FILE NUMBER

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1/3

FILE BEGINS 08/02/1986

ENDS 24/06/1988

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ANNEX A

ANNEX: KNOX TO CH/EX 16/11/84

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

FROM: B H KNOX

DATE: 16 November 1984

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monger
Mr Battishill
Mr Lord
Mr Portillo

CONSUMER CREDIT DUTY

At your meeting on 22 June although you did not regard the prospects for including a consumer credit duty in the 1985 Budget as promising, you asked us to give further consideration to the implications of introducing such a duty. Since then we have refined our proposals in a number of areas, and a decision is now needed on whether work should continue on the duty with a view to its inclusion in the 1985 Budget. There are a number of general considerations bearing on this.

2. The arguments in favour of introducing the duty include:-

(a) It would be a useful extension of the indirect tax base into an area which has done relatively well in recent years and where the existing tax burden is low in comparison with that on goods and services liable to VAT. Such an extension would be consistent with the Government's policy both of shifting the burden towards indirect taxes and of removing distortions in the tax system. Our EC obligations mean that the only VAT burden which can be borne by financial services is "sticking tax" which results from institutions being

/unable

Internal distribution:

CPS, Mr Jefferson Smith, Mr Harris, Mr T Jenkins, Mrs Boardman unable to recover the VAT paid on their purchases of goods and services. This is roughly equivalent to a levy of 3% on the value added by the financial sector's exempt activities.

(b) The opportunities for other increases in the indirect tax area may be limited. Within the VAT area, the scope for extending the tax base is being considered but may prove limited. Within the excise area there is some room for manoeuvre but this is restricted by factors such as the effect of the European Court decisions on the wine/beer relativities, the industrial and economic consequences of changes in the oil sector, and the declining markets for spirits and tobacco.

(c) It could provide a useful, if small, contribution to the revenue, amounting to £250 million in a full year (or £210 million PSBR effect) assuming a 1% rate and the exclusion of mortgages.

(d) It would help, albeit marginally, to restrain the growth of credit, and to that extent ease the pressure on interest rates. Once it was in place, changes in it could be made to help influence credit conditions.

3. The arguments against introducing the duty include:-

(a) The revenue benefits would not be large in overall terms, and would only build up over a period. There are strong arguments (see para 14 below) which suggest that if it were decided to introduce the duty the timetable should be slower than envisaged last year. However, even on the earlier scenario, no revenue would accrue until 1986/87, and the yield in that year would be only about 45-50% (or £110-120 million) of the expected full year yield (with a 1% rate and the exclusion of mortgages). The PSBR effect in 1986/87 on this

/basis

basis would be £90-100 million as compared with £210 million for a full year.

(b) The duty would be unpopular with both the institutions and the consumer. Its implementation would require considerable resource costs and adjustment by the institutions, coming on top of other major tax changes. Depending on the detailed decisions on mortgages and other points discussed below, it could also be criticised not only as increasing the cost of borrowing generally, but also as creating inequities between different forms of credit. There is no particular argument at present that excessive bank profitability justifies a tax which discriminates against them; indeed their need to strenghen their balance sheets as a result of the changes in capital allowances in the last Budget argues against any tax which would make this more difficult.

(c) The duty would be complex, and subject to a number of uncertainties in an area of which we have little experience. On the maximum assumption of 40-50,000 lenders to control it could require up to 200 staff to administer. With a 1% rate and the exclusion of mortgages, this could result in a staff cost/revenue ratio of 1.5% as compared with, for example, one of 1.1% for VAT and an average ratio of 0.38% for the excise duties. It is too early to give a firm estimate of the Finance Bill space likely to be required, but this could be up to 20 pages, in addition to Schedules. Even then, it would not be possible to cover all the points required in primary legislation; technical consultations with the trades concerned after the Budget announcement would be needed on a considerable number, with a view to further detailed secondary legislation. Even then, there could remain considerable opportunities for avoidance and leakage.

/4. If you

4. If you wish work to proceed for the 1985 Budget we have been advised by Parliamentary Counsel that he would need to receive the necessary authority to start work by early December in order to be able to allocate the necessary additional drafting resources. We would also need your authority to hold further consultations urgently, and in confidence, with the Office of Fair Trading, the Chief Registrar of Friendly Societies and the Department of Trade and Industry, and your decision on a number of key structural points:-

(a) Whether or not mortgages should be included within the scope of the tax;
(b) Whether fixed interest agreements in force at the date of its announcement should be excluded from the scope;
(c) At what rate the duty should be charged;
(d) What should be the level of any <u>de minimis</u> exemption (more work will be required on this); and
(e) The timing and method of the duty's introduction.

Mortgages

5. Although recognising it would be right in principle to include mortgages, Ministers provisionally decided before the last Budget to exclude all mortgages from the scope of the duty except for those for which no income tax relief is available (mainly the portion of larger mortgages over £30,000 and loans for second homes etc). That decision was based on:-

(a) The need to minimise potential hostility to the new duty in a context where the banks were seen as the major legitimate target for any new impost;

(b) The apparent inconsistency of "clawing back" a small proportion of the income tax relief on mortgages - the scale of which had been increased as recently as 1983; and

/(c) The potential

(c) The potential impact on the RPI. Whilst non-mortgage consumer credit does not feature in the RPI (although the possibility of including it has been mentioned in the Advisory Committee), a 1/2% duty on mortgages would haved an RPI impact effect of about 0.15%, and require consequential increases in social security benefits and income tax allowances.

It also took into account the administrative arguments for aligning any reliefs strictly with the existing boundaries for income tax purposes.

6. Since the Budget two new points have emerged which may bear on any reconsideration :-

(a) The banks will be particularly sensitive to any apparent discrimination in favour of the building societies in relation to themselves. It has been a consistent theme of the Government's policy over recent years to remove discrepancies between the tax treatment of banks and building societies (eg taxation of building societies trading gains on gilts, and introduction of composite rate for bank interest). If mortgages were to be exempt from the duty, the banks would argue that the building societies - which supply 75 per cent of mortgage finance - will be enjoying a substantial advantage on the great bulk of their lending, as compared with the banks. This objection would to some extent be met by the fact that qualifying bank mortgages would receive similar exemption, and only mortgages qualifying for income tax relief are being considered for exemption anyway. But the advantages of mortgage borrowing through equity withdrawal, as compared with the conventional forms of bank finance, would undoubtedly be increased. On the other hand, as the figures in paragraph 10 illustrate it could be argued that a duty on credit which was not related to the lender's margin could bear unfairly heavily on building society borrowers when compared with other forms of credit.

/(b) Any

(b) Any apparent inconsistency with the income tax relief will now need to be reviewed in the light of any other proposals, for example, in relation to the higher rate relief.

7. There remain two main arguments for including mortgages within the duty's scope. The first is general principle. The general rationale for the duty is that it is appropriate for the consumption by individuals of the resources involved in the provision of consumer credit to be taxed in parallel with the tax or levied on their consumption of most goods. It would be anomalous to exempt the largest element in consumer credit from the duty. The second is to maximise revenue. Exclusion of mortages would give a further incentive to dress up consumer credit as mortage lending (although even with a rate of 1% on their outstanding value, this would be small compared with the incentive provided by the income tax relief). More immediately, the inclusion of mortgages would increase the revenue base six-fold. The net effect on the PSBR would be less than half the gross revenue gain, as the table below illustrates, as a result of considerable leakage in the form of additional social security benefits and income tax allowances (particularly those given under MIRAS and higher rate relief (HRR)). Nevertheless the inclusion of mortgages within the scope would enable you to achieve nearly double the effect on the PSBR for half the rate than would otherwise be the case.

<u>Full Year Yields (£ million)</u>

Rate	Type of Credit	Gross Yields	MIRAS + HRR	Consequential effects on indexation 2	Demand Effects 3	Net Yield (PSBR effect
1/2%	Consumer Credit	125	-	-	20	105
	Mortgages	650	200	90	100	260
	Total	775	200	90	120	365
1%	Consumer Credit	250	-	-	40	210
	Mortgages	1300	400	170	200	530
	Total	1550	400	170	240	740

1 Assuming no relief for existing fixed-interest credit
2 Of social security benefits and income tax allowances
3 Effects on yield of other indirect taxes

/<u>Fixed</u>

Fixed Rate Credit

8. There is also the question of whether existing fixed interest credit should be exempted. We assume that in the majority of cases where lenders are free to do so they would choose to pass on all or most of the costs of the duty to the borrower. But there would be a particular problem in respect of loan contracts entered into before the announcement of the new duty, at fixed rates of interest. Last year you provisionally decided that the duty should not apply to any such existing contracts , in order to avoid one potential source of criticism. Although probably over half of consumer credit other than mortgages is in this form, because fixed-interest credit agreements are normally short term (up to 5 years and in the majority of cases between 12 months and 3 years) the effects of a relief for "existing" agreements would wither away quickly in the early years of the new duty; particularly if the date of its introduction were to be delayed in the way suggested in paragraph 14 below. This is illustrated by the following table:-

Estimated Revenue effect of excluding fixed-interest credit in place at time of 1986 Budget :-

Starting Date	Revenue Yield (excluding mortgages) at 1% duty			
	1st year Including Fixed-Int	Excluding Fixed-Int	2nd year Including Fixed-Int	Excluding Fixed-Int
1 July 1986	115	95	250	240
1 July 1987	115	105	250	245

An exemption along the lines of excluding those fixed rate commitments entered into when the duty is announced is strongly supported by the Bank of England because:-

(a) Without the exemption the duty could be deemed to be retrospective in nature

(b) Traders extending fixed-interest rate credit have no existing arrangements for changing interest rates and would have to suffer considerable inconvenience. Alternatively they could bear the cost themselves which could have prudential implications for some of the smaller lenders.

(c) The impact, which is not large, would wither away relatively quickly, particularly if the start date was July 1987.

/9. There

9. There are two possible alternatives :-

(a) The legislation could include a provision similar to Section 42 of the VAT Act 1983 authorising lenders, if they so choose, to adjust the interest charged under existing contracts to take account of the new duty. This would have major longer term advantages, in that it would build into the structure of the duty a means of avoiding similar problems recurring whenever the rate is changed. But it would have presentational difficulties at the start of the tax, by appearing to place the burden squarely on the shoulders of the borrower, and it would almost certainly give rise to a number of individual hard cases where borrowers were unable to meet the new requirements.

(b) You could also do nothing and rely on the general short term nature of fixed-interest credit to minimise the costs which would actually have to be absorbed by lenders. It is difficult to calculate how great this burden would be but our best estimate is that with a starting date of 1 July 1986 possibly less than a fifth of the outstanding credit (excluding mortgages) at the start of the tax would have been taken out at a fixed rate before Budget Day 1985. With a starting date of 1 July 1987 this proportion would fall to between 5 and 10%. This suggests that the cost of the exemption is relatively small but by the same token lenders would not have to absorb a severe burden if there were no exemption, particularly with a delayed starting date. However the position could vary considerably between lenders (although HP contracts generally run from 12 months to 3 years, personal loans from the banks can run up to 10 years), and the lack of any relief could give rise to increased criticism.

The Rate of Duty

10. Before the last Budget you decided that the rate should be set at 1% initially, in order to achieve a worthwhile revenue

/yield

yield whilst excluding mortgages. As the figures in paragraph 7 show, if mortgages were included within the tax base it would be possible to obtain nearly double the revenue and PSBR benefit with a 1/2% rate. There are a number of arguments against an initial rate higher than 1%. Financial services on average already bear the equivalent of a 3% levy in the form of "sticking" VAT. A 1% rate is not negligible (though it would generally be below the equivalent of a 15% VAT). The effective rate would depend on the interest charged for the loan and the lender's margin and therefore would differ both between different lenders and over time - probably ranging between 5 and 10 per cent. Finally any higher rate would increase the risk of creating distortions in addition to increasing the incentive for avoidance and hostility to the establishment of a new tax. A lower initial rate would not rule out the possibility of raising the rate at some later stage, once the system is established and any initial difficulties overcome.

De Minimis Limit

11. Before the last Budget it was envisaged that a de minimis exemption based on the amount of a creditor's outstanding loans would be required. We have since given considerable thought to what level this should be set since the final decision could have wide implications for the collection system. Our earlier discussions with the Office of Fair Trading suggested that between 40,000 and 50,000 lenders are potentially registerable. A trade population of this size would take considerable resources to control, and led to our suggestion last year that the collection system should be based on dividing creditors into a number of stagger groups who would fall due to account for the duty in different months. In order to maximise the first year revenue accruing with a 1 July starting date, we envisage concentrating

/the 1200-2000

the 1200-2000 largest lenders (excluding Building Societies) who appear to be responsible for nearly 90% of outstanding credit (excluding mortgages) in the first stagger group. A de minimis exemption limit set at a fairly high level could, however, drastically reduce the number of registerable lenders, and in this event we would need to reconsider whether the stagger system was necessary or should be modified. This would not affect our recommendations concerning the starting date or more than marginally affect the first year yield, but it could substantially reduce the costs and difficulties of collection.

12. Ideally these considerations would point to a limit being set at a fairly high level in order to cut out as many as possible of the smaller lenders. On the other hand, if the limit were set at too high a level this could invite charges of inequity between lenders and increase the risks of serious duty avoidance as a result of disaggregation (although in practice we think that disaggregation could be contained by special provisions in cases involving the insurance or factoring of loans and loans made by associates). There is very little hard published information on which to base an assessment of where the line should be drawn, and this is one of the main areas on which we would need to consult further with other Departments before making a firm recommendation. What published data we have suggests that a limit set at about £100,000 would certainly catch all of the 2000 largest traders, but we cannot estimate how many others (particularly in sectors such as retailing) would also be caught.

Timing and Introduction

13. A decision is also required on the starting date for the new duty. Last year it was provisionally decided that the duty should come into effect from 1 July 1985 having been announced in the 1984 Budget. There are a number of reasons why we would recommend against any faster timetable this year :-

(a) Introduction of the duty will entail a major re-programming and implementation exercise for the banks and other major creditors for which they are likely to requite

/at least

at least 12 months from the date when all the necessary technical details can be announced. In practice, although it should be possible to announce the basic outline of the duty at the time of the Budget and embody this in the Finance Bill, there will remain large areas on which detailed decisions will have to await technical consultations for the industry and be implemented subsequently by secondary legislation. We doubt whether it would be possible to complete the necessary detailed discussions much before Royal Assent next year, and this points clearly to 1 July 1986 as the earliest practical date for implementation by the major creditors.

(b) In practice, there would not be any significant revenue advantage in trying to advance the implementation date to, for example, 1 April 1986, since the fact that lenders will be called on to account for the tax twice yearly, three months in arrears, means that it would not be possible to obtain more than six months' worth of duty (or 50%) from all traders, even with a 1 April starting date. With a 1 July starting date and suitable stagger arrangements we would expect to be able to collect about 45% in 1986/87 of the expected full year yield.

(c) A 1 July 1986 starting date should allow sufficient time for any changes announced in the 1986 Budget to be implemented from the start of the duty under a resolution under the Provisional Collection of Taxes Act.

In these circumstances we would strongly recommend against any attempt to introduce the duty before 1 July 1986.

14. There is indeed a strong case for delaying implementation beyond that date. The Bank of England feel strongly that it should be delayed until 1 July 1987, in order to allow time for the necessary legislation to be included in the 1986 Finance

/Bill

Bill in the light of detailed technical discussions with the industry on the basis of a consultative document on the technical proposals to be issued after an announcement of the Government's intention in the 1985 Budget. This would have two advantages :-

(a) The duty would be a significant extension to the tax system in an area of which we have little experience. There are considerable technical difficulties on which detailed decisions will not be possible in advance of technical consultations with the industry, and these could be done more readily and with less haste in the context of a Green Paper.

(b) Second, an extended timescale would allow the banks a short breathing space before they were called upon to implement yet a further complex series of changes in their computer systems at the Government's behest. Over the last few years, the banks' programming resources have been heavily committed to meeting Government requirements at the expense of commercial projects such as improvements in the transfer system. These difficulties could be increased by any further calls on the banks' resources, such as the current proposals for changing the banks' input to the monetary statistics to a calendar month basis.

15. On the other hand, a later starting date would mean that the new system would not be in place until near the end of the current Parliament, and would give additional opportunities for concerted criticism to emerge.

Bryce Knox

B H KNOX

GRS 800

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FM LAGOS

TO DESKBY 131100Z FCO

TELNO 1258

OF 131035Z DECEMBER 85

AND TO DESKBY 131100Z BANK OF ENGLAND, TREASURY, ECGD, DTI

AND TO DESKBY 131100Z PARIS

AND TO DESKBY FIRST CONTACT UKDEL IMF AND IBRD.

MY TELNO 1257: NIGERIA: IMF LOAN

SUMMARY

CONSIDERABLE ENTHUSIASM LOCALLY FOR THE GOVERNMENT'S DECISION TO BREAK OFF NEGOTIATIONS WITH THE IMF. THE GOVERNMENT'S FUTURE INTENTIONS IN THE LIGHT OF THEIR DECISION ARE STILL UNCLEAR BUT THE PROSPECTS OF NIGERIA'S BEING ABLE SUCCESSFULLY TO OVERSOME THE MANY ECONOMIC PROBLEMS FACING IT HAVE BECOME MORE REMOTE. RECENT MOVEMENTS IN WORLD OIL PRICES WILL COMPOUND NIGERIA'S PROBLEMS.

DETAIL

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1. THE DECISION TO REJECT AN IMF LOAN WAS TAKEN AT A FIVE HOUR MEETING OF THE ARMED FORCES RULING COUNCIL ON 12 DECEMBER. IT SEEMS LIKELY THAT THE PRECISE FORM OF THE STATEMENT WAS IN THE BALANCE UNTIL THE LAST MINUTE: WE HAVE HEARD THAT BABANGIDA WAS DUE TO BROADCAST TO THE NATION TWICE IN THE PAST FEW DAYS BUT EACH TIME IT WAS POSTPONED. AS RECENTLY AS 6 DECEMBER, AAA APPEARED TO BE HINTING TO ME THAT PRESIDENT BABANGIDA MIGHT STILL DO A DEAL WITH THE FUND (MY TELNO 1231).

2. THE INITIAL REACTION IN THE PRESS TO BABANGIDA'S STATEMENT IS PREDICTABLY ENTHUSIASTIC, REFLECTING THE OVERWHELMINGLY NEGATIVE VIEW TAKEN HERE ON AN IMF DEAL. THE ABRUPT TONE OF THE STATEMENT IS BEING WIDELY INTERPRETED AS ''LAYING THE GHOST'' OF THE IMF.

3. BABANGIDA MAY HAVE FELT IT NECESSARY FOR POLITICAL REASONS TO TAKE A HARD LINE. BUT IT IS STILL NOT CLEAR WHETHER HIS INTENTION IS TO PUT PAID TO AN IMF SETTLEMENT ONCE AND FOR ALL. AAA MAY HAVE THROWN SOME LIGHT ON THIS POINT IN HIS CONVERSATION WITH LITTLER ON 11 DECEMBER (YOUR TELNO 859 REFERS). CERTAINLY, BABANGIDA'S COMMENT THAT ''GOVERNMENT HAS COME TO THE CONCLUSION THAT FOR NOW THE PATH OF HONOUR AND THE ESSENCE OF DEMOCRATIC

CONFIDENTIAL /PATRIOTISM

PATRIOTISM LIES IN DISCONTINUING NEGOTIATIONS'' MIGHT BE SIGNIFICANT.

4. IMMEDIATELY PRIOR TO THE BROADCAST, THE FINANCE MINISTER, KALU, GAVE SOME CREDENCE TO THE VIEW THAT THE NIGERIANS MIGHT EVENTUALLY GO BACK TO THE IMF. HE IS REPORTED IN TODAY'S ''GUARDIAN'' AS STATING THAT THE BUDGET WOULD NOT BE ''AN IMF BUDGET AND THAT NEGOTIATIONS FOR THE LOAN HAD BEEN DISCONTINUED''. BUT HE WAS ALSO QUOTED AS SAYING ''NOT TAKING THE LOAN DOES NOT PRECLUDE IMPLEMENTATION OF THE PACKAGE''. HE ADDED THAT THE CONDITIONALITIES DEMANDED BY THE IMF WOULD NEVERTHELESS ONLY BE ACCEPTED IF TAEY WERE RELEVANT TO THE NIGERIAN SITUATION. KALU ALSO REFERRED TO A POSSIBLE RESUMPTION OF TALKS WITH THE IMF IN DUE COURSE.

5. KALU HAS OF COURSE ALWAYS BEEN PRO IMF AND HIS REMARKS MUST BE TREATED WITH CAUTION. NEVERTHELESS, JUDGING FROM THE TONE OF BABANGIDA'S STATEMENT, THE 1986 BUDGET DUE ON 1 JANUARY WILL ALMOST CERTAINLY CONTAIN TOUGH MEASURES (INCLUDING REDUCTION OF THE PETROLEUM SUBSIDY AND CUTS IN GOVERNMENT SPENDING). THE NIGERIANS MAY HOPE TO BE ABLE TO PERSUADE THEIR FOREIGN CREDITORS THAT THIS IS A GOOD ENOUGH COMPROMISE TO BE WORTHY OF SUPPORT, IN THE FORM OF DEBT RESCHEDULING, NEW CREDITS ETC, WITH OR WITHOUT THE IMF. THEY MAY EVEN HOPE, AS RECENTLY SUGGESTED TO US BY A MINISTRY OF FINANCE OFFICIAL (MY TELNO 1239), THAT THEY WILL BE ABLE TO EVOLVE A PACKAGE WHICH WILL BE ACCEPTABLE TO THE FUND, TO THAT, EVEN WITHOUT TAKING IMF MONEY, THEY WILL BE ELIGIBLE FOR THE OTHER NORMAL BENEFITS OF AN ANREEMENT. OTHER SENIOR NIGERIANS HAVE IN THE PAST SPOKEN MORE VAGUELY OF SEEKING AN IMF ''SEAL OF APPROVAL'', SOME SORT OF ENDORSEMENT STOPPING SHORT OF A FULL AGREEMENT.

6. THE NEXT FEW DAYS SHOULD THROW FURTHER LIGHT ON THE GOVERNMENT'S INTENTIONS. BUT MY INITIAL REACTION IS THAT BABANGIDA, LIKE BUHARI BEFORE HIM, BY FAILING TO BITE ON THE IMF BULLET, HAS PROBABLY IRREVERSIBLY DESTROYED THE PROSPECTS OF HIS ADMINISTRATION'S EXTRICATING NIGERIA FROM THE ECONOMIC MORASS IN WHICH IT FINDS ITSELF. HIS STATEMENT WILL STRENGTHEN THE ALREADY STONG ANTI-IMF FEELING IN THE COUNTRY AND MAKE IT MUCH MORE DIFFICULT FOR HIM TO RESUME MEANINGFUL NEGOTIATIONS WITH THE FUND. AS SUGGESTED ABOVE, THE GOVERNMENT MAY BE RELYING ON ITS ''FRIENDS AND TRADING PARTNERS'' TO HELP IT OUT. HOWEVER, WITHOUT CONCRETE EVIDENCE OF A REAL WILL TO SOLVE THE ECONOMY'S MAJOR STRUCTUAL DISTORTIONS, IT IS DIFFICULT TO SEE WHAT WE CAN DO. THE PROBLEM IS LIKELY TO BE COMPOUNDED BY THE PRESENT WEAKNESS IN THE OIL MARKET. THIS WILL ALMOST CERTAINLY WIDEN THE FINANCING GAP, AND COULD NOT HAVE COME AT A WORSE TIME FOR NIGERIA.

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TELNO 1275
OF 131411Z DECEMBER 85
INFO PRIORITY DTI, ECGD, TREASURY, BANK OF ENGLAND, PARIS
INFO PRIORITY UKDEL IMF/IBRD

C. President Big Bang's statement is v. bad news. We are trying urgently to get hold of the JMB report referred to at X, but no luck yet.
RS 16/12

MY TELNOS 1257 AND 1258: NIGERIA/IMF

1. WHILE CALLING ON THE CENTRAL BANK GOVERNOR ON 13 DECEMBER ABOUT JMB (SEPARATE REPORT), I ASKED HIM FOR HIS COMMENTS ON THE PRESIDENT'S ANNOUNCEMENT THAT NIGERIA WAS BREAKING OFF DISCUSSIONS WITH THE IMF.

X

The usual Nigerian mess.

2. THE GOVERNOR SAID THAT HE HAD NOT (NOT) EXPECTED THE PRESIDENT'S STATEMENT. HE DESCRIBED THE BROADCAST AS ''POLITICAL'', NOT ECONOMIC OR FINANCIAL. HE EXPRESSED CONCERN THAT NIGERIA COULD SAY THIS SORT OF THING JUST WHEN THEY WERE PLANNING ON INTRODUCING MEASURES IN THE BUDGET WHICH WERE VERY MUCH IN LINE WITH THE FUND'S REQUIREMENTS. IT WAS PARTICULARLY UNFORTUNATE NOW, SINCE THE SIGNALS THEY HAD BEEN GETTING FROM ABROAD (INCLUDING THE UK) INDICATED THAT THEY HAD ONLY NEEDED TO MAKE A LITTLE MORE EFFORT TO REACH THEIR OBJECTIVE. HE NEVERTHELESS SUGGESTED THAT FINAL JUDGEMENT SHOULD WAIT UNTIL THE BUDGET PACKAGE CAME OUT.

WYATT

MONETARY

WAD

THIS TELEGRAM WAS NOT ADVANCED.

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Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

C/ This is for MST, but you might be interested to see.

CR 28/8.

From: B H KNOX

Date: 22 August 1986

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Monger
Miss Sinclair
Mr Cropper
PS/Inland Revenue

MINISTER OF STATE

A most rational & important submission. I shd be grateful if MST cd see how this can be speeded up so that we can legislate in next year's Budget/Finance Bill. I shd also like to consider raising the VAT threshold to £24,100! I don't see how we can [illegible] Commons [illegible] take us from the CRCS! [illegible]

VAT: SMALL BUSINESSES REVIEW

Introduction

1. This note is to summarise the conclusions of our internal examination of the procedures and requirements which the recent deregulation White Paper "Building Businesses .... Not Barriers" committed us to review by mid 1987, and to seek your approval to our putting in hand the drafting of a consultative paper to be published this autumn. Details of our consideration, revenue costs, legal implications and dates for implementation are in the attached papers at annexes A to F.

Building Businesses ... Not Barriers

2. In Chapter 6.4 of this White Paper we are committed to reviewing our VAT policy towards small businesses. This review, to

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Internal distribution

CPS	Mr Trevett	Mr Huband	Mr Wilmott
Mr Howard	Mr Tracey	Mr Goddard	Mr Holloway
Mr Jefferson Smith	Mr Fryett	Mr Hogg	Mr Hewett

be completed by mid-1987, and in close consultation with small businesses, the EDU and other Government Departments, is to include:

- "cash accounting", where VAT would be claimed and paid on a cash basis rather than on the basis of invoices;

- the special schemes for retailers. This would include a review of the need for the limits on turnover which apply to some schemes;

- an annual system for VAT under which VAT would be assessed annually, but regular monthly or quarterly payments would be paid to Customs based on the trader's annual assessment; and

- requirements for record keeping and accounts.

3. At Chapter 6.5 the White Paper also publicised our intention to review, by the end of 1986, the procedures for VAT registration and deregistration. For this review there was, however, no specific commitment for us to consult with persons outside the Department.

4. We have now completed our internal consideration of each of the above items and our findings are detailed in the papers:

Annex A Cash Accounting
Annex B Retail Schemes
Annex C Annual Returns
Annex D Record and Accounts
Annex E Registration and Deregistration requirements.

In addition we have also looked again, Annex F, at the NFSE case for the abolition of VAT on credit transactions between registered traders.

The 22nd Directive

5. Any changes to VAT legislation have to be in accordance with EC law which is primarily determined by the EC 6th VAT Directive. The Commission have now submitted to the Council a proposal for a 22nd Directive which would provide a special scheme for small and medium sized businesses. This draft Directive is therefore of direct relevance to our review. A copy is at Annex G. Miss Sinclair's note to the Chancellor of 14 August provided a short commentary. If implemented, without amendment, the draft Directive would make the following provisions:

attached at A

a. A mandatory tax exemption (registration threshold) of 10,000 ECU - currently equivalent to about £6,900;

b. An optional registration threshold of 35,000 ECU - about £24,100;

c. A mandatory simplified "accounting" scheme for charging and collecting tax for traders with a turnover of less than 150,000 ECU - about £103,000. This scheme would consist of:

i. Cash accounting for both outputs and inputs; together with

ii. Annual returns and monthly or quarterly payments;

d. The option for member states to introduce a flat rate percentage for calculating deductible input tax. (We have not received any demand for this facility. It would be complicated and expensive to administer. We do not propose to pursue this option.)

The draft Directive does not provide for compulsory deregistration and traders below the relevant threshold, 10,000 or 35,000 ECU, may opt for exemption (not to be registered in UK terms), the normal system, or the simplified system.

6. Given our conclusions below that the offering of schemes of cash accounting and annual returns is now virtually inescapable in the domestic VAT context, we believe that this draft Directive is broadly acceptable and that in order to secure the threshold proposals its adoption, subject to points of detail, would be in the UK's interest. We shall, however, be submitting a fuller note on the draft Directive together with a draft Explanatory Memorandum for your approval.

Consideration of our review

A. Cash Accounting (Annex A)

7. We have not previously given serious consideration to the introduction of a scheme allowing small traders to account for tax on the basis of cash received or paid. This is not only because it would have involved a revenue loss, but also because in our view hitherto it would have further complicated the operation of the tax. There have, however, been significant developments which now make this an option to be given serious consideration. The first is the importance now placed on deregulation and removing the burdens on small businesses; in this context the prevailing view is less that cash accounting would involve a new non-standard VAT scheme with inevitable complexities, than that it would offer some welcome relief from the financial burdens caused by slow-paying customers. The second is the default surcharge to be introduced on 1 October 1986, with the first surcharges, for quarterly traders, to be imposed in May 1987. These two factors, while in fact quite separate, are now intertwined. Lord Young and the EDU perceive the default surcharge as imposing yet another financial burden on small businesses. Whereas previously such small businesses could with impunity delay payment of VAT (emphasis again being given to those with slow-paying customers rather than those who simply "played the system") they now face the prospect of being surcharged. This, it is argued, will further exacerbate their already precarious cash flow.

8. Finally, although at this stage it is no more than a Commission proposal, the draft 22nd Directive would make it mandatory on Member States to provide a scheme of cash accounting for use by small traders. In doing so, the draft Directive lays down certain parameters which, consistently with the need to balance the provision of assistance to small traders with minimising the impact on the revenue, we suggest should form the basis of our consideration. They are:

- it must be available to all traders with a turnover below £103,422; (we have used the figure of £100,000 as 150,000 ECU fluctuates depending on the £/ ECU exchange rate).

- it must apply to both output tax payable and input tax deductible.

<u>Numbers using the scheme and revenue cost</u>

9. At paragraph 5 in Annex A we have produced estimates for the likely number of users and the revenue costs involved. Nearly half of all registered traders have turnovers not exceeding £100,000 and so, in theory, could opt for cash accounting. In practice, however, we can immediately exclude certain trade groups for whom the proposed scheme would offer no benefit - probably the reverse - leaving a maximum net figure of 230,000. If all of these choose to use cash accounting, there would be a once-and-for-all revenue loss of about £60 million together with an ongoing annual cost of £9 million. In fact, it is most unlikely that the take up would be 100% and therefore the revenue cost would be commensurately less and we estimate a 50% take up (£30m-5m).

10. If we offer a cash accounting scheme, we would expect some considerable pressure for it to apply only to outputs with input tax still being calculated on the basis of invoices received, whether or not paid. The revenue cost of such a system would, however be significant: a maximum once and for all loss of £125m. It is also ruled out by the proposed 22nd Directive. Nevertheless,

its proponents would argue that retailers enjoy such a version of cash accounting. This is considered in detail at Annex B, together with the withdrawal of the 'Standard Method' for calculating gross takings. If this method was withdrawn, as we recommend, it would mean that retail scheme users would account for tax using tax points applicable to all taxpayers; for the majority of retailers the date of sale and receipt of payment is, of course, the same.

11. It could also be argued that other groups, such as barristers also enjoy cash accounting for outputs, but not inputs. In the longer term, but not as part of this exercise we shall need to consider whether this should be changed, possibly as part of a review of tax points in general.

Summary

12. We believe that we now have little option but to offer, in the consultative paper, a system of cash accounting, which for a significant number of small businesses would offer an easement of their cash flow problems caused by slow paying customers. This would be based on the parameters defined in the 22nd Directive.

B. Retail schemes (Annex B)

13. Since the introduction of retail schemes, we have as a matter of course reviewed every four years the various limits, which determine eligibility to use certain schemes, and revalorised them to take account of inflation. This would have been done again this year regardless of "Building Businesses ... Not Barriers". We have, however, been increasingly conscious of a number of abuses concerning the use of retail schemes and those allowed to use them. We therefore considered that the time was opportune to undertake a wide ranging and fundamental review of retail schemes.

A balanced package

14. The package we recommend can be conveniently divided between measures which will further assist the small trader while removing anomalies which produce an unwarranted tax loss; and measures to remove abuses of the schemes and to limit their use, as was originally intended, to those traders and transactions where the normal VAT system cannot be used.

Measures to assist the small trader

15. The present limits on eligibility to use some of the simpler schemes is too restrictive and our aim is to make such schemes available for use to the great majority of retailers, other than the large national chains. We have therefore proposed substantial increases in most limits, well-above the four year rate of inflation; modification to some schemes to allow their use by more businesses; and properly targetted mark-ups to replace the present unrepresentative blanket mark-ups which can either be unfair to scheme users, or result in unwarranted revenue loss.

Measures to remove abuses

16. Eligibility. Retail schemes were intended for use by shop keepers who do not normally issue invoices. However, and in the early days of the tax when our prime concern was to get it up and working, use of retail schemes was allowed to persons other than retailers, who neither needed them, nor should have been allowed to use them. Such traders, estate agents, solicitors etc, who do issue invoices, are therefore able to enjoy the benefit of cash accounting for their output tax while using the normal invoice system for their input tax. With our proposals for full cash accounting for small traders we recommend that the use of retail schemes be generally withdrawn from such traders.

17. In the longer term we shall also be making more radical proposals to take account of the revolution which has taken place on the high street. With the use by such companies of computer linked tills, issuing itemised invoices, the need to use retail schemes to calculate tax payable is highly questionable. It would appear that many of the large multiples and mail order companies continue to use the less than fully accurate retail schemes to minimise their tax liability.

Calculation of gross takings

18. This somewhat complicated subject is set out fully at pages 13 to 15 in Annex B. The proposal to withdraw the standard method is, we believe, necessary not only because of the unwarranted distortions that can result and its use for tax manipulation - one recent case involved over £500,000 - but because of our recommendations concerning cash accounting. The proposal would require careful presentation in order to minimise largely uninformed and ill considered criticism and we shall aim for careful explanation in the consultative paper. Central to this is the fact that withdrawal of the standard method would have little or no impact on the great majority of retailers, who do not finance their own credit and with the use of cheque cards and credit cards have few if any bad debts. For them gross takings would still be cash received from sales.

19. Revenue cost. The cost of introducing this balanced package is difficult to gauge but our best estimate is that overall it should be broadly neutral.

Summary

20. This review of retail schemes has gone further than the EDU will have expected. It is, however, a balanced package offering real benefits to the great majority of retailers, while removing areas of abuse. It should, we believe, be exposed as a whole in the consultative paper.

C. Annual returns and monthly payments (Annexe C)

21. Annual accounting in one form or another has been considered on several previous occasions; but hitherto it has been impossible to devise an acceptable scheme. Most recently, in 1983 a scheme of annual returns and annual payments was rejected by the majority who were asked for their views. The proposal for annual returns and monthly payments recommended in the 1984/5 "Scrutiny of the Administrative and Legislative Requirements on Business" was rejected because of the large numbers of extra staff required - the system then envisaged would have been semi-manual and offered a considerable addition to enforcement work.

22. Although we are now running a pilot exercise of monthly payments and monthly returns this, we have accepted, is neither satisfactory for us, or what the majority of small businesses really want - of 5000 businesses invited to join under 10% chose to do so. We have therefore given considerable thought to a fully computerised system for periodic payments and annual returns which is set out in detail at Annex C. The key to this system, and the modest staff saving it would secure, is the use of direct debit for payment. The scheme should, we believe, be generally welcomed. In particular it offers to nearly half of all registered traders the following benefits:

a. While in the scheme the trader is effectively outside the default surcharge regime. We would, of course, draft the necessary regulations to ensure that defaulters, on either monthly instalments or the annual return, could be returned to the normal system;

b. The period for submission of the annual return is two months, as opposed to the one month for quarterly returns - an effective extension of due date for small traders, but because of the interaction with the instalment date having a negligible revenue cost;

c. With only one return a year and two months in which to complete it small traders should have less to fear from the serious misdeclaration penalty and default interest (and less to complain about if they do get their return wrong).

23. Unlike the earlier schemes considered this proposal has few disadvantages for the Department, indeed it may offer a modest staff saving and less ministerial correspondence. The only possible negative factor concerns control where some traders may fail to maintain records on an ongoing basis, relying instead on their accountants at the end of the year. It would, however, together with cash accounting, be a powerful tool in our review of the Keith penalty system to be completed before the 1988 budget.

24. The one problem we do foresee is that annual returns would impose a fresh load on our computer systems. The extensive changes required could not be implemented at the earliest until after the introduction of Keith Phase III on 1 July 1988. Moreover, we are advised by our computer specialists that the VAT database is becoming increasingly overloaded and fragile, so that there can be no certainty that it could cope with annual returns without a complete redesign and rewrite. We are examining the problem and the scope for alternative solutions. We hope to find one, since a redesigned database could not be operational before 1991. We shall in any case need in the consultative paper to dampen expectations of any immediate implementation of this apparently favourable scheme.

D. Record keeping and accounts (Annex D)

25. It was with this topic that we had the greatest difficulty in formulating any new proposals. In essence the records and accounts that a trader keeps are for him to determine. Our only requirement is that they record the supply and receipt of all goods and services, including importations. We do not specify that these records are kept in any particular form, except for the VAT account. Once a trader has decided on the records he wishes to

keep the law requires he preserves them for six years.

26. The problem we face is therefore that it is neither centrally possible, nor desirable, to lay down rules regarding which records should be preserved for six years and which may be disposed of at some earlier date. Indeed to do so would be to impose a further burden on traders. The present system whereby the keeping and preservation of records is determined on an individual basis, at local control level, is in our view the best and least burdensome.

27. We must also question the underlying assumption of the EDU that our requirements are burdensome. Since Royal Assent to the Finance Act 1985 we have had few complaints about having to preserve records for six years, which is after all consistent with other requirements of commercial and revenue law. We therefore consider that in the consultative paper we should emphasise that the records required to be kept and preserved are a matter for agreement between individual traders and their local VAT office.

28. Nevertheless, Lord Young and the EDU have in the past been strong advocates of employing outside consultants to examine particular burdens placed on businesses, and this is the one item which may be suitable to be given to a consultant. He would examine the alleged burden of preserving records for six years by questioning small traders using the normal sampling techniques. We shall need, however, to draw his terms of reference tightly in order to obviate recommendations inconsistent with our revenue control needs.

E. <u>Registration and Deregistration requirements (Annex E)</u>

29. It was not our original intention to include this item for inclusion in the consultative document. We were not committed to any outside consultation in the White Paper, although in formulating our recommendations we did consult earlier this year with some 20 outside bodies. Indeed inclusion will delay completion of our review beyond the end of this year, which was the date

attached at B

published in "Building Businesses ... Not Barriers". However, a new factor has emerged, that of compulsory deregistration which was the subject of Mr Howard's separate submission of 18 July and your subsequent meeting with us on 29 July. It was then agreed that if compulsory deregistration were to be included in the consultative document it should not be in isolation but as part of a balanced package on registration and deregistration requirements.

Reasons for the review of Schedule 1

30. With the advent of the Keith penalties for late registration we recognised that the present registration requirements would be seen as oppressive. It is for this reason that we have been allowing a three months period of grace before assessing penalties. In addition, and on the deregistration aspect, there were also aspects of the current law which appeared to produce unintended results, principally in that the law, on occasion, did not permit deregistration where the trader wanted it and his future tax exclusive turnover would not require him to have been registered.

Revenue cost

31. To amend our present registration and deregistration requirements, so as to make them less oppressive, can only be achieved at some cost. For our recommended solutions the continuing annual revenue loss would be:-

Registration

i.	The backward look -	£2m to £6m
ii.	The forward look	£10m to £25m

Deregistration.	Up to £10m.

The proposals to ease the requirements on registration are symmetrical, for both the forward and backward looks we would allow 30 days in which to notify and register. We have looked at a proposal to abolish the forward look, put forward by the VAT Practitioners Group, (who repesent the leading firms of accountants and some consultants specialising in VAT), but this would be prohibitive in revenue, costing some £150-200M. Even to abolish the forward look for small businesses, up to £100,000, could cost £50m together with considerable administrative complexities.

Compulsory Deregistration

32. The purpose of including CD in the consultation document would be less to secure general acceptance of the proposal on its merits (which would be highly improbable), than to see whether it is possible to establish a climate in which it would at least be acknowledged by the business community at large and the myriad special interests that the Government has a reasonable case for pursuing it on resource saving grounds as part of a balanced package on registration matters. The view both of our own Departmental and FCO lawyers is that Article 24 of the 6th VAT Directive does not permit compulsory deregistration. Businesses below the threshold must be allowed to enter the normal VAT system, ie register and account for tax. If we were now to introduce compulsory deregistration the Commission would therefore probably institute infraction proceedings. In addition the draft 22nd Directive, which amends Article 24, provides that businesses below the threshold may opt to be registered. This is, of course, something on which we would negotiate in Brussels, with a view to persuading the Commission and other Member States that while having regard to the burdens on small businesses we must also have regard to the administrative burden of controlling the smallest trader.

F. Abolition of VAT on credit transactions between registered traders (Annex F)

33. This subject was not included in "Building Businesses ... Not Barriers" as one of the items to be reviewed and we are therefore not committed to including it in the consultative paper. Nevertheless, we have considered the idea afresh, and Annex F highlights not only the factors which have been seen as important in the past but also the particular problems associated in maintaining the revenue. We fully anticipate, as is clear from their letter of 23 July and your reply of 31 July, that the NFSE will raise the subject again in response to our consultation exercise, but we see no advantage in exposing it generally. Domestic considerations apart, we believe it is a complete non-runner in EC terms and that we should look to restricting dialogue as far as is possible.

attached at C

Conclusion

34. Our review has shown that we can offer a package of proposals for inclusion in the consultative document. They are:

Cash Accounting;
Retail Schemes;
Annual Returns;
Records and Accounts; and
Registration and Deregistration

We now seek your approval for the drafting of a consultative paper as outlined in this note and the attached annexes. We should also be grateful to know whether you agree that on records and accounts we should employ an outside consultant with carefully drawn terms of reference.

35. As Mr Howard said in his note of 27 June, we aim to submit the draft consultative paper to you for approval in September. We shall then send drafts to the EDU and other interested Departments. In our discussion with them we shall, of course, underline

the fact that while our aim is to reduce the burden on small traders, we must also have regard to revenue cost and the need to effectively control the tax. This should prepare the ground for the meeting with Lord Young which you suggested in your letter to him of 1 August.

attached at D

36. We should be glad to discuss.

Bryce Knox

B H KNOX

B/f with advice

[illegible]

NEW ST. ANDREW'S HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX

SECRETARY OF STATE FOR SCOTLAND

CH/EXCHEQUER	
REC.	05 SEP 1986
ACTION	MST
COPIES TO	

3/9

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

3 September 1986

Dear Nigel,

At my recent visit to the Royal Incorporation of Architects in Scotland, and in subsequent correspondence, the Royal Incorporation pressed the case for VAT zero rating on alterations to listed buildings to be extended to works of repair or maintenance, on the grounds that the present arrangement acted as a substantial disincentive to sensitive schemes of historically accurate repair. Similar arguments were put to my colleague Michael Ancram when he recently met representatives of the Convention of Scottish Local Authorities to discuss listed building matters.

Michael and I agreed to pass on the comments raised to our Treasury colleagues. In so doing on behalf of both of us I should like to stress that we share the concern expressed by the RIAS, COSLA and heritage interests generally in the point about the long-term effects on the built heritage of a system which discriminates financially in favour of alterations at the expense of repair and maintenance of existing features. We have, of course, raised this point with you in our representations before the last two budgets.

It is a point worth making that the present arrangements significantly reduce the impact of the grants we offer for the repair and maintenance of historic buildings. Given the increased public awareness of and interest in the conservation of historic buildings, it seems to me that VAT zero rating of all works to listed buildings would be a readily comprehensible and popular way of underlining the Government's commitment to this important part of the heritage and of ensuring that the direct funding we in Government provide has the maximum desired effect.

JSS05905

I should welcome your comments and am copying my letter to Nicholas Ridley and Nicholas Edwards for their related interest.

Yours ever,

Malcolm

MALCOLM RIFKIND

JSS05905

097.ACSA

CONFIDENTIAL

1. Cathy 2 Andrew or 3. Tony or

BF for 22/9 meeting.

FROM: A C S ALLAN
9 September 1986

PS/MINISTER OF STATE

cc PS/CST
PS/FST
PS/EST
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Ross Goobey

PS/IR
PS/C&E

A Credit Card Tax

The Chancellor feels that, given the continued large growth in credit card lending, it would be worth dusting off the papers on a credit card tax. He would be grateful for the Minister of State's view on such a tax.

ACSA

A C S ALLAN

ACSA To PS/MST 9/9

CONFIDENTIAL

FROM: M W Norgrove

DATE: 15 September 1986

PPS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Ross Goobey

PS/Inland Revenue

PS/Customs & Excise

Ch
For discussion @ meeting on 22nd.

Right. Prior to that mtg perhaps we have a quick word with you [illegible] possible tax [illegible] of its [illegible] [illegible]

A CREDIT CARD TAX

The Minister of State has seen your note of 9 September and has reviewed the papers back to Mr Knox's note to the Chancellor of February 1985. The Minister believes that it would still look inappropriate to concentrate on credit card transactions unless it was against a wider backdrop of a tax on other transactions of personal finance, or we shall have a political outcry (from an articulate group of consumers who can be very inexpensively briefed) at this singling out and potential distortion. He feels that, if we are to do something in the 1987 Budget, an early discussion of the wider context would be sensible: this office will arrange. As agreed, we shall aim to report the outcome of such a discussion before Monday's tax strategy meeting.

Not part of your idea.

M W NORGROVE
Private Secretary

PS/MST to ACSA 15/9

Y SWYDDFA GYMREIG
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-233 3000 (Switsfwrdd)
01-233 6106 (Llinell Union)
Oddi wrth Ysgrifennydd Gwladol Cymru

16/9

WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-233 3000 (Switchboard)
01-233 6106 (Direct Line)
From The Secretary of State for Wales

16 September 1986

Dear Nigel

Having seen a copy of Malcolm Rifkind's letter to you of 3 September about VAT on repair and maintenance works to listed buildings, I would like to add my own support for the case which he has made.

The present VAT arrangements not only encourage owners to alter, rather than repair, their historic buildings - in the face of our wider 'heritage' policies - but they certainly reduce the impact of our historic buildings' grants, as Malcolm points out.

I wrote to Geoffrey Howe about this as long ago as 1980 but we are still in the position where an element of our grant-aid is negated by owners' need to pay VAT. Given the achievements in the field of conservation over the past five or six years, the VAT 'anomaly' seems even more pronounced now. I do hope that something can be done.

My only slight reservation on what Malcolm proposes is the suggestion that repair or maintenance works should be zero-rated in respect of all **listed** buildings. Such action would be likely to place pressures on our structured listing programme - many owners might be inclined to clamour for their buildings to be listed. Not only could that lead to pressures which we could not absorb at present but it might also make the whole listing process in itself more sensitive and controversial. Of course, from the Exchequer viewpoint, it would also mean that several hundreds of thousands of buildings would at once be "removed" for VAT purposes.

Instead, I would suggest zero-rating for all repair and maintenance works to historic buildings - whether listed or not - which attract Government grant-aid. In effect, this would cover the best outstanding buildings and the most worthy conservation area schemes.

/The number ...

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer

The number of eligible buildings and schemes would thus be greatly reduced (probably by well over three-quarters). However, in this way, the most obvious 'anomaly' would be removed and the conservationist lobby would see it as going some way towards meeting their aspirations; whilst at the same time the loss of revenue would be small when compared with zero-rating for all listed buildings. It may also be more practicable to operate such a scheme - which would relate to specific works rather than to buildings - as a certificate for tax purposes could easily be issued to owners by the grant-aiding Department at the same time as the grant offers or payments are made. It should be noted, too, that the legislative provisions governing grant-aid for historic buildings are designed to ensure uniformity, as far as possible, between different parts of the UK.

I realise that this suggestion would not go far enough in the eyes of many but it could certainly prove an attractive compromise which eliminates the worst defects of the present arrangements in grant-aid terms.

/ I am copying this to Malcolm Rifkind and Nicholas Ridley.

Yours ever

Nick

RA3.46 CONFIDENTIAL FW 22/9 meeting.

FROM: A C S ALLAN
DATE: 17 September 1986

PS/MINISTER OF STATE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Ross Goobey

PS/IR

PS/C&E

A CREDIT CARD TAX

The Chancellor was grateful for your minute of 15 September recording the Minister of State's views. He would like to discuss it at the meeting on tax strategy fixed for 22 September. Before that, he would be grateful if Customs and MG/FIM could provide a quick note on the size of the potential tax base, and its current rate of growth.

ACSA

A C S ALLAN

ACSA to PS/MST 17/9

CONFIDENTIAL

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023....

From: P G WILMOTT
Date: 19 September 1986

Chancellor

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobey
PS/Inland Revenue

WILMOTT to CX/EX 19/9

A CREDIT CARD TAX

Mr Allan's minute of 17 September asked for a quick note on the size of the potential tax base and its rate of growth.

2. Before we can arrive at such figures we need first to define what the tax base would be. And there are several ways of doing that. Unfortunately we do not have a full account of all types of cards used for payment, so some of the figuring verges on the speculative. All revenue estimates should therefore be treated with more than the usual caution. A further cause for caution is the extent to which a tax could induce people to switch from taxed to untaxed payment or credit media, thus undermining the tax base.

This is getting overworked, like CBI orders & Polish harvests!

Internal distribution: CPS, Mr Knox, Mr Jefferson Smith, Mr Bone, Mrs Hamill.

CONFIDENTIAL

3. The first question has to be what constitutes a credit card. The alternatives are fundamentally bank credit cards which permit extended credit (such as Access) or these plus charge cards which allow credit but with the proviso of full settlement after a short period (eg American Express). Most shop cards (such as Marks & Spencers') are either credit or charge cards. There are two hybrids: the 'gold' card, which works like a charge card but also offers substantial overdraft facilities, and the shop 'budget' card, which entails the cardholder paying a fixed monthly sum determining a credit limit but which can also leave him in credit with a shop. Our view is that if we were to single out payment and credit cards from all other forms of payment and credit as the object of taxation then we should not seek to distinguish between types of card. This is partly because of the risk of people shifting from taxed to untaxed cards if a distinction were made, and partly because we see such a tax as being defined by the physical method of payment - perhaps it would be called a payment card tax.

4. The second question concerns what the tax base should be. It could be the ownership of a card or its use. And usage could be measured in different ways: by the number of transactions, by issue of monthly statements, by volume of turnover or by the average amount of credit taken.

5. In 1985 there were some 19 million bank credit cards on issue. There were just over one million charge cards, making a total of about 20 million. In addition there were an unknown number of shop cards, perhaps as many as 5 million (we can find no reliable source of information on retail credit). It would therefore be possible to impose an annual tax of, say, £5 on the holding of a card with the hope of collecting £125 million revenue. But such a tax would be more likely than most to encourage switching to other payment media and abandoning under-used cards. The average number of transactions per bank credit card is only about 15 a year and substantial numbers of card-holders are thought to own more than one card. It is easy to envisage a drop of as much as a third in the number of cards, which would reduce revenue considerably and perhaps blight growth in the industry. We understand that the Irish have a tax of this sort: our latest information is from 1983 when they had a £5 annual stamp duty on each credit card. The tax is of course unrelated to either payment or credit.

6. Estimates for the number of transactions on credit card vary. An average of sources gives us about 300 million transactions in 1984 on bank credit cards. We have no hard information about numbers of charge card or shop card transactions, but earlier work suggested a total of 450 million transactions on all types of card . (This seems a little on the high side, but we have no way of checking.) A tax of 10p on each transaction would therefore yield £45 million, assuming no change in behaviour.

7. In 1984 it was estimated that some 200 million monthly accounts had been issued for credit cards. A specific duty of 10p a statement would yield £20 million therefore.

8. Gross turnover on bank credit cards in 1984 was estimated to be about £8 billion. We have no figures for the other types of card, but by making various assumptions we can just about make a plausible case for estimating their turnover to be in the region of £2 billion, making a total turnover of about £10 billion (roughly equivalent to 5 per cent of consumer spending). So an ad valorem tax would yield about £100 million for each percentage point.

9. In contrast to the taxation of a form of payment one might concentrate on taxing cards as a means of credit. It is easiest to look at a tax on outstanding credit over a year (although monthly payments could still be made at a fraction of the annual rate). At the end of 1984 there was just over £3 billion outstanding on bank credit cards. It is not possible to disaggregate the information we have on other types of credit to make a precise estimate of the amount outstanding on other cards, but it would be in line with our earlier guesstimates if it were something under £1 billion, making a total of perhaps £4 billion. An ad valorem tax would yield therefore about £40 million for each percentage point. But, unlike for example a thoroughgoing tax on all consumer credit, this would be singling out a particular form of credit for taxation.

10. Most of these different bases are thought to be growing fast. The number of bank credit cards nearly tripled between 1976 and 1984. Roughly 30 per cent of adults hold at least one, so there remains potential for growth. Shop credit cards seem to be increasingly popular though they are starting from a much lower

base. (Marks & Spencers' venture into this field was the first mass attempt in the retail market and they are looking for continued big growth over the next few years. Others will no doubt follow.) Equally the number of transactions and the volume of turnover have consistently shown real increases. The inexorable move towards new technology and EFTPOS makes it likely that growth will continue. The only slowing-up visible according to the information available is on the average value of transactions by credit card. With the likely increase in shop cards this average value might even decline (because, hitherto at any rate, retail credit has tended to have a relatively low value per account), but the number of transactions would accordingly rise further still. We know that the sum outstanding on bank credit cards rose greatly in 1985: at the end of the year the sum was over £4 billion.

P G WILMOTT

CONFIDENTIAL

FROM: M W Norgrove

DATE: 19 September 1986

PPS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell*
Mr Peretz*
Mrs Lomax
Mr Scholar
Miss Sinclair*
Mr Ilett*
Mr Romanski*
Mr Cropper*
Mr Ross Goobey*

PS/Inland Revenue

PS/Customs & Excise
Mr Knox - C&E (or)
Mr Jefferson Smith* - C&E
Mr Bone* - C&E

A CREDIT CARD/PERSONAL FINANCE TAX

The Minister of State yesterday met those starred above, in advance of Monday's tax strategy meeting, to discuss the options for levying a tax in the credit area. Discussion began with a credit card tax, which the meeting was largely disposed against, widened to a consumer credit tax, which the Chancellor has previously ruled out for this administration, and to a balance sheet tax, where the risk of driving transactions off-shore has proved the decisive negative factor in the past.

Not what you had meant

A credit card tax

Mr Jefferson Smith rehearsed the arguments in favour. Payment cards had a total turnover of £10 billion in 1984. There were nearly 19 million credit cards and just over one million charge cards, the former generating 300 million transactions a year. Previous consideration had centred on a transaction tax but an ad valorem tax would be self-indexing, and could bring in far greater revenue (eg a yield of £100 million at one per cent). There would be borderline definitional problems even if both charge and credit cards were included (which he thought they would have to be) but such a tax, levied on monthly statements and involving a relatively small number of companies, was an option worth considering as a revenue raiser. To remove distortion, the tax would need to be spread very thin over the widest possible base.

Mr Cassell was concerned about the introduction of such a tax at a time when all efforts had been geared to moving the economy away from cash. The computer changes it would require from banks etc would be coming on top of several others in recent years (eg composite rate). The definitional problems would be compounded by a constantly changing picture of new cards, electronic transfer of funds etc. He preferred the alternative of taxing stock, including pension funds. His view was that credit could be discouraged for reasons other than tax but he was against the very concept of taxing transactions and the £50-100 million potential revenue from a distortive credit card tax was not worth the candle. Mr Ross Goobey feared that such a move would be widening the tax base unnecessarily and controversially without raising much revenue; in its distortive effect away from an efficient medium of exchange to cash, it was likely to be supported only by Securicor. Of the two evils, he preferred a statement-based rather than transaction-based tax. Mr Ilett raised for consideration the Irish practice of levying a tax on the issuing of charge cards, which appeared to have the advantage of simplicity, but where it would be difficult to get the revenue in quickly. The tax would need to be based on the annual re-issue of cards, to prevent companies extending card life to 4 or 5 years. The Minister of State asked for a note on what effect the introduction of this tax had had in Ireland.

Consumer tax

Mr Peretz said that revenue from such a tax could be high if mortgages were included in its scope but very low if they were excluded.

Although he had asked the Revenue to treat this as a firm starter in a new adminstration, the Chancellor had ruled out two years ago the introduction of such a tax before the Election. The question was therefore what had changed in the interim to cause that decision to be reconsidered. The Chancellor had made his decision principally because, although the hostility raised by the announcement of such a tax would be immediate, the revenue would be slow to come in, not reaching full yield until after two full years. There was now some doubt as to whether credit companies really would need so long to re-vamp their systems: Mr Ross Goobey noting that banks seemed prompt enough to re-calculate monthly repayments when interest rates rose. There were fewer demands being placed on the financial sector's computer programmers now than there were two years ago; and there had been a big surge in consumer credit. Problems nonetheless remained. Even the most optimistic revenue estimate for the first year put the yield at no higher than 25 per cent (compared with zero in the first year on the original estimate and only half in the second year). If such an acceleration were required, Customs would need to consider the practicalities - eg how to de-limit the trader population, since the 40,000 credit brokers licensed by the DTI would pose real control problems. Mr Ross Goobey thought that the number of providers of credit as such was likely to be far lower (perhaps not in excess of 2,000). Mr Ilett foresaw problems for small businesses and, again, of definitional borderlines.

If mortgages were included, a distinction would need to be drawn between that element of a mortgage which attracted tax relief (which would be exempt) and the rest (which would be taxed). For ease of administration, Customs would need to follow Inland Revenue criteria. Mr Jefferson Smith said that the tax need not apply to new credit only and that a way might even be found round exempting fixed interest loans.

Mr Cassell and Mr Peretz agreed that the argument was now stronger for doing something on credit grounds.

The Minister of State said that the two arguments against such a tax had therefore been the delay in revenue delay (which could perhaps be overcome to a certain extent) and the politics of including mortgages in the tax net. On the latter, the political argument cut both ways unless the Party went into the election without saying a word about its intention to levy such a tax.

Balance sheet tax

If a tax on credit cards was ruled out on the grounds that it singled out for no good reason one (efficient) medium of payment and if the same arguments remained on a consumer credit tax as had obtained two years ago, the remaining option was a balance sheet tax.

Mr Cassell said that, when this had been discussed in the past, it had been rejected for its possible distortive effects and for its inherent danger of driving financial transactions off-shore. This danger was not inherent in a consumer credit tax, where safeguards (or at least scarecrows) could be built in.

On the question of whether anything should be done in the finance area at all, Mr Cropper said that an assessment was needed of the balance between tax on financial transactions and tax on real goods. His perception was - and the meeting agreed that there was no doubt - that the financial sector was undertaxed. He had in mind, for example, transactions involving billions of pounds worth of gilts which escaped tax. Mr Peretz said that there was a danger of driving such transactions off-shore but this could be minimised if the rate was kept very small. Mr Cassell said that, although the rate itself might appear low (eg 0.001 per cent), the tax base was so great that considerable sums of revenue were involved - it was like expressing the rates on a house not as a global figure but per brick. The Minister of State said that, if the idea was to correct the fiscal imbalance, that was not an argument against imposing the tax.

This would not be (at least exclusively) a bank levy - pension funds, building societies etc would all be included. Mr Ross Goobey raised the question of whether the Chancellor had ruled out any tax on pension funds without a Green Paper.

Mr Peretz thought such a tax less likely to be passed on to the consumer and Mr Cropper felt it would have clear presentational advantages over a more transparent credit card tax - for example pension fund members were less likely to notice such a charge than a Marks and Spencer's card holder who would object to paying an extra one per cent charge on goods which had already incurred 15 per cent VAT.

Customs would circulate the note requested by the Chancellor in time for consideration before Monday's tax strategy meeting.

MWN

M W NORGROVE
Private Secretary

~~BIF~~ 2214

BIF 24/9.

FROM: M W Norgrove

DATE: 19 September 1986

APS/CHANCELLOR OF THE EXCHEQUER

Cathy

VAT ON REPAIRS TO HISTORIC BUILDINGS

We discussed on Wednesday and again this morning the whereabouts of a draft reply to Mr Rifkind's letter of 3 September and Mr Edwards' of 16 September to the Chancellor, both expressing concern at the VAT levied on repairs to historic buildings but each proposing slightly different solutions.

Customs understand that the Secretary of State for the Enviornment is likely to enter the fray in the next few days in the same vein, but perhaps proposing a third option, and it seems to them sensible to delay their drafting of a reply until we see Mr Ridley's letter.

This seems sensible. I think we can afford to wait another couple of days before we insist on a draft reply which, when it comes, will be the usual negative response to this old chestnut. Mr Tracey from Customs will chase DOE on Monday. I shall ring him on Monday afternoon and ask for a draft reply, whatever DOE's intentions, to reach us on Wednesday. Do you agree?

Mike

M W NORGROVE
Private Secretary

SECRET

TAX: FORWARD PLANNING MEETING
22 SEPTEMBER 1986

CREDIT CARD TAX

42. The Chancellor saw immense problems in a wider tax on consumer credit. But he did not think that this should rule out a credit card tax, which could be a significant revenue-raiser. He did not think that taxing credit cards (and charge cards) would lead to a significant diversion to other forms of payment, because of the convenience of plastic cards. The political acceptability of the tax would be helped because it would bring home to people how much they paid for credit anyway. He asked for further work to be done.

43. Mr Cassell said that the ideas had not been ruled out because a wider tax did not look feasible; indeed, the administrative difficulties of a wider tax appeared to have eased. But he was concerned that singling out one means of credit for tax would lead to distortions, and could have an impact on M0. Sir T Burns thought the tax would be a backward step, and Mr Byatt thought it would look odd, given the emphasis on non-distortionary financing. The Chancellor did not accept this: he started with the view that financial services generally were undertaxed, and was looking at how to redress this.

EXTRACT
TAX
FORWARD
PLANNING
MTG
22/9

44. The Minister of State said that there would be a massive campaign against such a tax, though the Financial Secretary pointed out that the opponents of credit would support it. The Chancellor noted that taxation on credit card companies had been increased two years ago, with no protest at all.

SECRET

SECRET

TAX: FORWARD PLANNING MEETING
22 SEPTEMBER 1986

Insurance Premium Tax

45. The Chancellor said that this was another potential revenue-raiser, which other countries had and we did not.

46. The Economic Secretary said that he would not object to the tax if it were already in place, but was not keen to introduce it. The Financial Secretary also had reservations about "taxing prudence". But the Minister of State was keener on this than on a credit card tax. Mr Byatt was nervous about approaching the taxation of financial services in a piecemeal fashion.

47. Sir A Fraser said that Customs would need to consult the DTI to take the work much further, and that they would probably be hostile. The Chancellor asked for that work to be done, and asked Customs to find out about other countries' experience, particularly with off-shore leakage, either from DTI or from Embassies.

SECRET

BIF 2419

From: Mr J W Tracey

Date: 22 September 1986

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE
01 ~~626 1515~~ 382-5369

PRIVATE SECRETARY TO THE MINISTER OF STATE

cc PS/Chancellor
PS/Chief Secretary
PS/FST
PS/EST
Sir P Middleton
Mr Scholar
Mr Monger
Ms Sinclair
Mr Romanski

VAT : LISTED BUILDINGS

I recommend the attached draft reply to the letters from the Secretaries of State for Scotland and Wales.

I understand from DoE that their Secretary of State does not intend to intervene.

J W TRACEY
VAT Administration

Internal Circulation: CPS, Mr Knox, Mr Jefferson Smith please type for to sane

The Rt Hon Malcolm Rifkind MP
Secretary of State for Scotland
New St Andrew's House
St James Centre
EDINBURGH EH1 3SX

check

cc ~~The Rt Hon Nicholas Edwards MP~~
~~Secretary of State for Wales~~
~~The Rt Hon Nicholas Ridley MP~~
~~Secretary of State for the Environment~~

Both attached

Thank you for your letter of 3 September about VAT and listed buildings. You received qualified support for your views from Nicholas Edwards in his letter of 16 September.

Under Group 8A of Schedule 5 of the VAT Act 1983 services and associated goods supplied by a VAT registered builder in the course of an approved alteration to a listed building are zero-rated. (The legislation refers to "protected building"; in practice this largely means listed buildings but scheduled monuments are also covered). Approved alterations are those which both require and obtain listed building consent from the appropriate planning authority. Listed building consent is required for work on a listed building which would affect its character as a building of special architectural or historic interest. The VAT legislation also enables a redeveloper to zero rate the sale or letting on a long lease of a listed building which he has substantially reconstructed. Alterations not requiring listed building consent (usually internal ones) and works of repair or maintenance are standard rated.

This relief for listed buildings amounts to a substantial mitigation of the effects of the VAT changes announced in the 1984 Budget and it was widely welcomed at the time by those concerned with the preservation of our national heritage. The rationale of the concession we made was that the Government accepted the case for retaining a substantial degree of zero rating for alterations to listed buildings so as not to worsen their position in relation to VAT, particularly when these buildings were being substantially reconstructed or converted as the only means of giving them a continuing useful life.

The relief does not amount to an incentive to make alterations which would be out of keeping with the character of the building or which would destroy important features since listed building consent for these can always be refused. While it might be argued that to relieve repair or maintenance work to listed buildings alone would cost relatively little in revenue terms, benefit would be seen as going to owners of, on the whole, very desireable properties whose income tax burdens have been substantially reduced in recent years. Furthermore any new special relief in this area would lead to pressure to extend it to buildings owned by other worthy contenders such as the churches or charities. To zero rate all repairs or maintenance could cost over £500 million a year as well as resurrecting, in inverted form, the old unworkable dividing line between repairs and alterations.

I appreciate your concern to optimise the money you are able to make available by way of grants and that it may appear strange that work which is eligible for grant aid also bears tax. There is, however, nothing illogical about this. The system of grants represents a flexible and economical way of giving help where it is most needed. A general VAT concession, on the other hand, would inevitably lead to relief being spread more thinly and indiscriminately. Although Nicholas Edwards' alternative suggestion of allowing VAT relief only for works which attract Government aid might seem less objectionable, I am afraid that I cannot agree to it. The current levels of grant must be assumed to reflect the fact that repair and maintenance work has always borne VAT. If more resources were needed and were available for this area, it would surely be better to increase the levels of grant rather than in effect give claimants two separate sources of public subsidy with their separate administrative mechanisms, one via grant and one via VAT. In any case giving two sources of assistance would seem doubly unfair to those who qualified for neither.

Even if in domestic terms the change advocated by the RIAS and COSLA could be justified, our obligations under the EC Sixth Directive would prevent it. As you know, we are facing infraction proceedings in the European Court in which, among other items, our zero-rating of new construction is being challenged. While the Government has announced that it will defend the United Kingdom's present zero-rates vigorously before the Court, we must accept that there is no authority under the EC Sixth Directive for introducing any new zero rating or restoring one that has already been given up. I am afraid, therefore, that I can hold out no hope of relieving works of repair or maintenance to listed buildings from VAT.

I am copying this letter to Nicholas Edwards

CHANCELLOR OF THE EXCHEQUER

Ch

If pressed ignore. I'm sure another week is not crucial
AL

C/ The letters from Mr Rifkind and Mr Edwards are concerned with the case for VAT zero rating on alterations to listed buildings to be extended to repair or maintenance. Mr Ridley is expected to write fairly soon, but officials think there is advantage in sending your letter first

The Minister of State has looked through the draft letter at A and is content.

Letter to issue?

OK

CR 24/9

FROM: M W Norgrove

DATE: 24 September 1986

APS/CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Mr Scholar
Mr Monger
Miss Sinclair
Mr Romanski

PS/Customs & Excise
Mr Tracey - C&E

VAT: LISTED BUILDINGS

The Minister of State has seen Mr Tracey's minute of 22 September and is content with the draft reply for the Chancellor's signature.

MWN

M W NORGROVE
Private Secretary

RC2.4

cc PS/CST PMP
PS/FST
PS/EST
Sir P Middleton
Mr Scholar
Mr Monger
Miss Sinclair
Mr Romanski
Mr Norgrove
PS/C&E
Mr Tracey - C&E

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

25 September 1986

The Rt. Hon. Malcolm Rifkind MP
Secretary of State for Scotland

Dear Malcolm

Thank you for your letter of 3 September about VAT and listed buildings. You received qualified support for your views from Nicholas Edwards in his letter of 16 September.

Under Group 8A of Schedule 5 of the VAT Act 1983 services and associated goods supplied by a VAT registered builder in the course of an approved alteration to a listed building are zero-rated. (The legislation refers to "protected building"; in practice this largely means listed buildings but scheduled monuments are also covered). Approved alterations are those which both require and obtain listed building consent from the appropriate planning authority. Listed building consent is required for work on a listed building which would affect its character as a building of special architectural or historic interest. The VAT legislation also enables a redeveloper to zero rate the sale or letting on a long lease of a listed building which he has substantially reconstructed. Alterations not requiring listed building consent (usually internal ones) and works of repair or maintenance are standard rated.

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The relief does not amount to an incentive to make alterations which would be out of keeping with the character of the building or which would destroy important features since listed building consent for these can always be refused. While it might be argued that to relieve repair or maintenance work to listed buildings alone would cost relatively little in revenue terms, benefit would be seen as going to owners of, on the whole, very desirable properties whose income tax burdens

have been substantially reduced in recent years. Furthermore any new special relief in this area would lead to pressure to extend it to buildings owned by other worthy contenders such as the churches or charities. To zero rate all repairs or maintenance could cost over £500 million a year as well as resurrecting, in inverted form, the old unworkable dividing line between repairs and alterations.

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Even if in domestic terms the change advocated by the RIAS and COSLA could be justified, our obligations under the EC Sixth Directive would prevent it. As you know, we are facing infraction proceedings in the European Court in which, among other items, our zero-rating of new construction is being challenged. While the Government has announced that it will defend the United Kingdom's present zero-rates vigorously before the Court, we must accept that there is no authority under the EC Sixth Directive for introducing any new zero rating or restoring one that has already been given up. I am afraid, therefore, that I can hold out no hope of relieving works of repair or maintenance to listed buildings from VAT.

I am copying this letter to Nicholas Edwards.

Yours

Nigel

NIGEL LAWSON

RA7.1

1. Tom
2 Cath
3 Andrew
4 PWP

FROM: A C S ALLAN
DATE: 20 October 1986

PS/MINISTER OF STATE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mrs Lomax
Mr Scholar
Miss Sinclair
Mr Ilett
Mr Romanski
Mr Cropper
Mr Ross Goobey

PS/IR

PS/C&E
Mr Knox - C&E
Mr Jefferson Smith - C&E
Mr Bone - C&E

ACSA to PS/MST 20/10

CONSUMER CREDIT TAX

The Chancellor feels that the recent attention paid to the growth of personal sector credit means that we should look again at the option of a consumer credit tax. Your note of 19 September recorded the discussion the Minister of State had had with Treasury and Customs Officials on this subject (among others). It was not pursued further at the meeting on tax strategy on 22 September, because at that time the discussion focussed on a credit card tax alone.

2. The Chancellor would be grateful if you could arrange for a short note setting out the options for a consumer credit tax and their implications, as a basis for discussion at a meeting we shall be arranging shortly.

ACSA

A C S ALLAN

CONFIDENTIAL

Yes, but subject to rapid progress: need to have a mtg v. soon.

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: B H KNOX

Date: 27 October 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobie
Mr Tyrie
PS/Inland Revenue

KNOX to CH/EX 27/10

Ch

I don't find Bryce Knox's note v convincing — but the note below sets out the practical points well.

agreed

Wait for note on wider consumer credit tax before taking this further?

AA

A PAYMENT CARD TAX

extract attached

At your meeting on 22 September you asked for further work to be done. I attach a note (agreed with the official Treasury) which sets out as much as we know or can guess about the subject without seeking expert advice from the Bank of England and perhaps others, such as the Department of Trade and Industry. A separate submission is being prepared by the Treasury on the wider question of taxing consumer credit.

2. Much of the material will be familiar reading from both earlier and more recent considerations of payment cards as a possible candidate for taxation.

Internal distribution: CPS, Mr Jefferson Smith, Mr Wilmott, Mr Bone, Mrs Hamill

CONFIDENTIAL

However, this is a convenient point at which to draw together all the information which we have. The note shows that it ought to be possible to devise a tax, through various bases, on payment cards, though there are some undeniably grey areas where decisions could be difficult or contentious (such as store cards or cards with more than one use). Each tax base would bring its own particular problems: none stands out as trouble-free. For example, a stamp duty type of tax on card-holding is simple but could not differentiate subtly between different types of card; whereas an ad valorem charge related to payments would be fairer in avoiding these problems and in being related more closely to usage, but would be more distortive. The revenue which the tax would raise would of course depend on both the base and the rate, but it seems unlikely that the full-year yield could be at the very most more than about £100 to £200 million without the tax appearing unduly swingeing. First-year yield could be considerably less. The RPI impact effect would be nil. There would be compliance costs for the finance houses running the various credit schemes and, to the extent that the retail sector dealt with finance 'in-house', for some stores. Extra Customs and Excise staff would be required to operate the tax.

3. What we find difficult, if not impossible, to assess is the wider effect of such a tax. Some variants would be more perceptible than others to the consumer and could be expected to result in a reduction in the number of cards held or in the number of card transactions or in the level of turnover on cards. For example, a stamp duty on card-holding could have a disproportionate effect on the store card sector, since these cards have less general application than bank credit cards and might be more willingly jettisoned. As this is the sector of the market with the most potential for growth, such a move could easily be seen as retrograde.

4. This brings us on to more general questions which will need to be considered in coming to a decision on taxing cards. First, assuming that more taxation ought to be raised from the financial sector, is this the right place

Not the right question. This is a useful revenue raiser, not the first step towards a wider tax in 1984 was estimated to be about 4% of consumer's spending). They are an efficient means of effecting payment, and technological developments suggest

to start? Payment cards represent only a small, though expanding, part of the sector. (In 1985, according to Financial Statistics, bank credit card lending amounted to some 16 per cent of consumer credit. And bank credit card turnover much wider uses for them in the near future, such as direct debiting at check-outs. It is not fanciful to imagine still more extended uses for them, going beyond simple payment for purchases, before the end of the century. (The Financial Times recently reported that GEC were developing a card which, in addition to performing financial transactions, could also carry data, such as medical records, and allow access to buildings, computers and perhaps even countries, as a replacement for passports.) Leaving aside the administrative problems which could arise in distinguishing between cards used solely for payment and those which might have other functions as well, there remains the question of whether it makes a great deal of sense to tax one, efficient, medium of making payment (as well as conceivably doing other things) and not others.

That's more relevant

5. Second, although a tax on some financial transactions, it would not be a tax on the financial sector as such, since we can think of no way in which it would not be passed on to consumers, and perceptibly at that. (This is in contrast to the much more modest and technically different change in VAT status of the card companies in the 1984 Budget, which could not have been perceptible to card holders.) Two issues arise from this: a) whether it is the consumer or the industry which is intended to be the target; and b) whether the group of consumers most affected (predominantly ABC1 males in the South of England) is one which you wish to single out for taxation.

Again not right question

Why not

6. Third, the tax would need to be considered against the Government's overall taxation strategy. Although it would mark a further shift towards taxing spending, it would be small; even if we managed to squeeze a full year yield of £200 million from the tax, that would finance a reduction in the basic rate of income tax of no more than one sixth of a penny.

Implying not worth doing !?

CONFIDENTIAL

7. Fourth, Ministers would have to consider what messages they would be sending out by imposing such a tax. Although it would appear to respond to demands to cut the volume of credit available to the country at large, it would in practice have little effect on that amount; and this would be immediately obvious to the knowledgeable in, for example, the City. At the same time it would appear to demonstrate Government disapproval of an efficient payment medium.

8. These wider issues are more for the official Treasury to advise on than for us. But this note provides a convenient means of drawing together many of the points that will need to be pursued.

Bryce Knox

B H KNOX

A PAYMENT CARD TAX

THE TARGET SECTOR

Types of Card

1. There are two main types of card. Bank credit cards like Access and Visa offer revolving extended credit: the cardholder has a choice of settling the bill in full upon receipt of a monthly statement, or of making a minimum payment and being charged interest on outstanding credit. Charge cards (eg American Express) do not offer the extended credit facility, and an annual membership fee is payable. "Store cards" (eg Marks & Spencer) combine various features of the two main types in different ways: monthly accounts resemble the charge card system, without the annual fee; option accounts operate like credit cards; and budget accounts offer the client credit equal to a multiple of a monthly payment made into the account. Various other hybrids are found, for example the "Gold cards", which are issued to customers of standing and which offer unlimited (but not extended) credit in addition to overdraft facilities; as for charge cards, monthly statements require settlement in full. This paper proceeds on the assumption that we do not distinguish between the different types of credit offered by the various cards, but are concerned with the taxation of all cards allowing the facility of delayed payment. ?!

CONFIDENTIAL

Numbers of cards

2. Press reports at the beginning of October gave the following details of ownership:

a) Bank Credit Cards

Barclaycard		8.3 million holders
Access		9.1 million
Trustcard		2.5 million
	Total	19.9 million

How many individuals? (Lot of overlap?)

Charge Cards

American Express		1.0 million
Diners Club		0.3 million
	Total	1.3 million

The overall total of 21.2 million is thought to be about a million up from the beginning of the year.

b) Store Cards

Although store cards are widely acknowledged to be a rapidly expanding sector of the credit card industry, we have not been able to turn up detailed facts and figures. Some outside research earlier this year indicated that approximately 13 per cent of adults in the UK held one or more store cards. The Burton Group and Debenhams each have over 1 million cardholders, and Marks and Spencers about 1.5 million At the moment it looks as if there could be about 5 million store cards in existence. Store cards are still in their infancy, with new cards appearing and different schemes being tried out. There is some evidence of moves towards consolidation, reflecting trends in the retail trade generally. For example, stores in the Conran group each issue their own cards, but accept each others'; a Richards Shop card could be used for purchases in Mothercare or BHS. It is possible that one or more of the store cards will rise in acceptability and importance to compete with Access and Visa. Other retailers are known to be keen to accept the St Michael card.

We deduce that the total number of payment cards could be of the order of 26 million.

Payment Card Transactions

3. Estimates for the number of transactions on credit cards vary. An average of estimates gives about 300 million transactions on bank credit cards in 1984. In the absence of hard information about transactions on other cards, we are forced to stick with the earlier estimate of about 450 million transactions on all types of card. This suggests that on average, a card will be used between once and twice a month. As a method of payment, credit card usage has increased as people gradually move away from postal orders and cash. But this is from a very small base: in 1984 nearly seven out of eight household payments (of £1 or more) were still made in cash, credit cards accounting for less than 2 per cent of household transactions.

Turnover and volume of credit

4. Expenditure via bank credit cards has gradually increased, from about 1 per cent in 1976 to over 4 per cent of consumer spending in 1984. Store cards will add a little to this, so the total is perhaps about 5 per cent now. The proportion of outstanding consumer credit (excluding mortgages and the like) attributable to bank credit cards at the end of 1985 was about 16 per cent. It is not possible to disaggregate retail credit to show the different effects of store cards and, for example, hire purchase arrangements. Recent press reports suggest that bank credit cards are now the single largest source of consumer credit, accounting for getting on for 40 per cent of new advances in the last three months.

TRENDS

Penetration of retail outlets

5. At the end of 1984, 218,000 retail outlets accepted Access cards (the total for Visa was 215,000). Penetration has more than doubled in eight years, although there still remains scope for expansion, for example in the food sector. As card usage becomes more common, it is likely that cards will be used increasingly for low-value purchases, and there are already indications that the average value of card transactions is falling. Wide acceptance of credit cards by supermarkets would certainly accelerate this trend, no doubt aided by the growth of store cards.

Card-holding

6. At the end of 1984, about a third of adults in the UK had credit cards. With the notable exception of "Trustcard", credit card usage is low in Scotland, the North, and East Anglia, and amongst members of the C2, D and E socio-economic

groups. Credit card usage is greater amongst men than women, apart from Trustcard which is also the only card to have a high take-up rate with the under 24's and over 50's. The success of Trustcard indicates that there are no reasons why areas with low card take-up rates could not eventually be penetrated to a high level with successful marketing. Businesses are increasingly using company cards for expenses.

The future

7. All the indications in the card market point to an inevitable rise in card holding and perhaps new possibilities for card use. Commentators expect cards, both as a method of payment and as a means of obtaining consumer credit, to become increasingly important. And it is quite possible that cards will become more multi-functional: if card ownership rises to a very high level, scope for adding extra functions to cards could be considerable.

8. Experiments in EFTPOS (electronic funds transfer at point of sale) and in "town cards", which are regionally based, suggest gains in efficiency both in the retail trade and in the transmission of money. EFTPOS operates in Australia, New Zealand, much of the Far East, the USA, France, Spain and Portugal, with card details on a magnetic stripe or silicon chip on the card. In the UK, there are several regional EFTPOS experiments at present being run by different banks and building societies, with a target start date for a single nationwide system of 1988.

OPERATION OF A TAX

9. A tax could be on the holding or on the usage of cards, or even on both.

A Tax on card-holding

10. A tax on card-holding has the appeal of simplicity: it would be easy to collect and after an initial period of volatility in cardholding (as multiple cardholders surrendered little-used cards to avoid the tax), revenue should be buoyant. The tax could operate (as we believe happens in Ireland) as a type of stamp duty on issue or renewal of cards: probably annually, though it could bite more frequently. One difficulty might be that cards now tend to be issued for periods of more than a year, but it should be possible to draft legislation in such a way as to call for tax from companies in respect of cards held in a particular period. Annual returns and payments should keep administration costs to the mimimum. Inasmuch as there would be compliance costs for any types of the tax, they will probably be less for this variant.

Taxes on card usage

11. Simple though a specific charge on card ownership would be, a tax related to card usage would be fairer and would therefore have a higher revenue raising capacity. By being related to use of the card as a payment medium, it could reduce, though perhaps not entirely eliminate, problems over multi-purpose cards. In principle, the largest tax base and greatest buoyancy would be obtained from an ad valorem tax, though there are specific alternatives. An ad valorem tax could be related to the value either of turnover or of credit extended on each card. The former could appear as a monthly charge on a statement. The latter could be more complex (eg on an average of outstanding credit) and would offer a smaller tax-base. By extension, usage could be taken to include receipt of a monthly account, and a specific duty levied on that. One possible awkwardness would lie in the possibility of taxing statements showing nil balances (eg when an account had just been paid). A more obvious way of taxing usage would be to levy a specific duty in respect of each transaction shown on a statement.

12. Apart from the tax on credit, none of these options would appear to pose insuperable operating problems. Since by its nature the industry is highly computerised, it should be possible to devise a collection procedure integrated with the industry's billing systems. And, provided the number of taxpaying companies could be kept low (the retail sector could prove to be particularly fragmented and pose problems), collection need not be unduly manpower-intensive. It is too early to give any indication of resources which would be required, but at this stage it seems plausible to assume that it would entail tens rather than hundreds of extra staff. Naturally any tax which is based on a number of variables is likely to require more administration (and be more open to manipulation) than a straightforward specific tax on card-holding.

Revenue

13. Mr Wilmott's submission of 19 September spelt out the various revenue possibilities of the different tax bases. Using the same data but manipulating them to show what unit charge is required for a common revenue yield, we reach the effects shown in the following table. These estimates are particularly uncertain, as there remain large gaps in our knowledge of the sector. They take no account of possible demand effects, to which there are no documented clues.

Tax base	illustrative unit charge needed to yield total annual revenue of £50 million (before demand effects)	£200m
card holding	£2 a card a year	£8
transactions	10p a transaction	40p
monthly accounts	25p a statement	£1
turnover	0.5% of turnover	2%
credit taken	1.25% of average outstanding annual credit.	5%

implies 8 statements per year

2½ transactions per statement (20 per year)

£40 turnover per year per card.

Any multiple of these unit charges could of course be chosen. But it seems probable that any tax raising more than about £200 million (eg £1 for a monthly statement or £8 a card) would be highly perceptible and could bring about major changes in the size of the tax base. In practice, we would see £100 million as a more realistic target. A tax on card holding would be particularly likely to reduce the base because of the large number of people, at present holding more than one card, who would be tempted to shed little-used cards. The impact effect of any of these options on the RPI would be nil.

Revenue-raising capacity and consumer resistance

14. A modest charge would be unlikely to provoke serious resistance by consumers. The average card-holder would probably not find paying 40 pence a month as 1 per cent of his turnover (or £5 a year stamp duty) too great an obstacle to the convenience of plastic money (and particularly of being able to delay payment). On the other hand the card companies will not be slow to show their customers the source of the charge, eg on each month's statement, or less frequently for the card-holding duty. There could be more general resistance to a transactions-based tax from operators, who could argue that it was an impost on an efficient means of payment and distortive as it singled out just cards, as opposed to cash or cheques.

Borderlines and difficult areas

15. There are two particularly difficult definitional areas. The first is the multi-purpose card, such as Barclaycard, which can be used solely as a cheque guarantee card but also as a payment card. A tax simply on cardholding would fail to make the distinction. Second, store-cards are but a particular type of retail payment and/or credit. In terms of payment there is no great conceptual difference between running an account with the local butcher which is settled monthly and paying in full the monthly account from Marks & Spencer. And if credit is wanted, most large stores operate hire purchase agreements as well. So taxing store-cards (whether by usage or holding) would be particularly awkward to present coherently. But not to tax them, in contrast to all other cards, would be inequitable.

But A plastic.

Avoidance

16. Store card traffic seems the most likely to be diverted into other forms of payment or (more probably) credit, eg by some form of token or document. More generally there could be attempts by card companies to operate from off-shore, which, although probably not insurmountable, could make a tax difficult to police. And many consumers would take to carrying cash for regular purchases currently made by credit card (eg petrol). much less convenient

17. Even if we knew as much as there was to know about the industry, we would be unable to have a tax ready to operate on Budget Day. This is because we would need a period of consultation with the industry to get the detailed legislation right. As it is, our knowledge is at best sketchy. Although it would most probably be valuable to have early discussions with the Bank of England and the Department of Trade and Industry, it seems unlikely that we could have more than an outline of the tax for inclusion in the Finance Bill. Thereafter the best we could aim for would be to consult on draft regulations during the spring and summer with the object of operating the tax from the autumn. This would of course affect first-year revenue. Depending on collection methods, it might mean only a quarter of the full-year revenue in 1987-88. Only with a tax on card-holding might it be possible to find a way of raising a full year's revenue in 1987-88.

FROM: M W Norgrove

DATE: 28 October 1986

MR TREVETT - C&E

VAT AND SMALL BUSINESS

The Minister of State has seen Mr Trippier's letter of 23 October covering an "interesting booklet" on this subject. The Minister has commented that he had not previously realised that one of the arguments in favour of the abolition of VAT on registered trader credit transactions was that it is is common practice in Latin America....

MWN

M W NORGROVE
Private Secretary

cf 23 OCT 1986 - 18

MS

Department of Employment
Caxton House Tothill Street London SW1H 9NF
Telephone Direct Line 01-213........................4884
Switchboard 01-213 3000

Parliamentary Under Secretary of State

(I had not previously realised that one of the arguments in favour of the abolition of VAT on registered trader credit transactions was that it is common practice in Latin America...) PB 27/x

* ACTION COPY ONLY

DAVID TRIPPIER RD JP MP

MINISTER OF STATE

REC	23 OCT 1986
ACTION	Mr TREDGETT C+E
	PS/CHIEX
	PS/CST, PS/FST, PS/EST
	Mr SCHOLAR
	MISS SINCLAIR

Mr CROPPER
PS/IR
Mr Corlett IR
MS
PS/AE

Hon Peter Brooke MP
Minister of State
HM Treasury
Parliament Street
LONDON SW1

23 October 1986

Dear Peter

VAT AND SMALL BUSINESS

Bernard Juby of the National Federation of Self Employed recently brought to my attention an interesting booklet entitled "VAT and Small Business: European Experience and Implications for North America" by Graham Bannock which was published earlier this year.

The main purpose of the booklet is to consider the advantages or otherwise of a system of VAT over purchase taxes and the NFSE felt that it provided a number of useful arguments in support of their proposals for abolishing VAT on transactions between registered traders. You will be familiar with the NFSE view and some of the arguments are summarised on pages 66 and 67 of the booklet.

I understand that following your meeting with David Young there will be a reference to the NFSE proposals in the forthcoming consultative document. I am aware that there are genuine objections to these proposals, but I think that Graham Bannock's work brings out well the inherent complexity of the VAT system and its regressive effect on smaller firms.

* ... I am enclosing a copy of the booklet which I am sure you will find of interest if you have not already seen it.

Yours ever

David

DT5AAG

Income Tax administrations have already been carried out in one part of the country.

To avoid these distortions and to keep as many businesses as possible within the VAT surveillance net, other European countries have other ways of treating small firms. There are a variety of flat rate schemes which involve setting VAT liability as a fixed percentage of sales or relating it to inputs. These schemes also result in distortions since they normally require the use of crude industry-wide margins, while attempts to tailor fixed rates for individual firms seem to result in higher administrative burdens for both government and business.

Another method widely used in the EEC for farmers is to exempt them from VAT registration and from charging the tax, but to allow their customers to deduct the farmers' notional input taxes from their VAT liability. In this way, the burden of administration is passed from the farmer to his customer, but this is only effective where all the farmer's sales are to registered traders. "Farmgate" and other direct sales thus become free of tax. This tends to encourage inefficient methods of distribution. A variant of this approach is to transfer the burden of administering VAT to the suppliers rather than the customers of small firms. This method works like a tax levied at the wholesale stage, but since it involves discriminating between different types of wholesale customer it greatly complicates administration for registered firms.

The other systems used to ease the burden of VAT on small firms involve compensating them for part at least of the compliance burden by allowing them to retain part of the tax collected. (Some US states and Canadian provinces allow the retention of a percentage of sales taxes, up to a ceiling, to compensate for compliance costs). This relief usually takes the form either of a VAT liability threshold below which tax need not be handed over to the authorities, or a tapered percentage relief varying with turnover size bands. All of these compensatory schemes involve some increase in the complexity of the system and therefore in the operating costs of both government and business.

Other alternatives exist. One method would be to allow small firms the option of being assessed for VAT on an annual basis, calculated from the annual accounts which have to be prepared anyway for business income tax purposes. The disadvantage of this approach is that, unless these accounts were to become more elaborate, the use of more or less arbitrary ratios of inputs and outputs would be necessary. Some form of regular payment would also be required, which would still leave some of the administrative burden.

Another alternative which has its attractions would be to eliminate all VAT payments between registered traders. Traders would be able to purchase tax free by quoting an exemption certificate number. Retailers would continue to charge VAT and their business customers would be entitled to reclaim taxes paid on retail purchases. This is the "ring system" of VAT operated in some Latin-American countries. Since VAT payments between registered traders do not contribute to net revenue collected there would, in theory, be no loss of revenue. At the same time, since the vast majority of all individually recorded VAT transactions are between registered traders, there would be a massive reduction in business record keeping and in the self-cancelling flows of tax revenues to and from the tax authorities.

Proposals to this effect were made by the Consultative Committee of Accountancy Bodies (CCAB) in the UK in 1978, but not adopted on the recommendation of an investigative committee which included representatives of the CCAB, the Confederation of British Industry (CBI), retailing and wholesaling bodies and Customs and Excise, but not small business as such (Commissioners of H.M. Customs and Excise (1979)). The tax authorities argued against the change on the grounds that only 28 per cent of registered traders predominantly supplied registered customers, while about 50 per cent sold regularly to both registered and non-registered traders, and their compliance costs would be worsened. The task of enforcement would also become more difficult so that neither most firms nor the tax authorities would find the administrative burden easier.

The tax authorities were mainly worried about the risk of increased evasion in the retail sector where "a disproportionate amount of VAT errors, under-declarations and fraud occurs". It has been argued that under the CCAB proposals one major source of fraud (false input tax reclaims) would be eliminated (see National Federation (1982)). Not mentioned in the official report was the fact that by cutting input tax returns, a major tool in policing the system (through computer ratio checks) would be removed from the hands of the authorities.

Retailers, including small retailers, were against the change because it would increase their administrative burden (mainly because the special simplifying schemes operating in the retail sector depend upon input tax invoices) while the CBI and wholesale interests did not feel that the advantages of the CCAB proposals would offset the adverse effect upon cash flow that would result. It was also doubtful if the proposals were consistent with either the letter or the spirit of the EEC 6th Directive.

The debate over the CCAB proposals has been summarised at some length because it illustrates how, once a VAT system is in place, it is likely to remain. The arguments and investigation were certainly not exhaustive—for example, no serious attempt was made to measure the effect of the proposed changes on the compliance costs of business as a whole, nor was the following question faced: once VAT between registered traders is eliminated, what are the advantages of that system over other indirect tax systems? A VAT without tax between registered traders is, in essence, identical to a comprehensive sales tax.

All schemes for lightening the burden of VAT on smaller registered traders inevitably introduce further complexity and economic distortions or increase the opportunities for evasion or all three. The fact is that although better schemes might be devised, small business and VAT do not go well together.

CONFIDENTIAL

PS/Chancellor

cc: PS/Chief Secretary
PS/FST
PS/EST
PS/MST
PS/Sir Peter Middleton
PS/Sir Terence Burns
PS/Mr Cassell
PS/Mr Scholar
PS/Mrs Lomax
PS/Miss Sinclair
PS/Mr Ilett
PS/Mr Cropper
PS/Mr Ross Goobie
PS/Mr Tyrie
PS/Inland Revenue

28 October 1986

Amended by ACSA.

A PAYMENT CARD TAX

I am afraid that the lines underlined below were missed from the fourth paragraph of Mr Knox's note of 27 October to the Chancellor. The third and fourth sentences on the third page should read:-

> "And bank credit card turnover in 1984 was estimated to be about 4% of consumer spending.) They are an efficient means of effecting payment and technological developments suggest much wider uses for them in the near future, such as direct debiting at checkouts.

Lance Railton.

J L RAILTON
Private Secretary

Rwd

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P Jefferson Smith
Date: 28 October 1986

MINISTER OF STATE

cc PS/Chancellor
Miss Sinclair
Mr Halligan
Mr Cropper

1. You may like to have notice of a VAT case that could be potentially embarrassing.

2. Our West End VAT Office have recently been approached by a firm of builders who are engaged in a major and very costly conversion of the house occupied by Mr and Mrs Norman Tebbitt. They have asked for zero rating of a significant proportion of work on the grounds that these are necessary conversions for Mrs Tebbitt's use as a disabled person.

3. If the supply were directly to Mr and Mrs Tebbitt (or to a charity), the zero rate could be applied to work relating to the installation of lifts, adaptation of bathroom or lavatory facilities, and alterations designed to improve access. In this case, however, the work is being done on behalf of the landlord, the Duke of Westminster's Grosvenor Estate. The builders have been told that there is no provision in the law to permit the zero rating of such supplies to a private landlord, and that they must apply the standard rate.

4. We understand that the builders accept this ruling and do not intend to pursue the matter further. Nonetheless, the ruling may seem harsh, although it is a correct application of the VAT law in an area where conditions for relief have been carefully prescribed. You may like to be forewarned in case the matter is raised with you privately.

P Jefferson Smith

Internal circulation: CPS; Mr Knox; Ms Barrett; Mr Monk

307/10/86

ANNEX B

VAT: Small business review

H M Customs and Excise

October 1986

We would like to simplify the VAT rules for small businesses. Full details of our proposals and possible changes are in a consultation document but the main points are summarised in this leaflet. So that we can decide how best to meet the needs of small businesses we would be grateful if you could tell us what you think by answering the questions in this leaflet and returning it, in the envelope provided, by 31 December.

If you would like to say more about any of these points or have any other ideas for changes please do this in the space provided at the end of this leaflet. You will, of course, be told when these or any other changes are actually to be introduced.

You can get more information and copies of the consultation document from:

David Brampton
H M Customs and Excise
Room 322
Knollys House
Byward Street
London EC3R 5AY

Telephone (01) 382 - 5365

TOTAL RECEIVED: 1256

Not all of our proposals affect all types of businesses. To help us to interpret your answers, will you please first show whether you:

	Yes	No
• are in the construction industry	350	
• use a retail scheme.	171	

If you do use a retail scheme, please show the scheme that you use here. [ ]

1. Cash accounting

This scheme would be open to all businesses with an annual turnover below £100,000. It would provide an alternative to the normal VAT accounting system which is based on invoices received and issued. In this scheme you would account for VAT on the basis of cash received and paid out. This means that you would not have to account for VAT until your customer pays you and you would not be able to reclaim the VAT until you pay your suppliers.

The normal VAT record-keeping requirements would still apply to anyone using the scheme and you would have to include a summary of all receipts and payments.

Use of the scheme would not be compulsory - you would have to apply to use it. If you did use the scheme, you would have to stay in it for at least two years unless your turnover exceeded a set limit when you would have to revert to the normal method.

	Yes	No
Would you want to use this scheme?	588	591

Annual VAT returns and regular payments

This scheme would be open to all businesses that have been registered for VAT for at least a year and have an annual turnover below £100,000. To use the scheme you would have to accept an assessment based on your previous twelve month's VAT payments. This figure would then be divided by ten. You would have to make nine monthly payments by direct debit - starting four months after you enter the scheme. You would then have two months to put in your annual return and make the tenth payment, adjusted to balance your account.

This scheme would not be compulsory but if you use it you would normally have to stay in it for at least a year. During this time you would not be in the default surcharge system. If you failed to make a payment you would have to leave the scheme and account for VAT in the normal way.

	Yes	No
Would you want to use this scheme?	281	938

3. VAT records and accounts

We are asking an independent consultant to look at the current VAT record-keeping requirements. If you would like to contribute to this review - for example, because one of the requirements causes you particular problems - please give your name and address in the space provided. This will help the consultant to choose a sample of businesses to contact.

Name

Address

Postcode

Phone no.

4. VAT registration and deregistration

We would like to simplify the rules. As you are already registered some of the changes would not affect you - for example, a longer time limit for notifying liability to register. But we also propose changing the deregistration rules. Please show whether you agree/disagree with **each** proposal by ticking the appropriate boxes:

	Agree	Disagree
• If you are thinking about deregistration you would only have to consider your **future** turnover **excluding** VAT - not your past turnover.	992	118
• If your turnover goes below the registration limit you would have to deregister.	338	797
• If you have to deregister you would have one month to tell your local VAT office - not 10 days.	1064	66
• If you deregister, you may later need to consider your liability to reregister. When you do this you would be able to work out your future turnover ignoring your turnover before deregistration.	949	163

5. Retail schemes - you should only answer this section if you use a retail scheme

We would like to improve the operation of these schemes. Please show whether you agree/disagree with **each** proposal by ticking the appropriate boxes:

- Scheme B would be made more widely available by removing the 50% zero-rated sales rule and introducing an annual adjustment based on zero-rated stocks at the end of each year. This would be done by:

	Agree	Disagree
— replacing the existing Scheme B	45	21
— introducing a new adaptation in addition to the existing scheme.	34	32

- Scheme C would be modified by:

	Agree	Disagree
— increasing the turnover limit to £90,000	46	11
— revising the fixed mark-ups - details are in the consultation document.	36	14

	Agree	Disagree
• The turnover limit for Scheme D would be increased to £500,000.	63	5

- Scheme G would be modified by:

	Agree	Disagree
— abolishing the £200,000 minimum turnover limit	39	10
— reviewing the 1/8th uplift.	36	10

- Adaptation 1 would be modified by:

	Agree	Disagree
— replacing the current 14% fixed mark-up by several fixed mark-ups based on the type of goods sold	32	19
— increasing the turnover limit to £500,000.	40	7

	Agree	Disagree
• An explanation of any scheme adaptation would be included in the relevant 'How to work' pamphlet.	81	2

	Agree	Disagree
• A more detailed explanation of the use that can be made of scheme mixtures would be provided.	79	2

- Use of the schemes would be restricted to:

	Agree	Disagree
— retail sales - if you make any wholesale supplies for which you have to issue tax invoices you would have to exclude them from your scheme.	41	31
— retail businesses - this means that businesses such as accountants, solicitors and estate agents that can issue tax invoices would not be able to use a scheme.	39	22

If either of these restrictions affect you, you may be able to use the cash accounting scheme instead - see Section 1.

JOINT HMT/C+E NOTE

296/06

Yield (f-[illegible])
RPI effect
Interaction with credit card tax
(slight fall in investment?)
Forestalling?

CONFIDENTIAL

[Such, I think, has been the line on this (F. Cassell's work) 1984.] [illegible]

CONSUMER CREDIT TAX

1. A consumer credit duty has been looked at several times in recent years. It was a runner for the 1984 Budget until being dropped just a fortnight beforehand. Work continued on refining proposals during 1984, but at a meeting in November Ministers decided not to pursue the matter further, although allowing it to be a firm starter for the next Parliament. At that time the proposal was for a 1 per cent duty on credit excluding mortgages qualifying for tax relief: this was estimated to have a net yield of £210 million in a full year.

2. The main considerations for such a duty are set out in Mr Knox's submission of 16 November 1984 (attached at Annex A). In the time available, and without the benefit of advice from the Bank of England, we have not been able to make a precise re-evaluation of the likely revenue yield. With the recent rapid growth in the volume of credit the tax-base would obviously now be higher. Our best guess is that the equivalent full year net yield in 1987-88 would be of the order of £250-300 million. If all mortgages were included the net yield would be increased by about £800 million, to about £1 billion.*

3. There are a number of basic issues that Ministers will need to consider at an early stage before deciding whether to pursue the idea of taxing credit. These are outlined below. First, however, it is important to be clear on what the purpose of the tax would be.

---

* Paragraph 7 of Annex A explains the significance of 'net': in brief, although the tax-base is increased five or six-fold with the inclusion of mortgages, the various direct tax reliefs and other offsetting costs (such as the impact of the increase in the RPI on social security payments) make a considerable dent in the gross yield.

Purpose of Tax

4. There are two possible purposes. The first is relatively straightforward: as a source of revenue. Given the rate of growth of consumer borrowing one would expect such a tax to be a reasonably buoyant form of revenue for the future, so long as the rates were not so high as to prompt individuals to find ways to avoid it. It could also be presented as a way of taxing the undertaxed financial services sector. Indeed it may be one of the few ways of doing so without provoking large scale avoidance, for example by driving business abroad. (This is because it seems unlikely that consumer borrowers would turn to borrowing through overseas branches and subsidiaries; and the provisions of the Consumer Credit Act in any case make that difficult.) So it has its attractions, in principle, as a source of revenue, although as paragraph 9(c) below explains, it could be some time before the full-year yields indicated came on stream.

5. The second purpose might be to assist in the operation of macro-economic policy. Of itself, a credit tax (like any other revenue-producing tax) would tend to reduce money GDP. Even if the PSBR were unchanged, because the revenue from the credit tax was used to finance income tax reductions, it might still be possible to keep monetary conditions on track at rather lower levels of interest rates than would otherwise be needed. We have tried to estimate the impact of a 1 per cent tax on the general level of interest rates and credit growth, under the constraint of keeping money GDP, the PSBR and M0 broadly unchanged. Not surprisingly the effects are modest: about ½ per cent off the growth of credit and 0.1 per cent off short-term interest rates in the first year (building up a little in later years).

6. In the short run, however, there could be a more significant effect from the <u>announcement</u> of such a tax. There is currently much market concern about the growth

of consumer lending. That is undoubtedly a factor affecting market confidence adversely, and hence contributing to the present level of short term interest rates. This concern may be further increased when, later this year, we come to announce the end of mortgage lending guidance (about which we will be letting the Chancellor have a note shortly). In this context, the announcement of a consumer credit tax could have a helpful immediate market impact, though informed commentators would no doubt quickly point out its longer-term effects on the volume of borrowing were likely to be small.

7. We would not need to claim any monetary purpose for the tax in public. Indeed it might be better not to do so. Interest rates are the instrument we use for operating monetary policy. We could perhaps note, if asked, that the imposition of a tax might allow the general level of interest rates to be lower than it would otherwise be. But the revenue arguments seem sufficient reason in themselves for introducing the tax; and using them would not prevent those who are particularly concerned about economic consequences of the growth of consumer credit from taking some comfort from our intention to tax it.

8. Against this background we conclude that the case for a credit tax is worth further consideration by Ministers.

Key questions

9. Before further work can be done, however, it would be helpful to have Ministers views on four key questions:-

(a) Should mortgages be included?

In principle they should: not just on the grounds that they are the largest single element of consumer credit, with all that that would imply for both equity and revenue yield; but also because to exclude them would be a further incentive for credit to be taken in this form. However, there would be obvious political difficulty in taxing borrowing for house purchase or improvement, as well as other disadvantages: the apparent inconsistency between taxing with one hand and giving tax relief with the other; and the fact that mortgages are represented in the RPI, whereas other forms of credit are not.

Since the matter was last considered, in 1984, it has become much more common for people to borrow against the security of a mortgage for non-housing purposes (and without mortgage interest tax relief). To distinguish, for the purposes of the tax, between mortgage-secured and other lending might simply encourage a further switch of consumer borrowing towards mortgages. So the only sensible distinction for the tax would be between lending that attracts mortgage interest relief and lending that does not attract it. This would no doubt give some further encouragement to borrow in a way that can attract tax relief. But it is hard to see any other line that could sensibly be drawn if the tax is not to be applied to <u>all</u> lending to persons.

(b) <u>Fixed interest loans</u>

The tax would not be confined to new credit, but would be levied on the total credit outstanding. This would prevent forestalling, bring in more revenue, create fewer distortions, and be easier to administer. But it does raise the question whether there should be some let out for fixed intrest loans taken out before the tax was announced. We are examining the extent of such loans (which include HP credit and some mortgages, at least in their early years) and whether contracts have let-out clauses to provide for tax changes. On the whole, we would recommend against any concession - though obviously this could give rise to substantial accusations of retrospection.

(c) When should the duty come into operation?

One of the unattractive features of the tax, when discussed in 1984, was the long lag before the full revenue flow was achieved. A tax of this sort, involving a large number of lending institutions with differing practices, would undoubtedly take some time to put in place. The earlier proposal envisaged a Budget announcement in Year 1, the tax coming into operation in July of Year 2 and raising about half the full-year yield in that year, the full yield only coming in Year 3. This allowed for primary (Finance Bill) legislation to cover principles, detailed consultation on technical matters with the industry and secondary legislation all in Year 1; and then 12 months implementation. The identical pattern now would mean a Budget announcement in March 1987, coming into operation July 1988 and fullyear revenue only in 1989-90. It is possible that the mechanics of collection could now be streamlined: for one thing the additional load on computer reprogramming is less of a constraint now than it was in 1984 (although the lending institutions' programming resources may also have been slimmed down since then). Even so, detailed consultation would be necessary and, even with an early announcement there seems little possibility of revenue actually flowing in before an Election has to be called.

Perhaps — What revenue then?

Officials getting election fever — this is not the only consideration!

(d) Should there be prior announcement?

As noted in paragraph 6, there could be advantages in early announcement of the intention to introduce such a tax (accompanied by some indication of its scope, mechanics and likely level). This might be followed by publication of draft clauses. The draft clauses, however, would need very careful preparation and we cannot yet judge whether this would be feasible; much depends on the load on Parliamentary Counsel in the run-up to the Budget (at this stage Customs have no estimate of the length of primary legislation required, but even at a bare minimum it will run to many pages).

Reaction

10. The banks, finance houses etc and retailers would obviously oppose the duty and no doubt point to borderline difficulties in distinguishing between personal and business borrowers. But we do not expect that the tax at the levels likely to be imposed would have any significant effects on the volume of their business. There would, however, no doubt be charges - possibly true in individual cases - that some retailers might stop providing consumer credit themselves and, if the tax applied to mortgages, that the level of repossessions would increase. But these effects would be marginal, and in the financial markets the announcement of the tax would probably go down well.

Next steps

11. Although we have previous work on which to draw for reference (and at this stage we could probably not scrap it and start afresh), if this is to be taken further for 1987 we should need to start early discussions with the Bank of England, the Department of Trade & Industry, as well as perhaps Parliamentary Counsel, the office of Fair Trading and the Building Societies Commission. If Customs & Excise are to be able to commit the resources required for planning in time for an early announcement (of whatever kind) - and extra HQ staff of the quality required cannot automatically be guaranteed - a very early decision to proceed to detailed planning would be needed.

12. In carrying forward the specification of the tax it would be helpful to know Ministers' views on the purpose of the tax, as outlined in paragraphs 4-8, and whether

RA7.28

CONFIDENTIAL

FROM: A C S ALLAN

DATE: 4 November 1986

MR B H KNOX - CUSTOMS AND EXCISE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobey
Mr Tyrie
PS/IR

ACSA to Knox 4/11

A PAYMENT CARD TAX

The Chancellor was grateful for your minute of 27 October. He would like to wait for the separate submission on the wider questions of taxing consumer credit before taking this forward. But he will want to hold a meeting on both subjects very soon.

ACSA

A C S ALLAN

they consider that it should cover all lending to persons that does not attract mortgage interest rate relief, that existing fixed interest loans should if possible be included and that we should aim at an early announcement of the intention to introduce such a tax.

H M TREASURY
H M CUSTOMS & EXCISE

4 November 1986

CONFIDENTIAL

MINISTER OF STATE TREASURY

NOTE OF MST's MEETING 7/11

CONSUMER CREDIT TAX

cc All those present at the meeting
PPS
PS/Chief Secretary
PS/Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Miss Sinclair
Mr Grice

PS/Customs & Excise

PS/Inland Revenue

Please find attached a copy of a note of the meeting held on 7 November on Consumer Credit Tax.

Deborah Francis.

MISS D L FRANCIS
Assistant Private Secretary

NOTE OF A MEETING IN THE MINISTER OF STATE'S OFFICE ON 7 NOVEMBER 1986

Those present	Minister of State	
	Economic Secretary	
	Mr Cassell	
	Mr Peretz	
	Mrs Lomax	
	Mr Ilett	
	Mr Romanski	
	Mr Cropper	
	Mr Ross Goobey	
	Mr Knox	)
	Mr Wilmott	)Customs & Excise
	Mr Bone	)

CONSUMER CREDIT TAX

The purpose of the meeting was to hold a preliminary discussion of the main issues raised in Mr Cassell's submission of 5 November before the paper went to the Chancellor. The discussion fell into two parts: the first on the general principles of having such a tax, and the second on specific points for decision.

General principles

2. Introducing the paper, Mr Cassell said that a tax on consumer credit could be attractive as a tax in its own right and certainly better than a tax on payment cards, if only by virtue of having a wider base. Moreover, there would be presentational attractions in being able to announce a tax on credit as a counter-balance to the ending of mortgage lending guidance, which it was

proposed should be announced soon. Mr Knox agreed that it would be more logical than a payment card tax, but he wondered if the modest (and delayed) revenue yield and the minimal impact on demand for credit would make the full panoply of a new tax worthwhile. The Economic Secretary thought that a tax on credit would be unpopular with both customers and lenders. He considered that a clear advantage would have to be demonstrated for the tax on either revenue or monetary grounds before the aggravation which it would cause could be justified. He was also concerned that any measures to restrict avoidance (in particular off-shore) could require draconian powers. Mr Peretz said that, although the effects on monetary policy would be more cosmetic than real, the tax could be a useful, as well as a buoyant, source of revenue. Public perception of it could place it in the class of sin taxes (like tobacco), so reaction need not be entirely negative. A low rate should not encourage avoidance. Mrs Lomax said that a low rate would be necessary if mortgages were excluded but that the tax would not be particularly helpful on any grounds as a result. Mr Ross Goobey saw the tax as a desirable addition to the range of indirect taxes, and thought that the impact on the average individual would be relatively painless. Mr Cropper saw the tax as a revenue-raiser rather than as an instrument of monetary policy. In his view a yield of a billion pounds would justify the aggravation of a new tax, but anything much lower would not. The Minister of State was generally in favour of such a potentially buoyant revenue-raiser.

Mortgages

3. The arguments for and against including all mortgages were agreed to be plainly set out in paragraph 9a of the paper. The general view was that it would be too difficult to include them in the tax base. The main obstacle to their inclusion, both logically and politically, was income tax relief. On the other hand, exclusion would be likely to lead to leakage: even at a low rate, a new tax might cause people to re-arrange mortgages to acquire tax-free credit.

Does this mean all mortgages or just those qualifying for MIR?

MIR

Fixed interest loans

4. It was generally agreed that in principle these should be covered by any tax on grounds of equity. Although any element of retrospection would always carry the risk of unpopularity, in practice the number of people affected would diminish as loans ran their course between announcement and introduction of the tax. There would be no legal difficulty if the law contained a similar provision to VAT law allowing lenders to vary fixed interest terms because of tax changes.

Timing

5. a) Introduction Although the banks would have got over the hump of computer (and other) changes which had been recognised as an obstacle to early introduction when the tax was discussed in 1984, there was no reason to suppose that they would be in a position to divert their own resources to speedier implementation now. As Customs would be heavily dependent on both the expertise and the goodwill of banks and other institutions to implement a tax, it would be unwise to assume that they could make any significant reduction in the lead-time of 15 months discussed in the paper. Some streamlining might be possible, for example by excluding small lenders, but the amount of work in introducing a new tax should not be under-estimated.

b) Announcement There were monetary policy reasons for an early announcement if it were decided to proceed with the tax. These, and Budget purdah in the New Year, pointed to an announcement before Christmas. The drawback to such a timetable was that six working weeks would be a very short period in which to make the necessary preparations, particularly at a time when the Customs staff concerned were already engaged in other Budget work.

Alternative taxes

6. There was no support for a tax on payment cards, but the question of a 'balance sheet' tax was briefly discussed. Its main advantage was as a potentially large revenue-raiser (perhaps as much as £2 billion) spread thinly over a wide range of institutions. The disadvantages were: that pension funds would have to be included, and their taxation had effectively been ruled out in 1985; and that a tax impinging on the gilts market in particular, and on the City in general so soon after Big Bang, would be untimely.

Conclusion

7. Summing up, the Minister of State said that there had been a useful discussion of the main points at issue. He would shortly forward the paper to the Chancellor for full Ministerial consideration.

Deborah Francis.

Circulation

Those present
PPS
PS/CST
PS/FST
Sir P Middleton
Sir T Burns
Mr Scholar
Miss Sinclair
PS/Customs & Excise
Mr Grice
PS/Inland Revenue.

CONFIDENTIAL

BF for meeting

MST to CH/EX 11/11

FROM: Minister of State

DATE: 11 November 1986

CHANCELLOR

cc Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Grice
Mr Ilett
Miss Sinclair
Mr Romanski
Mr Cropper
Mr Ross Goobey

PS/Inland Revenue

PS/Customs & Excise
Mr Knox - C&E
Mr Jefferson Smith - C&E
Mr Bone - C&E

CONSUMER CREDIT TAX

I attach the note for which Mr Allan asked on 20 October. Because there were different points of emphasis between Customs and the Treasury, who prepared it jointly, I took the liberty of hearing a preliminary debate between officials on the issue with the Economic Secretary, Mr Cropper and Mr Ross Goobey present. It would be fair to say that opinion was relatively evenly divided, the principal political objection being the relative sparseness of the yield (if tax-relieved mortgages were excluded) against the potential noisiness of the row.

One of the outstanding issues relates to the timing of any announcement if we were to proceed, which could argue for an early decision, but you are in any case going to be calling a meeting shortly on other related topics.

The Economic Secretary has seen this and concurs.

P.B.

PETER BROOKE

C/ Awaiting advice, but might like to be aware

CR 17/11

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB

01-212 3434

My ref:

Your ref:

The Rt Hon Nigel Lawson MP
HM Treasury
Parliament Street
LONDON
SW1

CH/EXCHEQUER

REC.	14 NOV 1986 14/11
ACTION	MST
COPIES TO	

14 November 1986

Dear Nigel

I have seen a copy of Malcolm Rifkind's letter of 3 September to you about the impact of VAT on the repair of historic buildings. I see that Nicholas Edwards has also written in support of Malcolm's view. I have been reflecting on the issues raised.

There is of course considerable pressure from the heritage lobby and I can appreciate their arguments. I consider however that they should be reminded of the very considerable tax advantages that have been given to owners of heritage property since 1980. These include the retention of zero rating for alterations of listed buildings, the much wider flexibility introduced by the change from capital transfer tax to inheritance tax and, perhaps most important of all, reductions in personal taxation. Given these improvements I am not convinced that the public would accept the case for offering further concessions to the owners of historic buildings. These considerations, combined with the Government's difficulties in sustaining zero-rating against challenge from our European partners, suggest to me that the time is not right to consider further concessions for heritage property, which would distinguish between owners on the grounds of the alleged quality of their houses.

I am copying this letter to Malcolm Rifkind and Nicholas Edwards.

Yours ever

Nicholas

NICHOLAS RIDLEY

RWP

CONFIDENTIAL

cc PS/Chancellor
Mr Scholar
Miss Sinclair
PS/C&E
Mr Wilmott - C&E

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Hon Michael Wilson
Minister of Finance
Department of Finance Canada
Place Bell Canada
160 Elgin Street
Ottawa
Ontario
CANADA K1A OG5

17 November 1986

Dear Mr Wilson,

INSURANCE PREMIUM TAXES

As part of HM Government's continuing review of the structure of taxation, officials here are studying possible new taxes as well as the operation of existing taxes. One possibility under examination at the moment is a tax on insurance premiums.

I understand that Canada has a federal tax on insurance placed directly abroad. This is of particular significance to our studies, since one of the major difficulties which we would foresee here is insurance moving off-shore to avoid tax. It would be most helpful if your administration were prepared to release details of how it copes with this problem, as well as any other facts and figures which you think might be useful. I enclose a questionnaire which we have been using in our fact-finding.

I need hardly tell you of the sensitivity with which we have to approach taxation questions here. It would be most unfortunate if it became public knowledge that we were even studying the possibility of introducing a new tax. I am sure that we can rely on your discretion.

We shall be very grateful for any advice which you can let us have.

Yours sincerely
Peter Brooke

PETER BROOKE

INSURANCE PREMIUM TAX: QUESTIONNAIRE FOR OTHER ADMINISTRATIONS

A. Basic facts

1. When was the tax introduced?

2. Why was it introduced?

3. What other taxes are levied on the insurance industry (eg payroll tax)?

4. What was the reaction to the tax - from the industry, political parties, economic commentators?

5. What is the tax base?

6. Are there any exclusions; if so, why?

7. What are the rates of tax? (If variable, why?)

8. How often do rates change?

9. What is the yield?

10. Does the yield increase faster than inflation?

11. What proportion of Government revenue from taxation does it represent?

12. How does the tax work?

B. Mechanics

1. How long was it between announcement and introduction of the tax?

2. What consultations were there between tax authorities and the industry?

3. What legislative difficulties were there (eg definitions)?

4. How do tax authorities determine whether or not a particular type of insurance is subject to a particular rate?

5. How do tax authorities treat

   a) taxation of foreign insurance for domestic risks?

   b) taxation of domestic insurance for foreign risks?

6. What control and enforcement mechanisms are there?

7. How many staff are employed to administer and collect the tax?

8. How does that number compare with

   a) initial estimates?

   b) the number required to introduce the tax?

   c) numbers employed on other taxes?

9. What use do authorities make of computers to operate the tax?

C. Effects

1. What effect has there been on the volume of insurance?

2. What proportion of the tax falls on business/private consumer/other?

3. Is there any estimate of the cost to the insurance industry of operating the tax?

4. Are there any benefits to the industry, eg prolonged use of revenue collected before transmission to tax authorities?

D. Problems

1. Are there difficulties in definitions and borderlines?

2. Does the existence of variable rates make those difficulties worse?

3. What is the scope for tax avoidance?

4. Is foreign insurance particularly difficult to tax?

5. How do tax authorities counter avoidance?

6. What other problems have been encountered?

7. What other problems may lie ahead?

PMP

From: P TREVETT
Date: 17 November 1986

HM CUSTOMS AND EXCISE
VAT CONTROL DIVISION D
ALEXANDER HOUSE 21 VICTORIA AVENUE
SOUTHEND-ON-SEA X SS99 1AJ
TELEPHONE SOUTHEND-ON-SEA (0702) 348944 ext 6285

PS/Minister of State

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

VAT AND SMALL BUSINESSES

Your minute of 28 October and Mr Trippier's letter to the Minister of State refer.

We have seen Mr Bannock's booklet and will be producing an internal critique, which the Minister may wish to see.

We have made enquiries of some (but not all) Latin American embassies, including the Brazilian and Chilian, but have not been able to identify any tax-free rings as used to operate with purchase tax. However, several countries have a sales tax, the net effect of which is broadly similar. Even so, we assume that Mr Bannock must have had good reason for his assertion.

A draft reply to Mr Trippier is attached.

P TREVETT

Internal distribution:

Mr Knox
Mr Howard
Mr Wilmott
Mr Holloway

DRAFT LETTER FROM MST TO MR TRIPPIER

VAT AND SMALL BUSINESSES

Thank you for your letter of 23 October, enclosing a copy of the booklet "VAT and Small Business: European Experience and Implications for North America".

Graham Bannock has produced an interesting report on VAT and its benefits and drawbacks over other systems of indirect taxation. I was particularly interested in the section to which you drew my attention.

You will doubtless have seen a copy of the consultation paper, which includes an annex on why it is not proposed to abolish VAT on transactions between registered traders. I doubt if this will close the discussion and we fully expect to receive representations on the topic. Nevertheless, we have not yet seen any arguments, including those put forward by Graham Bannock, which have convinced us that there is any real advantage to small businesses in making such a fundamental change.

RA7.48

pmg

FROM: A C S ALLAN
DATE: 17 November 1986

CHANCELLOR

Star ✓ 18/11

CONSUMER CREDIT TAX ETC

There are two related subjects for your meeting tomorrow: consumer credit tax and credit card taxes.

Consumer Credit Tax

2. The main issues are:

(i) Purpose. There may be too much worry about pinning down the philosophy, which must combine both revenue raising and monetary policy (both presentation and substance).

(ii) Coverage. Yes to all mortgages except to those attracting MIR? And yes to fixed interest loans?

(iii) Yield and RPI. Need estimates of effects based on coverage agreed.

(iv) Timing. A Budget announcement in March 1987 but with the tax not coming into operation until July 1988 seems unattractively slow. Would an earlier announcement help? (Could be linked in with ending of mortgage guidance.) And is there scope for compressing the time between announcement and implementation?

(v) Next steps. Consultation with BofE, DTI etc.

Credit Card Tax

3. If we do have a consumer credit tax, then credit balances will be within the scope of that tax. That would not in itself rule out an additional tax - for example a type of stamp duty on the issue or

renewal of cards. But it might make it rather difficult to have a tax on payment card transactions on top.

4. If we do not have a consumer credit tax then there remains a case for a free standing payment card tax: it could be a useful revenue raiser (up to £200 million). But it will run into opposition

(i) for taxing one payment medium and not others; and

(ii) (much less valid) for being only a partial tax on the financial sector, or not having a clear rationale.

5. The main issue for a free-standing tax is what base it should use:

(i) Annual charge: simple; quick to introduce; but more visibe as large lump sum.

(ii) Transactions: fairer; potentially more buoyant; but more complex.

ACSA

A C S ALLAN

LC/5

cc PS/CST
PS/FST
PS/EST
Sir P Middleton
Mr Scholar
Mr Monger
Miss Sinclair
Mr Romanski
Mr Norgrove
PS/C&E
Mr Tracey C&E

PWP

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

17 November 1986

Isabel Ogilvy
Private Secretary to the
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON SW1

Dear Isabel,

VAT: LISTED BUILDINGS

Your Secretary of State wrote to the Chancellor on 14 November concerning the issues raised in the Secretary of State for Scotland's letter of 3 September and the Secretary of State for Wale's letter of 16 September. I am afraid that the Chancellor's reply to these letters was not copied to your Secretary of State. A ... copy of this letter is attached and I apologise for any inconvenience caused.

Yours sincerely,

Cathy Ryding

CATHY RYDING
Private Secretary

c1.4

cc PS/C
PS/FS
PS/EST
Sir P M
Mr Schol.
Mr Monger
Miss Sincl.
Mr Romanski
Mr Norgrove
PS/C&E
Mr Tracey - C&E

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

25 September 1986

The Rt. Hon. Malcolm Rifkind MP
Secretary of State for Scotland

Dear Malcolm

Thank you for your letter of 3 September about VAT and listed buildings. You received qualified support for your views from Nicholas Edwards in his letter of 16 September.

Under Group 8A of Schedule 5 of the VAT Act 1983 services and associated goods supplied by a VAT registered builder in the course of an approved alteration to a listed building are zero-rated. (The legislation refers to "protected building"; in practice this largely means listed buildings but scheduled monuments are also covered). Approved alterations are those which both require and obtain listed building consent from the appropriate planning authority. Listed building consent is required for work on a listed building which would affect its character as a building of special architectural or historic interest. The VAT legislation also enables a redeveloper to zero rate the sale or letting on a long lease of a listed building which he has substantially reconstructed. Alterations not requiring listed building consent (usually internal ones) and works of repair or maintenance are standard rated.

This relief for listed buildings amounts to a substantial mitigation of the effects of the VAT changes announced in the 1984 Budget and it was widely welcomed at the time by those concerned with the preservation of our national heritage. The rationale at the concession we made was that the Government accepted the case for retaining a substantial degree of zero rating for alterations to listed buildings so as not to worsen their position in relation to VAT, particularly when these buildings were being substantially reconstructed or converted as the only means of giving them a continuing useful life.

The relief does not amount to an incentive to make alterations which would be out of keeping with the character of the building or which would destroy important features since listed building consent for these can always be refused. While it might be argued that to relieve repair or maintenance work to listed buildings alone would cost relatively little in revenue terms, benefit would be seen as going to owners of, on the whole, very desirable properties whose income tax burdens

have been substantially reduced in recent years. Furthermore any new special relief in this area would lead to pressure to extend it to buildings owned by other worthy contenders such as the churches or charities. To zero rate all repairs or maintenance could cost over £500 million a year as well as resurrecting, in inverted form, the old unworkable dividing line between repairs and alterations.

I appreciate your concern to optimise the money you are able to make available by way of grants and that it may appear strange that work which is eligible for grant aid also bears tax. There is, however, nothing illogical about this. The system of grants represents a flexible and economical way of giving help where it is most needed. A general VAT concession, on the other hand, would inevitably lead to relief being spread more thinly and indiscriminately. Although Nicholas Edwards' alternative suggestion of allowing VAT relief only for works which attract Government aid might seem less objectionable, I am afraid that I cannot agree to it. The current levels of grant must be assumed to reflect the fact that repair and maintenance work has always borne VAT. If more resources were needed and were available for this area, it would surely be better to increase the levels of grant rather than in effect give claimants two separate sources of public subsidy with their separate administrative mechanisms, one via grant and one via VAT. In any case giving two sources of assistance would seem doubly unfair to those who qualified for neither.

Even if in domestic terms the change advocated by the RIAS and COSLA could be justified, our obligations under the EC Sixth Directive would prevent it. As you know, we are facing infraction proceedings in the European Court in which, among other items, our zero-rating of new construction is being challenged. While the Government has announced that it will defend the United Kingdom's present zero-rates vigorously before the Court, we must accept that there is no authority under the EC Sixth Directive for introducing any new zero rating or restoring one that has already been given up. I am afraid, therefore, that I can hold out no hope of relieving works of repair or maintenance to listed buildings from VAT.

I am copying this letter to Nicholas Edwards.

NIGEL LAWSON

LC/5

~~Pse send copy to~~ PS/AAST
Pse circulate to officials

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

17 November 1986

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Department of the Environment
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Private Secretary

RC2.4

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I am copying this letter to Nicholas Edwards.

NIGEL LAWSON

CONFIDENTIAL

1. Alex
~~Papers please~~
Alex - did you deal with this? I don't remember it at all + Michael can't find papers.

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023....

o/To be aware

CR 17/11

FROM: P G WILMOTT

DATE: 13 November 1986

Minister of State

cc Chancellor
Mr Scholar
Miss Sinclair

INSURANCE PREMIUM TAX

As you know, we are doing further work on the possibility of introducing an insurance premium tax and are duc to report later this month. We have already gleaned some first-hand information about the operation of taxes in France, Germany and the Netherlands, but we think it could be useful to learn something of what goes on in the North American market.

2. As it happens, one of our officials is in Canada at present and has established that the Department of Finance there would be content to release details of their insurance tax, provided that their Ministers agree. They suggest that a Treasury Minister should write in confidence to the Canadian administration asking for what information could be made available.

Internal circulation: CPS, Mr Knox, Mr Jefferson Smith, Mr Bone.

3. Although this information is likely to come rather late in our deliberations and may not of itself be decisive, we think that it would nonetheless be useful to fill in gaps in our knowledge, particularly on the scope for and means of containing off-shore avoidance (where the European experience has not been particularly helpful or encouraging). Accordingly we recommend that you should write to the Canadian Minister of Finance. A draft letter is attached.

P G WILMOTT

DRAFT

CONFIDENTIAL

The Hon Michael Wilson
Minister of Finance
Department of Finance Canada
Place Bell Canada
160 Elgin Street
Ottawa
Ontario
CANADA K1A 0G5

INSURANCE PREMIUM TAXES

As part of HM Government's continuing review of the structure of taxation, officials here are studying possible new taxes as well as the operation of existing taxes. One possibility under examination at the moment is a tax on insurance premiums.

I understand that Canada has a federal tax on insurance placed directly abroad. This is of particular significance to our studies, since one of the major difficulties which we would foresee here is insurance moving off-shore to avoid tax. It would be most helpful if your administration were prepared to release details of how it copes with this problem, as well as any other facts and figures which you think might be useful. I enclose a questionnaire which we have been using in our fact-finding.

I need hardly tell you of the sensitivity with which we have to approach taxation questions here. It would be most unfortunate if it became public knowledge that we were even studying the possibility of introducing a new tax. I am sure that we can rely on your discretion.

We shall be very grateful for any advice which you can let us have.

PETER BROOKE

INSURANCE PREMIUM TAX: QUESTIONNAIRE FOR OTHER ADMINISTRATIONS

A. Basic facts

1. When was the tax introduced?

2. Why was it introduced?

3. What other taxes are levied on the insurance industry (eg payroll tax)?

4. What was the reaction to the tax - from the industry, political parties, economic commentators?

5. What is the tax base?

6. Are there any exclusions; if so, why?

7. What are the rates of tax? (If variable, why?)

8. How often do rates change?

9. What is the yield?

10. Does the yield increase faster than inflation?

11. What proportion of Government revenue from taxation does it represent?

12. How does the tax work?

B. <u>Mechanics</u>

1. How long was it between announcement and introduction of the tax?

2. What consultations were there between tax authorities and the industry?

3. What legislative difficulties were there (eg definitions)?

4. How do tax authorities determine whether or not a particular type of insurance is subject to a particular rate?

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   a) taxation of foreign insurance for domestic risks?
   b) taxation of domestic insurance for foreign risks?

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8. How does that number compare with

   a) initial estimates?
   b) the number required to introduce the tax?
   c) numbers employed on other taxes?

9. What use do authorities make of computers to operate the tax?

C. Effects

1. What effect has there been on the volume of insurance?

2. What proportion of the tax falls on business/private consumer/other?

3. Is there any estimate of the cost to the insurance industry of operating the tax?

4. Are there any benefits to the industry, eg prolonged use of revenue collected before transmission to tax authorities?

D. Problems

1. Are there difficulties in definitions and borderlines?

2. Does the existence of variable rates make those difficulties worse?

3. What is the scope for tax avoidance?

4. Is foreign insurance particularly difficult to tax?

5. How do tax authorities counter avoidance?

6. What other problems have been encountered?

7. What other problems may lie ahead?

CONFIDENTIAL

pmp

NOTE OF A MEETING IN THE CHANCELLOR'S ROOM, HM TREASURY AT 4.00 PM ON TUESDAY, 18 NOVEMBER

Present

Chancellor	Mr Peretz
Financial Secretary	Mr Scholar
Economic Secretary	Mr Cropper
Minister of State	Mr Ross Goobey
Sir P Middleton	Mr Tyrie
Sir T Burns	Mr Knox - C&E
Mr Cassell	Mr Bone - C&E
Mrs Lomax	Mr McGivern - IR

CONSUMER CREDIT TAX AND CREDIT CARD TAX

Note of Mtg 18/11

The Chancellor said that a consumer credit tax had been discussed several times before. There was a strong case for arguing that this part of consumer expenditure was under-taxed. There was no chance of taxing it via VAT because of EC restrictions. So a free-standing tax was the only option. It had been rejected in the past because of potential political problems. But the politics had changed and a fresh look now seemed warranted.

2. **The Minister of State** said he had discussed the issues with Customs and Treasury officials. There had been divisions between those who favoured introducing a consumer credit tax regardless of the likely row; and those who felt it would not be worth doing unless much more revenue was raised.

3. **Sir P Middleton** said that this sort of tax always brought out conflicting feelings. There would be some helpful impact on credit growth, but not all that much if the rates had to be kept low. And if rates were low the yields were correspondingly low - only about £250 million if mortgages attracting MIR were excluded. **Mr Cassell** said that a critical issue was timing. We would not get the money in full for

2½ years. He had always been attracted to something on these lines, and thought that if it were decided on, it should be announced as soon as possible.

4. **The Economic Secretary** said he thought the balance between the immediate political criticism and the slow build-up of revenue made this tax unattractive. He thought it would not be worth doing unless all mortgages were covered, which would increase the yield to over £1 billion.

5. **Sir T Burns** said that if all mortgages were included - ie including those qualifying for MIR - he would be quite enthusiastic about this tax. But with a narrower coverage, he would be very nervous about increasing distortions and widening the gap between borrowing via mortgages and via other sources.

6. **Mr Peretz** pointed out that a ½ per cent tax was small compared with the 3 per cent benefit from MIR for standard rate taxpayers - and up to 6 per cent for higher rate taxpayers. We provided a huge incentive to borrow via tax-relieved mortgages already. There would be a very small additional incentive to switch to mortgages if we had a tax which exempted them.

7. **The Chancellor** said there were obvious political difficulties over having qualifying mortgages within the scope. By giving tax relief and taxing mortgages it would look as if we were going in two directions at the same time. He thought that if mortgages were included it would have to be done at a lower tax rate. The assumption for future work should therefore be that we were either having a ½ per cent tax on all consumer credit, or a 1 per cent tax on everything except qualifying mortgages. He thought, rightly or wrongly, this tax would attract considerable support from business and industry; they felt aggrieved that consumers could borrow cheaper than they could.

8. **The Chancellor** then turned to the separate submissions on a credit card tax. He saw advantages in this as part of a package: it took a long time before the full revenue from a consumer credit tax was received; it was therefore desirable to fill in the hole; a credit card tax would be simple and could raise revenue early. The fact that it might introduce distortions of its own would not matter because it would be announced as a temporary measure only.

9. **Mr Cassell** commented that there could still be behavioural changes depending on what form the tax took. **Sir T Burns** said he was wholly in favour of taxing the credit element of credit cards, but was strongly opposed to taxing the payment element.

10. **Mr Knox** said that the simplest tax would be a flat rate levy on the issue of credit cards. But it would also be possible to have a tax on the interest portion of monthly statements. It could, though, be up to a year before any revenue was received.

11. **Mr Ross Goobey** questioned why a tax on the credit charges on credit cards could be introduced any quicker than a full consumer credit tax. **Mr Cassell** said that further work would be needed to consider how banks could distinguish between consumers and small businesses.

12. **The Chancellor** said he would like further work done on a package which:

(a) worked towards the introduction of a ½ per cent consumer credit tax right across the board;

(b) during the early period introduced a tax on credit cards alone, which tried to combine two conflicting considerations: first, that revenue was received quickly; and second, that it followed similar principles to the eventual consumer credit tax into which it would be merged.

13. **Mr Knox** said that there would need to be much wider consultation, about these proposals, including with the Bank of England and with DTI in particular; and it would involve considerable claims on staff resources. He asked when proposals would be announced. **The Chancellor** said he was not attracted to any announcement before the Budget. It was much more sensible to have a combined presentation of all tax changes there. He would be grateful if Mr Knox could investigate quickly the feasibility of a package of this kind, in consultation with Mr Cassell, and report back to him.

ACSA

A C S ALLAN
24 November 1986

Distribution

Those present
Chief Secretary
Sir G Littler
PS/C&E
PS/IR

From: P TREVETT
Date: 26 November 1986
HM CUSTOMS AND EXCISE
VAT CONTROL DIVISION D
ALEXANDER HOUSE 21 VICTORIA AVENUE
SOUTHEND-ON-SEA X SS99 1AJ
TELEPHONE SOUTHEND-ON-SEA (0702) 348944 ext 6285

Minister of State

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

We have a strong interest in the early adoption of this directive, & shd not therefore press the compulsory designation option except in the last session @ the end of para 5. If the Commission is not [illegible] we shd then drop it.

DRAFT VAT DIRECTIVE: SPECIAL SCHEMES FOR SMALL AND MEDIUM SIZED BUSINESSES

1. This Commission proposal was discussed, for the first time, in the forum of the Financial Questions Group on 20 and 21 November. We thought you would welcome a short note on the outcome of that meeting and whether this proposal is likely to be progressed further during the remainder of our Presidency and subsequently in that of Belgium.

2. The UK, of course, welcomes this proposal and has a major interest in seeing its adoption by the Council as soon as possible. This is primarily because it would once and for all remove the threat of infraction proceedings on our existing registration threshold, while at the same time, if the optional threshold of 35,000 ECU is agreed, permitting us to have a modest increase in real terms, some £4,000. Its adoption while not essential to the changes proposed in the small business review would add considerable weight to any legislation which might be proposed.

Internal distribution

CPS	Mr Wilmott	Mr Topping
Mr Knox	Mr Cockerell	Mr Craske
Mr Howard	Mr Holloway	

3. In opening discussion on the proposal both the Presidency and the Commission reminded delegations of the importance to which heads of Governments attached to it and for the need to encourage small and medium sized businesses. This objective of simplification was accepted by all the Member States, but with less enthusiasm by some than others. In an initial "tour de table" several Member States said that there had been insufficient time to consider the Commission's proposals in detail and to complete the necessary consultation with interested trade bodies. There then followed the first detailed examination of the Commission's proposals.

Exemption (Registration) thresholds

4. The Commission propose two thresholds, the first a mandatory threshold of 10,000 ECU (about £7,200) and the second an optional threshold of up to 35,000 ECU (about £25,000). We have little interest in the mandatory threshold, but it was about this that most of the discussion centred with several Member States considering it too high. On the optional higher threshold both the UK and Ireland said that it was the minimum that they could accept and suggested that there was scope for increasing it still further. This suggestion of a further increase received no support, but most Member States were open to the idea of an optional limit and none appeared to be opposed to it. The only serious question raised, by Belgium and Germany, was whether such an option was compatible with the need to avoid cross border distortion of competition and the objective of creating an internal market. Such theoretical questions are very much in character for any initial consideration of a Commission proposal and we would hope for a rather more pragmatic approach in future discussions.

Compulsory Deregistration

5. We did not at this first discussion bring up the subject of compulsory deregistration. We did, however, question the precise meaning of article 1.5 of the proposal (which repeats the text already contained in article 24 of the Sixth Directive):

"taxable persons coming under the exemption scheme may opt either for the normal value added tax scheme or, where appropriate, for a simplified scheme."

The Commission confirmed that this meant that any trader with a turnover below the registration threshold had a right to opt for registration. It would therefore appear that the suggestion for compulsory deregistration included in the consultative paper "VAT: Small Business Review" is contrary to existing EC law. As a consequence if Ministers wished to proceed with compulsory deregistration, and having considered representations made as a result of the consultation document, it would be necessary to secure an agreed amendment to the draft directive. This we suspect may be difficult, if not impossible, to achieve and could well delay for an indefinite period adoption of the Directive. We would therefore propose that initially we should raise this question in bilateral discussion with the Commission and outside the forum of the Financial Questions Group.

Simplified schemes

6. While most Member States agreed with the concept of a community simplified scheme it was apparent from the outset that most, if not all, wished to retain their present schemes. There was therefore little discussion on the detail of the Commission's proposal for a simplified scheme, but on how Member States should notify their existing schemes to the Commission and whether they could continue to use them. We shall in future discussions be as flexible as possible in agreeing the use by Member States of their own schemes, if by so doing we can secure adoption of a Directive acceptable to us.

Future Progress

7. The draft Directive is scheduled to be discussed again at the Financial Questions Group on 18/19 December and we understand (privately) that Belgium will be taking this proposal up in the course of their Presidency.

Conclusion

8. While there is still a considerable amount of detail to be agreed we can allow ourselves some cautious optimism that the Directive will not be assigned to a shelf and that discussion will continue with some prospect of agreement and adoption by mid 1987. We shall, of course, continue to press for a higher optional threshold, but suspect that agreement to any significant increase is unlikely.

P TREVETT

C4/2

FROM: A W KUCZYS
DATE: 27 November 1986

PS/MINISTER OF STATE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Trevett - C&E
PS/Customs

DRAFT VAT DIRECTIVE: SPECIAL SCHEMES FOR SMALL AND MEDIUM SIZED BUSINESSES

The Chancellor has seen Mr Trevett's note of 26 November. He has commented that we have a strong interest in the early adoption of this directive, and should not therefore press the compulsory de-registration option except in the way suggested at the end of paragraph 5 (raising the question in bilateral discussion with the Commission and outside the forum of the Financial Questions Group). If the Commission is not forthcoming, we should then drop it.

AWK

A W KUCZYS

Bring in copy of attachment

From: P TREVETT
Date: 28 November 1986

HM CUSTOMS AND EXCISE
VAT CONTROL DIVISION D
ALEXANDER HOUSE 21 VICTORIA AVENUE
SOUTHEND-ON-SEA X SS99 1AJ
TELEPHONE SOUTHEND-ON-SEA (0702) 348944 ext 6285

PS/Minister of State

Cathy
we didn't get the attachment. I have asked Min's office to let us have their copy when it comes back from the Minister. It will probably be tomorrow. Shall I b/f till tomorrow? — Yes please
Megan 1/12

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
(all without enclosure)

VAT AND SMALL BUSINESSES

X 1 Further to my note of 17 November I now enclose our critique of the Bannock booklet.

You will see that in our view the report is unbalanced and gives the sponsors the sort of report they were looking for (paragraph 21).

P TREVETT

Internal distribution

Mr Knox
Mr Howard
Mr Wilmott
Mr Holloway
(all without enclosure)

I assume para 12 is accurate. This is defensively quite useful, not least in the general context of "They order these things better in France"
PB.

"VAT AND SMALL BUSINESS IN NORTH AMERICA
- A REVIEW OF EXPERIENCE IN EUROPE"

DPU SUMMARY OF REPORT

General

1. This report was prepared by Graham Bannock and Partners Ltd a UK firm of economic consultants. It was commissioned by the Federations of Independent Businesses in USA and Canada. Both the US and Canadian governments are attracted by the revenue-raising potential of VAT and are at present considering the introduction of comprehensive federal systems of indirect taxation. The small firm lobbies in both countries are campaigning strongly against the introduction of VAT, and the issue of compliance costs and their effects on small businesses has loomed large in their campaigns.

2. Bannock's report examines the practical operation of VAT in Europe from the small traders' perspective (drawing heavily on UK experience), and little attempt is made to see things from the administrators' viewpoint. The general proposition is that most of the theoretical advantages claimed for VAT, such as its neutrality and its ability to minimise economic distortions, disappear in practice because of attempts to make the tax less regressive for those on low incomes. These attempts result in greater complexity and tend to create new distortions in production and consumption; the costs of operating the tax, both compliance and administrative, become highly regressive with respect to the size of business. Costs therefore tend to fall most heavily on those small businessmen and entrepreneurs least able to bear them and to whom governments are increasingly looking for the creation of wealth and employment.

3. The report makes much of the disadvantages of VAT compared with a retail sales tax - particularly in the area of compliance costs. Although it is accepted that a retail sales tax at a relatively high rate, say 10 per cent, would involve a greater risk of evasion with less means of control, the author considers this a worthwhile price to pay for lower administrative and, in

particular, lower compliance costs.

Summary of conclusions

4. Bannock reaches four main conclusions:

- although the introduction of VAT need not, in itself, result in higher taxes, experience shows that once the infrastructure has been created few governments have been unable to resist the temptation to increase the rate of VAT;

- although in theory VAT introduces a minimum of economic distortions, in practice it is far from economically neutral in most countries;

- where levied at a uniform rate, VAT is regressive. This regressivity can be reduced by the use of multiple rates and exemptions but only at the cost of increasing the compliance burden and economic distortions;

- both compliance and administrative costs are regressive with respect to size of firm. Measures taken to counteract this effect do not seem to work. VAT and small business do not go well together.

Chapter 1

5. Drawing on OECD data the report highlights the growing contribution made to revenue in European countries from general consumption taxes such as VAT and the declining contribution made by taxes on specific goods and services (excises). It is the rising revenue from VAT in the EC which has excited the interest of the North American governments. The point is also made that in modern democracies public expenditure tends to rise inexorably to the limits of tax and borrowing potential. Because of this the introduction of any new broadly-based tax machinery such as VAT will inevitably lead to higher taxation overall.

Chapter 2

6. This chapter discusses the theoretical advantages and disadvantages of VAT and how these are modified in practice. Bannock remarks that while the advantages of VAT over turnover and wholesale taxes are very clear, the advantages over a general retail sales tax are, in his opinion, less clear cut. The report dismisses the managerial benefits obtained from small traders having to keep better records for VAT purposes as marginal. On the subject of incidence, it argues that although business might bear some of the burden of the tax in the short term, in the long term the tax is fully shifted forward to the consumer.

7. The major disadvantages of VAT cited are its complexity in practice, the new and expensive machinery which governments require to administer it and the heavy compliance costs it imposes upon small firms. Because VAT involves all businesses, not just retailers, the report argues that the total social costs and distortions of a VAT system are very much greater than a retail sales tax would be. Bannock contends that the use of multiple rates and exemptions to relieve special categories of expenditure is so important that: "all the theoretical advantages of the VAT in terms of neutrality towards production and consumption .... go out of the window". This is a rather sweeping statement; although any deviation from the ideal of a simple rate of tax applied to a comprehensive base will tend to increase costs and cause distortions, if the differential rate or rates are restricted to a fairly narrow range of items which are easily identifiable and are not easily substituted for other commodities, the distortions should not be too great. In any event, taking the UK as a guide, the distortions do not appear to be anywhere near as great as this report suggests.

Chapter 3

8. This deals with the history of VAT in Europe and discusses the differences between the systems of the various EC Member States. Referring to the 6th Directive, the report remarks that adherence to the Directive is general but not absolute. In table 3.2 (page 32) Bannock presents two alternative estimates of

the VAT tax base as a percentage of total consumer expenditure in various EC Member States. The first is based on the Commission's notional tax base, expressed as a percentage of total consumer expenditure; the UK with a figure of 95 per cent comes top of the table. The second estimate is Bannock's own; this attempts to isolate and total those elements in consumer expenditure which are subject to VAT and expresses them as a percentage of total consumer expenditure. The UK, at 52 per cent, comes bottom of this table. The report suggests a number of reasons for the wide variations, these include the extent to which certain services are provided by the public sector in the various Member States, and the extensive range of zero-rated items which are included in the first estimate but not the second.

9. Table 3.4 (page 34) gives an interesting breakdown of where the French authorities estimate net VAT payments come from. Bannock compares the French breakdown with what he estimates the position would be if the 6th Directive were fully implemented in France. The major difference is that the proportion of VAT paid by firms would decrease (from 16.5 to 8.6 per cent) while the proportion paid by households would increase by a similar amount. Presumably this redistribution would come about mainly because of the relaxation of the input tax blocking on hotel, restaurant, travel and fuel expenses and business cars.

10. Table 3.5 (page 35) compares the progressivity/regressivity of VAT in a number of European countries by calculating VAT as a percentage of household consumption expenditure for different categories of disposable income. Unsurprisingly the VATs are all mildly progressive, except for Norway which with a single rate of tax and no zero-rating for necessities, has a regressive VAT.

<u>Chapter 4</u>

11. This chapter discusses the operation of VAT in Europe and deals with implementation, administration and its costs, compliance costs, evasion and enforcement. The report claims that the administration of VAT is its least attractive facet. Table 4.1 (page 40) compares the numbers of VAT traders per official in a number of European countries. The range is from 115 (UK) to 267 (Italy). However, as Bannock admits, because of the differences in

administration, methods of control, import regimes, thresholds, etc it is impossible to use the ratios in any meaningful way. In fact a table such as this is more likely to mislead than to inform. On page 41 the report states that the Inland Revenue deals with 387 individual income tax assessments per official employed - "well over three times the number of registered trader per VAT official". This is a highly dubious and misleading comparison. Tax assessments for Schedule D, self-employed taxpayers and limited companies are prepared from the accounts submitted by the taxpayers (or their accountants) and the vast majority go through on the nod; only those with obvious errors or inconsistencies receive any sort of scrutiny. A more meaningful test might have been to compare the number of control visits per control officer with the number of annual accounts scrutinised or queried per IR official.

12. The report discusses compliance costs at some length and draws heavily on Prof Cedric Sandford's work. It compares the effects of VAT on the cash flow of registered traders in the UK and France. Tables 4.4 and 4.5 (page 47) show that UK traders, in general, receive substantially greater cash flow benefits (or "loans") from VAT than do French traders. This is largely because the French regime is less favourable to traders: returns are made more frequently, the grace period is shorter, input tax is not immediately deductible, and repayments take significantly longer to process.

13. On page 48 et seq the report discusses evasion. It agrees that the strength of the VAT system is that it allows routine computer checks to be carried out on the ratio of inputs to outputs and that these help to pinpoint evasion. It also makes the point that although less tax is at risk at each stage of the VAT collection process, there are many more points in the economy at which scope for fraud exists. VAT facilitates input tax frauds and makes it easier for registered traders and their employees to acquire goods for personal consumption free of tax. These possibilities do not (apparently) exist under a sales tax system. Discussing the amount of tax evaded, the report arrives at a figure of 6 per cent of revenue in the UK. This is done by taking the simplistic approach that as only a third of traders are visited each year and underdeclarations from this source amount to approximately 2 per cent of revenue, then the true rate of evasion must be about 6 per cent! Considerations

such as risk analysis, credibility checking and large trader control are totally overlooked.

14. One major point which the report glosses over when discussing evasion is that the detection and assessment of evaded tax are much easier and less laborious when comprehensive purchase records exist. If these records did not exist (as would often be the case with a retail sales tax, since traders would not be obliged to maintain purchase records) there would probably need to be frequent and lengthy visits to suppliers to obtain details of supplies made to the retailer in order to build up a profile of his inputs which could then be compared with his declared sales. To maintain effective control under such a system would entail a great deal of administrative time and effort and could quite possibly swallow up any administrative savings to be had from restricting the tax to retailers only. In any event the amount of tax evaded would almost certainly increase and it would all be "sticking tax".

Chapter 5

15. This chapter analyses the effects of VAT on small firms and concludes that VAT is their greatest burden. On page 59 Bannock takes a swipe at our current series of VAT publications which are: "... to say the least, not easily understood ...".

16. The report once again discusses compliance costs in detail, this time with particular emphasis on the problems faced by small firms. It compares the results of a study on net compliance costs of sales tax for firms in the US (conducted by Peat Marwick - table 5.5, page 61) with Sandford's original work on compliance costs (table 5.4, page 60). The turnover categories in the US study are much higher and this makes direct comparisons difficult, however "small" US firms (less than $1m turnover) had net compliance costs of 0.16 of sales while Sandford's second highest category (£100,000 to £999,999 turnover) had net costs of 0.22 of sales - some 70 per cent higher. This is not surprising since under a sales tax regime retailers would benefit more than the average from the cash flow benefits and, in addition, they would not have the additional work of recording inputs or dealing with multiple rates, etc.

Bannock agrees with Sandford that compliance costs are highly regressive with respect to size of firm.

17. The report also asserts that administrative costs are highly regressive with respect to size of firm. On page 62 Bannock uses a highly specious assumption to arrive at the conclusion that in 1983/84 the administrative costs for the 125,000 traders with a turnover of under £10,000 could be about £7m, compared with £10m of revenue obtained from them. The £7m is obtained by calculating an average administrative cost per trader and multiplying it up. Bannock reluctantly admits that the administrative costs of small traders are probably somewhat less than average; however given the 8 year control cycle, etc I should have thought that, once registration had been effected, ongoing costs for these traders would be fairly low - certainly in absolute, if not relative, terms.

18. The report rehearses all the "Burdens on Business" arguments and then goes on to examine the various special regimes aimed at making life easier for small traders: these include thresholds, flat-rate schemes, compensatory payments, annual assessments, tapering schemes and the elimination of VAT between registered traders. It concludes that all schemes for lightening the burdens on small traders inevitably produce more complexity and distortions, and usually increase the opportunities for evasion.

Chapter 6

19. In this concluding chapter the report attempts to bring the lessons learned from the practical experience of VAT in Europe to bear on the tax policy debate going on in North America. Bannock summarises the case against VAT and nails his colours firmly to the retail sales tax mast. While accepting that a move from direct to indirect taxation is good for small business (because of the adverse effects of direct taxes on incentives), the danger as he sees it, is one of replacing one set of distortions with another. VAT in practice is complex and expensive to administer and small firms bear the brunt of the compliance burden.

20. Turning to the practicalities of introducing VAT in the USA, the report quotes estimates that there would be about 20m registered traders, the administrative costs would be in the region of $700m per annum and the IRS would require an additional 27,000 staff. On the basis of 77 per cent coverage and with a rate of 10 per cent, it is estimated that US VAT would yield about $240 billion per annum - enough to cover the budget deficit. Using Prof Sandford's data the report estimates that compliance costs would be about $10 billion, falling mainly on small traders. By contrast, the report claims that a federal RST would involve much smaller administrative and compliance costs (uncosted), would fit well with state RSTs and would require only one return and audit for both. Bannock accepts that at high rates the incentive for evading the RST would be greater and the scope for control less, nevertheless the savings in compliance and administrative costs would justify the risk of greater evasion. The report makes no attempt to estimate likely evasion or administrative costs.

21. Although Bannock's report is interesting it does not break much new ground. The report is unbalanced and dwells mainly on the disadvantages of VAT as seen through the eyes of the small trader. Administrative considerations are largely ignored or glossed over. Although the report favours a RST rather than VAT, it fails to subject this form of taxation to the same rigorous analysis and while acknowledging that there is a greater risk of evasion with RST at high rates it does not attempt to evaluate the risk, to estimate the additional revenue likely to be lost, or to compare it with VAT evasion. Nor does the report attempt to deal with the difficulties of effectively controlling a RST and the effects this would have on administrative costs. It blandly concludes that "it seems inconceivable that the public costs of enforcing higher rates of sales tax would be greater than those of a VAT system, while the enormous saving in compliance costs would remain". Mr Bannock has in effect given his sponsors precisely the sort of report they were looking for.

DPU

November 1986

FROM: M W Norgrove

DATE: 1 December 1986

MR TREVETT - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
PS/Customs & Excise

DRAFT VAT DIRECTIVE: SPECIAL SCHEMES FOR SMALL AND MEDIUM SIZED BUSINESSES

The Minister of State has seen your minute of 26 November and Mr Kuczys' of 27 November and has asked what the timing would be of a conversation with the Commission on compulsory de-registration please.

M W NORGROVE
Private Secretary

PWA
PW
please
(when
arrive
tomorrow)

MINISTER OF STATE TREASURY

FROM: M W Norgrove

DATE: 1 December 1986

MR TREVETT - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
PS/Customs & Excise

9 see also papers below

CR 1/12

VAT AND SMALL BUSINESSES

The Minister of State was grateful for your note of 28 November covering the DPU's critique of of the Bannock booklet.

The Minister noted paragraph 12 in particular, comparing UK and French systems. He assumes that the information in this is accurate - it is useful defensive material, not least in the general context of accusations that "they order these things better in France".

MWN

M W NORGROVE
Private Secretary

C11/7

UNCLASSIFIED

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Stephen Ratcliffe Esq
Private Secretary to
The Rt Hon Lord Young of Graffham PC
Secretary of State
Department of Employment
Caxton House
Tothill Street
LONDON
SW1H 9NF

3 December 1986

Dear Stephen,

LORD YOUNG AND THE REVENUE DEPARTMENTS

Your Secretary of State met with the Chancellor at 9.30am on Monday 1 December at 11 Downing Street. Also present were the Financial Secretary, the Economic Secretary, the Minister of State, Mr Battishill (Inland Revenue), Sir Angus Fraser (Customs and Excise), Mr Scholar (HM Treasury), Mr Brownlee (Department of Employment) and Mr Twyman (Department of Employment).

Your Secretary of State began by expressing concern about the large number of complaints received concerning taxation matters. The number here was far higher than that in the US for example. Many people were now becoming self-employed or employers for the first time. The tax affairs of these people were far more complicated than for employees. The general impression seemed to be that although the government promoted enterprise, Inland Revenue was against it. In his view there was much more of a problem with Inland Revenue than Customs and Excise where people seemed to understand rather better the problems of VAT. He wondered if there was anything that could be done to change the climate.

Mr Brownlee welcomed the move to VAT cash accounting and annual returns, but was concerned about the £100,000 limit, which he thought needed to be increased, perhaps as high as £½ million. Both he and **Mr Twyman** expressed concern that individuals were unwilling to complain about the tax authorities' treatment of them because of fears of intimidation.

On the question of the £100,000 limit for cash accounting and annual returns, **Sir Angus Fraser** said that Customs had confined the consultative document to a scheme which would be consistent with the EEC draft directive, which had mentioned a figure of 150,000 ECU. The consultative document had received a very good reception. **The Chancellor** added that we were bound by Community directives. To go for a higher limit, only to have to reduce it later would be very bad indeed. **Sir Angus** said that it might be possible at some later stage to go for a higher limit, but at the moment he thought there was everything to be said for £100,000. **The Chancellor** noted that increasing the limit would increase the revenue loss from the scheme. The response to the proposal had been a very good one.

Mr Brownlee said that there was a considerable image problem for both Revenue Departments. He referred to a recent open letter to your Secretary of State in the Accountancy Age Magazine. The letter sent by Customs to individuals on late VAT registration was very formal, and did not explain adequately the appeal procedure. A more "user friendly" letter would be an improvement. **Sir Angus** said that he had seen the open letter to Lord Young. The tone of the letter to individuals had already been changed but there was a need for a certain formality on a matter which could come up in a tribunal or court. In practice there was often some delay in sending these letters.

Turning to your Secretary of State's criticisms of the Inland Revenue, **Mr Battishill** said that it was very difficult to defend against general charges. He was always ready to examine specific complaints. However, he could say that there was no bias against the self-employed. The Keith Committee had looked at all compliance relationships in the Inland Revenue, and self-employment in particular. They had given the Inland Revenue a very good ticket. There was no evidence of harshness either in the instructions inspectors were given, or evidence of harshness in the way these instructions were carried out. The Inland Revenue had some 120 Ombudsmen cases last year. Half of these had led to criticism of the Inland Revenue but only one case concerned the self-employed. It might indeed be the case that individuals were reluctant to complain, but given the amounts of tax frequently at stake he would be surprised if this were the case.

Continuing, **Mr Battishill** said that for the most part the self-employed only had very limited dealings with the Inland Revenue. For every hundred individuals that submitted accounts, 95% were just ticked by the Revenue. Of the remainder, three out of every hundred were simply enquiries about the arithmetic. Only 2% received a proper investigation and in the great majority of these cases underpayments of tax were discovered. He would be grateful if Mr Brownlee could write giving him details of the individual complaints he had mentioned. **Mr Brownlee** said that this would be very difficult. **The Chancellor** said that it really was necessary to see specific examples of allegations of victimisation. The only way to look into this complaint was by individual cases.

Continuing, **the Chancellor** said that he feared that there was no way round the problem of the classification of the self-employed. This had been looked into exhaustively by the previous two Financial Secretaries. The point was that there was a very substantial grey area. There was no easy dividing line. There would always be people who felt they should be self-employed and who were not classified as such. Another problem was that there may not be complete uniformity up and down the country. In some cases the grey areas arose because of contrived arrangements which might or might not meet the necessary tests. If it was thought that the Inland Revenue were trying to stop the growth of self-employment, then they were the most unsuccessful department in Whitehall! He accepted that when an individual went into business for the first time the amount of paper from governments departments to read was very daunting.

Your Secretary of State noted that 200,000 of the unemployed had become self-employed under the enterprise allowance scheme. Many of these would be those who had previously been in the black economy and had now moved into the white economy. There was a great deal of activity outside the Inland Revenue net. His aim was to find a way through this problem and encourage people out of the woodwork. One possibility would be to grant an amnesty.

The Chancellor said that the question of an amnesty had been looked at very carefully. There was no objection in principle, but it would only be effective if, after the amnesty was over, there was a major crackdown. There were not the resources for this at the present time. **Mr Battishill** commented that the most serious barrier was the question of unpaid tax due that had accumulated when individuals were operating in the black economy. On the question of the weight of paper sent to someone setting up a new business a number of steps had been taken to help individuals:-

- Leaflets had been considerably simplified.

- The starter pack for new businesses had been examined in great detail - but much of the remaining bulk was issued on behalf of the DHSS.

- Informally, the procedures had been relaxed a little for the very small business. The Revenue were willing to allow PAYE to build up for three or four months and profits for two to three years.

Your Secretary of State said that he thought it was worth considering with DHSS if anything could be done to simplify these entry procedures further. **Mr Twyman** said that he recognised that there had been tremendous steps forward, but further progress was needed to improve the sensitivity of the Revenue departments' dealings with individual taxpayers. **Sir Angus** said that they had invested more time than almost anyone else in improving letters etc and they had bent over backwards to bring home to tax officials the importance of their approach to individuals. There was survey evidence that individuals did find officers helpful, but one would always expect that people starting up in business would find the VAT system complex.

The Chancellor commented that although much had been done on the starter side, it would be useful to look at it again, with DHSS. On the interface between individual tax officers and payers, improvements could only made by reporting cases of alleged bad behaviour. There were bound to be some cases where complaints were justified, although the instructions to the individual tax officers were very clear. **Mr Battishill** explained that the Inland Revenue had met with the Federation of Self-Employed a little while ago and as a result the Director of Operations at the Revenue was to meet with them every three months. They had been asked to report any cases which had been badly handled and these would then be examined.

Your Secretary of State emphasised the importance of public perceptions. Much had been done to improve the situation, but people were unaware of this. His concern was to remove people from the unemployment count. It was a very difficult change for people to become self-employed and it was important to do everything possible to facilitate this. **The Chancellor** said he was very happy for officials to consider whether anything could be done to improve matters further in the areas which your Secretary of State had covered.

Yours sincerely,

Cathy Ryding

CATHY RYDING

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

FROM: A M FRASER

DATE: 3 December 1986

MINISTER OF STATE

cc: Ch/Ex
FST
EST
Mr Scholar
Mr Cropper

Interesting. This suggests the far an upper limit higher upper limit for cash accounting, we lower phase in a place ASAP – ie in time for the 1987 Budget. So! Should like to know, now, the cost of having various higher limits between £100,000 → 7½m.

CASH ACCOUNTING FOR VAT

At the meeting with Lord Young about taxpayers and Revenue departments, the question arose of whether EC legislation would prevent us from introducing cash accounting above the £100,000 turnover level, if it turned out that we wanted to.

I had said that we proposed a £100,000 limit because, inter alia, that was the equivalent of the level (150,000 ECU) set as a maximum for simplified accounting by the draft Small and Medium Enterprises Directive. Mr Brownlee of the EDU suggested that we would be free to go above £100,000 since, while that was the dividing line below which simplified accounting would be mandatory, a member state would have the option of being more liberal if it wanted to. I was none too sure of my ground on this point, not having the draft Directive with me, and the discussion rested on the conclusion that this was something we would look at in the follow-up to the consultation document.

I find that the 150,000 ECU limit is indeed a maximum in the draft SME Directive, so that it would, as I suggested, preclude extendinq cash accountinq above that limit if we rested on this draft directive. Mr Brownlee may have been thinking, however, of the present 6th VAT directive, and we are looking again at the vires for cash accounting under that directive. Our preliminary view is that if we were to introduce it by that means with a hiqher cut-off point than £100,000, it should be possible to retain this higher level even if the draft SME Directive comes into force, because the latter provides a let-out for current schemes. However, the EC legal background is fairly complex, and it will be best for us to take up this aspect again in more depth, along with all the other factors affecting the dividing line, when we are reporting on the consultation exercise early in the New Year.

A M FRASER

MR 3/94

UNCLASSIFIED

Ry

FROM: CATHY RYDING
DATE: 4 December 1986

PS/MINISTER OF STATE

cc: Financial Secretary
Economic Secretary
Mr Scholar
Mr Cropper
PS/C&E

CASH ACCOUNTING FOR VAT

The Chancellor has seen Sir Angus Fraser's minute to the Minister of State of 3 December, which he found interesting. It suggests that if we are to have a higher upper limit for cash accounting, we have to have it in place as soon as possible - ie it must be in the 1987 Budget. He would be grateful to know the cost of having various higher limits between £100,000 and £½ million.

C.R

CATHY RYDING

PMT

From: R P Wigglesworth
Date: 8 December 1986

1. Mr Waller AW 8/12

Our ref: AN/5

2. Minister of State

cc P/S Chancellor
P/S Chief Secretary
P/S Minister of State
Mr Monck
Miss Sinclair
Mr Waller
Mr Wetherell
Mr Hughes
Mr Cropper
Mr Bolt (C & E)

FREEPORTS

In the attached letter the Minister for Shipping returns to the subject of the possibility of creating more freeports, particularly on the east coast at Aberdeen, Felixstowe or Tilbury.

2. We advised you last time that you should maintain the line that further designations will not be considered by the Government until the present experimental period is completed. The relevant considerations were:

(a) to concede to this request would raise the question why these ports should be chosen and not others of the original unsuccessful candidates (this argument was further strengthened by an approach we had recently from the Industrial Development Officer of the Central Regional Council in Scotland who enquired about the prospects of designating Grangemouth port - an unsuccessful applicant in 1983 - now that Prestwick has ceased to function. We made it clear to him that there is no prospect of additional freeports during the experimental period).

(b) there has been considerable public criticism of the freeport regime and the poorer than expected performance of the present sites (this has not abated).

(c) the Adam Smith Institute, which also supported the introduction of new freeports, had as a precondition that important changes, many of which are unacceptable to HM Customs and Excise, be made in the freeport regime.

3. Lord Brabazon has pressed you to reconsider that approach - though he concedes that the practical problems of designating new sites so late in the experiment might prove insuperable.

4. He says that if you are unable to agree to create more freeports he would settle for an assurance from you that when you are considering the outcome of the experiment you will not let the poor performance of sites such as Prestwick, Cardiff and Belfast colour your judgement of the worth of the experiment as a whole or predispose you to de-designate the other, "successful", freeports where considerable amounts of time and money have been invested in trying to "make a go" of the regime.

Comment

5. We continue to believe that, for the reasons set out above, the creation of new freeports 28 months into a 5-year experimental period should be ruled out.

6. Nevertheless, despite the uncertainty at this stage of what the review of the experiment will show, it seems quite reasonable to assure Lord Brabazon that the failure of some of the freeports will not necessarily result in the withdrawal of the designations of the more successful ones. The Government assumed from the start that there was a possibility that some of the freeports might fail. Mr Hayhoe told the House on 2 February 1984: "If the review shows that any of the sites designated has failed to work well and does not have the opportunity and potential for the future, the Government will take the necessary action" (Col 419). Moreover, in addition to what it tells us about existing freeports, the research should enable us to assess what factors, eg location, airport v seaport etc, determine whether a site will be successful and to apply those lessons in considering the designation of any new freeports (if that is thought desirable).

7. A draft reply conveying those views is attached.

R P Wigglesworth

Draft letter from Minister of State
to Minister for Shipping

The Lord Brabazon of Tara
Minister for Shipping
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

FREEPORTS

Thank you for your letter of 10 November. I continue to believe that there is no case for departing from our existing policy of not designating more freeports during the current experimental period.

You asked for an assurance that the time and money some operators are devoting to making the experiment successful should not be jeopardised because of the poor performance of the other freeports. I think we have always been clear that we will be looking at the performance and prospects of each freeport individually at the time of the 5-year review. (That review should also enable us to look at the factors which explain why some were successful while others were not, and to ask what lessons can be drawn from that.) I can therefore assure you that the failure of some of the freeports will not of itself result in the withdrawal of the designations of the successful ones.

Hon Peter Brooke

LB

ll/s 12 NOV 1986 -3

MINISTER FOR SHIPPING

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB
01-212 3434

My ref: T/PSO/12365/86

Your ref:

The Hon Peter Brooke MP
Minister of State
HM Treasury
Parliament Street
London SW1P 3AG

10 NOV 1986

MINISTER OF STATE
REC. 12 NOV 1986
Mr Wigglesworth
PS/Chancellor
PS/CST
Mr Monck
Miss Sinclair

Mr Waller
Mr Wetherell
Mr Symes
Mr Cropper
Mr Bell C&E
MST

Dear Peter,

FREEPORTS

Thank you for your letter of 10 October about the possible designation of an additional freeport on the East Coast.

I have now had a chance to look at the Adam Smith Institute's review of the freeport experiment, which tends to reinforce my belief that the six sites chosen in 1984 cannot plausibly be presented as a good mix which will enable the freeport experiment to be properly tested. It begins to seem very likely that the 1989 review of the experiment will conclude that nothing worthwhile has been achieved at three of the sites, namely Belfast, Cardiff and Prestwick. This will not tell us anything very much about the applicability of the freeport concept to UK circumstances; it will merely show that these three freeports were in locations where it was unlikely, from the outset, that they would prosper. It is, in fact, fairly clear from the note of the Chancellor's meeting of 31 January 1984 that the final selection of sites was not made exclusively in terms of their suitability as freeport locations.

Ideally, it would be best to designate one or more additional freeports now, in locations where they might reasonably be expected to prosper. The Adam Smith Institute suggest Aberdeen, Felixstowe and Tilbury as possibilities. All three of these sites were short-listed back in 1984 and rejected at the 31 January meeting, for reasons which are not entirely convincing, read with the benefit of hindsight.

However, I appreciate that there are practical problems in the way of designating new freeport sites at this fairly late stage. If you feel that these are insuperable, then I would certainly not wish to press the matter, but I should still be concerned that the investment of time and money in Birmingham, Liverpool and Southampton was being jeopardised by the poor performance at the other three freeports. I should welcome your assurance that this is not the case and that there can be no question of the experiment being judged a failure on the basis of experience at Belfast, Cardiff and Prestwick.

Yours ever,

Ivan

THE LORD BRABAZON OF TARA

SECRET

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023....

From: P G WILMOTT

Date: 10 December 1986

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Mr Peretz
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey

WILMOTT → ACSA 10/12

CONSUMER CREDIT TAXES

This is to confirm that, at your request, we are accelerating the timetable for submission of a progress report on our preparatory work in this area. Our aim is to put up a paper by close on 15 December, so as to allow more time for discussion with Ministers before Christmas (this is, in our view, important if options are not to be closed off by a combination of the passage of time and working assumptions we are having now to formulate for the preparation of legislation). The purpose of our submission would be to present Ministers with an account of our thinking so far - which is showing some perhaps significant

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Internal circulation: CPS, Mr Knox, Mr Jefferson Smith, Mrs Boardman differences from the 1984 exercise - and with our assessment of the wider economic and political issues that our research is uncovering. We hope that a brief discussion with Ministers will not only give us a steer on some of the choices to be made but will also enable Ministers to check whether the project as it now stands still accords with the objectives set at the Chancellor's meeting on 18 November.

P G WILMOTT

From: P TREVETT
Date: 11 December 1986

TE

HM CUSTOMS AND EXCISE
VAT CONTROL DIVISION D
ALEXANDER HOUSE 21 VICTORIA AVENUE
SOUTHEND-ON-SEA X SS99 1AJ
TELEPHONE SOUTHEND-ON-SEA (0702) ~~XXXXXX~~ 366285

Minister of State

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

DRAFT VAT DIRECTIVE: SPECIAL SCHEMES FOR SMALL AND MEDIUM SIZED BUSINESSES

1. In his note of 27 November, Mr Kuczys said that the Chancellor agreed that the question of compulsory deregistration should first be discussed bilaterally with the Commission. You have asked when such a discussion is likely to occur (Mr Norgrove's note of 1 December).

2. The next meeting of the Financial Questions Group to discuss this draft directive is scheduled for Thursday 18 December, and I propose to take the opportunity to see the Commission on Wednesday 17 December. At this meeting I shall explore the Commission's views on compulsory deregistration. In addition I shall also follow up the suggestion made by Mr Brownlee of the EDU that neither existing EC law nor the draft SME directive preclude us from setting a higher limit for cash accounting than the £100,000 currently proposed (Chairman's note of 3 December).

3. On my return from Brussels I shall, of course, inform you of the outcome of my meeting with the Commission.

P TREVETT

Internal distribution:

CPS	Mr Butt	Mr Hewett
Mr Knox	Mr McFarlane	Mr Topping
Mr Howard	Mr Cockerell	
Mr Jefferson Smith	Mr Holloway	

Confederation of British Industry
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Director-General
Sir Terence Beckett CBE

Secretary
Maurice Hunt

1. Debbie - Personal folder
2. Awaiting advice but to be aware
CE 11/12.

CBI
INDUSTRY YEAR 1986

CH/EXCHEQUER
REC. 11 DEC 1986
ACTION MST 11/12
COPIES TO

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London SW1P 3AG

I think that the Chancellor should consider the MST version of this ASAP. I would also be grateful for Lord Young's experience @ the small business angle.

Dear Chancellor

VAT: Partially Exempt Businesses

In August Customs and Excise published proposals for changing the law on how much input VAT should be repaid to businesses whose outputs are only partly taxable. We have replied to Customs in detail, but we wish also to bring to your own attention certain aspects of the proposals that go beyond what is necessary and would impose an extremely heavy compliance burden on business.

Before itemising these features, let me say that we accept that under the present rules more input tax is sometimes repaid than Parliament intended, and that some remedy seems desirable; but the task of judging the need is made difficult by no figure for the Customs loss having been published, so that it is impossible for us to compare the size of the problem with the remedy.

Our first criticism concerns the proposal to bring the new rules into force on 1 April 1987. This is far too short a lead-time, and we believe that many companies would be unable to comply with it. The new requirements are not yet known.

Our second criticism is directed at the proposed obligation on businesses to analyse their inputs according to whether the resultant outputs are taxable or not taxable. This is a threshold, or "de minimis", test, and would have to be carried out even if the result showed that all the input tax could be repaid. An analysis and attribution of input tax is an entirely new requirement; it would need a new procedure to be set up and staff of a fairly high calibre. It would be imposed on any business that had exempt outputs, however small they might be.

For companies that did not pass the threshold test, the standard calculation of what input tax could be repaid would require a high degree of analysis of inputs and matching with outputs. In addition, its arithmetical rules are capricious: little input tax will be repayable if little can be related specifically to taxable outputs, even if most of the outputs are taxable. Again it makes a big difference to what proportion of input tax is recoverable, whether most inputs are positive-rated or zero-rated.

Customs have said they expect that most companies found to be partially exempt will opt for a special method, so that any deficiencies in the standard method are not a serious matter. Our view is that a standard method ought to be fair and workable.

Next there is the lack of precision about what the present abuses are. Some are identified in the consultation paper and others have been identified in discussion. But we disagree with the apparent Customs view that where several companies make a group election for VAT, there is inevitably an "abuse" if the result is that more input tax is repaid; sometimes it is indeed an abuse, but in most instances not.

Rather similar is the fact that the Customs paper says that some businesses make "distortive" taxable outputs, but does not indicate why basing the test on input tax would improve the position.

Our recommendation is that Customs should publish revised proposals that take account of the views they have received, that the new proposals should specify the abuses they are aimed at, and that a far greater effort should be made to minimise the compliance burden and confine it to the smallest possible number of businesses.

Yours sincerely

Alan Willingale

A E Willingale
Chairman, Taxation Committee

ED50QPKJW92L

CONFIDENTIAL

Subject to MST's views, this does not look a sensible starter for the 1987 Budget; but this reinforces the attraction of the corporate side CGT package. N.

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: B H KNOX

Date: 12 December 1986

Minister of State

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
Mr Spence - IR
PS/IR

Ch
This doesn't say anything about timetable for decisions (I suspect because Customs regard it as a non-runner). In spite of problems French raise £2 bn and Germans £1 bn. (Customs do not, of course, know about possibility of integrating CGT). AA

A POSSIBLE INSURANCE PREMIUM TAX (IPT)

– Extract attached.

At the Chancellor's tax planning meeting on 22 September we were asked to do further work on this, specifically giving an account of how IPTs work abroad and considering the problems of potential avoidance (particularly of the off-shore variety). We have consulted administrations in France, Germany and the Netherlands, and we are waiting for a written response from Canada. We have also talked to the Department of Trade and Industry, as sponsors for the insurance business, and to the Inland Revenue, who have a good deal of experience on other aspects of insurance. The attached paper records the main points of interest in the sizeable volume of material culled from our research in Europe; the rest of this note summarises the essential points to emerge from all our consultations. I am sorry not to have reported earlier: the staff engaged on this project are also working on other Budget matters.

Internal distribution: CPS, Mr Jefferson Smith, Mr Wilmott, Mr Bone, Mrs Hamill.

Foreign IPTs

2. You will see that practice differs between countries, both as to coverage and to rate structure. No doubt had we gone further afield, we would have found still more variations. Despite all the differences, we see two crucial common elements. First, each country has taxed insurance for many years. This means that there is now no political argument about whether it should be taxed. Second, no country has been able to insert into the tax system a satisfactory mechanism for countering off-shore avoidance. The barriers to insurance going off-shore have nothing to do with the tax system: they are declared as either exchange controls or consumer resistance to foreign insurance (and, in the case of the Germans, as the improbability of people seeking to avoid tax). There is a third barrier, which administrations did not discuss in detail: namely the restrictions in the European insurance market, which of course the UK is keen to liberalise, and which this month's European Court judgment will do much to break down.

Off-shore avoidance

3. In our view the prevention (or, at least, the satisfactory containment) of avoidance is central to the good operation of an IPT. But the more we study it the less we think that the tax could be ring-fenced. The experience of our European partners is not encouraging. And there are two factors which are likely to make matters worse here. First, the UK insurance industry is on a much bigger scale and operates in a much more international market than any other. Second, the UK already has well-developed off-shore operations.

4. On the corporate front, it would be possible under existing insurance company structures for domestic insurance to be switched abroad to be written tax-free; but the existence of the tax would also provide an incentive for insurance companies to establish themselves in, eg, the Channel Islands and would give a boost to the foreign 'captive' insurance market (when subsidiaries of large companies are set up to deal exclusively with the insurance of their parent firms). If private individuals chose to insure with a company wholly established off-shore (ie more than just a 'poste restante') there would be no

tax trail for us to follow. Without draconian powers of enforcement to counter these possibilities, we do not think we could police an IPT adequately in either the corporate or the personal sector. Even with such powers there would be no guarantee that we could keep the lid on avoidance. For example, there would be a route for tax avoidance through the exemption of re-insurance, since risks could be insured abroad and re-insured here. (The DTI warned us not to underestimate the capacity of the insurance industry to devise methods of circumvention.) A tax open to the sort of manipulation which we can foresee would be neither equitable nor reputable.

Other issues

5. Revenue Quite apart from the possibility of the tax-base being eroded by business moving off-shore, we think that the revenue estimate of a full-year yield of half a billion pounds at 1987-88 prices from a 5% tax is likely to be on the high side. DTI analysis of the £8.4 billion gross premium income in 1985 shows that a significant (though unfortunately unquantifiable) proportion of property and general liability insurance is written in the UK for foreign risks. If this were to account for a quarter of the total, then after making an allowance for the resulting reduction in other tax receipts (direct from companies, indirect from consumers), the net yield could be more like £300 million.

6. There is however a further twist, since to the extent that insurance companies moved off-shore, the Inland Revenue's yield from income tax and corporation tax would be reduced. We cannot compute the risk, but it is not impossible that the losses on the direct tax side could off-set or even outweigh the gains on the indirect.

7. Tax base Our earlier note suggested that there should be exemption from tax for life assurance, international insurance like marine aviation and transport (MAT) and re-insurance. As a result of our consultations we think that this remains broadly right, in theory anyway. Much life assurance is essentially saving, and, political awkwardness aside, to tax it in contrast to other forms of saving would not be equitable. For the rest we take it as

axiomatic that it would be wrong to impose tax on non-UK risks. Taxing MAT and the like would be an effective tax on exports (London has about half of the total world MAT market.) Because much re-insurance is of non-UK risks taxing re-insurance would entail taxing exports or double taxation. The DTI registered a strong preference for excluding life assurance from the tax and they were in no doubt that the UK market would lose a lot of business if MAT and re-insurance were not excluded.

8. On the assumption that life assurance would be exempted the Inland Revenue advise that the exemption should apply to all long term business (as prescribed in the Insurance Companies Act 1982), ie including capital redemption (eg saving in the form of endorsement insurance or towards an annuity) and permanent health insurance (not annual BUPA agreements but minimum 5-year contracts). This is because of the conceptual problem in distinguishing between certain types of long term business at the margin. The Revenue suggest that such a borderline would be easily identifiable. On the international front, however, our enquiries lead us to think that the borderlines could not be so straightforward. We see real difficulty in separating out UK risks from foreign risks in some large areas. A good example of this is product liability where, for example, a British company might seek worldwide indemnity. It is not clear where the risk lies. A related problem would occur with the foreign multinational which has extensive risks to be insured in this country as well as elsewhere. The location of the insurance contract and the currency in which it was drawn up need not, in commercial terms, bear any relation to the location of the business which is insured. Any rules which we could devise to impute a liability to tax in these circumstances would be complex and likely to give rise to dispute, with difficulties for both companies and our officers.

9. An alternative approach would be to seek to exempt corporate premiums altogether, so that tax fell solely on the domestic consumer. This would reduce (but not eliminate) the probability of insurance going off-shore, since individuals may be presumed less likely than big business to look outside the UK for cover. It would also cut out many of the problems in distinguishing between UK and foreign risks. However, it would roughly halve the tax-base (though,

because there would be no off-setting direct tax losses, the net yield might be reduced by only a third), and it would reduce much of the business costs associated with the tax. But the introduction of a new borderline would give rise to a different set of demarcation and administrative problems in distinguishing between business and personal insurance and might increase compliance costs for the insurance industry; there could well be difficulties with small businesses, particularly those not registered for VAT.

10. Lloyds There is one other main area where we foresee problems, and that is with Lloyds. Apart from the 500 or so insurance companies with which we would have to deal (on the assumption that companies concerned exclusively with life and MAT were not in the net), there could be about 200 Lloyds syndicates to be controlled. We have considered the possibility of controlling Lloyds through their central Policy Signing Office, but we understand that as currently structured it would be unlikely to be able to act as a suitable focal control point. Even if it were, however, the fact remains that in formal terms the insurers are the "names" - some 30,000 of them - and in practice it could be necessary, particularly when disputes arose, for us to deal with them individually. The Inland Revenue tell us that this is becoming a problem area in dealing with Lloyds names, which they have already mentioned to Ministers. We see little chance of our being able to proceed smoothly where they have so far been unable to.

11. EC Internal Market As you know, one important objective for the UK in completing the internal market is the liberalisation of insurance, which may move forward now following this month's European Court judgment (which effectively allows insurers to sell into a Member State without a physical presence there). We should record that the DTI consider that the introduction of an IPT here would complicate and could jeopardise progress on the insurance directive. They do not think that the non-existence of a tax would prove a stumbling-block. (This contrasts with the German view that a harmonised IPT would be a desirable concomitant to a liberalised insurance market.)

12. VAT There is one further EC point. The Sixth Directive precludes the application of VAT to insurance. As you will see from the annex, the French are attracted to the idea of changing the rules so that they could tax insurance through the VAT system. In our view their chances of success are very slim. We do not see VAT as a realistic alternative to an IPT either now or in the foreseeable future.

Conclusions

13. We have considerable reservations about introducing a tax on insurance. The potential revenue yield could be severely undermined by losses on the direct side, and we can see no acceptable way of containing off-shore avoidance. We do not think that the European experience is a particularly good guide to what would happen here: partly because they have had insurance taxes for a long time, but more importantly because a) both their consumers and their industries tend to accept, in a way that the UK would probably not, regulatory and other constraints that aid collection of the tax, and b) the insurance industry in this country is on a totally different scale. We have become very aware in all our discussions of the increasing internationalisation of the insurance business; there is no sign that the trend will slacken; and we see a good possibility of the tax inducing movement of insurance away from the UK, with resultant economic distortions and loss of overseas earnings.

Bryce Knox

B H KNOX

INSURANCE PREMIUM TAXES IN EUROPE

1. Between 28 and 30 October we visited Paris, Bonn and The Hague to discuss with administrations the introduction and operation of their insurance taxes. We had sent beforehand a thorough questionnaire, and for the most part our discussions followed the questions in it. (A copy of the questionnaire is attached.)

2. The essential features of the three taxes are shown on the attached summaries. They vary widely in scope, tax rates and (therefore largely) in complexity. The French tax is particularly complicated. All have been in place for so long that there are no useful records of their introduction or any problems which may have cropped up at the time.

3. Both German and Dutch versions of the tax are cheap to operate. The French were unable to disaggregate the effort expended on IPT from that on other taxes. We could not elicit any estimate of 'burdens on business': the concept is not a familiar one on the Continent. However, we were led to believe that there were few problems in that sphere. Both the Germans and the Dutch allow small insurance companies to make quarterly returns instead of the normal monthly; by contrast the French have a system of 2-monthly returns with tax payable 6 weeks after the end of each period, allowing quite a cash-flow advantage to all insurers.

4. All three countries relied on factors external to the tax mechanism to minimise off-shore avoidance.

H M CUSTOMS & EXCISE

December 1986

CONFIDENTIAL

INSURANCE PREMIUM TAX: QUESTIONNAIRE FOR OTHER ADMINISTRATIONS

A. Basic facts

1. When was the tax introduced?

2. Why was it introduced?

3. What other taxes are levied on the insurance industry (eg payroll tax)?

4. What was the reaction to the tax - from the industry, political parties, economic commentators?

5. What is the tax base?

6. Are there any exclusions; if so, why?

7. What are the rates of tax? (If variable, why?)

8. How often do rates change?

9. What is the yield?

10. Does the yield increase faster than inflation?

11. What proportion of Government revenue from taxation does it represent?

12. How does the tax work?

B. Mechanics

1. How long was it between announcement and introduction of the tax?

2. What consultations were there between tax authorities and the industry?

3. What legislative difficulties were there (eg definitions)?

4. How do tax authorities determine whether or not a particular type of insurance is subject to a particular rate?

5. How do tax authorities treat

    a) taxation of foreign insurance for domestic risks?
    b) taxation of domestic insurance for foreign risks?

6. What control and enforcement mechanisms are there?

7. How many staff are employed to administer and collect the tax?

8. How does that number compare with

    a) initial estimates?
    b) the number required to introduce the tax?
    c) numbers employed on other taxes?

9. What use do authorities make of computers to operate the tax?

C. Effects

1. What effect has there been on the volume of insurance?

2. What proportion of the tax falls on business/private consumer/other?

3. Is there any estimate of the cost to the insurance industry of operating the tax?

4. Are there any benefits to the industry, eg prolonged use of revenue collected before transmission to tax authorities?

D. Problems

1. Are there difficulties in definitions and borderlines?

2. Does the existence of variable rates make those difficulties worse?

3. What is the scope for tax avoidance?

4. Is foreign insurance particularly difficult to tax?

5. How do tax authorities counter avoidance?

6. What other problems have been encountered?

7. What other problems may lie ahead?

INSURANCE PREMIUM TAXES

Country	France
Brief history of tax	Latest tax dates from 1944, but insurance subject to a variety of state imposts since 1850.
Tax base	In principle all premiums (and associated charges) on all domestic risks.
Exemptions	a) Exports (including export elements of MAT). b) Life assurance which can be defined as saving. (In practice the great bulk of life assurance appears to be exempt, not least because of reliefs for occupational groups.) c) Agricultural insurance.
Tax rate(s)	'Standard' rate is 9% of total premium, but there are nine other rates depending on type of risk. They range from 0.25% to 30%. The most frequent rate is for car insurance: 18%, but because of other hypothecated levies (for accident funds and so on) the true rate is about 35%.

Yield (£ million, approx)	1985: 2,000 (of which nearly three-quarters from car insurance)	Yield as % of Central Govt taxation	1.8%

Treatment of off-shore insurance

Tax due on domestic risks, whether insurer based in France or abroad. Foreign insurers obliged to appoint a representative in France who is personally responsible for paying tax. Most effective weapon against off-shore avoidance is exchange control.

Comments

Not an example which we would wish to follow. The multiplicity of rates is unattractive. The high effective rates, on car insurance in particular, lend themselves to competitive distortions. (We learnt for example that as many as one million households run cars without any insurance. Apart from being illegal, this has potentially grave social implications.) There are large distortions in favour of farmers, and the rules on life assurance have massive loop-holes. Enforcement by means of exchange controls would not be practicable in the UK.

The French are aware of the deficiencies in the tax and would much prefer to include insurance in the VAT regime. This carries its own disadvantages, as to achieve the same yield (after allowing for deductible input tax) the VAT rate would have to be set at 50% for car insurance.

INSURANCE PREMIUM TAXES

Country	Germany
Brief history of tax	Premium tax dates from 1922, but there were stamp duties before then.
Tax base	In principle all payment for all insurance (ie premiums and associated charges), including exported insurance in the form of MAT.
Exemptions	"Social" insurance, such as health, life and unemployment insurance Re-insurance Small farmers' animals insurance.
Tax rate(s)	In most cases 5% of total premium. For ships' hulls it is 2%. There is a 5% extra levy on fire insurance. And a special rate of 0.02% of the sum insured for hail insurance.

Yield (£million, approx)	1985: 900	Yield as % of Central Govt taxation	1.5% (0.8% of federal and states' total)

Treatment of off-shore insurance

The insured is obliged to declare insurance abroad to the Finance Ministry and to pay tax on the premiums. There is no control mechanism to enforce this, although some cross-checking is possible through, eg, income tax returns. Level of off-shore insurance thought to be low at present.

Comments

This appeared to be a reasonably efficient and buoyant tax, with two drawbacks. The first is in coverage, where the non-exemption of MAT can lead to some double or even triple taxation. The second is in off-shore avoidance, where there is effectively no control. When pressed, the Germans conceded that the main bar to insurance going off-shore was the fact that most people would want to insure risks in their native country. However, they found it difficult to contemplate insurance going off-shore with the object of avoiding tax. They recognised that a more liberal market in European insurance would mean more off-shore insurance, and to avoid distortion of competition they favoured a harmonised IPT throughout the Community. They had no thoughts about how this would prevent insurance going outside the EC.

INSURANCE PREMIUM TAXES

Country	NETHERLANDS
Brief history of tax	Premium tax dates from 1972, when a revenue-neutral package of tax changes was brought in. Previously there were stamp duties.
Tax base	In principle all premiums (and associated charges) on policies taken out in the Netherlands or on risks situated in the Netherlands.
Exemptions	Life assurance Accident, health and unemployment insurance MAT Re-insurance Export credit insurance.
Tax rate	7%

Yield (£million, approx)	200	Yield as % of Central Govt taxation	0.5%

Treatment of off-shore insurance

The insured is obliged to declare and pay tax on insurance taken out abroad. There is no control mechanism to enforce this, although some cross-checking, eg via company taxation, should be possible. Scope for off-shore insurance thought to be low at present, but domestic law due to be liberalised on 1 January 1987.

Comments

This was the simplest and cheapest to run of the three tax systems studied. However, officials showed a disarming lack of concern about a couple of key aspects. First, the revenue yield is not particularly buoyant (it declined in real terms during the early 1980s when the tax rate was 6%, and there appears to have been a further fall in volume when the rate went up to 7% in 1983). Second, there is no effective control over off-shore avoidance. The Dutch are aware that a freer market will increase the possibility of avoidance but they see no real way to deal with it.

RC6.5

UNCLASSIFIED

Rwp

FROM: CATHY RYDING

DATE: 12 December 1986

PS/MINISTER OF STATE

cc Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

PS/IR
Mr Jefferson-Smith - C&E
PS/C&E

VAT: PARTIALLY EXEMPT BUSINESSES - LETTER FROM CBI

The Chancellor has seen the letter from Mr Willingale, Chairman of the Taxation Committee of the CBI.

2. The Chancellor would like to see the considered advice the Minister of State receives on this as soon as possible. He would also be grateful if the Minister would look especially at the small business angle.

CR

CATHY RYDING

SECRET

CONSUMER CREDIT TAX AND PAYMENT CARD TAX

I. INTRODUCTION

1. At your meeting on 18 November you asked for a feasibility study to be done on a package which would include the eventual introduction of an across the board consumer credit tax; to be preceded by a separate tax on credit cards alone, which would try to combine two conflicting considerations: first, that revenue was received quickly; and second, that it followed similar principles to the eventual consumer credit tax into which it would be merged.

Timing and implementation

2. Our subsequent work has underlined the large number of uncertainties against which planning must proceed. Under conditions of Budget security, we have consulted the Office of Fair Trading (OFT), the Inland Revenue, the Department of Trade and Industry (DTI) and the Bank of England. But these are unlikely to be able to provide all the detailed facts and figures which will be required. In particular, we are unlikely to be able accurately to predict the total number of traders requiring to be controlled, their size or their working methods. As a result, it will be difficult to arrive at final decisions on a number of facets of the tax (de minimis limits; and control and collection methods). We shall therefore need to prepare legislation on the best assumptions available, in order for it to be published as part of a consultation exercise after the Budget announcement, in the light of which we shall need to be prepared to amend the legislation as the Finance Bill progresses through the House up to, and including, Report Stage. As the basis for this consultation exercise, we propose to:

(a) include as many of the detailed provisions (on machinery, accounting etc) as possible in secondary legislation, following the VAT precedent. Even so, up to 20 pages of Finance Bill space could be needed.

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(b) Publish draft secondary legislation at the same time as the 1987 Finance Bill, as the basis for consultations.

3. We have little firm information on the time likely to be required by lenders to implement either tax. One of the reasons for delay present in 1984 - the additional heavy calls then placed on their computer resources by MIRAS - should no longer apply. Nevertheless, the advice we have received from the Bank of England and DTI officials suggests that:

(a) Card operators would require six months from the date at which the details of the tax were completely clear to implement any separate credit card tax that followed similar principles to the eventual broad-based tax. We take this to mean about six months from 1 July 1986. ?!

(b) Lenders generally should be able to implement a broad-based tax, possibly by 1 April 1988, or, certainly from 1 July 1988. 1 July 1988 would allow longer for consultation and implementation, and an opportunity to revise the primary legislation in the 1988 Finance Bill should this prove necessary. Because of the many uncertainties and complexities, we would prefer a 1 July 88 start, but this would lose three months yield.

II. SEPARATE CARD TAX

Case for a separate tax

4. No matter what its scope (see paragraphs 8-10 below) basis or duration, any separate card tax is likely to produce additional distortions and hostilities, and some disruption of the card sector. DTI advise firmly against it on these grounds; but in the Bank of England's view, these distortions could be lived with provided that the tax was clearly intended to be short-lived and applied only to "extended" credit. It would also complicate the legislative requirements. In practice, a card tax based on the same principles as we recommend for a broad-based tax but beginning on 1 January 1988 would not produce any revenue in 1987/88 and only £50 million additional revenue in 1988/89 as compared with a 1

But could charge a much higher rate?

SECRET

April 1988 start or £100 million as compared with a 1 July 1988 start. It would not therefore be possible both to obtain revenue from a separate card tax in 1987/88 and base it on similar principles to the eventual broad-based tax. A separate card tax for 1987/88 is feasibile only as a quick and simple revenue raiser: if you wish to proceed with it we suggest that it is justified on revenue grounds and as an earnest of your intention to extend the tax base in the consumer credit area.

Form of a separate tax

5. If immediate revenue is required, we think that this could be achieved best by imposing a once-for-all levy on card operators based on the number of cards in issue immediately prior to the Budget Announcement. A levy of £5 a card would produce up to £150 million in 1987/88 (on the assumption that both charge and credit cards and retailers' in-house equivalents are included). A poll tax on these lines would be comparatively simple and certain, would impose low compliance costs and be capable of providing a full year's revenue in 1987/88. By basing it on the number of pre-Budget holdings, we would avoid any opportunites for the tax-base to be eroded by card holders surrendering their cards. Payment could be at any time after Royal Assent, but during the financial year. Delaying the payment until, say, 1 January 1988, would allow card operators reasonable time in which to pass on the levy to card holders in whichever way they chose to do so, before having to account for the tax.

Necessary to get revenue but tricky. time.

6. As against this, a poll tax on these lines would bear little resemblance to the eventual broad-based tax except in respect of the types of cards covered; it could be represented as retrospective; and as unfairly burdensome on one sector of consumer credit. On the other hand, a yield of £150 million would amount to no more than three-quarters of that which would be obtained from a 1% levy on total repayments under the broad-based tax; and there is considerable evidence that lenders have found the card sector to be one of the most profitable forms of providing credit.

NB. (Bk Tm)

& fast-growing

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7. Depending on how the card operators chose to pass on a poll tax, it could be criticised also as bearing unfairly on;

(a) Holders of cards who make little use of them to obtain credit (This would be most marked in the case of Barclaycard, which in addition to providing a credit facility is also the only cheque guarantee card provided to Barclay current account holders; a proportion of Barclaycard holders, therefore, probably only use their cards as cheque guarantee cards, and could thus claim to be being unfairly penalised);

(b) Holders of multiple cards on a single account (for example where husband and wife have separate cards on the same account); and

(c) Businesses providing expense accounts for employees.

The only case for which we could easily provide some mitigation would be in respect of multiple card accounts. It would be possible to charge the poll tax on the basis of accounts rather than cards, but this would reduce the yield from about £150 million to perhaps £110-120 million, and could merely exacerbate criticisms from other types of holders. Overall, we think that if a poll tax is preferred, it should be presented primarily as a revenue-raiser of as broad and simple a nature as possible.

Card Tax : Coverage

8. Whether or not there is to be a separate tax, a decision will be needed on the scope of any tax on cards. The options are to draw the line so as to either:

(a) tax all credit and charge card (and retailer in-house equivalents) transactions which do not involve immediate payment; whilst excluding, for example, cash debit or cheque guarantee cards which involve an immediate debit; or

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(b) tax only those credit-card transactions (and retailer in-house equivalents) which incur interest as "extended credit"; whilst excluding any transactions (for example charge cards) where the amount is paid off in full before interest is incurred.

seems right.

We recommend that any tax be levied on all credit and charge card transactions not involving immediate payment. The statistics available suggest that in practice there is considerable overlap between charge and credit cards. Although most charge cards require the account to be settled in full each month, operators are increasingly offering linked interest-bearing "extended credit" facilities. Bank of England figures suggest that 90% of additions to credit card balances are repaid within the interest free period, whilst DTI advise that at any one time as many as 40-45% of credit cards are being used in effect as charge cards. Any narrower base, therefore, could give rise to distortions within the card sector, and allow considerable erosion of the tax base, and DTI advise strongly against it on these grounds.

even "interest free" cards levy a penalty for late payment!

9. As against this, the Bank of England strongly support the exclusion of charge cards and "interest-free" balances of credit cards, on the grounds that these are essentially payment rather than credit transactions. In practice, however, it is hard to see the justification for deeming such transactions to be purely concerned with payment, when non-cash alternatives such as cheques are readily available, and the card holder obtains up to 6-7 weeks before payment; to public perception, this would clearly amount to "credit".

10. Exclusion of "interest-free" card transactions might appear to be on all fours with our proposal to exclude certain other forms of "interest-free" credit provided by retailers (see paragraph 26 below). In practice, however, the latter normally recoup the cost of providing such credit through increased prices - which will normally be subject to VAT. Charge card operators recoup their costs through charges to retailers and card holders which are exempt from VAT. To exclude them also from the loans tax, therefore, could be argued to unfairly increase their relative tax advantages over rival forms of credit.

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III. BROAD-BASED TAX

<u>Basic Coverage</u>

11. We recommend that the legislative provisions should follow those for VAT by applying the tax to "all loans made by a registered lender in the UK, in the course or furtherance of any business carried on by him, unless either the loan or the lender is specifically exempted." The definition "loans made in the course or furtherance of business" will by itself exclude many loans (such as those between blood relatives, and many loans by charitable and public bodies). The extent of any further exemptions will need to be defined in detail, and will be the subject of a separate more detailed submission. In the interest of minimising the scope for avoidance, simplifying the tax structure, and maximising the revenue base, we recommend that the scope of any exemptions be kept to a minimum consistent with the main purposes of the tax.

Paragraphs 12 to 26 below consider the main options on which decisions in principle are required.

<u>Definition of "in the UK"</u>

12. One of the areas which may give rise to substantial definitional and avoidance problems is territoriality. It will be necessary to ensure that the tax applies to:

(a) Credit provided by a UK-based business to a UK resident in respect of goods, property etc purchased in the UK.

(b) Credit provided by a UK-based business to a UK resident in respect of goods, property etc purchased outside the UK.

(c) Credit provided by a UK business to a non-UK resident in circumstances similar to (a) above.

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(d) Credit provided by a non-UK business to a UK resident in respect of purchases in the UK (eg a loan from a bank based in the Channel Islands for house purchase in the UK).

In order to ensure that all these come within the legal scope of the tax, we would need to base the rules governing the "place of supply" initially on those in force for VAT (which relate to a supplier having a business establishment or his usual place of residence in the UK). This would not, however, catch off-shore suppliers of credit by post (including potentially many credit card companies and mail order houses). In order to catch these, we would need, additionally, to apply the tax to loans which are enforceable in the UK courts. It would be necessary to qualify such an "enforceability" borderline by special provisions covering, for example, instances where a loan's inherent enforceability in the UK may have been removed by the working of other UK legislation (such as the Consumer Credit Act 1974), or where international agreements provide for mutual enforceability.

13. A wide definition of this type would minimise the number of potential legal loopholes. In practice, also, it is questionable whether a low rate would provide a sufficient incentive for the establishment of large-scale artificial avoidance measures. But there could still be scope for considerable enforcement problems, and we will need to give further thought to the need for special powers (for example to act against UK associates of offending off-shore subsidiaries or companies).

Loans for business purposes

14. Whatever the eventual scope of the tax, it will be necessary to define and police an exemption for loans for business purposes. We see considerable potential for definitional and avoidance problems, particularly in respect of loans to the self employed and loans for cars and vans. There is a VAT precedent for treating all loans for cars and vans as consumer credit; but in practice, we

doubt whether it will be possible to wholly overcome these, except, for example, where business loans are clearly secured on the business.

15. As in 1984, we envisage that it will be necessary to require some form of certificate or contractual declaration of the "business use" together with his VAT registration number (where appropriate) to be provided by the borrower to the lender as the basis for applying the exemption. Requirements in this area would be related as closely as possible to existing Inland Revenue definitions and practices. Special arrangements may be required for cars.

16. An alternative would be to adopt DTI's proposals to amend the Consumer Credit Act (CCA) so as to exclude business loans as the legal basis for defining those loans which fall outside the tax's scope. But it is not at present clear whether time will be found for the necessary legislation to amend the CCA before the beginning of the tax, and a legal definition on these lines would not obviate the need for basic enforcement provisions.

De minimis exemption

17. We also consider that it will be necessary to impose some form of de minimis limit in order to reduce the number of potentially registrable traders and the staff resources required. There are few statistics available and it may not be possible to reach a firm conclusion on the optimum level in advance of the post-Budget consultation exercise. OFT advise that they have some 70,000 traders registered under the CCA; even allowing for those registrations which are moribund or out of date, the potential trader population, for a broad-based tax is in the order of 50,000. We estimate that we could require an additional 300-500 staff in order to control all these on a similar cost/revenue ratio as that for VAT. However, such statistics as are available suggest that a high proportion of the potential revenue will be paid by a relatively small proportion of the traders; possibly in the region of 90% being paid by under 10% of traders. Certainly the 50,000 potential traders will include many occasional and small lenders, and we think that we could substantially reduce the control effort

by imposing a de minimis limit, without a proportional effect on the revenue yield. If, for example, the trader population could be reduced to 10,000, the additional staff resources required would probably be up to 200. In deciding on the actual level it would be necessary to balance such potential control savings against the possibilities for creating distortions, or new opportunities for avoidance. We consider, however, that avoidance can be successfully minimised by suitable anti-dis-aggregation rules. We seek approval in principle for planning to proceed on the basis of a de minimis limit, and authority to undertake more statistical work (if necessary in discussion with the Business Statistical Office).

Treatment of existing fixed-rate loans

18. There is also the question whether existing fixed-interest credit should be exempted at the start of the tax. This hinges on who is intended to bear the tax burden: the borrower or the lender. We assume that in the majority of cases where lenders are free to do so they would choose to pass on most of the costs of the duty to the borrower. But there will be a particular problem in respect of loan contracts entered into before the announcement of the new duty, at fixed rates of interest. At any one time these account for between one-quarter and two-thirds of consumer credit (other than mortgages). But the majority of contracts are short-term and would dwindle away over a three year period. In addition, DTI advise that in a proportion of cases the terms of so called variable contracts would not be sufficiently elastic to allow them to be changed so as to reflect a new tax (as opposed, for example, to a change in the MLR). Some of these contracts could be long-term. Similar problems could recur at the time of any change of rate, although it is likely that future contracts would be drawn up so as to accommodate changes.

19. The options are:

(a) Taxing all existing contracts, without any provision for relief. This would mean relying on the generally short-term nature of fixed-interest credit to minimise the cost which would actually have to be absorbed by lenders. It is difficult to calculate how great this burden would be, but our best estimate is that with the starting date of 1 July 1988 possibly in the order of one-quarter of the outstanding credit (excluding mortgages) at the start of the tax would have been taken out at a fixed rate before Budget Day 1987. This suggests that lenders would not have to absorb a severe burden if there were no exemption, with a 1 July 1988 starting date; but by the same token the cost of any exemption would be relatively small. However, the position could vary considerably between lenders and the lack of any relief could give rise to increased criticism, both from lenders and from borrowers with variable-rate contracts.

(b) Taxing all existing contracts, but providing in the legislation (on the lines of Section 42 of the VAT Act 1983) for lenders to adjust the interest charged under existing contracts so as to recover the new duty, should they so choose. This would avoid similar problems recurring whenever the rate is changed. But it could have presentational difficulties at the start of the tax, by appearing to place the burden squarely on the shoulders of the borrower, and it would almost certainly give rise to a number of individual hard cases where borrowers were unable to meet the new requirements. It would need to be presented as placing the onus on the commercial judgement of lenders in deciding how much of (what would be a relatively small additional burden) they choose to pass on.

(c) Providing for a specific relief for any contracts entered into before the Budget announcement which cannot be adjusted to take account of the tax. This would avoid either the lender or the borrower (or both) having the original basis of the deal undermined. In the absence of detailed information on the number of variable-term contracts potentially involved, it is not possible to provide a firm estimate of the likely revenue cost. But on the assumption that the problem will be largely confined to fixed-rate contracts, and that the tax would be introduced on 1 July 1988, the potential cost would

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be £25-35 million in 1988-89, (assuming 50% of a full year yield), £35 million in 1989-90, dwindling to less than £15 million in 1990-91.

20. In the interest of providing a longer-term solution, we would recommend a Section 42 VAT Act 1983 approach. (Option (b)).

Other possible exemptions

21. Detailed decisions on the scope of other possible exemptions will depend on whether in principle the tax is intended to fall:

(a) simply on "consumer credit" as narrowly defined; or

(b) more generally on loans other than for business purposes.

In practice, many of the loans made by or to those bodies which might seek absolute exemption would be placed outside the scope of the tax by the operation of:

(a) the requirement that in order to be taxable loans must be "made in the course or furtherance of business", and

(b) any de minimis limit set at a reasonably high level.

22. Any specific exemptions would inevitably increase liability and avoidance problems, and the level of staffing which would be required. In general they are likely to be intrinsically more distortionary and any individual concessions can be expected to lead to fresh pressure from other interests. As a general approach, therefore, we would recommend against more specific exemptions, even though this might entail including more than pure "consumer credit" in the tax base. In practice, provided the rate of any broad-based tax is low, the additional burden on such bodies can be regarded as de minimis; any significantly higher rate would increase both pressure for specific exemptions, and the likelihood that such exemptions would be exploited for general avoidance.

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23. VAT experience suggests that the pressure for other exemptions for specific types of borrowers and lenders, would be based on arguments such as:

(a) Their activities are on a par with business borrowers;

(b) the burden of the tax would otherwise fall on the public sector (and potentially on the PSBR);

(c) they are not in the "business" of lending; or

(d) they enjoy some form of relief under VAT or direct tax provisions.

24. The 1984 proposals anticipated specific additional exemptions for:

(i) Loans made to or by public bodies (including local authorities) where these are not excluded by the "course or furtherance of business" test - similar to those provided for VAT.

LA mortgages?

(ii) Loans to (but <u>not</u> by): Corporate bodies
Charities
Trade Unions
Political, Religious or Philanthropic bodies

(iii) Loans by employers to employees at non-commercial rates; and

?? Why?

(iv) Loans made by or to Credit Unions under the Credit Unions Act 1979.

25. It will be necessary to give further thought to the detailed issues in this area. Our initial view, however, is that some form

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of relief may well be needed for:

(a) loans to public bodies (in order to avoid imposing additional public sector costs); and

(b) loans by employers to employees (in order to avoid both increasing the number of traders requiring to be registered and potential inconsistencies with the direct tax treatment of such loans). Any such relief would need to be carefully defined in order to minimise the potential for tax erosion. In general terms, we would expect that the tax would need to apply to all loans to employees except for those which are relieved from income tax.

?

With the exception of loans by employers to employees, we do not see any strong case in equity for excluding any loans by bodies listed in paragraph 24, which are "made in the course or furtherance of business". In certain cases, for example local authority mortgages, there are strong arguments in favour of loans by such bodies being taxable. The question of how far loans to such bodies (other than public bodies) should be excluded from the scope of the tax depends primarily on how far you wish to limit the coverage of the tax to pure "consumer credit". Any general relief on loans to charities and similar bodies could call into question their treatment under VAT, where there is no general relief by the status of the recipient.

Treatment of "interest-free" credit

26. As in 1984, we propose that in general the tax should not apply to "interest-free" arrangements where VAT is payable on a price which has been enhanced to allow for the cost of credit; or to any hire or rental agreements which already bear a VAT charge. Supplies under hire purchase, conditional purchase or credit sale agreements which are exempt from VAT would be subject to the loans tax.

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Basis of the tax charge

27. It will be necessary to decide on what basis the tax should be calculated. Previous proposals assumed that this would be on the basis of the amount of outstanding credit at particular points in the tax period. This would potentially provide the largest basis for computing the tax charge, and hence require the lowest rate to obtain sizeable revenue (a rate of half percent would produce £1 billion in a full year). It would, however, have a number of disadvantages. If passed on to the borrower, a uniform tax on the amount outstanding would have a non-uniform impact on different types of borrowing. In particular:

(i) A 1% rate on the outstanding stock, if simply added to the interest rate on loans, equates to a higher tax charge proportionate to the interest on loans carrying an interest rate of 12% (mortgages) - equivalent to a VAT rate of 8.3% - than to loans with an interest rate of 30% (credit cards) where it would be equivalent to a VAT rate of 3.3%.

(ii) A recurring tax on outstanding capital could bear unfairly on endowment mortgages (where the amount of capital outstanding remains constant throughout the life of the loan), as compared with repayment mortgages (where the amount of outstanding capital gradually decreases).

But IT relief favours endowment mortgages.

In addition, an outstanding credit basis would require relatively complicated tax rules concerning, for example, the treatment of bad debts, and the time of supply.

28. We therefore propose that the tax should instead be calculated on the basis of payments received by the creditor during a tax period. DTI and the Bank of England both favour this. It has the advantages that:

(a) It is closer to the VAT model.

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(b) On the assumption that any form of payments-based tax would include interest charges in the basis for computing the tax base, a payments basis would reduce the variations identified at (i) of paragraph 27. This would be most markedly the case if the tax was calculated on interest charges alone (as the Bank of England would prefer). However, including both capital and interest payments in the basis would make it possible to largely eliminate distortions of the type identified at (ii), whilst mitigating those identified at (i).

(c) it probably more readily accords with lenders' normal commercial records.

(d) It would avoid the need for a bad debt relief, and, provided that capital payments were included in addition to interest in the basis for computation, it could require simpler tax rules on points such as valuation.

29. As against this, the base for computing the tax charge would be smaller than for outstanding credit and the tax rate accordingly higher. The precise rate required would depend on precisely what payments are included. If repayments of both capital and interest were to be included, a rate of 1% would be required to produce £1 billion in a full year. The scope of the payments charge will need to be the subject of a further detailed submission. The main points to be decided are likely to be:

(a) Whether repayments of capital (in addition to interest) should be included in the tax base.

(b) Whether any interest element in the repayments should include or exclude income tax; and

(c) whether any other elements should be included (for example, card operators' charges to retailers and card holders, and insurance premiums for endowment mortgages).

Our initial view is that it will be necessary to draw the definition as widely as possible, in order to maximise the potential advantages.

EC Obligations

30. It has been suggested that doubts might be cast on whether a tax on either a repayments or an outstanding capital basis would be compatible with the UK's obligations under Article 33 of the EC Sixth VAT Directive against introducing new turnover taxes. The advice we have received to date is fairly optimistic that it will prove compatible, since, in the past, Article 33 has not been taken to preclude the possible introduction of, for example, a single stage local sales tax. The legal position is not entirely clear, however, and we are seeking urgent advice from the Law Officers.

Machinery and Enforcement

31. For any broad-based tax, we envisage similar machinery to the VAT model. The legislation would need to require traders to register (subject to any de minimis registration and de-registration limits), and to account for the tax at quarterly intervals, with one month to pay. As in the case of VAT, there would need to be special rules for the registration of partnerships, clubs and associated companies, anti dis-aggregation measures, change of duty rate provisions, and provisions to allow the use of commercial accounting periods. Traders could be divided into separate stagger groups on the VAT model, if the numbers require, but any such staggers would reduce the first-year yield. We would hope to be able to provide sufficient computer facilities for the central register and accounts from existing resources at the Betting Duty Computer Centre at Manchester; day-to-day control would be laid to local officers.

32. As the figures in paragraph 17 above indicate, the amount of additional staff resources required to control a broad-based tax would depend crucially on how far the potential trader population could be reduced by a de minimis limit. Given a relatively high limit, our initial view is that we could operate the tax with perhaps 200 additional staff. We could need considerably higher

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numbers (300-500), however, should the number of registered traders rise to significantly more than 10,000.

33. As far as possible, we would wish to prescribe the detailed requirements for administering and collecting any broad-based tax by regulations. The primary legislation, however, would need to set out the necessary enforcement and offence provisions. These will necessarily be complex, and will need to be the subject of a separate detailed submission. In general terms, however, we would envisage following the post-Keith VAT model. This would involve greater reliance on civil rather than criminal sanctions, and in particular on some form of additional payment for late payments or underdeclarations. The main alternatives would be:

(a) To try to model powers and penalties more on the excise duty model, pending decisions on how far these should be changed to met the Keith proposals. Legislation on Keith in the excise area, however, is unlikely before 1988 at the earliest. In any case, the new tax will be much closer to VAT than to the more traditional excise duties on goods.

(b) To declare loans made by persons who have failed to register or fully account for the tax unenforceable in the courts. This would probably require such traders to be shown on the register of the Director of Fair Trading. We are currently considering the potential usefulness of this with OFT. Our initial view, however, is that although "unenforceability" is likely to be of some use as a sanction, this is likely to be limited, and to involve some costs (including some additional staff for the OFT).

34. In the event of a separate card tax being introduced, card operators would be required to register separately in advance of the main-registration exercise for the broad-based tax; the card tax register would then be subsumed within the main register.

HM CUSTOMS AND EXCISE
15 December 1986

SECRET

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

KNOX → CH/EX 15/12

From: B H KNOX

Date: 15 December 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobie
Mr Tyrie
PS/Inland Revenue
Mr Coleby - Bank of England
Mr Graham -
Parliamentary Counsel

Ch
Meeting on this on Friday
But may like to see in advance.

Dancing. Grateful for quick reactions of Mins & advisers in writing prior to mtg. N.

TAXES ON CONSUMER CREDIT

1. At your meeting on 18 November you commissioned further work on consumer credit taxes. The aim was to work on a package comprising a consumer credit tax constructed broadly on the lines of that designed in the exercise aborted in 1984, and a temporary tax on credit cards. The latter was intended both to fill the revenue gap created by the unavoidable delay before the permanent tax could build up to its full yield and (by demonstrating a structural link with the permanent tax) to serve as an earnest of the Government's desire to take action on consumer credit.

Internal distribution: CPS, Mr Jefferson Smith, Mr Wilmott, Mrs Boardman, Mrs Smith, Mr MacLachlan, Mr P V H Smith, Mr Butt, Mr Mier.

SECRET

2. Our project team started work on 25 November, and have produced the attached paper summarising progress to date. That paper, together with this covering note, constitute in effect the "feasibility study" that you asked for. They outline the tax schemes as we expect them broadly to turn out and pick out the various issues which Ministers will wish to consider in reaching a decision whether or not to proceed to the next stage of development. This also provides a convenient point for Ministers to review the tax in the light of its original objectives (revenue raising, and the exertion of some downward pressure on the demand for consumer credit).

3. In very broad terms, the taxes as outlined in our report could yield revenue of the following order:

			(£m)
	1987-88	1988-89	1989-90
temporary card tax	150	-	-
consumer credit tax	-	500*	1000

still quite a slow build-up

* assuming a 1 July start.

(The size and robustness of the consumer credit tax yield depends crucially on the continued inclusion in the base of mortgage lending.)

We expect lenders to pass both taxes on to borrowers, though the temporary tax is likely to be very much more perceptible than the permanent tax, which could be hidden in the interest charge. This has implications for the effects of the tax on consumer behaviour; since the yield is comparatively small in comparison with the volume of credit transactions, it is the perceptibility of the tax that may be of more effect in affecting demand.

4. In our research so far we have experienced considerable difficulty in obtaining the facts and figures we need. We are continuing with our efforts, but it seems likely that under conditions of Budget security it will be impossible to obtain all the information necessary to be confident of our

proposals for the permanent tax. Particular problems have arisen in trying to establish the number of traders to be controlled, their size, and their working methods. This affects the design of the tax (de minimis limits; control methods and priorities; tax collection mechanisms, etc) and the assumptions we have to make about avoidance, evasion and enforcement. As a result, we think a twin-track approach is unavoidable (ie simultaneous legislation and consultation).

5. We shall prepare primary legislation on the best assumptions avilable, and publish the draft clauses as part of a consultation exercise after the Budget announcement. As much detail as possible will go into secondary legislation, but will still need to be published in draft as early as possible. In the light of the response to the published proposals, we shall need to be prepared to amend the Bill and the draft Regulations as the Finance Bill progresses through the House (the latest opportunity for change being, of course, Report Stage). This risks being messy procedurally, and lays the tax open to perhaps more criticism, special pleading and amendment than might otherwise be the case.

6. If Ministers accept the disadvantages inherent in this way of proceeding and decide to move to the next stage, we require a decision on the form of the credit card tax. Our paper argues that the card companies could not have a simulacrum of the permanent tax up and running before January 1988, and that on revenue grounds at least a "quick and dirty" one-off tax in 1987-88 looks a better prospect. It could of course still be presented as a forerunner of the consumer credit tax, though the argument may be weaker than with a tax closer in structure to the full credit tax.

7. Unless Ministers decide to abort the exercise at this stage, we shall also need very early guidance on a range of issues identified in the accompanying paper. They are as follows:

a) Should planning proceed on the basis that the broad coverage of the tax will be as outlined in paragraphs 8 to 26 of the note? In particular:

(i) Should there be exclusions for extra-territorial loans and loans for business purposes as described in paragraphs 12 to 15?

(ii) Should there be a de minimis limit designed to minimise the number of registered traders (paragraph 17)?

(iii) Should the legislation include a provision on the lines of Section 42 of the VAT Act 1983 to allow lenders to vary the terms of fixed-interest loans?

(iv) Should the borderline of the tax with "interest-free" credit be drawn as in paragraphs 8 to 10 and 26?

(v) Should other exemptions be kept to a minimum (paragraphs 21 to 25)?

b) Should planning proceed on the basis that the broad-based tax should be calculated on a payments received basis rather than an outstanding credit basis (paragraphs 27 to 29) and that any definition of "payments" should be widely drawn?

c) Should the enforcement and machinery provisions broadly follow the VAT model (paragraphs 31 to 34)?

Because of the tight planning schedule, we are already working on the assumption that the answer to all these questions is yes, and with the passage of time alternative options will inevitably (and rapidly) be closed off. Early decisions will therefore be essential if Ministers favour approaches that differ from our working plan.

Bryce Knox

B H KNOX

RC6.10 CONFIDENTIAL PWP

FROM: CATHY RYDING
DATE: 15 December 1986

PS/FINANCIAL SECRETARY

cc Chief Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR

A POSSIBLE INSURANCE PREMIUM TAX (IPT)

I have minuted out separately that the Chancellor does not think that a possible insurance premium tax (Mr Knox's minute to the Minister of State of 12 December) looks a sensible starter for the 1987 Budget. However, the Chancellor thinks that this reinforces the attraction of the corporate side of the CGT package.

CR

CATHY RYDING

RC6.11

CONFIDENTIAL

FROM: CATHY RYDING
DATE: 15 December 1986

PS/MINISTER OF STATE

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
Mr Spence - IR
PS/IR
Mr Knox - C&E
PS/C&E

A POSSIBLE INSURANCE PREMIUM TAX (IPT)

The Chancellor has seen Mr Knox's minute to the Minister of State of 12 December.

2. The Chancellor has commented that subject to the Minister of State's views, this does not look a sensible starter for the 1987 Budget.

CR

CATHY RYDING

~~BIF 16/12~~

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P Jefferson Smith

Date: 15 December 1986

MINISTER OF STATE

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
PS/IR

VAT : PARTIALLY EXEMPT BUSINESSES - LETTER FROM CBI

1. The letter from Mr Willingale, Chairman of the CBI Taxation Committee, is undated but appears to have been written before he attended the meeting with the Chancellor on 9 December. He may feel better able to accept the timing of the proposed changes now that he knows the scale of the present avoidance problem.

2. The proposed de minimis rules, combining generous monetary limits and selective exclusions, are intended to remove the vast majority of small businesses from the partial exemption net and enable other businesses to establish their position with relative ease. For those who will be partly exempt we will continue to operate the special method option in a sensible manner; with our limited control resources we too have a vested interest in systems which are economic to administer and verify.

Internal circulation:

CPS Mr Knox Mr Howard Mr Bazley Mr Michie

234/12/86

3. These points and others raised in the letter were covered in more detail in my submission to you of 11 December and if you decide to go ahead with an early announcement using the draft PQ answer followed by the suggested reply to the written question from Mr Jerry Wiggins then the answers to all of Mr Willingale's queries will all have a public airing before he gets your reply to this letter. We suggest the attached reply to Mr Willingale, to go at the same time as the announcement.

P Jefferson Smith

DRAFT

A E Willingale Esq
Chairman, Taxation Committee
Confederation of British Industry

Thank you for your letter on the subject of the proposed changes to the rules governing recovery of VAT input tax and in particular the potential compliance burdens on business.

I was glad to note your acceptance that action is necessary to curtail the present scale of avoidance which you may recall was one of the topics discussed at the meeting with the Chancellor on 9 December. We believe that the anti-avoidance measures which we now intend to introduce will result in increase of VAT revenue of £300 million in 1987-88 and £400 million in a full year. Avoidance of this magnitude demands a prompt response and that is why we intend to introduce the changes with effect from 1 April 1987. An announcement is being made today.

The proposed new de minimis rules have been devised in order to be as generous and simple as possible while not open to manipulation and substantial revenue loss. There will be generous monetary limits for the benefit of small businesses and a list of certain exempt supplies which may be ignored by businesses will be readily able to establish whether or not they are eligible for de minimis treatment without having to make detailed calculations.

Where partial exemption calculations have to be made, there will inevitably be compliance costs but the businesses involved will for the most part be large, with well developed accounting systems. While the proposed new partial exemption rules lay down a standard method, as you correctly observe, many businesses will either continue to use or will opt for a special method. The criteria for these special methods will be that they are practical, accurate and fair. Past experience is that in almost every case Customs and Excise have been able to agree, either with a trade association or individual business, a basis of calculation which utilises existing information systems and thereby minimises compliance costs.

Given the need for early action to stem existing abuse and to give the maximum possible notice of our intentions to those businesses who will be affected and need to make their preparations there has not been time for a second round of discussions. Nevertheless Customs remain available to discuss any implementation problems and possible special method options put to them.

From D J HOWARD

Date 16 DECEMBER 1986

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

Is there any reason why the turnover limit shd not start @ £100,000, & be raised by £100,000 a year to £500,000 in year 5, thus spreading the once-for-all cost? NL.

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

Minister of State

CASH ACCOUNTING FOR VAT

Ms Ryding's note of 4 December recorded the Chancellor's views on Sir Angus Fraser's note of 3 December and asked about the costs of having limits between £100,000 and £500,000 for cash accounting.

attached

2. The figures in the attached annex update and expand those given in Mr Knox's minute of 22 August. The three turnover bands illustrated are the ones for which records are available, and are now based on 1985 figures, rather than those for 1984 on which the earlier estimates were based. The detailed calculations show the potential costs if all eligible traders were to take up the cash accounting option. Assuming a more realistic 50% take-up - broadly in line with the initial responses to the small trader questionnaire we issued in October - our best estimates are that the approximate costs would be:-

Turnover limit	Once-and-for-all cost (£ million)	Continuing annual cost (£ million)
£100,000	40	7
£250,000	75	15
£500,000	110	22

Internal distribution:

CPS	Mr Trevett	Mr Goddard	Mr Holloway
Mr Knox	Mr Fryett	Mr Hogg	Mr Hewett
Mr Jefferson Smith	Mr Huband	Mr Wilmott	

3. The arrangements to introduce cash accounting (and annual accounting) are well in hand and Parliamentary Counsel has been instructed to draft the necessary Finance Bill clauses on a contingency basis. At the present we are continuing to assume a threshold of £100,000, but this will be a matter for later decision by Treasury Ministers taking account of the following factors:

- the revenue cost as set out in this minute;;
- responses to the consultation paper, a full analysis of which will be provided in the New Year following discussion with the Enterprise and Deregulatiopn Unit; and

- the EC vires for a threshold higher than £100,000. On this Mr Trevett is to have an initial discussion with the Commission tomorrow (his note of 11 December).

attached

We shall provide considered advice in due course.

D J HOWARD

ANNEX

COST OF INTRODUCING CASH ACCOUNTING FOR VAT

	Turnover not £100,000	Exceeding £250,000	(cumulative) £500,000
Number of payment traders	645,000	840,000	920,000
Potential market (after exclusion of those currently enjoying the equivalent of cash accounting for output tax)	235,000	305,000	340,000
Estimate of revenue loss (once-for-all effect in <u>all</u> potential users opt)	£75m	£145m	£225m
Interest cost (annual) (assuming 10%)	£7.5m	£14.5m	£22.5m
Increased evasion (annual) (assuming 5%)	£1m	£1.25m	£2.25m
Bad debt relief (annual) (excluding that currently allowed)	£6m	£12m	£18m
Total annual cost (100% take-up - rounded)	£15m	£30m	£45m

In arriving at our estimated costs we have made the following assumptions:

a. a delay of six weeks in payments of bills, so delaying 1/8 of annual revenue from the target population, and

b. as no accurate data is available for bad debt relief, 1 per cent on the revenue received has been used.

SECRET

RC6.12

PWP

FROM: CATHY RYDING

DATE: 16 December 1986

CR → PS/CST 16/12

PS/CHIEF SECRETARY

cc Financial Secretary
Economic Secretary
Minister of State
Mr Cropper
Mr Ross Goobey
Mr Tyrie

TAXES ON CONSUMER CREDIT

The Chancellor has seen Mr Knox's minute of 15 December.

2. The Chancellor would be grateful for quick written reactions from Ministers and Advisers, copied to officials, prior to Friday's meeting.

CR

CATHY RYDING

1. Alex
2 meeting for consumer credit tax

CROPPER → CH/EX 17/12

3215/15

CONFIDENTIAL

FROM: P J CROPPER
DATE: 17 DECEMBER 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Ilett
Mr Knox
Mr Ross Goobey
Mr Tyrie

You asked for a quick reaction to Mr Knox's minute of 15 December on a Credit tax.

2. Although I was one of those who argued that the UK financial sector was under-taxed in comparison with that sector of the economy subject to VAT, I have to say that the proposals set out in Mr Knox's minute are most unappealing.

3. I think a credit card tax would be as unpopular as a window tax. If anybody tried to charge me £5 per card (directly on indirectly) I would immediately give up my recently acquired TSB card and all but one of my Midland cards. Perhaps it would be just as well; too many cards and they become a nuisance. But some people make great use of them and I do not think they represent a very good taxable object.

4. I have always thought that a transactions tax was more sensible than a credit tax, and the present paper confirms that view. A transactions tax would be a closer parallel to VAT than would a credit tax. I prefer a very broadly based impost, at a very low rate, on an extremely wide range of transactions - and then only if it can be

made to yield at least £2 billion a year, preferably £5 billion. A sum like that would help us to get the basic rate down quite significantly.

5. At the level of detail, I see hideous problems in trying to discriminate between loans for private purposes and loans for business purposes, eg cars and vans.

P J CROPPER

3361/25

SECRET

FINANCIAL SECRETARY TO THE TREASURY

FROM: JEREMY HEYWOOD
DATE: 18 December 1986

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR
Mr Knox - Customs & Excise

TAXES ON CONSUMER CREDIT

The Financial Secretary has had a quick look at Mr Knox's minute of 15 December and the attached paper, in advance of the Chancellor's meeting tomorrow.

2. Provided that mortgages are included in the consumer credit tax, the Financial Secretary would support its introduction, although he believes that its detailed effects would inevitably be rather arbitrary at the margin. He agrees with Mr Cropper that it would be difficult in practice to discriminate between loans for private purposes and loans for business purposes.

3. The Financial Secretary sees the main attraction of the broader tax as being its potential as a revenue-raiser in a relatively under-taxed sector. He would advise, however, that we would need to consider the consumer credit tax in the context of the other measures, currently under consideraton for inclusion in

the Budget, which might also affect the financial sector. The Financial Secretary does not believe that the tax would have a perceptible effect on the demand for credit.

4. Whilst generally supporting the broader credit tax, the Financial Secretary sees little attraction in a credit card tax. The latter would seem to him to do little to prepare the way for the former. It would not bring in, as proposed, substantial sums of money; it would doubtless be unpopular; and it would appear to suggest that the Government wanted to discourage an efficient method of transaction. To introduce for one-year an impost of this nature for no demonstrably sensible reason would appear to be ill-advised.

J.H.

JEREMY HEYWOOD
Private Secretary

ps4/13H SECRET

MINISTER OF STATE TREASURY

FROM: MINISTER OF STATE
DATE: 18 December 1986

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobey
Mr Tyrie
PS - C&E
Mr Knox

MST TO CH/EX 18/12

CREDIT TAX

This is a very quick reaction to the Credit Card/Consumer Credit Tax latest paper. I have been a consistent protagonist of a tax on consumer credit, and the latest paper does nothing to deter me absolutely, though it offers a leper's squint at the complexity. If I have understood matters correctly and am being offered the option of a transactions tax at the initial credit card tax stage, I would much prefer that to a poll tax on cards. At the latter consumer credit stage, my answers to the questions asked are essentially "yes". It is the buoyancy of the tax that attracts me, plus certain Polonian tendencies. I am resigned to having to sign lots of letters.

MWMayfrat

for **PETER BROOKE**

SECRET

For individuals, tax on interest (ie paid, as well as received by)
For companies, interest tax-deductible

FROM: F CASSELL
18 December 1986

CASSELL TO CH/EX 18/12

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Ilett
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
Mr Knox)
Mr Wilmott) C&E
Mr McGivern, IR

CONSUMER CREDIT TAX

May I offer two brief comments, reflecting discussion with colleagues here, on the Customs' paper we will be discussing at your meeting tomorrow.

First, the second stage - "broad-based" - tax outlined in the paper looks far more attractive than the proposals for the first stage "once-for-all levy" on cards. A levy based on the number of cards in issue seems a very inefficient way of raising revenue. It would surely be much better, and fit in with what is envisaged for the second stage, to impose a tax on the <u>interest</u> charged by the operators to their customers. In very crude terms it looks as though there is about £3 billion outstanding on credit cards that is subject to interest (ie beyond the interest-free period). At an interest rate of 25 per cent this would suggest a tax base of about £750 million. A 10 per cent tax would therefore yield about £75 million in a full year - not a vast amount, but a useful one. If you wish to pursue two-stage approach further, it would be worth examining the feasibility of levying the tax in this way. Probably only about 20 card operators would be involved.

Second, if the second stage tax were also based on interest payments it would fall more lightly on mortgages than on the more expensive forms of credit. This seems attractive - not least in terms of its effects on the RPI. Again in very broad terms, a 10 per cent tax on interest payments might yield about £2 billion gross or say £1½ billion net. Or a full year PSBR effect of £1 billion could be secured from a tax of around 7 per cent (which would be equivalent to adding at most 1 percentage point to the mortgage rate).

This looks to many of us the most promising way of developing a credit tax. But obviously a lot of work will be needed by the Treasury, Customs and the Bank before we could be reasonably sure of its feasibility.

F CASSELL

FROM: A ROSS GOOBEY
DATE: 18 DECEMBER 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Cropper
Mr Tyrie

ARG → CH/EX 18/12

TAXES ON CONSUMER CREDITS

You asked for reactions to Mr Knox's minute of 15 December.

2. There is no point in having a pro tem credit card tax as a precursor to a full consumer credit tax unless it raises revenue in 1987-88. This would suggest the £5 flat fee for all true credit cards (both extended credit and payment cards) on that one-off basis.

3. The consumer credit tax would surely not attempt to cover capital repayments? (Para 28).

4. The Economic Secretary's proposal that the tax would be levied on a percentage of interest debited to a borrower in a period (quarterly or yearly) seems to have been lost. This scheme is fairer than the flat rate and, I am certain, could be introduced without straining the systems of the lender; he has to declare his interest revenue in any case and adjustment to interest charges seem to be made with great facility by credit card, bank and mortgage lenders who should, therefore, be able to introduce such a tax very rapidly.

5. Although interest-free credit would be caught by VAT on an associated supply of goods, other lending for unspecified purposes interest-free (for share investment for instance) would not. Take, for example, the Koranic system of "lending" where, to avoid the strictures against usury, the sum repaid is merely higher than that borrowed without a specific interest rate being mentioned.

The legislation would therefore have to capture any associated commissions or premia.

6. If there is <u>any</u> possibility of a Consumer Credit Tax being ready in 1987-88 (even for part of the year), which I am far from convinced is impossible, then I would resist the Credit Card Tax, which is perverse in some of its behavioural effects.

7. I am not familiar with the relative workings of the Customs and Inland Revenue, but since the Revenue must pick up interest credits to lenders in their tax returns, is it necessary to duplicate the information source?

ARG

A ROSS GOOBEY

CHANCELLOR OF THE EXCHEQUER

RP

C/

I am sorry I haven't shown you this sooner. I had understood the MST was going to do something more on the small business angle (see my minute of 12 Dec) His office now say that this point is covered in Today's announcement. Also attached are all the letters from the MST that have gone out today.

Thanks

CR 19/12

Cc PS/CHANCELLOR
PS/CST, PS/FST, PS/EST
MR SCHOLAR
MS SINCLAIR
MR CROPPER
PS/ IR
PS/ C&E
MR JEFFERSON SMITH

Treasury Chambers, Parliament Street, SWIP 3AG

A E Willingale Esq
Chairman
Taxation Committee
Confederation of British Industry
Centre Point
103 New Oxford Street
LONDON WC1A 1DU

19 December 1986

Dear Mr Willingale,

Thank you for your letter on the subject of the proposed changes to the rules governing recovery of VAT input tax and in particular the potential compliance burdens on business.

I was glad to note your acceptance that action is necessary to curtail the present scale of avoidance which you may recall was one of the topics discussed at the meeting with the Chancellor on 9 December. We believe that the anti-avoidance measures which we now intend to introduce will result in an increase of VAT revenue of £300 million in 1987-88 and £400 million in a full year. Avoidance of this magnitude demands a prompt response and that is why we intend to introduce the changes with effect from 1 April 1987. An announcement is being made today.

The proposed new de minimis rules have been devised in order to be as generous and simple as possible while not open to manipulation and substantial revenue loss. There will be generous monetary limits for the benefit of small businesses and a list of certain exempt supplies which may be ignored by businesses will be readily able to establish whether or not they are eligible for de minimis treatment without having to make detailed calculations.

Where partial exemption calculations have to be made, there will inevitably be compliance costs but the businesses involved will for the most part be large, with well developed accounting systems. While the proposed new partial exemption rules lay down a standard method, as you correctly observe, many businesses will either continue to use or will opt for a special method. The criteria for these special methods will be that they are practical, accurate and fair. Past experience is that in almost every case Customs and Excise have been able to agree, either with a trade association or individual business, a basis of calculation which utilises existing information systems and thereby minimises compliance costs.

Given the need for early action to stem existing abuse and to give the maximum possible notice of our intentions to those businesses who will be affected and need to make their preparations, there has not been time for a second round of discussions. Nevertheless Customs remain available to discuss any implementation problems and possible special method options put to them, and I would of course be happy to see you myself if that were thought relevant or useful.

Yours sincerely

Peter Brooke

PETER BROOKE

I have taken the liberty of signing this though yours was to the Chancellor, since I would be involved in a future meeting: I know of course that you saw the Chancellor on the C.B.I. occasion, when I was away in Strasbourg in connection with the Community Budget. P.B.

CC PS/CHANCELLOR
MISS SINCLAIR
MR CROPPER
PS/C&E
MR JEFFERSON SMITH

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Roger Moate Esq MP
House of Commons
LONDON SW1A OAA

19 December 1986

Dear Roger,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views, and those of Bobby Neame of Shepherd Neame Limited, on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

These discussions have been invaluable in the process of refining the original set of options into what is now considered to be a set of workable proposals which will effectively block major avenues of tax avoidance without imposing an excessive compliance burden on business. I attach a copy of a Written Answer being given today which sets out what steps we propose to take.

In responding to the consultation document, many organisations and individuals drew attention to the compliance costs of the proposals, particularly in relation to partial exemption. We have considered most carefully the points made, and the current proposals aim to strike a fair balance between prevention of serious tax loss and the reasonable interests of business. The proposed new de minimis rules have been devised to be as generous and simple as possible whilst not open to manipulation and substantial revenue loss. There will be generous monetary limits for the benefit of small businesses and a list of certain exempt supplies which may be ignored by businesses outside the financial sector. Where partial exemption calculations have to be made, rules lay down a standard method. But Customs and Excise will allow alternative methods, as they do now. The criteria for these alternative methods are simply that they should be practical, accurate and fair. Past experience is that in almost every case

Customs and Excise have been able to agree either with a trade association or individual business a basis of calculation which utilises existing information systems and thereby minimises compliance costs.

We received a number of representations about the effect of the proposals on brewers with income from tied-house rentals and I have written today to General Mangham of the Brewers' Society in specific response to the representations they made.

I am afraid that it has not proved possible to allow special treatment for such rentals. But this does not close the door against working out arrangements with breweries which are consistent with the new rules and take account of any quantifiable and unique features of these rentals. I hope that discussions between brewers and Customs and Excise can continue on this basis, and I have indicated my own willingness at an appropriate stage to be involved in them.

Yours ever

Peter

PETER BROOKE

Treasury Chambers, Parliament Street, SWIP 3AG

Sir Geoffrey Finsberg MBE JP MP
The Great Universal Stores PLC
PO Box 1BZ
Universal House
251-256 Tottenham Court Road
LONDON W1A 1BZ

19 December 1986

Dear Geoffrey,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

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these alternative methods are simply that they should be practical, accurate and fair. Past experience is that in almost every case Customs and Excise have been able to agree either with a trade association or individual business a basis of calculation which utilises existing information systems and thereby minimises compliance costs.

Yours ever

Peter

PETER BROOKE

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

R C W Bardell Esq
Chief Executive
Association of British Insurers
Aldermary House
Queen Street
LONDON EC4N 1TT

19 December 1986

Dear Mr Bardell,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

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Yours sincerely

Peter Brooke

PETER BROOKE

Minister of State Treasury

Treasury Chambers, Parliament Street, SW1P 3AG

Sandy Anson Esq
Secretary
Taxation Committee of
Institute of Directors
116 Pall Mall
LONDON SW1Y 5ED

19 December 1986

Dear Sandy,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

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Yours sincerely

Peter Brooke

PETER BROOKE

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

T G Abell Esq
Chairman
The Association of Investment
  Trust Companies
Park House (6th Floor)
16 Finsbury Circus
LONDON EC2M 7JJ

19 December 1986

Dear Tim.

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

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A very happy Christmas –

Yours ever

Peter

PETER BROOKE

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Sir Dudley Smith MP
House of Commons
LONDON SW1A OAA

19 December 1986

Dear Dudley,

Thank you for your letter of 15 December on the subject of VAT input tax recovery, and Michael Stern has kept me apprised of his conversation with you.

I was left in no doubt by the Brewers' Society that the industry feels that it merits some form of special treatment in respect of its tied-house rentals but as I explained to them when I met a delegation on 4 December the scale of tax avoidance more generally under the present rules is such that the rules must be fundamentally recast. I am sorry that one consequence is that the special arrangement the brewers have enjoyed in respect of tied-house rentals would no longer apply.

I am aware that this seems harsh, but I do not feel able to agree to maintaining a special position for the brewers which would be at odds with that allowed to everyone else. More helpfully it does not follow that the tax impact has to be as severe as some have predicted. A promising avenue which has already begun to be discussed with Customs would be agreement of a special method of input tax calculation which, while consistent with the new rules, would take into account the quantifiable and unique features of tied-house rental agreements.

The Chancellor has now made an announcement giving details of the proposed changes to primary and secondary legislation and I enclose a copy. This leaves entirely open further discussion of the appropriate treatment of tied-houses, and I hope such discussion can continue. I would certainly be happy to discuss this with you and any others you would like to bring with you in early January. My office will be in touch shortly to agree a date.

Yours ever

Peter

PETER BROOKE

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Sir Derrick Holden-Brown
Chairman & Chief Executive
Allied Lyons PLC
Allied House
156 St John Street
LONDON EC1P 1AR

19 December 1986

Dear Sir Derrick,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

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We received a number of representations about the effect of the proposals on brewers with income from tied-house rentals and I have written today to General Mangham of the Brewers' Society in specific response to the representations they made.

I am afraid that it has not proved possible to allow special treatment for such rentals. But this does not close the door against working out arrangements with breweries which are consistent with the new rules and take account of any quantifiable and unique features of these rentals. I hope that discussions between brewers and Customs and Excise can continue on this basis, and I have indicated my own willingness at an appropriate stage to be involved in them.

Yours sincerely

Peter Brooke

PETER BROOKE

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Sir Derek Palmar
Bass PLC
30 Portland Place
LONDON W1N 3DF

19 December 1986

Dear Derek,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

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Yours ever

Peter

PETER BROOKE

Treasury Chambers, Parliament Street, SW1P 3AG

Richard Weir Esq
Acting Director
British Retailers Association
Commonwealth House
1-19 New Oxford Street
LONDON WC1A 1PA

19 December 1986

Dear Mr Weir,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

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Yours sincerely

Peter Brooke

PETER BROOKE

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Sir Stanley Grinstead FCA
Chairman & Group Chief Executive
Grand Metropolitan PLC
11/12 Hanover Square
LONDON W1A 1DP

19 December 1986

Dear Sir Stanley,

VAT: INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

You wrote giving your views on the proposals set out in the Customs consultative document published on 7 August entitled "VAT: Input Tax: Origin and Scope of the Right to Deduct". In all, well over a hundred written responses were received and there have since been over twenty meetings between Customs and trade associations and professional bodies.

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I am afraid that it has not proved possible to allow special treatment for such rentals. But this does not close the door against working out arrangements with breweries which are consistent with the new rules and take account of any quantifiable and unique features of these rentals. I hope that discussions between brewers and Customs and Excise can continue on this basis, and I have indicated my own willingness at an appropriate stage to be involved in them.

Yours sincerely

Peter Brooke

PETER BROOKE

Treasury Chambers, Parliament Street, SWIP 3AG

Major-General W D Mangham CB
Director
The Brewers' Society
42 Portman Square
LONDON W1H OBB

19 December 1986

Dear General Mangham,

I much enjoyed seeing you again on 4 December, and as you know was sorry for an atypical interruption. Thank you now for your letter of 5 December, which thoughtfully confirmed and expanded on the points you had made at our meeting on the previous day. I said then that an early announcement would be likely, in order to give proper lead time for the introduction of the new measures.

I of course reported fully to the Chancellor: having considered the outcome of the consultation exercise as a whole, the Chancellor has now made an announcement giving details of the proposed changes to primary and secondary legislation, to give effect to the new rules for VAT input tax recovery.
... I enclose a copy.

As foreshadowed at our meeting, I am sorry that it has not been possible to find any way of retaining the existing special concession for tied-house rentals under Regulation 32(i) nor to agree that these rents should be treated as taxable. As we explored at the meeting, however, Customs are very prepared to discuss the possibility of agreeing a special method of calculating input tax entitlement which, while consistent with the new rules, does take account of any quantifiable and unique features of these rentals. I hope that these discussions can continue: just as Allied-Lyons were anxious to see me earlier, so now I gather Bass might wish to, and I would of course be entirely content, if agreeable to Bass, for the Society to be likewise involved again.

Yours sincerely

Peter Brooke

PETER BROOKE

SECRET

pup

MINUTES OF A MEETING IN THE CHANCELLOR'S ROOM, HM TREASURY AT 10.30AM ON FRIDAY, 19 DECEMBER

__Those present__

Chancellor
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Knox - C&E
Mr Jefferson Smith - C&E
Mrs F Boardman - C&E
Mr Wilmott - C&E

CONSUMER CREDIT TAX

__Sir P Middleton__ said that he thought this was rather daunting as a starter. He had always been strongly in favour of doing something in the financial sector if we could. But his main single feeling on reading Mr Knox's paper was how risky it was to take a flier in the Budget. But he saw some attractions in raising revenue quickly via a credit card tax.

2. __Sir T Burns__ said he continued to favour a widely based tax on all credit including mortgages. But he thought the proposals for a lump sum credit card tax were not at all attractive. __The Economic Secretary__ agreed. The more he looked at the papers, the less he was attracted to stage 1.

3. __The Chancellor__ noted that credit advanced on bank credit cards was the most rapidly growing proportion of consumer credit. It had grown consistently by 30 per cent per annum over the last 10 years. There did thereford seem a strong case to take action on that front first, since it was both the most buoyant sector and also the one where the revenue could be received earliest.

He asked for views on whether there was a better alternative to a lump sum tax.

4. Mr Ross Goobey felt it was surely possible to get a full tax on interest charges in place in 1987-88. The banks were swift to adjust interest rates, and could presumably make similar arrangements for a new tax. Mr Jefferson Smith said it was very hard to be certain of this without going out to consultation. The Economic Secretary felt that a tax on interest payments was much more logical than a lump sum tax on credit cards.

5. Mr Cassell also agreed. His minute had showed - on crude calculations - that a 10 per cent tax on interest charges on credit cards should bring in a yield of £75 million.

6. Mrs Lomax was concerned that a tax on interest on credit cards alone would not be tenable. It would simply lead to a rapid movement to debit cards with associated overdrafts: no interest would be paid on the credit card itself.

7. The Chancellor said this point certainly needed further examination. But it made sense to press ahead with this as a short-term revenue raiser and as a forerunner of a wider tax. The main issue was how we handled the extension to the more broadly based tax. If we announced a credit card tax but said nothing about any extension (and simply continued to plan) we might get independent pressure to extend the base. The Minister of State felt that if we came out with a credit card tax alone there was a considerable risk that we would look foolish. If our eventual plan was to have a broader tax - and he hoped it was - he would much prefer it if we made our intentions clear.

8. Mr Cropper said he favoured a broadly based tax in principle, but was very doubtful whether it would be possible to impose the tax on mortgages. Without mortgages, the yield came down to £½ billion and the tax would introduce new distortions. The Chancellor acknowledged the difficulties. It would be much better

to include mortgages, but he saw little scope for doing this in 1987. If we announced plans in the Budget to tax all credit except mortgages, we would be questioned closely about whether we had any plans to extend the coverage later. There was a danger that we might be forced to give a commitment that we would not. This seemed to imply that the options for 1987 were either (i) a credit card tax alone - and he acknowledged the Minister of State's powerful arguments against this - or (ii) a credit card tax plus an announced plan to tax other non-mortgage credit, with an acceptance that we might well be forced to give a pledge to exclude mortgages for all time.

9. The Chancellor said he would be grateful if Customs could carry out further planning for an ad valorum tax on interest on consumer credit. This work should cover three areas separately: credit cards; mortgages; and other credit. Further discussion would be needed about the tactics of how these three stages might be announced and implemented, if a decision was taken to go ahead.

ACSA

A C S ALLAN
19 December 1986

Distribution

Chief Secretary
Miss Sinclair
Mr Ilett

ps2/45R

UNCLASSIFIED

RP

FROM: CATHY RYDING

DATE: 22 December 1986

PS/MINISTER OF STATE

cc Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Howard - C&E
PS - C&E

CASH ACCOUNTING FOR VAT

The Chancellor has seen Mr Howard's minute to the Minister of State of 16 December.

2. The Chancellor wonders if there is any reason why the turnover limit should not start at £100,000, and be raised by £100,000 a year to £500,000 in year 5, thus spreading the once-for-all cost.

CR

CATHY RYDING

394/042

MINISTER OF STATE TREASURY

BF

FROM: M W NORGROVE

DATE: 23 December 1986

MR D J HOWARD - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
PS/C&E

CASH ACCOUNTING FOR VAT

The Minister of State was grateful for your minute of 16 December and has seen Mrs Ryding's of 22 December; he will be interested to hear Mr Trevett's news on his discussion with the Commission.

MWN

M W NORGROVE
Private Secretary

ANNEX C

CASH ACCOUNTING. FRAUD RISKS AND REVENUE CONTROL CONSIDERATIONS

Introduction

1. Our original recommendation for a turnover limit for cash accounting of £100,000 was influenced by the case for consistency with the draft SME's Directive; revenue cost; and the need to minimise the risks of fraud and abuse. Any turnover limit significantly above this level will have a proportionately greater impact on our revenue control of traders. This note supplements Mr Howard's note of 6 February which explained the potential market for cash accounting and the revenue at risk for turnover limits of £100,000; £250,000 and £500,000 and sets out some of the main fraud and control considerations.

Fraud/Evasion

2. There are a number of potential opportunities for deliberate fraud and evasion of tax through the introduction of cash accounting. The main areas of risk are:-

- understatement of actual or potential turnover in order to secure membership <u>or</u> stay in the scheme;
- the writing-off of book balances;
- payments to and by third parties;
- deliberate loss of audit trails;
- suppression of receipts and alleged part payments;
- the manipulation of VAT between associated businesses;

- the mixture of private and business bank/building society accounts; and

- increased use of the "phoenix" syndrome (contrived insolvencies).

3. The opportunities and temptations for fraud and evasion would increase with higher turnover limits, where the amount of tax at risk would be greater. They would also be particularly rife if cash accounting were allowed for output tax only (with the current system of allowing input tax to be reclaimed on the basis of a tax invoice being retained). In the latter case, apart from the problem of revenue cost to which we have referred in paragraph 9 of the main submission, there would be:

- still greater incentives to the use of the phoenix syndrome; and

- even greater opportunity for manipulation between associated businesses, eg exchange of invoices between businesses for spurious transactions, particularly in the service sector.

Control

4. The main problem for our VAT control staff will be that cash flow does not easily relate to the picture presented by an invoice-based system. Payments can be delayed, staged or related to a mixture of standard and zero-rated supplies. Within the cash flow, transactions will relate to non-deductible expenditure (cars and business entertainment) exempt payments (rent) and amounts outside the scope of VAT (wages etc). A carefully compiled VAT element of all cash transactions will therefore be necessary.

5. As we have explained in Annex B1, item 3, we shall be encouraging businesses to structure their records to provide a clear audit trail, but of necessity this will have to stop short of imposing a set system. Our control staff will need to recognise, quickly, inadequate accounting systems which will lead to errors in the trader's VAT account, and they will have to familiarise

themselves with cash systems in the context of the traders' other business procedures. Control techniques will have to be developed to test and evaluate cash systems to ensure that they will not be manipulated to evade VAT.

6. The essence of these problems will arise with almost every trader using cash accounting. However, as already noted in relation to deliberate fraud, they increase in significance as the turnover limit, and the amount of tax at risk through cash accounting rises. As explained in Mr Howard's note of 6 February (which was based on further, more precise numerical work following the discussion with you the previous morning), in broad terms the total tax at risk for our best estimate of 66% take-up of cash accounting rises in almost equal proportions from £400 million for a turnover limit of £100,000 to £800 million for one of £250,000 and £1,200 million for £500,000. We have concluded, therefore, that any increase above the £100,000 level will involve additional control effort to safeguard the revenue; and that this would be particularly significant for a limit of £500,000.

Further work

7. To carry forward this analysis we are examining urgently two further aspects:-

i how the regime of "Keith" penalties introduced by the Finance Act 1985 would apply to abuses of the cash accounting system; and

ii the detailed resource implications of cash accounting, covering both

- the increased control effort resulting from a higher turnover limit; and
- the upfront administrative costs of vetting and otherwise handling applications for the scheme,

particularly now that we are working to an operative date of 1 October 1987 which excludes any possibility of a computer solution.

We shall let you have further notes shortly.

CASH ACCOUNTING

Confederation of British Industry	Propsal supported: should be available to those with turnover up to £1m. In longer term question need for a limit at all and whether invoice basis need be the norm.
Inst. of Directors	Proposal supported: should be available to all in due course. Simplicity should not be lost in a welter of complex anti-avoidance rules and excessive accounting requirements.
Association of British Chambers of Commerce	Proposal supported: should be available to those with turnover up to £500,000. A number of detailed questions posed.
National Chamber of Trade	Proposal supported: the two year period for membership should be reduced to one; transitional arrangements should be simple.
British Retailers Assoc.	No comment.
Mail Order Traders Assoc.	No comment.
National Farmers Union	Proposal supported: should be allowed to remain in scheme for 2 years after tolerance turnover limit exceeded.
National Fed. of Self Employed & Small Businesses	Proposal supported: a positive and long overdue reform, but should be available to all without turnover limit.
Alliance of Small Firms & Self Employed People	Proposal supported: should be available to all in stages. Customs should not be able to vet applicants.
Association of Independent Businesses	Proposal supported: should be available to all in the long term, but immediately if turnover below £2m.

Small Business Bureau	Proposal supported: should be available to those with turnover up to £500,000.
Forum of Private Business	Proposal welcomed as an optional scheme.
Development Commission and COSIRA	Proposal welcomed: particularly in giving bad debt relief. Implied regret that shopkeepers would be excluded because of turnover limit.
Inst. of Chartered Accountants (E&W)	Proposal welcomed: many small businesses operate from bank and cash records. A number of detailed proposals made on operation; concern about arrangement for leaving.
Inst. of Chartered Accountants (Scotland)	Proposal strongly favoured: complexity in new legislation should be avoided.
Chartered Assoc. of Certified accountants	Proposal welcomed: would help cash flow and give bad debt relief. Transitional move to normal accounting would be complicated.
Chartered Inst. of Management Accountants	Will not achieve very much, threshold too low.
Law Society	Implied support, but urges higher limit and bad debt relief for all. The problems in changing between the two regimes could deter traders from joining.
Law Society (Scotland)	Welcomed positive nature of the action proposed in reducing the burden of administration. Comment covered all proposals.
VAT Practitioners Group	Proposal welcomed: simplicity essential. Threshold too low. A number of detailed proposals made including suggestions for accounting adjustments on entering and leaving the scheme.
Inst. of Taxation	Proposal welcomed. Three technical points raised.

ANNUAL ACCOUNTING

Confederation of British Industry	Proposal welcomed: 12 payments suggested to fit in with normal monthly cycle. Scheme should be available in first year of trading.
Institute of Directors	Proposal welcomed (not as important as cash accounting). 'Health warning' to ensure that payments based on previous year's turnover do not exacerbate cashflow problems in business downturn.
Assoc. of British Chambers of Commerce	Proposal welcomed: should be available to those with turnover up to £500,000. Scheme should be available in first year of trading. A number of detailed questions posed.
National Chamber of Trade	Proposal supported.
British Retailers Assoc.	No comment
Mail Order Traders Assoc.	No comment
National Farmers Union	Proposal supported: should be available to payment traders.
National Fed. of Self Employed & Small Businesses	Proposal supported in principle but should be available to all. Foresee wrangles on fixing the annual assessment; must be simple and fair.
Alliance of Small Firms' Self Employed People	Lukewarm support: doubt demand for facility. Final payment should be tied to firm's accounting year.
Assoc. of Independent Businesses	Opposes proposal: discipline to maintain financial control and administrative efficiency would be lost.
Small Business Bureau	Lukewarm support: direct debt payments may not be welcomed.

Forum of Private Businesses	Opposes proposal even as an option. 75% of Forum members do not want it. High administrative costs for effective operation.
Development Commission/COSIRA	Proposal supported: the annual assessment should be negotiable and subject to appeal.
Inst. of Chartered Accountants (E&W)	Proposal supported: annual return should be linked to the accounting year; scheme should be available in first year of trading and a number of other detailed proposals.
Inst. of Chartered Accountants (Scotland)	Proposal supported: year should co-incide with trader's accounting year.
Chartered Assoc. of Certified Accountants	Not opposed to optional scheme, but sceptical about advantages. The annual assessment should be negotiable.
Chartered Inst. of Management Accountants	Benefits reduced by requirement to make monthly payment. Two years too long a period for compulsory membership; there could be cash flow problems on final payment.
Law Society	Implied support: a number of detailed questions asked.
Law Society (Scotland)	(See general comment under cash accounting)
VAT Practitioners Group	Potentially beneficial but a number of disadvantges outlined eg reduced discipline in record-keeping. Threshold too low. Availability of the facility in first trding year would be useful.
Inst. of Taxation	Implied support: several detailed point raised.

RECORDS AND ACCOUNTS

Confederation of British Industry	Implied support. Would like to put views forward to consultant. 6 year preservation period too long. Publicity to continue re-authorisation of early destruction. Following satisfactory inspection records over 3 years old to be scrapped.
Inst. of Directors	Independent study welcomed. Report should be published. Opposed to 6 year retention period.
Assoc. of British British Chambers of Commerce	Independent study supported, by inference. Clarification of terms of reference sought. Opposed to 6 years retention period.
National Chamber of Trade	Independent study welcomed.
British Retailers Assoc.	No comment.
Mail Order Traders Assoc.	No comment.
National Farmers Union	Independent study welcomed, 6 year preservation period should be reduced if arrangements working satisfactorily.
National Fed of Self Employed & Small Businesses	Independent study supported, by inference.
Alliance of Small Firms' Self Employed People	No comment on appointment of consultants; book-keeping necessary for present structure is the true burden on business.
Assoc. of Independent Businesses	Support of independent study implied: the 3 year period for the retention of records should be reinstated.
Small Business Bureau	No comment

Forum of Private Businesses	No comment
Development Commission/COSIRA	No comment on the appointment of consultants. Specimen samples of financial records should be published.
Inst. of Chartered Accountants (E&W)	Independent study welcomed, terms of reference considered to be too narrow.
Inst. of Chartered Accountants (Scotland)	Independent study welcomed: terms of reference to be clarified.
Chartered Assoc. of Certified Accountants	Independent study welcomed.
Chartered Inst. of Management	Independent study welcomed: terms of reference considered to be too narrow.
Law Society	No comment
Law Society (Scotland)	(See general comment under cash accounting.)
VAT Practitioners Group	Independent study welcomed.
Inst. of Taxation	No comment

ANNEX A 4

REGISTRATION/DEREGISTRATION

Confederation of British Industry	Strongly opposed to compulsory deregistration.
Inst. of Directors	Supports the detailed proposals. Strongly opposed to compulsory deregistration. Threshold should be increased.
Assoc. of British Chambers of Commerce	Supports the detailed proposals, but looks for a longer period to notify liability to register. Strongly opposed to compulsory deregistration. Threshold should be £50,000.
National Chamber of Trade	Strongly opposed to compulsory deregistration.
British Retailers Assoc.	No comment.
Mail Order Traders' Assoc.	No comment.
National Farmers Union	Supports increased time for notifying liability to register. Opposed to compulsory deregistration which would discriminate harshly against many farmers.
National Fed. of Self Employed & Small Businesses	Supports the detailed proposals. Totally opposed to compulsory deregistration (or refusal to allow voluntary registration).
Alliance of Small Firms' Self Employed People	Opposed to compulsory deregistration (and to disallowing voluntary registration) which would be very damaging to many small firms.
Assoc. of Independent Businesses	Supports increased time for notifying liability to register. Opposed to compulsory deregistration. Threshold should be increased to£50,000; later £100,000.
Small Business Burea	Strongly opposed to compulsory deregistration which would impose considerable burdens on businesses which are on the margin. Threshold should be at least £50,000.

Forum of Private Businesses	Supports the detailed proposals. Opposed to compulsory deregistration.
Development Commission/COSIRA	Supports the detailed proposals. Opposed to compulsory deregistration: exporters and new businesses would be hit.
Inst. of Chartered Accountants (E&W)	Supports increased time for notifying liability to register and deregister. Opposed to compulsory deregistration, cites examples of traders who would lose.
Inst. of Chartered Accountants (Scotland)	Supports the detailed proposals. Strongly opposed to compulsory deregistration. Threshold should be increased to £50,000.
Chartered Assoc. of Certified Accountants	Supports the detailed proposals. Opposed to abolition of right of voluntary registration and, by assumption, compulsory deregistration.
Chartered Inst. of Management Accountants	Opposed to compulsory deregistration. Threshold should be £100,000.
Law Society	Supports the detailed proposals although some time limits could be greater. Opposed to compulsory deregistration.
Law Society (Scotland)	(See general comment under cash accounting).
VAT Practitioners Group	Support time limit proposals. Opposed to compulsory deregistration.
Inst. of Taxation.	Welcomes extension of time limit, but seeks longer period to notify liability to register. Opposed to compulsory deregistration.

RETAIL SCHEMES

Confederation of British Industry	Objects to limitation on use of retail schemes and withdrawal of standard method of reckoning gross takings. Clarification necessary on mixture of retail schemes proposal.
Inst. of Directors	Objects to the withdrawal of the standard method of reckoning gross takings.
Assoc. of British Chambers of Commerce	Strongly objects to the withdrawal of the standard method of reckoning gross takings, and cannot support the limitation on use of retail schemes.
National Chamber of Trade	Accepts need for detailed changes, proposals should be subject to discussion with appropriate trade associations.
British Retailers Assoc.	Objects to withdrawal of standard method of reckoning gross takings: would have major implications for cash flow and profitability for those providing self-financed credit.
Mail Order Traders Assoc.	Objects to withdrawal of standard method of reckoning gross takings: would add very significantly to members' costs, asked for meeting at highest level.
National Farmers Union	No comment.
National Fed. of Self Employed & Small Businesses	Not yet ready to comment.
Alliance of Small Firms' Self Employed People	No comment

Assoc. of Independent Businesses	No comment
Small Business Bureau	No comment
Forum of Private Business	Welcomes retail scheme proposals.
Development Commission/COSIRA	Broadly content with detailed proposals; some figures questioned.
Inst. of Chartered Accountants (E&W)	Standard method of calculating gross takings should be retained, at least for small businesses.
Inst. of Chartered Accountants (Scotland)	Broadly content with detailed proposals, they should however be subject to detailed consultation.
Chartered Assoc of Certified Accountants	No comment
Chartered Inst. of Management Accountants	No comment.
Law Society	Objects to the withdrawal of retail schemes from non-retailers. Members have legitimate expectations for use of these facilities.
Law Society (Scotland)	(See general comment under cash accounting.)
VAT Practitioners Group	Broadly content with retail scheme simplification and operation proposals. Preference for actual rather than fixed mark-ups. Opposes withdrawal of standard method for calculating gross takings; supports restriction on use of schemes.
Inst. of Taxation.	No comment.

ABOLITION OF VAT ON TRANSACTIONS BETWEEN REGISTERED TRADERS

Confederation of British Industry	No comment.
Inst. of Directors	No comment
Assoc. of British Chambers of Commerce	No comment
National Chamber of Trade	Prefers present system
British Retailers Assoc.	No comment
Mail Order Traders' Assoc.	No comment
National Farmers Union	No comment
National Fed. of Self Employed & Small Businesses	A lengthy paper from Mr Holland argues against the points in the Annex to the consultation document. Customs is said to have exerted its influence to prevent simplification
Alliance of Small Firms' Self Employed People	Tacit support for change: some form of final sales tax would be preferable.
Assoc. of Independent Businesses	Proposes a new study.
Small Business Bureau	No comment.
Forum of Private Businesses	No comment.
Development Commission/COSIRA	No comment.

Inst. of Chartered Accountants (E&W)	No comment.
Inst. of Chartered Accountants (Scotland)	No comment
Chartered Assoc. of Certified Accountants	No comment
Chartered Inst. of Management	Debate should be re-opened: it should be established whether EC law would allow the facility.
Accountants Law Society	No comment.
Law Society (Scotland)	No Comment.
VAT Practitioners Group	No comment.
Inst. of Taxation	No comment.

ANNEX A

RESPONSES

		CASH ACCG			ANNUAL ACCG			RECORDS & ACCOUNTS			VAT REGISTRATION						RETAIL SCHEMES						ABOLITION OF VAT ON TRANSACTIONS BETWEEN REGD. TRADERS		
											EXTENDED TIMESCALES			COMPULSORY DEREGISTRATION			CHANGES TO SCHEME DETAIL			RESTRICTIONS					
	Total replies	For	Against	No firm view	For	Against	No firm view	For survey	Against survey	No firm view	For	Against	No firm view	For	Against	No firm view	For	Against	No firm view	For	Against	No firm view	For	Against	No firm view
National Trade Associations & Professional Bodies	47	34	2	11	32	5	10	22	1	24	25	0	22	1	34	12	10	1	36	8	9	30	5	3	39
Other Representative Organisations	26	25	0	1	17	4	5	9	5	12	18	0	8	1	14	11	4	2	20	4	2	20	3	1	22
Individual Traders (Incl. Local Accnts)	110	63	8	39	29	24	57	17	4	89	19	1	90	7	55	48	3	2	105	3	8	99	5	2	103
Respondents to Questionnaire (1)	1256	588	591	77	281	938	37	0	0	(2) 1256	1002	116	138	338	797	121	48	12	1196	(3) 40	26	1190	0	0	(2) 1256

Notes:
(1) Including 37 individuals who were not part of the random sample.
(2) The questions were not posed, but no comments were received.
(3) Businesses were not asked for a view on the withdrawal of the 'standard' method of calculating gross takings.

ANNEX B1

CASH ACCOUNTING

COMMENTS RECEIVED	CUSTOMS RECOMMENDATION
1. The turnover for membership is too low.	There are EC, cost and control implications for a higher turnover limit. The nature and extent of EC constraints are currently being explored with the Commission and with the Law Officers. Control considerations and the increased scope for evasion also argue against too high an initial level of threshold, while the once-and-for-all revenue cost would militate very strongly against some of the more extreme suggestions. To increase the level of the threshold to £1 million or £2 million (or to have no limit at all) as some have suggested would be prohibitively costly. Our recommendations are contained in pargraphs 9-10 of the main submission.
2. Unease with proposals for leaving the scheme.	Accept. A business moving back to normal record-keeping will be allowed to account for VAT on cash received and paid basis for all supplies made while a member of the ring. However, the original proposals will remain for those businesses who cease to trade.
3. Concern over record-keeping requirements; the benefits could be lost through the additional burdens.	We will naturally require a clear audit trail through a business's records, but we have stopped short of telling a trader exactly how those records should be set-up. Some will adapt day books. Others will have cash books, a few will have more sophisticated systems. On the other hand, some consider that there will be a loss of record-keeping discipline.
4. Purchases should not require a receipted tax invoice before input tax credit can be taken.	Accept. A receipted tax invoice will only be required for a cash (as opposed to cheque etc.) purchase.

5.	Business should only be required to remain in the scheme for one year.	This requirement will be reviewed in the light of experience. However, in view of the work in admission, we would wish to retain the two year period at the outset.
6.	The 25 per cent tolerance in turnover for remaining in the scheme should be more flexible.	Again, we would wish to keep the limit under review. However, there is no provision for any tolerance in the draft EC Directive.

No other proposal was supported by more than one trade association or by more than one individual business. These points covered the need to define turnover (it will be the same as used to determine liability for registration); turnover should exclude sales of assets (as it will); the different turnover for supplies of goods and services (this would add to the complexity of the scheme at the outset); the need for an official cash accounting book (such stamps of approval have been resisted in the past); input tax should be claimed as at present (which would be the best of both worlds) or, at least, for assets (the same argument, and would add complexity to the scheme).

ANNUAL ACCOUNTING

	COMMENTS RECEIVED	CUSTOMS RECOMMENDATION
1.	The turnover for membership is too low. It should be increased in line with that proposed by trade associations for cash accounting.	Agree that the turnover limit should follow cash accounting. There are no legal or revenue cost problems with annual accounting, but it would be sensible and consistent to have the same turnover limit.
2.	The scheme should be available in the first year of registration.	Reject. Two problems are foreseen. First, it would be difficult to estimate the size of monthly payments, with no previous trading pattern to draw on, and secondly, our experience is that in its first year a new business would be more likely to be reclaiming VAT on its capital and stock purchases and so would not therefore benefit.
3.	Businesses claiming repayments should be allowed to join.	Reject. We have explained to the National Farmers' Union, who made the suggestion, that it would be imprudent to make regular repayment of revenue before vouched claims were submitted.
4.	Businesses should be allowed to make separate claims for capital purchases.	Reject. We are not in favour because of the resource implications and the further complication of processing returns.
5.	Estimating instalments based on past year's trading would be too inflexible, particularly in downturns of business.	Accept. The system will allow a business to vary the instalment in the event of a genuine downturn, either before joining the scheme or subsequently.
6.	Payments should be made on a monthly basis over the whole year.	Reject. The proposed system is more favourable to small businesses and allows two months for the final payment.

ANNEX B3

RECORDS AND ACCOUNTS

COMMENTS RECEIVED	CUSTOMS COMMENTS (subject to the Consultant's report.)
1. Preservation period should be reduced.	The increase to six years was introduced as a result of the recommendations of the Keith Committee, in the Finance Act 1985. The detailed arguments are in the consultation document - Chapter 3.
2. Routine earlier disposal of ancillary records.	See consultation document - Chapter 3.3; but consultant may wish to comment.
3. There should be a dispensation to destroy records after a 'satisfactory' control visit.	We take the view, supported by Ministers, that a control visit is not an audit, and cannot possibly cover all aspects of a business's VAT affairs.
4. Customs to advise more positively on the form and type of records required.	Our view has been that we would wish to impose the minimum on businesses, and work from their normal commercial records. Consultant may wish to make recommendations.
5 Customs to assist with preservation and costs.	It is not normal practice to directly reward businesses for handling tax matters according to responsibilities imposed by Parliament.
6. No changes needed and the consultant's brief was a waste of public money.	We considered that, in view of representations received, an independent review was essential.

On the whole, respondents reserved comment pending the outcome of the review.

BUDGET CONFIDENTIAL

ANNEX B4

REGISTRATION/DEREGISTRATION

PROPOSAL	COMMENTS RECEIVED	CUSTOMS RECOMMENDATION
Extend time limit for notifying liability to be regis-tererd.	Acceptable, but some trade bodies have requested extended time limits ranging between six weeks and one year.	Reject. Any extension beyond one month would result in an unacceptable loss of revenue (in the order of £65m for every month's extension). We could be exposed to accusations of unjustified distortion of commercial competition from established businesses which have no interest in longer time limits.
Extend time limit for notifying cessation of trade to one month.	One trade body proposed an extended time of three months.	Reject. This would not allow a cost effective management of the VAT register.
Compulsory deregistration of all businesses below the threshold	Although some favourable responses received, mainly via the questionnaire, the vast weight of opinion was strongly opposed.	Accept. Despite the reduced burden, in the light of small business opinion covering a variety of arguments, the Government will be recommended against proceeding with this proposal
Abolish deregistration test based on past turnover. Exclude output tax from deregistration calculation Ignore pre-deregistration turnover when determining further liability to be registered. Introduce time limit of one month for notifying material changes.	Very few responses received, virtually all in favour.	

BUDGET CONFIDENTIAL

ANNEX B5

RETAIL SCHEMES

(Detailed)

Introduce a replacement/alternative to Scheme B.	All comments were in favour of introducing an alternative rather that a replacement, this being mainly due to the annual stock adjustment factor.	Accept. The proposal will be an alternative rather than a replacement.
Amend 'Adoption 1' to provide for varied fixed mark-ups based on type of goods. Increase turnover limit to £500,000.	Varied reaction to fixed mark-up percentages. All comments in favour of increase in turnover.	Accept. Proceed with scheme, with further consideration to be given to mark-ups.
Revise Scheme C fixed mark-up levels.	As above. Strong opposition to proposed mark-up for health foods.	Accept. Proceed with the principle, but the health foods mark-up is likely to be substantially reduced.
Review level of the Scheme G 1/8th uplift.	Considered to be punitive, a lower uplift should be considered.	Review. Further representations will be considered
Increase Scheme C turnover limit to £90,000 Increase Scheme D turnover limit to £500,000	Favourably received	
Abolish Scheme G minimum turnover limit Incorporate the working methods of the available Scheme J adoptions within the pamphlet for the scheme	No specific comments	

(General)

Withdraw the standard method of reckoning gross takings.	Very strong and concerted opposition received from large retailers, in particular the mail order houses who operate self-financed credit.	Defer for this year. We wish to give further consideration to the representations in the light of a wider review of the need for retail schemes by larger businesses and their revenue costs.

Withdraw these from non-retailers.	Potentially disadvan- wholesale businesses such as 'cash and carry'. Opposition from particular groups in particular the Law Society. Also some support on grounds of equity and logic.	Reject. In principle we would wish to proceed with the proposal while at the same time giving particular attention to the needs of any special groups who may be aversely affected.
Withdraw use of schemes in respect of non-retail supplies Clarify eligibility for use of mixture of schemes. Clarify meaning of separte parts of a business. Amend the law to clarify the Commissioners' powers to refuse the use of retail schemes.	No specific comments	

ANNEX B6

OTHER MATTERS

COMMENTS RECEIVED	CUSTOMS RECOMMENDATION
Keith penalties should be reformed. Unfair; power of mitigation should be given to Customs or VAT Tribunals.	Accept to the extent that a review will be held of these penalties before the 1988 Finance Bill. These comments should be added to the representations By that time there will have been the opportunity to view default surcharge in the light of a year's experience, in addition to over two years of late registration penalties.
Extension of time should be given for rendering VAT returns.	Reject. Although there would be less upheaval to the VAT system than cash accounting, it would not be easy to restrict the facility to small businesses while an extension to all businesses would be prohibitively expensive (in the order of £60m for every day's extension). Moreover, the concern over bad debt relief would remain.
Businesses should be paid for collecting VAT.	Reject. It has been the policy of successive Governments that a precedent of this kind should not be created; or there would inevitably be claims for similar reliefs elsewhere. Overall there would be a substantial loss of revenue which would have to be made up elsewhere.
Across the board bad debt relief.	Reject. Again, costs rule out such a line, and we recommend that experience be of the current proposals before any further extension be considered.
VAT should be based on profits rather than supplies and there should be a merger of the requirements of the two revenue departments.	Reject. Corporation tax, for example, is based on profitability whereas VAT is a tax on consumer spending which is collected by businesses. Even so, there is a move towards joint visits to businesses and progress on this aspect is being carefully monitored. The taxpayers charter is a further valuable safeguard for the small business in this area.

Further consideration should be given to the flat rate scheme. (Suggested by one trade association).	Reject. We explained in the consultation document that a scheme, an option under the draft SME Directive, is more suited to multi-rate systems of VAT and that computations would increase burdens for businesses and ourselves.