource control measures referred to above. These are now subject to annual review with the Treasury.

Computerisation

52. The Land Registry looks to exploit to the full the benefits of computerisation throughout its operations as quickly as possible. In April of this year

computerisation of the register was introduced at the Gloucester District Registry and plans are well advanced for implementation of the full system at the Swansea District Registry in October. Following the initial implementation in September 1986 at Plymouth, where the benefits are already being realised, nine of the 16 district registries will, by the end of 1989, have introduced major aspects of the computerised system.

Fees

53. The Land Registry agrees with the Committee that a quicker and more flexible fee-making system is needed. It is pursuing the need for fresh legislation which will enable fee levels to be adjusted more promptly. The main reason for the very high level of fee receipts has been the exceptional increase in the volume of business and in property price inflation (66 per cent and 65 per cent, respectively) over the last three years. The Fee Orders made in 1985 and in 1986 reduced the *ad valorem* fee scales, but the impact of these reductions was overtaken by the massive increase not only in the volume of business but in property prices. A further Fee Order came into operation in June of this year, again reducing *ad valorem* fees for most applications. The Land Registry will continue to review the basis of Fees and Charges, having regard to the need to minimise conveyancing costs and maintain cost-effective registration services.

Planning and management

54. The Land Registry accepts the Committee's view that planning and management will need to be strengthened. With continued growth in conveyancing activity, and legislative change which is likely to widen the Registry's role further in the future, its commitments will continue to grow significantly. The Land Registry is committed to meeting the challenges of this growth in its services and the Treasury and the Registry recognise the need to strengthen the organisation and the structure. In accordance with the Government's new policy of "Improving Management in Government", the potential candidacy of the Land Registry as an Agency is currently under review.

Thirty-third Report
HM Customs and Excise

Investigation of Fraud and Smuggling

55. The Treasury and Customs and Excise (C&E) note the conclusions and recommendations of the Committee.

Staffing

56. As the Committee recognises, C&E intends to carry out more frequent reviews of investigation staffing requirements. In addition, the annual assessments by local management which supplement the more formal reviews will be enhanced with the introduction of the Investigation Division Operational Planning System. This system will also improve the Department's ability to direct resources to those areas where there is the greatest risk and will enable it to monitor more closely the additional value derived from the increases in complement which have been agreed for the period to 1990–91.

57. C&E shares the Committee's concern at the continuing shortfall in investigative staff, especially in London and the South-East. Consultation will continue between the Department and the Treasury to look for further ways in which to alleviate the problem.

Effectiveness

58. C&E notes the Committee's comments on the explanations given for the fall in the number of investigations completed. The Department emphasises that the fall in the number of cases completed is almost entirely due to the increase in the number of more complex cases handled and the fact that, except in the most serious incidents, VAT cases have been decriminalised and taken out of the statistics. Despite the fall in the number of cases completed the trend has been for a marked increase in the amounts of revenue involved and the value of the drugs seized. The introduction of the operational planning systems will improve the quality of management information, in particular, demonstrating with more accuracy how investigators' time has been spent and what results have been achieved. The Department will continue to seek to ensure that staff are deployed to best effect.

59. The Committee welcomes the development of the operational planning system for the Investigation Division. The system is currently undergoing successful trials and will be fully implemented by the end of the current financial year. The additional input required from the staff is minimal since much of the basic data is captured from other sources. The system will be tested in the Collection Investigation Units from April 1989, with the intention of completing the service-wide implementation by March 1990 at the latest.

Seizure of drug smugglers' assets

60. The previous target for the seizure of assets derived from the proceeds of the illegal importation and sale of drugs was set without experience of the operation of the scheme and was based on the value of Confiscation Orders expected to be made by the Courts. Experience of the first year of operation, however, has suggested that it would be more sensible for the C&E target to be related to the number of cases to be investigated, and the monetary proceeds associated with them, rather than to Confiscation Orders which are in the control of the Courts. The Department regards the revised target as stretching but realistic and will continue to monitor closely the development of this important new weapon in its anti-drug smuggling armoury.

61. C&E notes the Committee's recommendation that, as an incentive to maximise the amounts confiscated, consideration should be given to earmarking some of the proceeds to enhance the Department's drugs investigation work. They will be considering the possibilities further with the Treasury.

Co-operation with the police

62. C&E fully shares the Committee's view on the importance of co-operation between the Department and the police and will continue its efforts to maintain a very close working relationship. Co-operation has recently been enhanced, especially in the area of drugs enforcement, by the revision and distribution of the Government's strategy document entitled "Tackling Drug Misuse", which clearly defines the separate but linked responsibilities of the two services.

Information

63. C&E notes the Committee's reference to the research which is being carried out into the amount of drugs being smuggled into the UK. This work will be completed as quickly as possible. The Department also notes the references to compounding and the use of intelligence data and will make every effort to take action accordingly.

General

64. Like the Committee, the Treasury and C&E consider fraud and smuggling to be serious matters. C&E is determined to maintain its progress in combatting them.

Forty-first Report
Export Credit Guarantee Department

Effect of International Debt on Accounting Results and Other Matters

99. The Treasury and the Export Credits Guarantee Department (ECGD) note the conclusions and recommendations of the Committee.

Changes to provisioning methodology for countries with currency transfer difficulties

100. ECGD agrees that provisions should be assessed as realistically and objectively as possible. ECGD has fully consulted NAO on the provisioning methods to be used in the preparation of the 1987–88 trading accounts in the light of the consultants' report. The new methodology uses the Bank of England guidelines for banks as a starting point. ECGD adapts them to reflect ECGD's business as a credit insurer and its own experience with individual troubled countries.

Trading surplus reported in 1986–87 and new form of accounts

101. The accounting format and policies used to determine the trading surplus in 1986–87 were similar to those used for a number of years without qualification by the C & AG. ECGD recognised some time ago that its accounting policies and format required a thorough review. The Committee was informed on 3 March 1986 that this review was in hand and that changes would be introduced in the 1987–88 Trading Accounts. The 1987–88 Trading Accounts will be in a clearer form and will as far as possible take account of best commercial practice.

Estimated maximum drawings on the Consolidated Fund

102. ECGD produces the estimates in accordance with information available at the time. As the Committee notes at paragraph 3(i) of its report, ECGD is forecasting in a rapidly moving and uncertain situation and it is, therefore, inevitable that forecasts will have to be adjusted. ECGD's financial position is reviewed as part of the annual business planning procedures and decisions taken accordingly.

Investigation unit

103. ECGD welcomes the Committee's acknowledgement of the cost effectiveness of the Unit. ECGD continues to increase the awareness of its staff of the dangers of fraud. The Unit has adopted a targeted approach which should help improve further the assessment of the level of potential fraud. The Unit's staffing needs are the subject of regular review and in the last few months the post of Head of Unit has been upgraded.

Medium-term bank guarantee documentation

104. ECGD's support for extended terms business (which includes this facility) is under review. The intention is to resolve the position on medium-term bank guarantee documentation as soon as possible.

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(now the prison service financial management system) and is considering how best to remedy the shortcomings.

Planning workshops in new prisons

98. The Home Office welcomes the Committee's endorsement of the new arrangements for planning workshops in new prisons.

Thirty-sixth Report
Home Office

Prison Service Industries and Farms (PSIF)

92. The Treasury and the Home Office note the conclusions and recommendations of the Committee.

Management and level of trading losses

93. The Home Office welcomes the Committee's recognition of the progress made in the management of PSIF and the reduction of annual trading losses since the Committee's report in 1985–86. The Home Office is committed to sustaining and further developing these management changes, and to working towards further cost reductions.

Longer-term objectives

94. The Home Office shares the Committee's concern about the fundamental tension between PSIF's twin objectives of running its business as nearly as possible on commercial principles while at the same time providing employment for prisoners in circumstances where the operational requirements of establishments must always take precedence. The Home Office notes the Committee's recommendation that it should address as soon as possible the longer-term issues involved in determining the necessary role and cost objectives of prison industries in the prison service. The pressures currently placed on the prison service by the high prison population are such that it may be some time before the position is sufficiently stable to enable effective longer-term planning to be undertaken. The Home Office is, however, determined to address these matters as soon as possible.

Improvement in the operation of prison workshops

95. The Home Office notes the Committee's recognition that the "contract" arrangements for the allocation of inmate labour are an improvement on the previous position, but also accepts that there is scope for further refinement. Procedures which are now being introduced to give prison governors weekly information about the delivery of regime activities, as part of the development of the existing arrangements, will enable the Home Office to draw more effectively on good practice in securing the efficient operation of prison workshops. As the Committee recognises, the "Fresh Start" working arrangements for prison officers and the new management structures in establishments also provide a better framework within which the Home Office can work to improve the performance of prison workshops.

Management relationships between PSIF and establishments

96. The management relationships between PSIF, prison governors and their industrial managers are one example of a difficult problem throughout the Prison Service. The difficulty is that direct management responsibility for staff in establishments needs to rest with local managers who have day-to-day contact with them. But Divisions in Prison Department Headquarters in many instances have ultimate responsibility for what local staff deliver. The Home Office recognises the need to clarify these management relationships and is considering how best to do so, both in respect of PSIF and more generally.

Prison costing system

97. The Home Office accepts the need to improve the prison costing system

the General Notice to Defence Contractors, stressing the seriousness with which MOD views procurement fraud and corruption, has now been issued.

Department of Defense (DOD) practice and hot-line

90. The MOD maintains regular contact with relevant Department of Defense officials and intends specifically to discuss with them the experience of their "hot-line" arrangement.

Dissemination of lessons learned

91. The Treasury confirms that it will inform departments of any lessons of wider application to be learned from reported cases of procurement fraud.

Thirty-fifth Report
Ministry of Defence

Procurement Irregularities

82. The Treasury and the Ministry of Defence (MOD) note the conclusions and recommendations of the Committee.

Incidence of procurement irregularities

83. The MOD welcomes the Committee's recognition that the incidence of procurement irregularities is small in the context of the MOD's total procurement expenditure.

Ministry of Defence Police (MDP)

84. MOD Police officers receive the same detective training as their counterparts in other UK police forces, but the investigation of defence procurement fraud is a specialised field for which practical knowledge of MOD and its procedures is essential. The special experience of the Serious Crime Squad of the MDP is supplemented as necessary by the secondment of specialist advisers, and by the deployment of additional officers if necessary to meet specific requirements. A close working relationship has been developed with the Serious Fraud Office, in particular in the handling of the more complex corporate investigations. Overall the MOD considers its investigative capacity to be currently adequate.

Payments to informants

85. The MOD accepts that its approach to the payment of informants should be generally in line, dependent on the circumstances, with that of other departments and will examine accordingly any case which arises.

Price-fixing

86. The MOD will continue to press contractors to adopt systems which will ensure the provision of accurate and complete information for price negotiation purposes. As a result of full discussions with major contractors, significant progress has been made in the preparation of monographs, which describe companies' cost estimating systems, leading to a more systematic approach to the presentation and examination of cost estimates.

Increased competition

87. The MOD accepts the general objective to maximise the extent to which work is placed to contract following competitive tendering. There has been a sustained improvement in the levels of competitive procurement over the last four years.

Sanctions against contractors who overcharge

88. The MOD will examine the scope for applying more severe sanctions against contractors where it has been deliberately overcharged.

Staff effort in reducing irregularities

89. The MOD accepts the importance of keeping under close review and augmenting as necessary the staff effort and training available for combating procurement irregularities. Fraud awareness seminars continue to be held and

merchant bank adviser and lead underwriter should be separated. Separate appointments to these positions have been made for the first time for the forthcoming sale of British Steel. The Government's merchant bank adviser will in future not be eligible to underwrite or sub-underwrite a privatisation offer.

(iii) Targets for wider or deeper share ownership

80. The Government shares the Committee's view that it is not practicable to set quantified targets in relation to objectives for widening or deepening share ownership. The level of demand which emerges in the offer from individuals, employees and institutions will depend on a number of factors, including the price of the shares, the nature of the company being sold and the state of the market. The Government will continue to cater for a range of possible outcomes, depending on the actual response of the market to the offer.

General

81. The Government agrees that the experience gained in past sales should influence the conduct of future offers. As part of its co-ordination role, the Treasury undertakes to pass on to sponsor departments the lessons learnt by departments handling preceding sales.

should be reduced further, and that competition should be extended to the sub-underwriting field.

73. In the case of primary underwriting, it is now the Government's normal practice to hold a competition. The Government is satisfied that competitive forces will ensure that the rates emerging from the competition will be as low as market circumstances allow.

74. In the case of sub-underwriting, the Government wants to see costs reduced, and it shares the Committee's view that the possibilities for extending competition should be pursued. But there are a number of practical difficulties in achieving this aim, for example, the limited time available once the offer has been priced but before it is offered publicly, and the large number of sub-underwriters operating in the London market who might wish to enter bids. The Government will nevertheless continue to look for ways in which these difficulties might be overcome.

(v) Sales incentives

75. The Government notes the Committee's concern that there is little firm evidence that sales incentives represent good value for money. The Government will consider case by case whether such incentives are necessary to the objectives for future sales. In doing so, the Government will also take into account the experience gained of such incentives in earlier sales, although it notes that most have yet to run through to completion (bonus shares, for example, are paid some three years after the relevant sale to eligible individuals who retain their holding for the qualifying period).

(vi) Profit and dividend levels

76. The board of each privatised company is best placed to estimate the future levels of profits and dividends of the company, and has legal responsibility for any such statements included in the prospectus. However, the Government will continue to seek independent advice on the reasonableness of any estimates made by the board, and will also seek to ensure that the interests of taxpayers are taken into account to the maximum extent, while also bearing in mind the objectives of the sale and the interests of future shareholders.

Results of sale

(i) Marketing costs

77. In the case of the British Gas and British Airways sales, Departments considered carefully in advance the level at which the marketing budget should be set and the way in which expenditure could best be targeted on sales objectives. The Government will continue to place emphasis on the tight control of marketing costs in future sales.

(ii) Pricing

78. Pricing decisions have to be taken in the circumstances of each offer, and necessarily vary from sale to sale according to the nature of the business being privatised and the state of the market. The Government assesses the outcome of each sale in order to draw lessons which may be useful when future pricing decisions are taken. However, it does not believe that firm general guidance can be given which will ensure an optimum price for the sale of different businesses in different market conditions.

79. In accordance with past practice, the Government will seek professional advice on the pricing of future sales in order to maximise net proceeds. The Government has decided that, in order to ensure that there is no conflict of interest in the advice given on pricing and other aspects of the sale, the roles of

Thirty-fourth Report
HM Treasury
Department of Energy
Department of Trade and Industry
Department of Transport

Sales of Government Shareholdings in British Gas plc, British Airways plc, Rolls-Royce plc and BAA plc

65. The Treasury and the Departments of Energy, Trade and Industry and Transport note the conclusions and recommendations of the Committee.

Arrangements for sale

66. The Government will continue to give careful consideration to the Committee's recommendations, and to seek professional advice before reaching important decisions, as the Committee notes it has done hitherto.

(i) Capital structure

67. In the case of Rolls-Royce, the Government believes that, while the matter cannot be conclusively proved one way or the other, the injection of £283 million into Rolls-Royce was broadly recovered in sales proceeds.

68. Where there are proposals for a capital injection in future sales, the Government will seek professional advice as appropriate, as it did in the case of Rolls-Royce, and will act in accordance with the best interests of the taxpayer. This will usually involve keeping any capital injection to a minimum, as recommended by the Committee, but might not always do so.

(ii) Sale in tranches

69. The Government notes the Committee's view that a phased sale by tranches can, in the right circumstances, minimise the risk of setting too high or low a price. As the Committee notes, a sale in tranches was carefully considered in each of the four sales examined by the Committee.

70. A sale of at least 51 per cent of the shares in a company is necessary to achieve the transfer of that company to the private sector, but the Government has a choice as to the appropriate size of an offer beyond this 51 per cent level. While pricing is certainly one factor taken into account, other factors include the extent to which any residual shareholding will overhang the market, market conditions and capacity, and any wider Government objectives for the sale. The Government will continue to consider, in the circumstances of each sale, the respective merits of full and tranche sales.

(iii) Partial tenders

71. The Government shares the Committee's view that the use of a partial tender for the BAA sale was highly successful, and agrees that a partial tender mechanism, not necessarily on identical lines to that devised for the BAA sale, should be considered carefully as one of the options for maximising proceeds in future sales, provided that this is consistent with market conditions and the wider objectives for those sales.

(iv) Underwriting and sub-underwriting

72. The Government notes the Committee's suggestion that underwriting costs

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TREASURY MINUTE DATED 18 JANUARY 1989 ON THE FORTY-THIRD TO FORTY-EIGHTH REPORTS FROM THE COMMITTEE OF PUBLIC ACCOUNTS, SESSION 1987-88

Forty-third Report
Home Office

Independent Broadcasting Authority:
Additional Payments by Programme Contractors

1. The Treasury and the Home Office note the Committee's conclusions and recommendations.

Measures of cost-consciousness and efficiency

2. The principal aim of the levy changes in 1986 was to lower the combined marginal rate of levy and corporation tax on programme contractors, with a view to encouraging greater cost-consciousness and efficiency in the industry. Since the introduction of the new levy arrangements, there has been some evidence of an improvement. In particular, ITV companies have been able to increase their programme output and hours of transmission while holding down and, in some cases, reducing staff numbers.

3. The Home Office and the IBA accept the case for developing systematic measures of ITV efficiency. In recent months, the IBA and the ITV companies have jointly developed a series of financial indicators which will be used to monitor progress, and will provide ITV management with additional information to assist further improvement of efficiency.

Review of levy arrangements

4. The Home Office and the IBA accept that while the 1986 levy changes were followed by an increased yield, maintenance of the pre-1986 rates would, other things being equal, have produced a greater income. In planning the levy changes, the Home Office calculated the effects of a possible fall in advertising revenue, in order to assess the risk of an absolute loss of levy yield, bearing in mind the Committee's previous concerns. But in the light of the previous weakness of advertising revenue, it was not appreciated at the time that such a strong upward movement was beginning.

5. It is not, however, possible to establish whether companies' profits would have been as high in 1986-87 and 1987-88 if the higher levy rate had continued in operation. Tax regimes tend to have their own influence on company practice. Nor could confident predictions have been made about the impact of relevant external factors such as exchange rates. Nevertheless, the Home Office, in consultation with the Treasury, and the IBA, will make every effort to ensure that the latest review of the levy arrangements result in the desired level of yield.

6. The Home Office and the Treasury have recently reviewed the structure of the levy and have consulted the Independent Broadcasting Authority. The Government has decided that for the 1990-92 contract extension period of the independent television contractors, the levy should be based on a combination of revenue and profits. The revenue element of the levy, by linking yields directly to advertising revenue, is designed further to encourage cost-consciousness. It is intended that the levy should produce a yield broadly equivalent to that which would have been secured under the profits-based system which applied prior to 1986. The structure of the new levy will be such that about three-quarters of the total yield is expected to arise from net advertising revenue, and the remainder from profits. The Home Office, with the Treasury, and in consultation with the IBA, is working to develop a model for forecasting levy yield and, is reviewing all

available information to assess trends in ITV companies' revenues, costs and profits. This exercise will determine the precise levy rates.

7. The arrangements for the 1990-92 levy are intended to cover a transitional period. The Government intends that from 1993 a levy on revenue will form part of a competitive tendering system for commercial television. It is intended that the new arrangements will be provided for in the next Broadcasting Bill.

Forty-fourth Report
Department of Health and Social Security

Quality of Service to the Public at DHSS Local Offices

8. The Treasury and the Department of Social Security (DSS), formerly part of the Department of Health and Social Security (DHSS), note the conclusions and recommendations of the Committee.

Standards of service in offices

9. The standard of service in many DSS local offices is good and is currently improving. Even in those offices where standards have fallen short of what the public is entitled to expect, changes are taking place in order to produce improvements, although some variations are bound to exist in a service which has to reflect local circumstances and to meet wide variations in such local circumstances. The replacement of Supplementary Benefit by Income Support has made the benefit system simpler for the public to understand and for staff to administer, and backlogs like those generated under the old scheme by claims for single payments have largely disappeared. In September 1988 Income Support claims were cleared, (nationally), in 5 days, compared with 6 days a year earlier, and error rates had improved from 11.5% to 9.7%. Such improvements are likely to continue. DSS expects a survey of caller waiting times, now under way, to show similar improvements.

10. As a means of providing more consistent levels of service DSS is urgently considering proposals to relocate some processing work away from London offices to speed up claims assessment. In addition, trials have begun of a new staff complementing system which facilitates the setting of local target levels of performance in order to help equalise local office service standards. In these ways DSS hopes to build on its recently improved general performance.

Target-setting

11. DSS has refined its target-setting processes in 1988, aligning them to the Public Expenditure Survey (PES) programme and the management accountability cycle. In 1988-89 performance targets were published in the House of Commons Library for the first time. Performance standards and targets are now being set for a 3-4 year operational planning period, with targets reviewed each year in the light of resources allocated in PES and within the processes developed for the Department's new complementing system. Target-setting arrangements will include the definition of quantified desirable standards for service delivery which are the Department's strategic objective, and a range of minimum tolerable standards for each aspect of service representing the level below which the performance of individual local offices should not fall.

Key management arrangements

12. Management attention is now concentrated on improving the poorest levels of performance in local offices to ensure that more consistent standards of service apply across the whole country. Particular attention will focus on those regions and offices performing below tolerable standards. A new reporting system is being established to monitor progress.

Extending the scope of performance measurement

13. From April 1989 the scope and coverage of performance monitoring will extend to 75% of local office activity, rather than 50% as now. Since October 1988 all local offices have begun to monitor — in quantifiable terms and on an annual basis — quality of service in areas like interviewing, correspondence, telephones, home visiting and caller waiting times, and to research customer opinion on the

service provided. This will lead to setting targets on quality of service in 1989-90 as part of the accountability process. For the future information about productivity, the time taken to clear claims, and quality of service, will be measured against targets set at the start of each year. This will identify local offices that are not achieving targets, and managers will be required to take action to try to ensure that agreed levels of service are provided.

Complementing local offices

14. A new complementing system for local offices based on performance as well as work measurement is being introduced on a trial basis. It will seek to deploy staff to meet agreed standards of service and agreed productivity levels, and will allocate staff to local offices in order to achieve targets set.

Staff turnover in the inner cities

15. DSS remains concerned at the high level of staff turnover in inner London offices and elsewhere. The Moodie Report "The Business of Service" analysed the problem, and made specific recommendations for its resolution based on relocation of local office work not requiring face-to-face contact with the public. Ministers have accepted the recommendations in principle. Detailed work is now in hand on how the recommendations will be implemented, and Ministers have been preparing an announcement.

Local office estate

16. DSS has embarked upon a major programme of rehousing and refurbishment. This is aimed at the offices with poorer quality accommodation. This increased spending will not only go a long way towards eliminating overcrowding for staff but should also provide attractive, comfortable offices for staff and public alike.

Advice and information

17. DSS considers it essential that the public have access to all the information and advice they need to decide whether or not to claim benefit, and welcomes the Committee's support for a policy of flexible response by local offices. DSS has made great strides over the past 5 years in expanding and improving its advice and information responsibilities — eg Freeline Social Security, which deals with over 700,000 calls each year, fast stream reception facilities to minimise waiting times, mobile information units, and Local Information Officers — and intends to maintain this momentum.

A more positive image for social security

18. DSS welcomes the Committee's support for its efforts to promote a more positive and customer-friendly image for the social security system. DSS is currently preparing a departmental-wide strategy to take this concept forward. The question of the issue of guidelines to all local offices on the provision of advisory services is one of the important issues to be addressed in the formulation of this strategy.

Communications with the public

19. DSS is aware of the risk of placing too great a reliance on written communications. More modern methods of communication are being introduced on a trial basis, and will in the future assume a greater role in DSS promotional activities. But the written work remains indispensible, and leaflets, backed up by posters and advertising in the press and on television, will remain the main channel of communication for the foreseeable future. The Department's new

Forty-fifth Report
Inland Revenue
HM Customs and Excise

Inland Revenue Department and HM Customs and Excise

22. The Treasury, Inland Revenue and Customs and Excise note the Committee's conclusions and recommendations.

Inland Revenue

Collection performance

23. The increase in the proportion of collectible assessed taxes which remained outstanding at October 1987 was largely due to technical accounting changes relating to composite rate tax paid by Building Societies.

24. After making an adjustment for this factor, the increase in the collectible balance was about ½ per cent, from 16.3 per cent in 1986 to 16.8 per cent in 1987. This compared with the significantly higher figure of 18.7 per cent in 1985. The Inland Revenue believes that, particularly in a period of rising workloads for the collection service, the figure for the total outstanding collectible balance gives an incomplete picture of collection performance and that it is more helpful to look both at the size and the age structure of that tax outstanding. In this respect, the Department notes that the proportion of the collectible balance which represents charges outstanding for more than three months has been steadily reduced from 11.9 per cent in 1985, to 11.4 per cent in 1986, and to 11.1 per cent in 1987. The Department is taking steps to reduce still further both the collectible balance and the amounts which have been outstanding for three months or more.

PAYE erroneous charges

25. The Inland Revenue notes the Committee's surprise at the level of erroneous charges though it recognised that these are not wholly within the Department's control. The estimated erroneous charges at October 1987 were reduced to a figure under one-third of that at October 1986. A number of steps have been taken to reduce the proportion of such erroneous charges further. These include setting clear priorities for district and collection staff handling Pay As You Earn charges and the introduction of quality control procedures in district offices.

Post arrears

26. The Inland Revenue is glad to note the Committee's welcome for the improvement in the end of year arrears of post in tax offices. The increase in postal arrears in May and June this year reflected normal seasonal patterns as tax offices gave priority to work on Budget PAYE recoding and the examination of annual tax returns. Arrears have now been significantly reduced and tax offices are on target to clear most of the remainder by April 1989.

Collection offices' workload

27. Collection offices have been making a concerted effort to process more outstanding charges. In the year to October 1988 they cleared 2.1m as compared with 2.05m in the previous year. As a result, for the first time for several years, the number of outstanding items at the end of year went down from 1.4m to 1.3m, a 7.7 per cent reduction.

Sub-contractors

28. The Inland Revenue notes the Committee's comments on the construction industry tax deduction scheme, and the related scrutiny.

structure for leaflets and advisory guides, introduced as part of its Communications Strategy, is designed to help those who have some difficulty with the written word. Illustrated client group leaflets give brief indications in simple language of the range of benefits available, while technical guides provide detailed information which advisers can use in helping claimants.

Monitoring the impact of information and advice activities

20. DSS is moving to a more systematic monitoring of the effectiveness of information and advice activities. The new structure of leaflets and guides was developed in the light of external research, and more has been undertaken this year to assess their effectiveness. Also this year, for the first time, all local offices are sampling customer reactions to the service they receive — including all aspects of communications — and line management will be accountable for the performance levels revealed. This will be a regular exercise, and from 1989-90 will be validated by an independent national customer opinion survey. The Treasury will issue guidance to Departments on the use of surveys and other methods for assessing the quality of services they provide to the public.

Conclusion

21. The Government is confident that, given the changes introduced by the 1986 Social Security Act, there has been a significant simplification of many important aspects of the Social Security system. This in turn has presented DSS with an opportunity to improve its standards of service to the public and this opportunity is already being grasped.

Inspector wastage and recruitment

29. The Inland Revenue shares the Committee's concern at the sharp rise in losses of Tax Inspectors, particularly of fully-trained Inspectors, to attractive jobs in the private sector. The Department is closely monitoring the effects of the various measures which are being taken to try to alleviate the position. The Exit London programme, which involves moving work from London to a number of provincial locations, is now well under way. Internal reviews have been completed into the scope for District Inspectors to delegate work to Inspectors who assist them and into the long-standing requirement that Inspectors accept an obligation to be fully mobile. Finally, use has been made of the added flexibility provided by new Civil Service pay agreements to address the overall shortage of Inspectors. Allowances for newly-qualified Inspectors have also been improved.

30. The Department notes the importance which the Committee attaches to its efforts to increase recruitment to the Tax Inspectorate. This is going well. In the year to end of September 1988 the target for the fully trained scheme was raised from 120 to 150, and 146 graduates took up post. The target for internal selection for the Inspector Accounts Investigation Course has been raised from 500 in the year to March 1988 (579 achieved) to 575 in the year to March 1989 (528 to date). The new scheme for Cadet Inspector recruitment at HEO level in the London area has also gone well so far. It is expected that about 80 will take up duty from applications received in the first year of the scheme.

HM Customs and Excise

31. Customs and Excise confirms that the Departmental Accounting System continues to work satisfactorily and that budget holders find the monthly reports a reliable source of information.

32. Customs and Excise notes the Committee's comments on its decision not to introduce a period of parallel running when the Departmental Accounting System was implemented. That decision was taken both because of the resource problems it would have created and in the light of the consultant's advice at the time that such parallel running seldom works effectively.

33. Customs and Excise has reviewed its strategy for testing new computer systems in the light of the problems it met in introducing the Departmental Accounting System and has prepared revised guidelines for use in future projects. They cover the planning and control of projects, fallback arrangements, post-implementation support and relations with contractors, in addition to system testing.

34. The Treasury will ensure that the lessons from this case are brought to the attention of departments.

Forty-sixth Report
Department of Health
Welsh Office

Management of the Family Practitioner Services

35. The Treasury, the Department of Health (DH)—formerly part of the Department of Health and Social Security (DHSS)—and the Welsh Office (WO) note the conclusions and recommendations of the Committee.

New management arrangements for the family practitioner services

36. DH and WO welcome the Committee's recognition of the steps taken to improve the accountability of Family Practitioner Committees (FPCs) and the management of the family practitioner services (FPS). As the Committee acknowledges, the November 1987 White Paper "Promoting Better Health" set out the Government's further intentions in these respects.

37. The Departments note the Committee's view that further guidance on planning should be provided to FPCs, and steps taken to integrate FPS planning with that of the hospital and community health services (HCHS). DH issued guidance to FPCs in September 1988, aimed at strengthening the planning and accountability arrangements. The revised arrangements aim to focus on the setting and achievement of objectives; to facilitate joint planning between the FPCs and health authorities; and to sharpen the FPC performance reviews carried out by the Department. In Wales, the accountability arrangements have been modified to place greater emphasis upon objective and target-setting by FPCs. The Corporate Management Programme for the health service in Wales points to full integration of FPCs in NHS planning. In addition the Welsh Health Planning Forum has been established in 1988 as a mechanism for expanding collaboration within the NHS in Wales.

38. DH and WO welcome the Committee's recognition of the progress made in computerising FPCs. The Departments accept the need for an information strategy for the FPS and work is in progress. This could not begin until the objectives of the FPS had been clarified following the November 1987 White Paper, but DH intends to have a strategy and plans for its implementation in place during 1989. An FPS information strategy will be an integral development of the Information and Information Technology Strategy for the NHS in Wales, published by WO in 1987.

39. DH and WO welcome the Committee's belief that FPCs should actively monitor and assess the quality of service. It is part of the Government's strategy for an enhanced management role for FPCs that they should make increasing use of performance indicators and other sources of information about local services in assessing service needs and devising strategies for improvement. As the Committee notes, the Government expects FPCs to conduct local consumer surveys from time to time so that consumers' views can be taken more fully into account. These surveys will be local in scope, but DH and WO expect to draw on FPCs' local experience in formulating national policy.

40. DH and WO fully accept the importance of keeping the resources available to FPCs under regular review. Resources to cover the administrative costs of English FPCs stand at £55.7m. in 1988–89. This represents an increase, in real terms, of 6.4% over 1987–88. The corresponding real terms increase in Wales is 9.2%. The White Paper "Promoting Better Health" makes clear that FPCs will be given additional funds to implement the new tasks they will be taking on.

41. The Committee also referred to the structure of FPCs within the NHS and to the title of these bodies and their chief officers. The Government is considering the organisational structure of the NHS as part of its current review, and will be announcing its conclusions shortly.

Impact of the new arrangements on GP services

Deputising services

42. DH and WO welcome the Committee's support for monitoring the quality and use of deputising services. The Departments believe that it is important for general medical practitioners to maintain continuity of care for their own patients so far as is reasonably possible. FPCs need therefore to have regard to both the quality of service provided by deputising services and the actual level of usage. Value for money is a further important consideration. DH and WO will consider carefully the Committee's recommendations.

The employment of ancillary staff

43. DH and WO note the Committee's disappointment that FPCs have not been required to take an active promotional role as regards the employment of ancillary staff. But as the White Paper "Promoting Better Health" made clear, FPCs will be expected to devise locally agreed strategies, in collaboration with District Health Authorities, for developing appropriate practice teams. A wider range of staff will qualify for reimbursement and the Government will be making extra resources available to fund the extension of the scheme. The Health and Medicines Act 1988 provides for cash limited funds to be allocated each year to FPCs, who will be responsible for ensuring that the best use is made of the funds and skills available, in the way most suited to local needs. The Departments will monitor FPCs' progress through the annual performance review programme.

Care for the homeless and rootless

44. DH and WO note the Committee's views on health care provision for homeless and rootless people. The Departments will consider further action in the light of the evaluation of the two pilot schemes for providing primary health care for single homeless people in London.

The promotion of group practices

45. DH and WO note the Committee's comments on the balance between group and single-handed practices. The distribution and selection of GPs is the responsibility of the Medical Practices Committee. The Departments agree that FPCs should have a greater input into the process to ensure that local needs are met in the most effective manner. They are discussing the matter with the Medical Practices Committee and with representatives of the profession and FPCs.

The standard of premises

46. DH and WO share the Committee's concern that practice premises in some cases, particularly in deprived areas, remain below acceptable standards. Expenditure on premises has been increasing, as the Committee acknowledges. Under section 16 of the Health and Medicines Act, each FPC will be allocated extra funds for the direct reimbursement of practice premises improvement costs. FPCs will be required to adopt strategies to ensure that money is targeted on those practice premises where the need is greatest. FPCs will offer advice and encouragement to practitioners currently working from sub-standard premises and will be expected to apply existing sanctions more stringently than at present.

Forty-seventh Report
Ministry of Defence

Major Defence Projects

47. The Treasury and the Ministry of Defence (MOD) note the conclusions and recommendations of the Committee.

Annual Statement on Major Defence Projects

48. The MOD notes the suggestions for expansion of the Major Projects Statement (MPS) which have been put forward by the Comptroller and Auditor General. Its response is as follows (sub-paragraph references relate to paragraph 5 of the Committee's Report):—

(i) The Comptroller and Auditor General suggested the provision of a note on any changes in quantities ordered since the time of Treasury approval. This will be provided in future MPSs.

(ii) Explanations will be provided in future MPSs of slippages in in-service date of two years or more and cost increases for development or production in excess of 20% in real terms.

(iii) Where major difficulties have arisen in programmes, brief notes will be provided in future MPSs.

(iv) This will be done, provided the equipments are similar in character.

(v) This will be done in future MPSs where the works or ancillary support is linked exclusively with the equipment in question.

(vi) Columns (h) and (i) of Table I of the MPS enable original and current cost estimates to be compared on the basis of constant prices and exchange rates. The MOD accordingly does not agree that the effect of changes in the volume of resources absorbed is liable to be masked, and sees no need for expansion of the MPS on account of exchange rates.

(vii) The criterion governing inclusion of possible additional expenditure in Table II was set out in paragraph 6 of the letter from the Chief of Defence Procurement which is reproduced on page 9 of the Minutes of Evidence appended to the Committee's Report.

(viii) In preparing future MPSs the MOD will take the following into account for purposes of determining inclusion in Table III:—

(a) expenditure on stages of the project other than project definition;

(b) any Supporting Technology Programme which is linked exclusively with the project in question.

(ix) The MOD does not agree that Table III should indicate the date by which the equipment is required or possible development and production costs, since these can only be estimated with any degree of confidence at the end of project definition.

49. Improved systems for supplying financial information within the Procurement Executive are being developed and may eventually help to facilitate preparation of the MPS. In the meantime, however, it will be necessary to continue to produce the MPS by existing methods.

50. The MOD has noted the relationship between development and production costs referred to in paragraph 3(i)c of the Committee's Report. As part of the "Learning from Experience" initiative the MOD will be systematically collecting data on projected and achieved costs on projects as they proceed through the procurement cycle. The reasons for any variations will be examined in order to identify the causes, so that lessons can be learned and disseminated to other project

managers. The MOD will keep the Committee informed of the results of this investigation.

51. The MOD notes the Committee's concern about the position on the Foxhunter project as reported up to 31 December 1987. The current position is that, as the Committee observes, a new firm price contract for the completion of Foxhunter radar development was signed in March 1988 with Marconi Defence Systems. The package of work agreed with the contractor is intended to bring the radar up to a standard required to meet the threat of the 1990s. The contract links taut technical criteria to strict arrangements which relate payments to achievements.

52. The MOD notes the Committee's concern on the relationship between the delivery rates of Tornado aircraft and Foxhunter radars. The present position is that all Tornado aircraft in front line service have Foxhunter fitted and the RAF has sufficient radars to meet all its current requirements. Radars to an agreed interim standard in service with the RAF are providing a capability superior to that of the aircraft they are replacing.

53. The MOD notes the Committee's recommendation that, in the light of the original Foxhunter contracts, the MOD should seek to incorporate contract clauses which would enable them to seek redress. The MOD will continue to secure taut contract terms and conditions, defining the requirement in terms of specification and delivery, under which redress can be sought whenever appropriate.

54. The MOD notes the Committee's recommendation that British Aerospace's costs incurred under the original ALARM contract be carefully scrutinised. The fixed price nature of the original contract was removed by the February 1987 agreement. From then, and up to 31 August 1987, BAe were to be paid their actual costs incurred against the original contract. Under the terms of the later (November 1987) agreement BAe were working, without payment from MOD, on the rocket motor risk reduction phase, under which they had to meet certain criteria by 31 March 1988. If this had been unsuccessful, then MOD would have been liable to meet BAe's costs incurred under the original contract, plus the costs of cancellation. In those circumstances the MOD would have had the right to verify the costs, in accordance with established procedures.

55. In the event, as noted by the Committee, the programme did proceed, and the revised fixed price contract as negotiated in the November 1987 agreement came into effect. Under the terms of this agreement costs incurred between February 1987 and the signature of the revised contract (29 February 1988) were subsumed into the revised fixed price. As part of its investigation of the BAe quotation for the revised fixed price, the MOD made a very careful assessment of costs already incurred and the estimates of future costs, to ensure that they represented a fair and reasonable charge for work undertaken.

56. The Department's legal advice is that no status, short of one whereby the Crown was entirely divorced from all responsibility for an involvement in the performance of the Research Establishments, could totally avoid the possibility of some contingent liability (legal or moral) arising. This possibility would remain if the Research Establishments were constituted as a Defence Research Agency (DRA) or if anybody acted for the Crown in this capacity. However, the risk of an ALARM type of problem with contingent liabilities arising should be reduced by the Department's tight control of resources and contractual commitments. It is the Department's intention to include firm performance requirements in contracts whenever possible. One element of work in hand in relation to the possible introduction of a DRA concerns the handling of the Department's contingent liabilities.

Treasury Minute

57. The MOD recognises the importance of applying careful and detailed scrutiny to the software aspects of proposals for new equipment. It is now standard practice for equipment projects coming before the MOD's Equipment Policy Committee which have a high software content to be tested against the guidelines reproduced in Appendix 3 to the Minutes of Evidence.

"Learning from Experience"

58. The MOD had already been improving project management in the direction of the recommendations of the Report. The MOD has now formed a directorate specifically to carry through the action plan and a number of the key recommendations have already been implemented.

59. In order to improve the professionalism of project managers, all potential managers have been identified and their training programme has been revised and tailored to the needs of the competitive environment in which they operate. We would expect major projects to be headed by managers with previous experience who would remain with their projects for a suitable period of time wherever possible.

General

60. The MOD shares the Committee's desire to see "a sustained and marked improvement" in project management and will be monitoring a number of future projects to assess progress in this direction.

Forty-eighth Report
Ministry of Defence

Sale of Royal Ordnance plc

61. The Treasury and the Ministry of Defence (MOD) note the conclusions and recommendations of the Committee.

Superannuation arrangements

62. The Treasury notes the Committee's concern about the basis of compensation for the delay in payment of the transfer value. It judged that the indexing arrangements eventually agreed, which represented the composition of a typical pension fund, were acceptable in the context of the settlement on the transfer value and the desire of Ministers to conclude the privatisation. In these circumstances, the Treasury acknowledges that some element of the compensation payment could be regarded as a cost of privatisation.

63. The Treasury's objective is to minimise the costs to the Exchequer and in any future such case it will consider the possibility of an interim payment. However, making a payment before it is due involves interest costs and would result in the total payment being higher than necessary if equity values declined.

Selling arrangements and price obtained

64. The MOD notes the Committee's concern that under the Scheme of Transfer as drafted and approved not all the outstanding liabilities of the R & D Establishments were transferred to Royal Ordnance plc (RO) on Vesting in January 1985. The Scheme did transfer liabilities arising out of contracts made after the Royal Ordance Factories (ROF) took over responsibility for managing the Establishments, on 1 April 1984, and certain other liabilities attributable to their activities after that date. As the Committee acknowledges, given the problems which subsequently arose over ALARM, it would not have been practicable to have vested RO with liabilities which exceeded its assets.

65. As the Committee acknowledges, the agreement with BAe on ALARM was made under pressure of the RO sale timetable. It was to take advantage of this that MOD did not allow BAe access to the financial information required for participation in the bidding for RO until a satisfactory agreement on ALARM was concluded. The MOD is responding separately to the Committee's further conclusions on the contractual aspects of the ALARM project contained in its Forty-seventh Report.

66. The MOD notes the Committee's views on the potential development values of RO landholdings. Before the sale, RO had been exploring the possibility of redevelopment at Waltham Abbey and part of the Enfield site, but had reached no definite conclusions about the future of the sites. The firm of surveyors who undertook the valuation of ROF lands and buildings made an assessment on the basis of the open market value in their existing use, and this was provided to bidders. The MOD also obtained an alternative use valuation. This, taking into account decontamination cost, was in fact less than the existing use valuation. It was therefore not provided to bidders, since it might have reduced the price they were prepared to pay. The MOD considers that any assessment of the price which might be realised on the sale or disposal of surplus RO land must at present be purely conjectural: this would have to take into account a realistic view of how much, and what type of, redevelopment might be permitted and on what terms; site preparation costs; and RO's restructuring costs.

67. The MOD and the Treasury note the Committee's recommendation that in any similar sales in the future any feasible planning permission likely to increase property values should be obtained before offers are invited. When a business is

being sold as a going concern, as was RO, this would require judgements to be made as to which land potential purchasers of a company might consider to be surplus to their total requirements; what type of redevelopment might maximise its value; and how likely it is that planning permission for this could be obtained. This could involve much nugatory time and effort, prolong uncertainty over the future of the company and delay the realisation of the wider benefits which such privatisations are intended to achieve, since it can take several years to obtain a final decision on planning permission. The Government will continue to obtain professional advice on the value of all a company's tangible assets, including interests in land, before a privatisation sale takes place, so that these can be fully taken into account where appropriate in negotiations with potential bidders.

68. The MOD welcomes the Committee's acknowledgement that the sale of RO achieved the Government's objective of transferring the company to the private sector within the prescribed timescale.

Future benefits of privatisation

69. The MOD notes the Committee's recognition that, after a period to ease RO into a new competitive environment, it is the aim to achieve better value for money on products previously purchased from RO. A five-year agreement has now been signed with RO to purchase certain ammunition products from the company at fixed prices which reduce annually, with the aim that RO should achieve competitive market prices by the fifth year. This will provide the company with a base workload whilst it is implementing efficiency and rationalisation measures. In order to widen the field of competition in due course, the MOD is also validating alternative sources of supply within NATO for ammunition and will be pursuing this vigorously during 1989.

70. The MOD fully accepts the need for competition and, as in the case of the Chieftain replacement, is prepared to consider tenders for future battle tank orders from any manufacturer, including those overseas, with the appropriate competence to fulfil a contract. The MOD does not, however, believe that it would be appropriate actively to assist manufacturers prepared to set up, modify or expand their present facilities so as to be able to compete for future orders. The MOD confirms that international collaboration for major defence equipment will be considered whenever appropriate.

71. The MOD notes the Committee's intention to review, after a suitable period, the effects of the privatisation of RO on MOD's procurement of products previously purchased exclusively from RO.

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Treasury Minute on the Forty-ninth to Fifty-second Reports from the Committee of Public Accounts 1987–88

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TREASURY MINUTE DATED 15 FEBRUARY 1989 ON THE FORTY-NINTH TO FIFTY-SECOND REPORTS FROM THE COMMITTEE OF PUBLIC ACCOUNTS, SESSION 1987–88

Forty-ninth Report
Ministry of Defence

Costs and Financial Control of British Forces Germany

1. The Treasury and the Ministry of Defence (MOD) note the conclusions and recommendations of the Committee.

Peacetime support from the Federal Republic of Germany (FRG)

2. In recent years the MOD has given increasing attention to the level of host nation support provided by the FRG. Arrangements have been introduced for co-ordinating information and policy on the support given and received by the UK in relation to other NATO nations. The studies which the MOD has completed so far show that the support provided by the FRG to the British forces stationed in that country is broadly comparable with that given to US forces there and with that given to US forces stationed here. The MOD will, however, keep under review all the UK's host nation support arrangements to ensure a consistent approach and to seek redress for inequalities.

Financial control

3. The MOD welcomes the Committee's support for the new Joint Efficiency Team, and for the setting of efficiency targets. Since the Committee took evidence, the MOD has introduced an efficiency initiative throughout the Department. Accordingly, it has set itself the ambitious target of making annual and cumulative efficiency improvements valued at 2.5% over the current and the next two financial years, either by producing the same output from reduced input or by enhancing output without increasing input.

4. Implementation of measures leading to greater efficiency, in Germany and elsewhere, will be pursued vigorously. The earlier 1.5% efficiency targets set for BFG have been subsumed into the new efficiency initiative. Both BAOR and RAF Germany will participate in an incentive scheme to encourage and reward initiatives which lead to improved efficiency.

5. A key feature of the efficiency initiative is the pursuit of greater rationalisation, both within and between the Services.

Accompanied service

6. The MOD welcomes the Committee's support for accompanied service in BFG. This policy has recently been re-endorsed by Ministers in the review of Armed Forces allowances which introduced changes in allowances to support the objective of encouraging accompanied service. The MOD recognises that the policy of accompanied service should not be pursued regardless of cost but only where there are clear military and management advantages: this is the case in Germany.

Employment of BFG dependants

7. The MOD welcomes the Committee's support for the efforts that are being made to increase dependant employment within BFG. The proportion had risen to 21% by the end of 1988. Continued efforts will be made to increase it further.

8. On the same statistical basis, the proportion of dependants among the US Army's locally engaged civilians in Germany is understood to be about 26%. The MOD will continue to keep in touch with the US authorities and share common experience of local civilian management, including such matters as salaries, conditions of service and the means of employing more dependants.

9. The staffing of civilian labour and recruiting offices in Germany will be kept under review in the light of the Committee's remarks. However, the MOD has no evidence to show that German involvement in the recruiting process discriminates against the employment of UK dependants. All recruiting office staff, both British and German, operate under the supervision of British overseeing staff. Moreover, vacancies arising in these offices need to be filled with those who are qualified to meet the essential requirements of the particular posts.

Promotion of British goods

10. NAAFI are regularly in touch with major British retailers who have trading arrangements with them in Germany. From time to time, NAAFI engage consultants to advise on trading and marketing strategies. NAAFI must, of course, respond to market forces and in this context will continue to supply British goods whenever these are competitive and in demand.

Fiftieth Report
Department of Health

Use of Operating Theatres in the National Health Service

11. The Treasury and the Department of Health note the conclusions and recommendations of the Committee.

12. The Department of Health regards operating theatres as a key resource in the provision of NHS care. Its policy is to encourage health authorities to plan theatre building and utilisation with great care, in the light of the health needs of the local population; to use all available resources — including available beds, nursing and medical manpower as well as financial resources — as effectively as possible and to reduce waiting lists for operations.

13. The Government has recently published a White Paper "Working for Patients" (Cm 555) setting out a wide range of reforms in the management and funding of the NHS. Many of the initiatives set out in the White Paper will help to tackle the under-use, or inefficient use, of resources generally, and operating theatres in particular. The White Paper proposes a move, over the next two years, towards funding arrangements for the NHS which will reward efficiency and promote local initiative and flexibility. District Health Authorities (DHAs) and General Practitioners will increasingly become the buyers of services from a wider range of providers, including not only their own, directly managed, hospitals but also those of other Districts, self-governing NHS Hospital Trusts and the private sector. Thus, for an increasingly wide range of hospital services, including in particular elective surgery, competition between providers will force managers to achieve the most cost-effective service. In addition, the introduction of a system of capital accounting which will, for the first time, effectively reflect the cost of valuable assets in management decisions, will increase the pressure to use expensive facilities such as operating theatres most efficiently.

14. Health authorities should monitor carefully the use of planned allocated sessions and should ensure that where efficient use is not being made of allocated sessions appropriate changes are made. The Department accepts that further guidance for health authorities is required and expects to go out to consultation on draft guidance in the summer, with a view to promulgating it in final form by the end of the year. The Department will then monitor its implementation. The guidance will take up points made by the National Audit Office and by the Committee, together with the recommendations of a Departmental study on theatre utilisation, which is due to report in March.

15. The Department is determined to increase the number of patients treated, including the number of operations performed. It recognises that inappropriate use of valuable resources, including operating theatres, contributes to waiting lists, and is tackling the problem via the Waiting List Initiative. This special funding (£86 million over three years) enabled some 100,000 additional in-patients and day cases to be treated in 1987–88. 110,000 more additional in-patients and day cases will be treated in the current year and more still in 1989–90. At 31 March 1988 there were 678,000 on the waiting lists as compared with 752,000 in March 1979, a reduction of almost 10 per cent. Over this period NHS activity has steadily increased: in 1987–88 over three million surgical acute in-patient cases were treated — three per cent higher than in 1986 and about 19 per cent more than in 1978. Day cases have increased by 79 per cent since 1978. Between 1978 and 1986 the number of operations rose by 26 per cent (from 2.5 million to 3.16 million), despite the changes in techniques and treatments which mean that fewer patients now need invasive surgery.

16. Additionally, next year, £6 million has been held in reserve from the Waiting List Fund for a targeted drive at 22 districts with particular waiting problems. Their waiting lists will be investigated by a team from Inter-Authority Comparisons and Consultancy, and the districts will then be required

to draw up contracts to reduce the waiting backlog. They will be able to apply for funding from the £6 million fund if the investigation identifies the need for an injection of funds.

Use of computers in operating theatres

17. The Department agrees with the Committee that computers can be useful in the scheduling and planning of operations. Work has been taking place in the Department and elsewhere on establishing appropriate systems and on modelling suitable programmes. Although a number of health authorities have installed systems, none of those currently in use are, in the Department's view, as yet sufficiently comprehensive or effective. The report of the study team on operating theatres will include a chapter on the kind of data which should be collected and the planning purposes for which computers might be used. Separately, the Department has been assessing the various systems in use. This work has not yet been completed but the Department expects its guidance to include advice on computers in operating theatres.

Rating of operations

18. The Department notes the Committee's view that a system of rating operations should be developed as an aid to admission planning. This is being considered in the work on computers referred to above. However, final responsibility for assessing the clinical need for an operation, its urgency and likely duration must rest with the clinician responsible for treatment.

Management of consultants' contracts

19. The White Paper outlines the Government's proposals for managing consultants' contracts. While consultants will continue formally to be employed by RHAs, District Management will have full responsibility, as the Region's agent, for the day-to-day management of their consultants' contracts. This will include agreeing, and regularly reviewing, a clear job description for each consultant and ensuring its fulfilment in accordance with the District's objectives. These new arrangements should cover an issue which particularly concerned the Committee, the notification of consultants' leave.

20. The Committee asked that early progress should be made to speed up disciplinary procedures for the small minority of consultants who do not perform satisfactorily. The Department of Health agrees that the present procedures are cumbersome and inflexible. A Joint Working Party was established in 1987 to review hospital and community doctors' and dentists' disciplinary procedures. This has reported to the Secretary of State for Health with a series of recommendations designed to improve — and speed up — current procedures. In particular, they recommended the introduction of new local procedures for dealing with circumstances warranting disciplinary action short of dismissal. They also proposed a timetable which would enable a consultant's appeal against dismissal to be concluded within nine months of dismissal. As announced in "Working for Patients", the Department will be discussing with the professions on the basis of the Working Party's report.

Recruitment of junior medical staff

21. The Department notes the Committee's views that it should renew its efforts to overcome the difficulties which health authorities have experienced in recruiting junior medical staff. The Department acknowledges that there are continuing difficulties in some specialities and in some districts, although a survey of vacant posts carried out last summer showed only a small number of vacant posts overall (4.5 per cent of the total number of posts). The Department believes that the most effective action which can be taken in the short term is to maintain the existing embargo on the creation of Senior House Officer posts, so as to prevent the gap between supply and demand from widening further. In the longer term, the solution lies in the reform of the hospital staffing structure set out in the 1987 report* "Achieving a Balance", which is being implemented as planned.

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* Issued on behalf of the UK Health Departments, the Joint Consultants Committee and Chairmen of Regional Health Authorities.

22. The White Paper also announced the introduction of a new scheme under which 100 additional consultant posts will be created during the next three years, over and above the two per cent annual expansion in consultant numbers already planned. The scheme will concentrate on increasing the number of consultants in those acute specialities which currently have the longest waiting times for treatment. Besides enabling additional patients to be treated, this scheme will help improve the career prospects and reduce the working hours of junior doctors, thereby facilitating the recruitment of junior medical staff.

Resource management

23. The Department shares the Committee's view on the importance of the Resource Management Initiative and the scope for improving efficiency by involving clinicians in the management process. Six pilot acute resource management sites have already been established and, as announced in the White Paper, it is intended to extend and accelerate the Resource Management Initiative with the aim of building up coverage to 260 acute units by the end of 1991–92. When fully implemented, the resource management data base should indicate all activity undertaken within the hospital and should provide management, clinicians and others with a powerful tool in their efforts to maximise efficiency.

Theatre utilisation and imbalance of hospital resources

24. The Committee's report acknowledges that the use of operating theatres cannot be seen in isolation. To achieve the most efficient possible balance between theatres, beds and staffing, is a crucial objective. This is given a great deal of attention in Ministerial and management reviews of health authorities' performance. Nevertheless, the issues can be complex. For example, emergency admissions, or unexpected complications following operation, or shortages of nursing staff, can lead to blocked beds on wards and thus reduce theatre utilisation.

Spare theatre capacity

25. In building theatres, health authorities need to plan ahead over a 10 to 20 year cycle and authorities should include in their plans only those operating theatres which can be brought into effective use during the period for which plans are being made. Many changes can occur, however, in the 10 to 20 years after theatres have been built — changes in treatment, in techniques, in demography, as well as in resources. Some older theatres may now be wrongly located on isolated sites, or may be reserved for particular specialities where dangers of cross-infection are high. Some spare theatre capacity is therefore inevitable. As the Committee will be aware, a new Building Note on Operating Theatres has been prepared and has been out to extensive consultation. It has been revised in the light of all the comments received. After a final round of consultations with the medical and nursing professions it will be issued to health authorities. The Building Note contains an appendix which provides health authorities with a method of estimating their future needs and planning future provision in new capital schemes. The Department will of course itself take account of present over-capacity when considering new schemes, as will health authorities themselves.

Cancellations of planned and allocated operating sessions

26. The Department of Health shares the Committee's concern about cancellations of planned and allocated theatre sessions. Since 1986–87 health authority managers have had available to them regularly collected data on numbers of operating sessions and cancellations by speciality. They are expected to use this information to see whether allocations need to be reconsidered. The regional data for 1987–88 are the first to be available centrally, are currently being checked, and will be published shortly. Performance indicators will also be available later this year on theatre costs and session cancellations. The Department's forthcoming guidance will cover the requirement for health authority managers to set targets which will need to take account of demography, geography and other local factors.

Departmental study of staffing and use of operating theatres

27. The current Departmental study, which is based on visits to 12 hospital sites, is considering reasons for cancellations and methods of improving utilisation. Recommendations are likely to cover the need for Theatre Managers; notification of leave arrangements; timely advice to patients on their admission to hospital and a number of other related topics. The study report, together with the results of other work in the Department, will be reflected in the guidance to health authorities.

28. The Department notes that the Committee did not accept its view that some cancellations were acceptable if "planned" and the allocated staff were redeployed. The Department shares the concern of the Committee that such cancellations should be kept to a minimum and theatre sessions reallocated if notice of cancellation can be given in time. In general the Department would expect hospitals to achieve a 90% utilisation of allocated theatre sessions, recognising that some non-utilisation is inevitable, for example because of sickness, consultants or other medical staff being called away on emergencies or beds being blocked if, for example, a hospital is on "red" alert during a bad weather epidemic or after a major accident. Where sessions have to be cancelled they should be reallocated. However, other consultants may have out-patient, teaching or other commitments, while available junior medical staff from the same "firm" may not be able to tackle the particular operations which the consultant had planned. If it is not possible to operate on patients on the planned list, it may prove difficult to persuade other patients to come into hospital for operation at very short notice, even in cases where they had agreed that their names should be put on a list of patients willing to come in at very short notice.

Fifty-first Report
Department of Trade and Industry

The Alvey Programme of Advanced Information Technology

29. The Treasury and the Department of Trade and Industry (DTI) note the conclusions and recommendations of the Committee.

Administration and finance

30. DTI shares the Committee's concern that collaborative programmes should have adequate technical and administrative support from the outset. The Department seeks to ensure that all programmes are run in a cost-effective manner, though in the case of novel and complex programmes such as the Alvey Programme, assessing the level of support required may be difficult. Additional resources have been provided for the early period of the Information Engineering Advanced Technology Programme (IEATP) run jointly by DTI and the Science and Engineering Research Council (SERC).

31. DTI recognises the importance of firm financial control of programmes, and of the need for programme managers to have good information systems. Financial commitments and payments under all DTI's selective assistance programmes must now be recorded on a central database (SAMIS — The Selective Assistance Management Information System).

Collaboration

32. DTI welcomes the Committee's recognition of the Alvey Programme's achievements in instigating so much new collaborative research in information technology (IT).

33. DTI notes the Committee's view that the Department could have done more to help participants conclude collaboration agreements. DTI believes, however, that it is for the participants in a collaboration to reach agreement themselves on matters which affect their commercial interests and on which they are best placed to make judgements. The Department does, however, provide much general guidance on collaboration to participants; for example, the detailed guidance booklet on collaboration agreements drawn up as a result of Alvey Programme experience has been distributed to all consortia submitting full applications under the IEATP.

34. DTI accepts that lessons learned from the Alvey Programme should be applied to new collaborative programmes. For example, the internal guidance on all collaborative innovation programmes takes account of lessons learned during Alvey; furthermore, any general lessons learned from the extensive evaluation of the Alvey programme will also be applied to other collaborative programmes. The need for close liaison with SERC has been reflected in the new joint committee structure set up to advise on all DTI and SERC research programmes in IT. More generally, DTI has adopted closer working relations with SERC in developing new LINK programmes, which, like Alvey, involve collaboration between universities and industry.

Participation in the Programme

35. DTI accepts that small firms played less part in the Programme than the Alvey Committee may have expected. It notes, however, that the Alvey Report's recommendation of 90% funding of some projects was not accepted by the Government; this may have made it less attractive for small firms. Nevertheless, small firms have been active in the Alvey Programme, both in research and club activities.

36. DTI notes the Committee's concern about the volume of overall spending on research in the Alvey Programme. But DTI believes decisions about the use of support funds should have regard for the likely quality of research outputs as well as resource inputs, and such concerns underlay the decisions to spend more on academic research as well as on Programme infrastructure.

Exploitation

37. DTI evaluates thoroughly the effectiveness and value of its programmes. The evaluation of the Alvey Programme has been particularly detailed, resulting in many published papers by the independent consultants undertaking it. DTI agrees that the final evaluation report should include an assessment of exploitation achieved by then, compared with that envisaged by the Alvey Committee. The final evaluation will also take account of subsequent external technical and commercial developments which have inevitably influenced the course of the programme, and hence the detailed strategies later developed by the Alvey Directorate itself.

38. DTI agrees that there should be satisfactory arrangements for disseminating the information generated by the Alvey Programme. The Alvey Directorate made considerable efforts to achieve effective dissemination, for example through the Alvey Club structure, as noted by the National Audit Office, but also through conferences, reports, and extensive publicity. These efforts will be continued.

Skill shortages

39. DTI and the Department of Education and Science (DES) note the Committee's conclusion on skills shortage. DES reaffirms that adjustments will be considered to the planning framework for the overall size of the higher education system, and the broad balance of provision within it, should evidence suggest that the economy's needs are not being met. The inter-departmental review announced in the DES Higher Education White Paper is intended to help get a clearer view of the pressures and demands for highly qualified manpower which exist in the economy, and its results will be one of the factors influencing Government policy in this area. The review will not address the specific area of skill shortages in IT, but this is, however, the subject of research commissioned separately by the Government. In the case of postgraduate training it is the responsibility of SERC to keep the matter under review and indeed it increased the number of research studentships in IT in response to evidence of national need for an increased supply of PhDs in this subject.

Evidence of the Accounting Officer

40. DTI and the Treasury note the Committee's remarks. The Treasury will circulate a note to all Accounting Officers about the rules for clearance of NAO reports and submission of evidence to the Committee, and the importance the Committee attaches to observance of these rules.

Fifty-second Report
Ministry of Defence

The Profit Formula

41. The Treasury and the Ministry of Defence (MOD) note the conclusions and recommendations of the Committee.

Competitive procurement

42. The MOD welcomes the Committee's further support for competitive procurement and hopes, notwithstanding the annual variations which will arise because of the nature of the particular requirements which come forward, to sustain the improvement in the level of competitive procurement secured over recent years.

Basis for pricing non-competitive contracts

43. The MOD is carefully examining the possible scope for "a radically different approach" to the pricing arrangements for non-competitive contracts. This work includes an analysis, now well advanced, of the approaches adopted in a number of other countries and their effectiveness.

44. The MOD acknowledges the Committee's re-affirmation that the Profit Formula should be based on the principle of comparability alone and in discussion with the CBI and the Review Board will ensure that this principle is given its full recognition in the forthcoming and future reviews of the Formula, and is not overridden by other considerations.

45. The MOD will pay full regard, in its submission for the forthcoming General Review of the Profit Formula, to the Committee's view that the target rate should include a realistic factor to reflect the lower degree of contractual risk attaching to Government non-competitive work.

46. The MOD shares the Committee's view that as only a limited number of companies in the UK produce accounts on a current cost basis the question of continuing with, and the means for devising, a profit formula expressed in semi-CCA terms need to be fully addressed for the purpose of the forthcoming General Review.

47. The MOD welcomes the Committee's acknowledgement that the additional profit assessed by the C&AG as having been paid over the three years 1982–84 is equivalent to a variation of only 1.5% on cost. The MOD also recognises, however, the Committee's concern that the processes of cost-estimation and pricing should be improved, with the aim of bringing out-turn profitability even more closely in line with the target rate. The work put in hand, jointly with industry, following the Report on the Fifth General Review, is now well advanced.

Timing of pricing

48. It is the MOD's aim to price non-competitive contracts as early as practicable, and ideally at the outset, and to negotiate reduced levels of profit where pricing is delayed for reasons attributable to the contractor.

Post-costing

49. The MOD agrees that it is important to improve the level of post-costing, taking account of available resources and the demand of other important work on non-competitive contracts. It is taking action on a continuing basis with individual contracts to secure their timely compliance with contractual requirements to submit cost statements.

50. The MOD confirms that in the examination of the results of post-costing it is the practice to give careful attention to the boundary between fraud and

mismanagement and to refer cases which show evidence of deliberate deception to the Police so that the question of prosecution can be pursued.

Spares pricing

51. The MOD confirms that all major contractors, with one exception, have now accepted the principle of the price labelling of spare parts.

52. The MOD accepts that it is important to deploy available resources so as to identify and deal with excessive prices on spares. It will continue to take measures designed to improve value for money in this field of procurement.

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Presented to Parliament by the Financial Secretary to the Treasury by Command of Her Majesty March 1989

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TREASURY MINUTE DATED 8 MARCH 1989 ON THE FIRST, SECOND AND THIRD REPORTS FROM THE COMMITTEE OF PUBLIC ACCOUNTS, SESSION 1988–89

First Report
Office of Arts and Libraries

Management of the Collections of the English National Museums and Galleries

1. The Treasury and the Office of Arts and Libraries (OAL) note the conclusions and recommendations of the Committee.

2. The OAL believes that many of the concerns expressed by the Committee in its report are being substantially met by a number of important developments in the relationships between the Government and the institutions which have taken place in the last few years and which the Report has noted:

- the progressive improvements in the institutions' corporate planning;
- the 3-year funding settlements;
- the major increase in building and maintenance grants-in-aid;
- the emphasis placed in recent funding allocations for running costs on conservation, storage and documentation.

The OAL believes that the institutions are tackling very positively and effectively the management of their collections.

Financial arrangements and planning

3. The OAL welcomes the Committee's endorsement of the introduction of corporate planning and the three-year funding settlement for OAL-sponsored national institutions. The OAL sees these measures providing a clear framework for the identification of priorities and of timescales for dealing with matters concerning the management of the collections.

4. The OAL encourages Trustees, in their corporate plans, to identify key objectives and targets and to define ways for progressing towards them. The OAL would expect institutions, in their plans, to comment on their problems and priorities. The OAL shares the Committee's view that Trustees' reports to the Minister and to Parliament provide a valuable medium for the expression of Trustees' stewardship and accountability. The OAL expects Trustees, in developing their reports, to have regard to the Committee's views.

5. The OAL agrees that institutions' concerns and priorities, reflected in their corporate plans, should inform the level of allocations to national museums and galleries (NMGs) as a whole, and to individual institutions. The OAL's allocations to the NMGs in recent years have reflected the institutions' priority concerns with their building and maintenance programmes (where the allocations have increased by 53% between 1987–88 and 1991–92) and with the management of the collections, including conservation, storage and documentation. The museums and galleries' budgets were increased by £13 million in 1991–92 on these grounds. The level of the arts budget is determined by Ministers in the annual Public Expenditure Survey.

Acquisitions, disposals and display

6. The OAL welcomes and encourages the efforts of the institutions to examine comprehensively the resource cost implications of their collections and collecting policies. The British Museum and the Victoria and Albert Museum (V&A) have initiated measures to assess the consequential costs of new acquisitions. The OAL intends to disseminate during 1989 the report of a study into the "real cost of collecting" which it commissioned in March 1988.

7. The OAL notes the Committee's view that institutions should regularly and positively review their disposals policies, based upon improved management

information systems. The OAL has recently undertaken a wide-ranging consultation exercise on powers of disposal, the conclusions of which will be announced in due course.

8. The OAL encourages the institutions to make material from their collections available as widely as is practicable, both for display and examination within the institution and by way of loans and touring exhibitions. The Museums and Galleries Commission's Travelling Exhibitions Unit is actively promoting such activities. A number of institutions have in recent years extended their displays and facilities by opening outstations in London and elsewhere; for example, the Tate Gallery in Liverpool and the Clore Gallery, the V&A's Theatre Museum, and the National Portrait Gallery's historic houses exhibitions.

Storage, conservation and security

9. The OAL notes the Committee's recommendations and views. It believes that the introduction of corporate planning and the improvements in the management of resources which this should make possible should, together with firm three-year funding allocations, provide the framework which the Committee seeks for the sustained and determined efforts of the institutions; for collaboration between institutions where there is scope for this and for effective monitoring by the OAL. The OAL believes that the British Museum and the V&A are according a high priority to these matters. It has asked OAL-sponsored institutions to indicate in their next plans the extent of any problems in these areas and how each intends to tackle them, and to report in future plans on the progress achieved. The OAL will monitor future plans with particular regard to these points and will report further to the Committee in due course.

Inventory control and stocktaking

10. The OAL shares the Committee's concern that institutions should have in place satisfactory inventory control and stocktaking procedures. The OAL will expect each institution to examine these aspects of its own collections management and housekeeping in its corporate plan and to set out the improvements which it intends to make. The OAL is aware that institutions may draw a distinction between the availability of adequate records of items in the collection, their location and movements, which are indispensable to adequate inventory control, and the computerisation of records which, given the scale of some national collections, may require a substantial investment of time and money over several years. The computerisation of records is proceeding at all OAL-sponsored institutions. The British Museum, for example, began some years ago its programme to computerise inventory records and gives a high priority to this work within the resources which it has available. The OAL hopes that the enhanced grant-in-aid allocated for collections management and care, the results of the "real cost of collecting" study, and the report of a recent conference on computerisation and inventory control which the OAL has asked the Museums Documentation Association to prepare, will all assist the museums and galleries to develop and improve their procedures.

Application to other institutions

11. The OAL and the other sponsor Departments note the Committee's observation that primary responsibility for the progressive improvement of storage and conservation conditions must rest on the appointed Trustees in the proper discharge of their responsibilities for the national assets placed in their care. The Departments will look to the institutions' corporate plans to accord appropriate priority to such concerns.

Second Report
Ministry of Defence

Transfer of the Royal Dockyards to Commercial Management

12. The Treasury and the Ministry of Defence (MOD) note the conclusions and recommendations of the Committee.

Previous PAC recommendations

13. The MOD welcomes the Committee's recognition of the difficulties involved in transferring the Royal Dockyards to commercial management and that the target date of 6 April 1987 was successfully achieved. The Ministry also notes the Committee's views concerning earlier recommendations by its predecessors.

Tender evaluation

14. In the view of the MOD the absence of a relatively small proportion of the information originally requested was not critical to the evaluation process. Changes in the Devonport consortium were entirely outwith the control of the MOD and the Ministry does not accept that either these changes or the lack of some data invalidated the proposals received or the thorough process of evaluating tenders and selecting the most suitable commercial managers.

Dockyard management circa Vesting Day

15. The MOD welcomes the Committee's acknowledgement that the difficulties in the Dockyards before and immediately after Vesting Day were at least in part the result of the tight timescale for contractorisation, and that there were benefits as well as penalties in allowing the commercial managers to make an early start. The Ministry considers that once it was announced that the Dockyards were to be transferred to contractor management there was an inevitable decline in motivation and performance and the most effective means of arresting this was by the earliest practicable transfer to the commercial regime: any delay would have served only to exacerbate the difficulties. One of the purposes of transferring the Dockyards to contractor management was to introduce appropriate commercial expertise and disciplines to deal with industrial problems of this nature.

Quality

16. The MOD shares the Committee's concern about the quality of refit work in the period immediately before Vesting Day. Firm action to improve Quality Assurance and Control in the Dockyards has now been taken by the contractors, one of whom has attained, and the other applied for, AQAP1, the highest NATO certification for an Industrial Quality Control System. The incidence of defects arising in ships returned to the Fleet remains unchanged and any significant rework arising during refits has been costed and recorded in accordance with normal practice.

Pricing

17. The Ministry notes the Committee's doubt about its ability to negotiate tight prices for contracts spanning Vesting Day. Various pricing methods were employed for these contracts as appropriate to ensure that the best price was obtained, taking account of the balance of the work still to be completed and the quality of information available. Only a small number of the larger projects in this category are still in hand and these will be completed shortly: all others have been brought to a satisfactory conclusion.

Surplus material at Dockyards

18. Steps have been taken to identify and bring on charge the small quantity of surplus material still remaining in the Dockyards. The contractors' continuing

development of their material accounting and control systems will be a key element in avoiding any recurrence of this problem in the future.

Size of customer organisation

19. The Director General of Ship Refitting (DGSR) has received a comprehensive report on his organisation from the Director of Naval Manpower Audit. This is now being considered in the context of the contribution DGSR is in any case expected to make to a planned reduction in overall MOD numbers. DGSR is also examining the division of responsibility and authority between his Bath and Dockyard-based staff.

Supplies and services from MOD sources

20. The MOD notes the Committee's comments on the arrangements for the provision of some supplies and services from Ministry sources. The Dockyard contractors remain tied to MOD organisations only in those areas where security considerations are overriding, for example MOD police and harbour movements. In all other areas they have the freedom to test the market and to seek changes or discontinue the present arrangements if they so wish. At Devonport the contract for provision of catering services ceased with effect from 6 April 1988 and that for welfare services will terminate on 5 April 1989; at Rosyth the catering contract has been renegotiated. At both Dockyards the occupational health and hygiene services currently provided by the Ministry are under review and contracts for transport services are due to be reviewed shortly. The Ministry is always prepared to consider proposals for change which offer benefits to the MOD and to the Dockyard contractors.

Efficiency savings

21. The MOD accepts the importance of balancing Dockyard workload and capacity in the pursuit of value for money. The contractors continue to introduce measures aimed at increasing efficiency and productivity and are updating their Business Plans to take account of the latest projections of these improvements and of current expectations for Naval and commercial work.

Commercial work won by Dockyard companies

22. Both contractors are committed to agreeing targets for commercial work with the MOD, as part of the annual negotiations of labour and tariff rates which take account of performance to date as well as current projections, and to regular consultation with the Ministry about the overall balance of Naval and commercial work. The MOD considers that it receives sufficient data on commercial work already, but steps have been taken to record this information more formally in future.

Licence fees

23. Annual labour and tariff rates, which subsume the licence fees, are agreed with and monitored by the Ministry. These already differentiate to some extent between the various types of work undertaken by the Dockyards. Both the MOD and the contractors are committed to extending this approach where it leads to increased accuracy in recording costs. Following consultation with the Treasury and both contractors, the Ministry has commissioned a review by external consultants of the present licence fee arrangements. The consultants' report is expected by Spring 1989.

Competition

24. The MOD notes the Committee's comments on the amount of refit work put out to open competition and the recommendation that all contracts should be on a full risk price basis by 31 March 1989. It remains the Government's policy to place an increasing share of the refit programme to competition while maintaining an adequate core workload in the Royal Dockyards for strategic reasons. In the first year of commercial management some 75% of all contracts placed were either on full risk or some other form of incentive pricing. The Ministry will continue to aim for maximum risk pricing on all contracts,

although practical considerations — including the need for both contractors and the MOD to develop satisfactory data bases, the difficulties encountered by the contractors in recruiting experienced estimators, and the engineering uncertainties which make any accurate estimate of risk on the larger and technically more complex projects difficult — make a target date of April 1990 more realistic than that suggested by the Committee.

Operating statement and performance indicators

25. A number of performance indicators and ratios, intended to provide a basis for year-on-year comparisons, were included with the 1987–88 published DGSR Operating Accounts. These will be refined and developed in the light of experience gained on their usage and value.

Job losses

26. The MOD welcomes the Committee's acceptance that there was no inaccuracy in the Ministry's evidence to the Committee on Dockyard job losses.

Third Report
Property Services Agency

Management of the Civil Estate

27. The Treasury and the Property Services Agency (PSA) note the Committee's conclusions and recommendations.

The provision of accommodation

28. The PSA is committed to increasing the freehold proportion of the Civil Estate. This policy, however, is subject to constraints on resources, and is also subject to landlords being willing to sell freeholds, the availability of sites and the need to meet client departments' requirements within their specified timescales. Opportunities to buy suitable properties often only arise at very short notice, with keen competition from property companies and financial institutions, especially in city centres, and may involve very substantial sums. In London, for example, a one per cent increase in the freehold proportion of the office estate might cost up to £200 million at current prices. The availability of funds is therefore a key factor. The PSA will, however, continue to make every effort to identify the right opportunities, to discuss these with the Treasury, and will look with the Treasury at the possibility of setting targets for increasing the freehold proportion of the estate within the resources available.

29. The Committee noted the steps taken to improve guidance on the methodology of investment appraisals. The changes made to improve the monitoring system for investment appraisals took place at the beginning of the 1988–89 financial year. Line management is now responsible for monitoring appraisals. In addition, internal audit provides an independent assessment, by including the monitoring of investment appraisals in the normal cycle of reporting.

30. The PSA recognises that lack of funding has not been the only factor which has caused delays in meeting departments' requirements. Planning and client liaison procedures are important too. These have been tightened up in the changes arising from the move to payment for major capital projects. Departments fund the work and their project sponsors set time and cost constraints in close liaison with the PSA project managers, who are responsible for ensuring that, at all stages, requirements are met and priorities observed. Schemes funded by PSA are subject to the same arrangements, with sponsors being appointed for each project to represent the client's interest and to liaise with the project manager.

The size of the estate, vacant space and disposals

31. The Committee was encouraged by the PSA's view that the Property Repayment Services (PRS) scheme, in conjunction with running cost controls, is stimulating movement to areas of cheaper accommodation. The contribution of charging systems, such as the PRS scheme, to stimulating a more cost-effective use of accommodation is being considered as part of the new arrangements for managing the Civil Estate after its division into departmental and common user estates.

32. The PSA shares the Committee's concern at the payment of rent on empty buildings. However, there is not always a solution to hand. In this respect the PSA is no different from any other major space user. Disposal remains the prime objective if there is no further government use for premises and no outside interest enabling PSA to assign or sublet. But rent has to continue to be paid under the terms of the lease until the expiry date. Sometimes the landlord can be induced to accept a surrender, normally for a premium. Such a premium

must, however, be compared with the cost of continuing to pay the rent and other outgoings.

33. The PSA notes the Committee's disappointment that actual savings from Civil Estate Town Reviews to identify opportunities for estate rationalisation are still only about half those anticipated. Town Reviews are essentially "value for money" exercises; direct savings are therefore only part of their outcome. Recommendations from any review are expected to be fully implemented and any savings achieved over a five-year period, but departments' requirements can alter in this period in ways which could not have been anticipated by the review. Only if there are no such changes can the full postulated savings be achieved.

34. The Committee was concerned that there has been a reduction in the level of savings identified in recent reviews. It should, however, be noted that a lot of earlier reviews were carried out when the estate was rapidly reducing in size. Since then the climate has changed: in some places demands on the estate were actually increasing and this reduced the opportunities for identifying new savings. For 1988–89 firm targets of saving 28,000 square metres in space, £1.8 million in annual running costs and £2.4 million in capital receipts have been set. Further targets will be set for 1989–90.

35. The PSA is now exploring with the Treasury ways of allowing departments a share of any benefits arising from estate rationalisation schemes and disposals of property declared as surplus, as an added incentive to departmental co-operation.

Maintaining the operational fitness and value of the estate

36. The PSA, as acknowledged by the Treasury, has been making steady improvements since 1984 in the plans produced for the Treasury which identify maintenance funding requirements and priorities. The quality of the information is now of a high standard; this was recognised in the 1987 Public Expenditure Survey (PES) round and again in the 1988 round, when Ministers confirmed a higher level of funding of some £120 million a year throughout the PES period 1989–90 to 1991–92. This has made possible longer term planning of maintenance work, particularly major schemes, thus achieving better value for money.

37. As the Committee was informed in evidence, it was not possible to accelerate the works programmes to achieve a substantially higher level of activity in 1987–88. But the following measures have been taken to ensure that all the funds available for maintenance are fully utilised in 1988–89 and subsequent years:

— full budgetary allocations are issued to the United Kingdom Territorial Organisation as early as possible following the Autumn Statement;

— the increased level of PES provision has allowed the level of allocations two years ahead to be underwritten, thus providing a firm basis for putting larger schemes into the maintenance programme;

— continuing effort is being put into improving techniques for forecasting and controlling the works programme and expenditure flows;

— the PSA's senior management are provided at monthly intervals with regular progress reports on performance at regional level so that they can take immediate corrective action wherever necessary.

38. The PSA is now on target to spend all funds available for maintenance in 1988–89 and is fully confident that it can maintain the impetus of the programme at a higher level of spending in future years. This is already achieving a significant impact on the higher priority work making up the maintenance backlog; and, through the joint planning and liaison arrangements, major departments are acknowledging the impact the programme of work is having on long outstanding schemes.

The future of the PSA and the Civil Estate

39. In the PSA's view, the move to Trading Fund status is indispensable if its responsibilities for the Civil Estate are to be discharged to full effect. The PSA accepts that progress towards setting up a Trading Fund will be heavily dependent on installation of the necessary information technology (IT). Financial approval for the first phase was received from the Treasury in November 1988 and a contract was let immediately for supply of IT hardware. Delivery and installation are now taking place and pilot running of applications to meet Estates Services requirements has started; a pilot for Project Services application is on target to start in April 1989. The strategy for change required to implement the extension of payment and untying across government departments and the move toward Trading Fund status introduces additional information requirements.

40. The maintenance of an up-to-date information base on both the Common User and Departmental estates is an essential feature of the Government's property management proposals. This will enable the PSA to instigate rationalisation of the Common User Estate and to exploit opportunities to re-use surplus Departmental Estate properties. Ways will be studied of making greater use of departments' occupancy audits to provide the necessary information. Client liaison arrangements will be further developed so as to ensure that co-ordinated planning information on departments' accommodation needs is readily available.

41. The Secretary of State's statement in Parliament on 25 May 1988 recognised the need to combine central management of a Common User Estate with the devolution of responsibility to departments. On the Common User Estate departments will be accountable for the amount and location of space they need and PSA will be accountable for meeting these requirements, including decisions to lease, buy or build, in the most cost-effective way. The Treasury and the PSA recognise that it is essential that accountabilities are clearly defined and that, as the Committee comments, the PSA's role as effective manager of the Common User Estate is clearly stated and understood by all. Departments will themselves be responsible for securing value for money on the Departmental Estate.

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FROM: A C S ALLAN
DATE: 13 January 1989

MR ROBSON

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Beastall
Mrs Case
Mr Culpin
Mr D J L Moore
Miss Peirson
Mr Gieve
Mr Shore

TREASURY MINUTE IN REPLY TO 43RD-48TH REPORTS OF THE PAC 1987-88

The Chancellor was grateful for your minute of 11 January. In the light of the points you made, he was content for the Treasury Minute to go forward as drafted.

A C S ALLAN

pem.11

FROM : S A ROBSON
DATE : 11 JANUARY 1989

1. SIR PETER MIDDLETON

2. CHANCELLOR OF EXCHEQUER

Copies attached for :
Chief Secretary
Paymaster General
Economic Secretary

c.c. Mr Anson
Mr Phillips
Mr Beastall
Mr Moore
Mrs Case
Mr Culpin
Miss Peirson
Mr Gieve
Mr Shore

TREASURY MINUTE IN REPLY TO 43RD - 48TH REPORTS OF THE PAC 1989-88

Mr Sparkes's minute of 9 January.

2. The disposal of RO in April 1987 was made by way of trade sale, not an equity offer for sale. Six companies made bids, including the winners, BAe. It is reasonable to assume that, if the relevant information was available, this process should ensure the bids properly reflected the potential vendors' assessments of the future prospects of the company, including the benefits of site rationalisation.

3. Rothschilds advised MOD on the sale. Rothschilds produced an Information Memorandum which was issued to the prospective purchasers in October 1986. This included the information that RO had announced its intention to close the Waltham Abbey site and that RO were preparing planning applications for that site and for the Enfield north site which joins it.

4. The relevant information was, therefore, in the market place. The NAO themselves said in their Report :

> "..... the final price of £190 million was obtained in a competitive situation and must be assumed to represent the maximum price available at the time from the method of sale adopted."

5. In the run up to the sale MOD did commission a report by the Chartered Surveyors Weatherall, Green & Smith on the alternative use valuation of RO freehold and leasehold properties. Against the background of the above points this was something of a belt and braces operation. The report noted the potential value for redevelopment of the Waltham Abbey and Enfield sites but also emphasised the planning uncertainties and the long process which would be involved in seeking planning permission. They also drew attention to the cost of decontaminating the sites. They described the redevelopment potential as "in essence a long term speculation". Taking account of the delays, risk and uncertainties, they put a combined alternative use value of the two sites of under £4 million.

6. With the relevant information in the market place, and with therefore a reasonable expectation that the discounted value of possible redevelopment gains would be reflected in the bids, I consider the Treasury Minute is right to say that obtaining planning permission "could involve nugatory time and effort".

7. As regards the reference to delaying the wider benefits of privatisation, the process of obtaining planning permission would undoubtedly have taken considerable time.

8. As already mentioned RO was seeking planning permission for two sites. It submitted applications in January 1987. The application was rejected by the District Council in June 1987. In December 1987 RO lodged an appeal with the Secretary of State for the Environment in relation to the Waltham Abbey site. This appeal has not yet been heard. It is expected to be heard "sometime in 1989". In short if we had delayed the sale of RO until resolving the issue of planning permission, the company would still be in the public sector some 20 months after its actual disposal.

9. One final point. Movements in the price of BAe on the Stock Market suggest that we did indeed get a reasonable price for RO. (On 11 August 1988 a Warburgs report argued BAe was going to make a killing on the redevelopment of the two sites. The report put an asset value on BAe of just over £10 per share. Prior to the publication of Warburgs report, BAe were trading at £4.98. The shares showed no significant move relative to the market on either of the two days following publication.

S A ROBSON

toa.jw/march89/min15

FROM: J S BEASTALL
DATE: 10 MARCH 1989

FINANCIAL SECRETARY

cc: Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Anson
Mr Phillips
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Saunders
Mr Gieve
Mr Shore

Ch. I do not think Mr Beastall should have let himself be drawn here at all. af 10/3

He clearly should not have allowed himself to be drawn on this issue. I consider Mr Beastall's guidance to officials when giving evidence to PAC.

HEART DISEASE AND TAXATION OF TOBACCO

I think you should perhaps be aware that Mr Rooker and Mr Terry Davis raised the issue of the taxation of tobacco at the PAC hearing this Monday (6 March), when the Department of Health were being examined about heart disease. I enclose the relevant extracts from the transcript, which has just arrived.

2. This is a pretty clear example of the PAC straying outside their proper territory.

JB

J S BEASTALL

2821. Could I ask Mr Beastall to look at page 9, Table 1? We see there that without any qualification of whether it is unproven or not the smoking of cigarettes is one of the three factors, listed first, which is an independent factor in actually bringing about heart disease and death through heart disease. Why is it therefore that in recent years, the last three years or so, the Treasury has given less importance to trying to cut down smoking by the operation of the taxation policy?

(Mr Beastall) The Chancellor always pays close attention to the needs of the nation's health in setting the levels of taxation on tobacco. The better way of looking at it is to take it over a period. The total taxation on cigarettes has increased by 50 per cent in real terms since 1979.

2822. But that is because more young children and women are smoking in greater numbers is it not?

(Mr Beastall) No; I mean the rates. The rates of taxation have increased by 50 per cent in real terms.

2823. On the years when the Chancellor specifically does - if my memory serves me correctly I think it was in 1984 that he specifically said - say that as a result and because of health policy he is going to jack up the tobacco tax - I think he doubled it compared to the rate of inflation; rightly applauded for that; obviously gets the support of the Department of Health - when he does not do that and does not raise it in line with inflation and does not say it is because of health policy, we take it therefore the Treasury that year are ignoring the health factors related to and involved in smoking. Is that true?

(Mr Beastall) That is not a fair deduction, no. I am sure the Chancellor always takes into account the health aspects, but although a very important aspect that is not the only factor in determining taxation policy.

2824. Is the very firm evidence that we have had this afternoon from the Department Health - in view of the fact that he is preparing or has prepared his budget - that smoking is the most important issue, it affects heart disease, unrelated to other factors, quite independently of other factors, actually fully taken on board by the Chancellor?

Mr Beastall) Yes, it is.

2878. Mr Beastall, you told Mr Rooker that the relationship of smoking to ill health was one of the factors which the Chancellor of the Exchequer takes into account in deciding the level of tobacco duty, did you not?

(Mr Beastall) Yes.

2879. What other factors does he take into account?

(Mr Beastall) I would imagine there are considerations of overall fiscal policy and the incidence of taxation on inflation, that sort of thing.

2880. So the Chancellor of the Exchequer would take two other factors, to the best of your knowledge, into account: the effect of an increase in tobacco taxation on the level of inflation and on general fiscal policy.

(Mr Beastall) I cannot say all the factors that are in the Chancellor's mind because I do not know them.

2881. You were able to give a categorical assurance to Mr Rooker that the Chancellor of the Exchequer had in mind the effect of smoking on health.

(Mr Beastall) I know he takes that into consideration.

2882. How can you be so sure about one factor and not the others?

(Mr Beastall) Because I know that both the Department of Health and outside organisations make representations to him about the effect on health.

2883. Do you mean that it is only because of the representations from the Department of Health that you know it is one of the factors?

(Mr Beastall) The fact that he considers these papers that are put to him, I would have thought was quite a good indication that he took them into account.

2884. You would not be able to give us any idea, I suppose, of the relative weight he gives these different factors?

(Mr Beastall) No, I would not.

2885. Sir Christopher, in what way do you make your representations to the Chancellor of the Exchequer?

(Sir Christopher France) We normally invite the Secretary of State to write to the Chancellor because this is a ministerial issue. That is the process.

2886. Does the Secretary of State write every year?

(Sir Christopher France) As far as I can recall, in my time he has, yes.

2887. Is it the same letter every year?

(Sir Christopher France) No.

2888. He does not just take it out of the files and sign it?

(Sir Christopher France) No.

2889. Does the Secretary of State draw the attention of the Chancellor of the Exchequer to the fact that, for whatever reasons, the level of tobacco duty has not been increased in recent years and that in the opinion of the Department this is harmful in terms of this country?

(Sir Christopher France) That is precisely the kind of argument he would advance.

2890. And he will have advanced it this year. Does he only do it at the time of the budget or does he do it in between budgets? Does he do it once a year or does he do it every month, or every week?

(Sir Christopher France) No, he certainly does not do it on any kind of regular basis like that. If the issue does come up in between then he would make the point again. It comes up in contexts like EEC regulations on advertising and so on. I would not want to give a categorical answer to that but there is no closed season for representations about smoking.

2891. Surely it would be within the power of the Secretary of State for Health to make sure that the issue came up more frequently?

(Sir Christopher France) If the Secretary of State decided that he wanted to give a certain issue priority, whether smoking or something else, he could do so.

2892. Is this matter given priority by the Secretary of State?

(Sir Christopher France) It is a matter which, among the whole range of the concerns which he has, does weigh with him.

2893. Are there any other taxation issues on which the Secretary of State for Health would write to the Chancellor of the Exchequer?

(Sir Christopher France) Alcohol is an obvious one.

2894. Any others?

(Sir Christopher France) I am trying to think whether there are any others; whether we said anything about unleaded petrol. That is the only other possibility that I can think of.

2895. But you do not know how many people die from alcohol abuse; you do know how many people die from coronary heart disease, which is attributed to smoking amongst other factors.

(Sir Christopher France) As does alcohol abuse of course.

2896. Alcohol abuse is one of the other factors?

(Sir Christopher France) Yes.

2897. In causing coronary heart disease?

(Sir Christopher France) Yes.

2898. I cannot remember whether it is listed on this table.

(Sir Christopher France) I think it is.

2899. It is, is it? Where? I am talking about Table 1.

(Sir Christopher France) Yes, I know.

2900. I do not see it.

(Sir Christopher France) It feeds into things like obesity, stress, blood pressure; it is not direct but it will affect all those things.

2901. Does the Secretary of State for Health send one letter about all these matters or does he send separate letters?

(Sir Christopher France) My recollection is that he sends separate letters but I would not like to be held to that.

2902. Mr Beastall, the Chancellor of the Exchequer gets many representations about taxation policy, particularly at the time of the budget, but presumably he will consider a matter such as this, which involves health, at other times in the course of the year as well. Does he?

(Mr Beastall) I do not think, frankly, it is for me to say what exactly the Chancellor takes into account and at what times of year. This is a matter of high policy.

2903. So it is a matter of high policy for the Chancellor of the Exchequer and the Secretary of State for Health to decide what the level of taxation will be. Is that your answer?

(Mr Beastall) Yes; it is a policy matter for Ministers and of course in particular the Chancellor.

2904. Who else makes representations to the Chancellor of the Exchequer about the level of tobacco duty?

(Mr Beastall) A number of organisations do, for example, ASH, the BMA, and also the Health Education Authority and the Tobacco Advisory Council also met Treasury Ministers on the subject.

2905. Not the industry?

(Mr Beastall) I do not know to what extent theindustry has meetings with Treasury Ministers but I am sure they make representations from time to time.

chex.ps/jmt/83 **CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 13 March 1989

PS/SIR P MIDDLETON

PAC

... The Chancellor has seen the enclosed note from Mr Beastall to the Financial Secretary, reporting the evidence which Mr Beastall gave to the PAC in response to questions about tobacco taxation.

2. The Chancellor thinks that Mr Beastall allowed himself to be drawn far too far here. He suggests that Sir Peter might consider issuing guidance to officials who have to attend the PAC.

J M G TAYLOR

Copy 6 of 6

SECRET

21.6.89

FINAL

THE EXCHANGE EQUALISATION ACCOUNT

MEMORANDUM BY THE COMPTROLLER AND AUDITOR GENERAL

This Memorandum is the property of the National Audit Office.

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SECRET

THE EXCHANGE EQUALISATION ACCOUNT

Memorandum by the Comptroller and Auditor General

I: BACKGROUND

1. The Exchange Equalisation Account (EEA) holds the United Kingdom's official gold and foreign currency reserves. It was established in 1932 to provide a fund which could be used for checking undue fluctuations in the exchange value of sterling. Subsequent legislation extended the possible uses of the fund; and, under the consolidating Exchange Equalisation Account Act 1979, it is now also used to secure for the nation the means of making payments abroad.

2. The Treasury have statutory responsibility for the Exchange Equalisation Account, but the Bank of England carries out the day-to-day management of dealings in gold and foreign currencies and the investment of reserves. Although there is no statutory requirement for statements of account to be prepared, the 1979 Act provides for the Account to be examined every year by the Comptroller and Auditor General and the Treasury prepare an annual cash account (unpublished and classified Secret) for this purpose.

3. From time to time the operations of the Exchange Equalisation Account have been examined by the Public Accounts Committee (PAC) in private on the basis of an abstract of the annual cash account and supporting documents prepared specifically for the Committee. PAC last carried out such an examination in 1978-79.

4. More recently, as part of their examination of the Government's 1988 Budget proposals, the Treasury and Civil Service Committee (TCSC) enquired about the profitability of Exchange Equalisation Account activities. The Chancellor of the Exchequer declined to provide the TCSC with such information but suggested that a confidential examination by PAC would be the appropriate way for Parliament to pursue this matter.

5. To enable PAC to follow up the Chancellor's suggestion, the Treasury have provided the Committee with:

(a) an abstract of the cash account for 1987-88;

(b) a foreword explaining the statutory basis and purposes of the account and the mechanics of its operations; and summarising the outturn on the account for 1987-88;

(c) a statement of the assets and liabilities of the Exchange Equalisation Account as at 31 March 1988.

6. Since these statements do not purport to show the gain or loss made on the reserves, the purpose of this memorandum is to provide supplementary information to assist PAC in their examination. It is based largely on information obtained from the Treasury and the Bank of England.

II: THE PROFITABILITY OF THE EXCHANGE EQUALISATION ACCOUNTS

7. The Treasury's current views on evaluating the operations of the Exchange Equalisation Account are, in summary:

(a) Any comprehensive evaluation of the operations of the Account has to reflect the totality of the operations which make up the management of the official reserves. These operations, broadly defined, comprise intervention on the one hand and, on the other, management of the portfolio of assets held in the official reserves and the UK's official foreign currency liabilities.

(b) The overriding requirement is that reserves should be available for intervention. This implies that in investing them, the maintenance of adequate liquidity is a crucial constraint. However, as the reserves have risen in recent years, there has been greater opportunity to increase the return earned on them, through more active management.

(c) The annual statements of account for the EEA provide information about the reserves in a form relevant to the formal public sector accounts. However, they do not purport to reveal the "gains or losses" made on the reserves in any given period; and, even if they did, they could not be used to judge the value for money achieved from the Account's operations.

(d) The formal accounts do not identify separately the impact of intervention on net worth and so do not provide any guide to the "profitability" of intervention as such. In any case, as in other major countries, the purpose of intervention is not to make profits, however profits are defined.

(e) The authorities are developing a management information system to provide performance and value for money measures of the Bank of England's reserves management undertaken on behalf of the Treasury. The system is designed to provide an assessment, in sterling terms, for currency and investment decisions.

(f) There are procedures agreed between the Treasury and the Bank for taking decisions on intervention and on reserves management more generally.

(g) In spite of the more active approach adopted in recent years to the management of the Exchange Equalisation Account, the administration costs remain low.

These views are considered more fully below.

The overall evaluation of profitability

8. The operations of the Exchange Equalisation Account comprise a variety of activities relating to intervention, management of the portfolio of official gold and foreign currency assets and management of the UK's official foreign currency liabilities. The Treasury agree that it is desirable to provide after the event an assessment, in financial terms, of the Account's activities; and that there is a more general interest in the Treasury and Bank of England's stewardship of the Account. However, in their view, each of the activities described above has to be taken into account before a comprehensive evaluation of the Account's operations can be made.

The need for liquidity

9. The reserves are held to provide foreign currency with which the authorities can intervene in the foreign exchange market in pursuit of the objectives set out in the Exchange Equalisation Account Act 1979 - notably to check "undue fluctuations in the exchange value of sterling" and to secure "the conservation or disposition in the national interest of the means of making payments abroad". The authorities have to be confident that reserves will be available, as necessary, to meet the policy objectives which apply to the use of the Account. This means that a crucial constraint in investing the total reserves portfolio is to ensure that sufficient assets are held in adequately liquid form in those currencies in which the Government judges it appropriate to intervene to influence the sterling exchange rate or in which it may need to make payments abroad. It has also long been accepted that the reserves, when invested, must be exposed to a minimum of credit risk. (And there is, of course, a trade-off between credit risk and the yield earned by individual assets which the authorities take into account in their investment decisions).

10. At the same time, the authorities need to secure value for money; and aim to invest the reserves to achieve the best return, subject to the constraints of liquidity and minimum risk. As the reserves have grown substantially in both gross and net terms in recent years, the Treasury consider that the liquidity constraints have been met more easily, so that greater attention can now be paid to securing value for money in the management of the stock of reserves.

The increase in net worth reflected in the Exchange Equalisation Account

11. Although the Account is not designed to show the gain or loss on exchange operations, it appears to identify broad trends in the overall net worth of Account assets. It shows receipts into and payments out of the Exchange Equalisation Account and the accompanying statement of assets and liabilities displays the increase or reduction in the net asset worth. Table 1 below shows the movement in net worth over the years 1979 to 1989:

Table 1

Total net assets after valuation* and capital adjustment+

£'000

	Position at 31 March	Net change during year
1979	3,144,027	
1980	4,979,555	1,835,528
1981	5,868,563	889,008
1982	7,137,134	1,268,571
1983	9,276,621	2,139,487
1984	8,899,456	- 377,165
1985	8,884,572	- 14,884
1986	7,953,347	- 931,225
1987	8,859,322	905,975
1988	6,975,675	-1,883,647
1989	8,583,668 †	1,607,993

* See paragraph 13(c).

\+ National Loans Fund (NLF) advances as a capital liability were adjusted for excess refunds at end March 1983, 1984 and 1985 (see paragraph 12).

† Treasury's provisional and unaudited estimate.

Source: EEA annual summary

12. These assessments of net worth take account of indebtedness to the National Loans Fund, since liabilities include the capital drawn from the National Loans Fund to finance purchases of foreign currency. Table 2 below shows the position over the last ten years and reveals that in some years the Account was drawing sterling from the National Loans Fund, while in others it was making repayments. During 1982-83 to 1984-85, the Account in effect made deposits with the National Loans Fund.

Table 2 — Net EEA indebtedness to the NLF

£'000

	Outstanding balance at 31 March	Net drawings/refunds
1979	6,800,000	
1980	6,600,000	-200,000
1981	5,200,000	-1,400,000
1982	1,600,000	-3,600,000
1983	0	-2,800,000
1984	0	-600,000
1985	0	-1,000,000
1986	2,300,000	2,300,000
1987	5,950,000	3,650,000
1988	16,200,000	10,250,000
1989	16,200,000*	0

Source: NLF Account

* Treasury's provisional and unaudited figure.

13. The figures in Table 1 do not show a fully accurate measurement of net worth, since they do not take account of the following factors:

(a) The figures take no account of valuation changes relating to Government borrowing by the National Loans Fund denominated in foreign currency or borrowing by public sector bodies on behalf of the reserves under the official exchange cover scheme. Such borrowing is undertaken to provide foreign currency for the Exchange Equalisation Account and the proceeds are surrendered to and held in the Account.

(b) By statute, sterling is advanced to the Exchange Equalisation Account from the National Loans Fund free of interest. (As Table 2 shows, in certain years, the Account has made a net payment of sterling to the Fund over and above advances outstanding). These interest costs are borne by the National Loans Fund accounts, not by the Exchange Equalisation Account, although they are relevant to a comprehensive financial assessment of the Exchange Equalisation Account's operations.

It would be impracticable to measure the effects of applying notional interest charges to the cumulative advances to the Account since its inception in 1932. If the average cost of short-term borrowing in 1987-88 were applied to the average value of the National Loans Fund advances outstanding in 1987-88 the notional interest charge to the Account would amount to about £1.0 billion. If it were applied to the average value of the net assets held in 1987-88 the notional interest charge would be about £1.7 billion.

(c) Assets held in the Account are valued conservatively for the purpose of the annual

statement. Foreign currency, for example, enters the accounts at the price at which bought and is then revalued at the year-end at the average of the relevant exchange rate over the three months to the end of March or the actual exchange rate at the last working day in March, whichever has the lower value. And gold is valued at 75 per cent of the average of the London fixing price for the three months to the end of March or at 75 per cent of its final fixing price on the last working day in March, whichever gives the lower value.

"Profitability" of intervention

14. Of the Exchange Equalisation Account's activities, attention has focused on the "profitability" of intervention in particular. However, as in other major countries, intervention carried out in order directly or indirectly to influence the sterling exchange rate is an instrument of short-term macro-economic policy. Its purpose therefore is not to make profits, in whatever way profits are defined.

15. The formal accounts do not identify separately the impact of intervention on net worth. But even if they did, in the Treasury's view, any attempt to measure performance in this respect would be subject to the objections which apply to using the accounts to evaluate operations more generally. Any such assessment would too, be particularly sensitive to the choice of period and to the closing exchange rate. Arguably, it only makes sense to measure performance over a period when intervention nets out to zero. But it is unlikely that all the authorities' operations in individual currencies will have unwound by the same date and that date would in any case almost certainly not equate with reporting periods. If

the figures were not calculated over a period when intervention had unwound, it would be necessary to revalue foreign currency assets and liabilities at current exchange rates, making the artificial assumption that the net purchases or sales could be closed out at the exchange rate observed at the end of the period, even though this operation in itself would probably affect the exchange rate's level. Similar problems apply to providing a financial assessment of the Account's operations in total.

The evaluation of the Bank's management of the reserves

16. Over recent years, the Treasury and Bank of England have jointly sought to develop a management information system to provide measures of the Bank of England's performance in managing the reserves on behalf of the Treasury. The analysis takes account both of foreign currency assets and the foreign currency liabilities arising from Government and exchange cover scheme borrowing.

17. The new system, which is not yet fully developed, is designed to supply figures relevant to management decisions and to assessing management performance. It is not designed to produce formal accounts. The system provides for monitoring at a variety of levels from strategic investment choices to consideration of whether the return from active trading of securities justifies the staff and other costs it entails. The information the system produces should be more relevant than that in the formal accounts to any assessment of value for money aspects of reserves management.

18. The system is designed to assess the sterling return earned by the Exchange Equalisation Account on its net currency assets, separated to show:

(a) The return on investments within currencies showing the total return on assets in each currency less total liabilities in that currency; and identifying separately the return from changes in the level of interest rates and the return from active investment.

(b) The return on currencies

19. For the calendar year 1988, the management information system disclosed a total sterling return on the Exchange Equalisation Account of £845 million, made up as shown below. The figures do not take account of the sterling financing cost of running a net asset position in foreign currencies.

	£ million
- return on interest rates	25
- extra return on active investment	24
- return on currency	796
	845

Work is also proceeding on measuring the extra cost of holding the assets in liquid form but no figures for this are yet available.

Procedures for decision taking

20. Decisions on intervention are, of course, a matter of monetary policy and are not made to secure a profit on the Exchange Equalisation Account. They are taken throughout the year in the light of market developments and policy decisions made by the Government. In addition, officials discuss regularly other aspects of reserve management. The Bank supplies the Treasury with a detailed monthly analysis of the disposition of the reserves and every six months the position is reviewed formally by a group of Treasury and Bank officials, chaired by the Accounting Officer for the Exchange Equalisation Account, against the background of recent developments in world foreign exchange and capital markets and the latest forecasts produced by the Treasury and Bank. The decisions taken are always acknowledged to be guidelines, subject to other policy constraints which may come to bear and to revision, by agreement with the Accounting Officer, in the light of changing circumstances.

Administrative costs of EEA management

21. Despite the more active approach adopted to reserve management in recent years Treasury and Bank evidence shows that the cost of administering the Exchange Equalisation Account remained low and the rise in the value of the reserves has been met with a very modest increase in staff numbers, as Table 3 below shows:

Table 3

	EEA costs charged to Government (£ million)	Value of reserves at end of period* (£ million)	Costs as % of funds managed	Staff employed at 1 March
1979-80	2.179	12,512	0.02	90
1980-81	2.836	12,112	0.02	84
1981-82	2.939	9,933	0.03	82
1982-83	2.646	10,672	0.02	77
1983-84	2.830	10,297	0.03	79
1984-85	3.247	10,544	0.03	81
1985-86	3.272	11,744	0.03	79
1986-87	3.552	16,373	0.02	87
1987-88	4.789	24,568	0.02	87
† 1988-89	5.968	26,198	0.02	95

* as shown in the EEA annual statement of account

† Treasury's provisional and unaudited estimates.

III: CONCLUSIONS

22. The NAO agree with the Treasury's views expressed in paragraph 7, particularly that any evaluation of the operations of the Exchange Equalisation Account must have regard to the fact that profitability is not a primary objective of the Account; and regard to the constraints within which the Treasury and the Bank of England must operate. There are, too, the practical difficulties of arriving at an accurate measurement of the financial results which mean that figures such as those for trends in net asset values must be viewed with caution.

23. Any limitations in the formal financial accounts (prepared for the National Audit Office and the PAC) have no implications, of course, for the Treasury's and the Bank of England's systems for controlling the Exchange Equalisation Account, which are briefly set out in paragraph 20. And, clearly, the Bank of England's new management information system should facilitate improved strategic and operational control and improved review of the Account's activities.

24. It also seems possible that the new system could facilitate the provision of extra information on the financial results of operating the Exchange Equalisation Account. In the NAO's view, the Treasury should consider providing such supplementary information to assist the PAC in any future examination the Committee may make of the Account.

21 June 1989

SECRET - NOT FOR NAO

Rec'd 26/6

FROM: N L WICKS
DATE: 23 JUNE 1989
Ext : 4369

CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Beastall
Mr Peretz
Mr L Watts (Accounts)
Miss O'Mara
Mr N P Williams (MG1)

PAC HEARING ON THE EXCHANGE EQUALISATION ACCOUNT

As you know, the Treasury and Bank are to appear before the PAC in camera next Wednesday to give evidence on the Exchange Equalisation Account. The NAO have produced the attached Memorandum for the Committee which they have cleared with us (and which is very largely drawn from material which we supplied to them). As you will see they have broadly accepted our arguments and their recommendations are very modest - essentially, that the Treasury should consider providing some supplementary information drawn from the Bank's management information system "to assist the PAC in any future examination the Committee may make of the Account" (paragraph 24). We have already done this on the present occasion, so the suggestion poses no difficulties for us.

2. However, I suspect that the Committee themselves may give us a rougher ride and I should therefore like to know that you are content with the line I propose to take on the most awkward issues we have identified.

3. First, publication. You will remember that the TCSC pressed you hard during their 1988 Budget enquiry on whether we could publish total figures of the profit/loss on EEA operations after the event and were unconvinced when you and Sir Peter Middleton pointed out that the markets might deduce from information about the past what our tactics would be in the future, making our operations less effective. They returned to the charge in their report on International Monetary Co-ordination last month, recommending that the amount of intervention the authorities

undertook should be strictly limited and should be costed and that both the amount of the intervention and gains and losses to the UK Exchequer should be made public "at appropriate intervals", praying in aid practice in Germany and elsewhere.

4. If the PAC raise this point, which I think they almost certainly will, I propose to reply initially along the lines that the Committee would not expect me to anticipate your own response to the TCSC. If pressed, I would go on to say that I believed that publishing figures for the scale of the authorities' intervention in the market, even well after the event, could affect the success of our operations by revealing the tactics we employ in different market conditions. If necessary, I can point out that the figures published in both Germany and the US provide only limited insight into the true "profit" of their foreign exchange activities. I would add that the NAO already have full access to the details of the operations of the EEA. If pressed further along the lines of the recommendation in the NAO's Memorandum, I should tell the Committee we would be willing to consider providing them with supplementary information drawn from the Bank's management information system to assist them in any future examination, paralleling the material we have supplied on this occasion (paragraph 19 of the NAO's Memorandum).

5. If at all possible, I will try to resist either providing the PAC annually with the abstract of the cash account and statement of account for the EEA which we prepare each year against a possible PAC examination, or any information drawn from the Bank's management information system, other than in the context of a further enquiry.

6. It occurs to me that, given the general interest in this subject, the PAC may well ask us whether the Bank's system can calculate the return on intervention, separately from the overall return on currency which is already contained in the NAO's Memorandum. (Of course, recent events have helpfully demonstrated the importance of holding a substantial stock of reserves and the fact that decisions to intervene must be guided by policy considerations - not by questions of profitability - a point I can

make forcefully.) We cannot deny that the Bank's management information system can produce this material. I therefore suggest I should respond along the following lines, if this question is put to me:

> "Intervention adds to or subtracts from a pot of currencies in the EEA. It is impossible to say after the event "These dollars were bought at $1.60 and sold at $1.50; therefore we made a profit of 10 cents on each pound." The Bank's management information system does calculate the gain or loss of the operations of the EEA as a whole and this figure can be broken down in various ways. But a number of essentially arbitrary assumptions would have to be made to define and calculate the return on intervention as a sub-component of the overall return."

7. Last, it occurs to me that I may be asked whether the authorities run a forward book, even though, at our request, the NAO made no mention of this in their own Memorandum. (The difficulty here is that we have openly referred to the existence of a forward book in the past, albeit during periods while exchange controls were still in operation.) If pressed, I propose to admit that we do hold foreign currency forward - and indeed Government departments with major future foreign currency requirements are positively encouraged to purchase them forward - but refuse to give any details of the existence, size and composition of the forward book on the grounds of market sensitivity.

and pregnant of FRN

8. If asked whether we use forward operations to disguise the scale of monthly reserve changes, I would acknowledge that there may be times when the authorities will not want to disclose to the market the scale of intervention in the month - whether adding or reducing reserves - and point out that by moving reserves into or out of the forward book, the reserve total, and therefore the level of intervention in the month, can be presented in a way which does not prejudice overall exchange rate policy. However, I shall certainly not volunteer this line of argument unless pressed.

? to letter to refuse to discuss?

9. Similarly, if asked about the currency composition of the reserves, I will simply decline to provide any further information.

10. Are you content for me to respond in this way if these points come up?

N.L.W.

N L WICKS

108g/mg1.pa O'MARA(779)

SECRET - NOT FOR NAO

FROM: MISS M O'MARA (MG1)
DATE: 26 June 1989
X 4699

CHANCELLOR OF THE EXCHEQUER

cc: Sir P Middleton
Sir T Burns
Mr Wicks OR
Mr Scholar
Mr Beastall
Mr Peretz
Mr L Watts (Accounts) OR
Mr N P Williams (MG1)

PAC HEARING ON THE EEA

In his minute to you of 23 June, Mr Wicks mentioned in paragraph 9 that, if asked by the PAC for details of the currency composition of the reserves, he would decline to provide "further information". Mr Wicks has asked us to set out for you the information the PAC will already have before them at the hearing, since in answer to a question from the TCSC on this point, in the course of their 1988 Budget enquiry, you told the Committee:

> "One of the things we do not reveal but which would be revealed [in a PAC enquiry] is the composition of the reserves, how much is in dollars, how much is in deutschemarks, how much is in other currencies. If you are interested in this, there is this precedent of the PAC enquiry in 1978-79". (Q327.)

2. As background to the PAC enquiry, we have already supplied, in line with past precedent, a statement of account for the EEA (attached). This reveals the currency composition of the gross spot reserves which at end March 1988 was broadly:

	% total foreign currency assets
US dollars	45
DM	22
Dutch florins	1
French francs	5
Ecu	20
Yen	5
Canadian dollars	2

SECRET - NOT FOR NAO

3. However, this breakdown is misleading in three respects:

i. it refers only to the spot reserves. In practice, if we want to increase the proportion of our reserves held in DM or Yen, it is easier to do this by holding the underlying asset in dollars and swapping forward into the other currencies;

ii. it focuses on our gross holdings of reserves but as you yourself pointed out to the TCSC, it is more sensible to look at the position net of any foreign currency liabilities;

iii. it assumes that as a result of the EMCF swap, we hold a significant number of official ecu (as indeed we do in a book keeping sense), whereas in practice, it is more sensible to look at the underlying gold and dollar holdings on which the swap is based.

4. If we adjust for all these factors, the net currency composition of the reserves at end March 1988 was:

	% total foreign currency assets
US dollars	42.6
DM (bloc)	46.0
Yen	10.5
Canadian dollars	0.9

5. It may well be that the PAC will not raise the currency composition of the reserves at all, assuming we have already provided it to them in the Statement of Account. If they ask us, on the basis of the formal account, whether the EEA holds eg 45 per cent of its reserves in dollars, we will explain that the formal accounts refer only to the gross spot reserves and also refer to the way in which the EMCF swap is treated. If pressed further, we will explain that we swap currency forward because this is the easiest way to hold assets in certain currencies (eg Yen). But if asked how this affects the figures, we shall decline to reveal the precise composition of the spot and forward book combined. If pressed on the composition of our foreign currency liabilities (information about much of which is in principle already publicly available), we will offer a note, but point out

SECRET - NOT FOR NAO

that this would still give the PAC an incomplete picture of our net exposure in individual currencies, given our unwillingness to disclose information about the composition of the forward book.

6. Are you content?

MOM

MISS M O'MARA

FROM: A C S ALLAN
DATE: 27 JUNE 1989

MR WICKS

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Beastall
Mr Peretz
Miss O'Mara
Mr L Watts
Mr N P Williams

PAC HEARING ON THE EEA

The Chancellor was grateful for your minute of 23 June and Miss O'Mara's of 26 June.

2. On your minute, he was content except on the point in your paragraph 8, where you said that if asked whether we use forward operations to disguise the scale of monthly reserve changes, you would acknowledge that there might be times when the authorities would not want to disclose to the market the scale of intervention in the month. The Chancellor feels you should decline to be drawn into discussing policy on the forward book.

3. On Miss O'Mara's note, he was apprehensive about going in to the details suggested in her paragraph 5, and particularly about pointing out that any additional information we provided would give an incomplete picture of our net exposure in individual currencies, given our unwillingness to disclose information about the composition of the forward book. The last thing we want to do is get involved in a discussion of the forward book, so these words should not be used. And it would be far better simply (a) to rest on the table of spot reserves already provided to the NAO, and (b) to add (if pressed) that the net picture is inevitably different.

ACSA

A C S ALLAN

SECRET

FROM: N L WICKS
DATE: 25 July 1989
EXT : 4369

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Beastall
Mr Peretz
Miss O'Mara
Mrs Chaplin
Mr L Watts
Mr N P Williams
Mr George } BoE
Mr Foot }

Ch/ Content with draft Answers?

PAC HEARING: SUPPLEMENTARY QUESTIONS FROM MR GRAHAM ALLEN MP

On behalf of Mr Graham Allen MP, the Clerk of the PAC has sent me a list of questions on the Exchange Equalisation Account to which he wants answers following my evidence last month. His questions and the suggested answers are attached. They are intended to be as helpful as possible so as to try to forestall the Committee from asking for further public disclosure of the Account's activities.

2. On specific points:

Answer 3: We have tried here to deal with the confusion apparent in some of the Committee's questions which suggested they thought we earned no return at all on some portion of the foreign currency reserves.

Question 4: You will see that we have acknowledged here that we do deal in futures. (You may remember that we were hoping not to reveal to the PAC that we trade in futures but it is difficult to duck such a direct question.)

Answer 5: We have referred here to the largest sales and purchases of sterling made in a single day in 1988-89 (the

most convenient period to choose since it avoids both the heavy sales of sterling in the first quarter of 1988 and the large purchases in June 1989). We could, if you preferred, refer simply to monthly underlying changes in the published reserves but, as you know, those figures can be misleading and, as the Notes to Editors points out each month, they refer to total, rather than market, intervention. The figures in the draft answer, by contrast, relate only to market intervention but are also restricted to spot sales or purchases. They therefore differ from the figures which are shown for market intervention on the evening report.

Incidentally, you will notice the (literal) hole in question 5. The Clerk told Miss O'Mara that he had removed a figure from Mr Allen's letter to avoid the need to treat it as classified. It is worrying that Mr Allen appears to have written down at least one classified figure (I doubt he remembered it), particularly since the thrust of his questions suggest to us that he has discussed the EEA, at least in general terms, with someone who has rather more knowledge of the subject than he does. (I find it difficult to believe, for example, that he thought up the question of dealings in futures and options himself!) I will stress in my reply to the Clerk the sensitivity of the answers.

3. Mr Allen has recently asked several PQs on the current level of the Reserves, on the amount spent in support of sterling in June and on the amount of money invested in sterling which could be withdrawn at one day's notice, one week's notice and with notice of withdrawal longer than one week. He is presumably seeking to demonstrate that any intervention we might undertake could be utterly swamped by the amount of "hot" money likely to flow out of sterling if sentiment in markets changed.

4. I should be grateful for your approval to reply to Mr Allen's questions as in the Answers attached.

N.L.W.

N L WICKS

1. **What arrangements exist to prevent our EEA competing with equivalent organisations in other countries and in what way can these be improved?**

Finance Ministers and Central Bank Governors of the seven major industrialised countries, or their Deputies, meet several times a year to discuss exchange rate issues and their strategy in the foreign exchange markets. Central Bank Governors also meet regularly. These meetings can be, and often are, supplemented by telephone conversations, in the light of specific market developments. All the major central banks also maintain a telephone link, by which they regularly share information and discuss market tactics. Regular contact of this kind provides the best means of ensuring that the authorities in individual countries do not, through their own market operations, negate the action which others may be taking.

2. **Would they list the sources of information on the EEA which is publicly available**

a. to MPs

b. the public?

The EEA holds the UK's official reserves, details of which are published in Table 17.1 of the Bank of England's Quarterly Bulletin and Table 10.3 of Financial Statistics. Information on reserves changes is also published each month by the Treasury as part of the reserves press notice. Historical material relating to the Exchange Equalisation Account is released in accordance with the Public Records Acts of 1958 and 1967. In addition, members of the Public Accounts Committee have examined officials on the EEA's operations in camera from time to time.

3. **What was the division of investments (for any given year) using spare EEA funds not engaged in EEA activities?**

All the EEA's resources are deployed for the purposes set out in the 1979 Exchange Equalisation Account Act: there are no "spare" funds. Virtually all the UK's foreign currency reserves earn a market rate of return and are invested in readily realisable form for use at need. Within the total, a pool of particularly liquid assets is maintained and topped up as necessary.

4. **Is EE ever used for buying options or futures; if so, what is the largest loss ever taken by the account?**

The EEA has recently for the first time entered into a number of transactions in futures markets principally to increase or reduce its interest rate exposure but also in operations to produce arbitrage profits and to improve liquidity at low cost. Futures markets have been used rather than spot (cash) markets where they are more efficient and where transactions costs are less. In the Bank's management information system, the returns from these operations are recorded as part of the overall return on interest rates or as part of the active management of the reserves, depending on the nature of the operation. Since exposures are managed on an aggregate level, the system makes no attempt to distinguish between the cash and futures operations to isolate the returns on the latter. But as paragraph 19 of the NAO's Memorandum to the Committee noted, the EEA has regularly earned money from these operations at the aggregate level. The EEA has not dealt in options.

5. **What is the largest and smallest amount of the £X billion reserves committed to intervention during the latest year for which figures are available?**

It is difficult to define a specific episode of intervention. However, the largest purchase of sterling in any one day in 1988-89 was $600 million and the largest sale in one day over the

same period was the same size. Intervention may, of course, be conducted in one currency or several.

6. **What methods and models of accountability for EEA equivalents exist in Governments elsewhere?**

The diversity of the EEA's "equivalents" elsewhere make this question difficult to answer. For example, the official foreign exchange reserves of the Federal Republic of Germany are held by the Bundesbank which has considerable constitutional autonomy. In other countries - the United States, Canada, Japan, France - the reserves are split between the relevant central bank and a Treasury/Ministry of Finance 'fund', often with different forms of accountability for each account.

7. **What will be the effect on EEA dealing and strategy of entry into**

a. EMS

b. EMU?

When the UK enters the exchange rate mechanism of the EMS, operations will have to be conducted to keep sterling within its ERM band and this will involve monitoring movements in the rate against other Community currencies to a greater extent than at present. Under the Delors Committee's definition of EMU, the EEA would cease to exist but there is, as yet, no agreed definition of what EMU would entail.

8. **What are the major changes in the operation and environment of the EEA over the last 10 years?**

Over the last decade, exchange controls have been abolished in the UK and abolished or largely removed in many other major countries. Financial markets have become much more sophisticated and the scale of financial flows across the exchanges has increased dramatically. The UK's ~~[illegible]~~ foreign exchange reserves have doubled from around $22 billion in June 1979 to $43½ billion in June this year.

[illegible] do not [illegible]

9. Which national and international organisations have profited from exchange instability and what strategies has the Treasury considered other than use of EEA to deter rather than perpetuate these benefits?

Only successful speculators profit from exchange rate instability. The UK has joined with other G7 countries in reaffirming the advantages of exchange rate stability and has demonstrated its determination to achieve this, whether by the use of intervention or adjustments in short-term interest rates.

10. What would be the consequences of discontinuing the use of EEA?

All the Government's foreign currency requirements would have to be met from the market at the time they arose, no matter what the prevailing conditions, and this could add to any pressures which might be affecting sterling. Moreover, ~~since~~ discontinuing the use of the EEA would deprive the Government of a major instrument for influencing the exchange rate on a day to day basis, that in itself could affect the sterling exchange rate, over a longer period.

FROM: D I SPARKES
DATE: 26 July 1989

MR N L WICKS

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Beastall
Mr Peretz
Miss O'Mara
Mr L Watts
Mr N P Williams
Mrs Chaplin

Mr George - B/E
Mr Foot - B/E

PAC HEARING: SUPPLEMENTARY QUESTIONS FROM MR GRAHAM ALLEN MP

The Chancellor was grateful for your minute of 25 July covering draft Answers to the Supplementary Questions on the exchange equalisation account posed by Graham Allen MP. He was broadly content, but had the following comments:

(i) Answer 4: there is a typo in the last line;

(ii) Answer 8, fifth line: "UK's reserves" to read "UK's foreign exchange reserves" (the Chancellor takes it that the figures quoted do not include gold);

(iii) Answer 9, first line: "Only speculators" to read "Only successful speculators";

(iv) Answer 10, third line: "could add" to read "could at times add"; final sentence to read: "Moreover, discontinuing the use of the EEA would deprive the Government of a major instrument for influencing the exchange rate on a day to day basis, and that in itself

could affect market sentiment and thus the sterling exchange rate over a longer period."

D.S.

DUNCAN SPARKES

ppg.jg/docs/Sargent

CONFIDENTIAL

FROM: S D H SARGENT
DATE: 26 JULY 1989
EXT: 4360

MR N L WICKS

cc PS/Chancellor
PS/Economic Secretary
Sir T Burns
Mr Scholar

PAC HEARING: SUPPLEMENTARY QUESTIONS FROM MR GRAHAM ALLEN MP

Sir Peter Middleton had a couple of comments on the answers attached to your minute of 25 July to the Chancellor. In the first sentence of the reply to question 4 he would delete the words "but also in operations to produce arbitrage profits" in lines 3 and 4. He also feels uncomfortable about the first sentence of the answer to question 9 "Only speculators profit from exchange rate instability". Some movement in exchange rates is a necessary consequence of relative changes in domestic monetary conditions, although excessive fluctuations are certainly undesirable.

S D H SARGENT

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