FILE NUMBER

PO-CH/NL/0752 PART A

FOR DISPOSAL ADVICE SEE INSIDE COVER

DISPOSAL DIRECTIONS	SIGNATURE	DATE
DESTROY AFTER YEARS		
PRESERVE		

FILE TITLE

BUDGET PAPERS 1989

1/2

FILE BEGINS 17/02/1989

ENDS 23/02/1989

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 17 February 1989

CHIEF SECRETARY
FINANCIAL SECRETARY
PAYMASTER GENERAL
ECONOMIC SECRETARY
SIR P MIDDLETON
SIR T BURNS
MR ANSON
DAME A MUELLER
MR WICKS
MR HARDCASTLE
MR BYATT
MR SCHOLAR
MR CULPIN
MR SEDGWICK
MR RILEY
MR MACPHERSON
MISS J SIMPSON
MRS CHAPLIN
MR TYRIE
MR CALL
SIR A BATTISHILL IR
MR BEIGHTON IR
MR ISAAC IR
MR PAINTER IR
MR UNWIN C&E
MR JEFFERSON SMITH C&E

cc Mr Gilhooly
Mr Matthews
Mr G Bush - IR
PS/IR
Mr P R H Allen - C&E
Mr Deacon IR (item (iv))
Mr Haigh IR (item (iv))
Mr Johns IR (item (iii))
Mr Precott IR (item (iii))
Mr Monck (item (v))
Mr McIntyre (item (v))
Mr Mace IR (item (v))
Mr Gieve (item (vi))
Mr Houghton IR (item (vii))
Mr Bryce IR (item (vii))

BUDGET OVERVIEW MEETING: AGENDA FOR FIFTH OVERVIEW MEETING ON MONDAY 20 FEBRUARY

... I attach the agenda for the fifth overview meeting, on Monday 20 February at 3.00pm.

ACSA

A C S ALLAN

AGENDA FOR FIFTH OVERVIEW MEETING: MONDAY, 20 FEBRUARY 1989

Main items

(i) Budget Scorecard:

Circulated by Mr Culpin

(ii) Car tax relief on cars supplied to motability for leasing:

Mr Jefferson Smith's note of 16 February.

(iii) Oil incrementals:

Mr Prescott's note of 16 February on PRT - incremental investment allowance

(iv) Life Assurance:

Mr Deacon's note of 16 February

(v) NICs:

Mr McIntyre's minute of 16 February

(vi) Presentation:

Mr Culpin's minute of 16 February

Other Items

(vii) Residence:

Mr Isaac's note of 3 February, on a receipts basis.
Note by the Financial Secretary (to be circulated).

OVERVIEW

CHANCELLOR OF THE EXCHEQUER

Ch/ I thought you might be interested to know that I rang the garage, which sold me my metro car last year, to ask about conversion to unleaded petrol. The salesman there knew nothing except that he had heard that conversion cost a great deal of money. When pressed he said about £300. He said he thought conversion wasn't something which Austin Rover were promoting, although they are making arrangements for all future cars to be able to use lead free petrol. Not very helpful.

Julie
12/12.

Scorecard

[illegible]RD/cov.minute

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COPY NO 1 OF 45 COPIES

FROM: ROBERT CULPIN
DATE: 16 February 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Macpherson
Miss Simpson
Miss Wallace
Mrs Chaplin
Mr Tyrie
Mr Call

Sir Anthony Battishill)
Mr Beighton)
Mr Isaac)IR
Mr Painter)

Mr Unwin)
Mr Jefferson Smith)C&E

Net t[illegible] should show [illegible] position.
But we [illegible] to "create" [illegible] transaction problem. [illegible] chose to start [illegible] & make date from which tax on prior transactions from future [illegible] position.

BUDGET SCORECARD

I attach the Scorecard for the Overview on 20 February.

2. It does not include the abolition of the earnings rule.

3. I should also draw attention to a point on stamp duty. If you announce in advance that you are going to abolish it, there will be effects on revenue before you actually do so. On the one hand, share prices will rise, because the value of abolition will be capitalised, and this will tend to raise revenue. On the other hand, some people may defer transactions, and this will tend to reduce it.

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4. If, as in previous Scorecards, we assume that you abolish stamp duty during 1989-90, this does not matter terribly: it all gets lost in the net cost for the year. But in this Scorecard, we assume abolition in April 1990. So any assumption about the effects on revenue in 1989-90 is bound to be transparent.

5. For the time being, we have assumed no net effect on revenue in 1989-90. That at least is simple, and unpretentious. We do not know when the value of abolition will be capitalised, or by how much; how far it may already be discounted in the market; or how many people will defer how many transactions until after abolition. If we had to make a guess, we should expect a net revenue gain in 1989-90, but it is unlikely that we should put it at more than small tens of millions.

6. In next week's Scorecard, would you prefer to stick to "nil" or to show a small positive?

ROBERT CULPIN

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Additional copies for Scorecard work:

Mr Gilhooly Mr Flanagan Mr O'Donnell	FP
Mr Matthews	ETS
Mr Pickford	EB
Mr Gieve	IDT
Mr Davies Dr Courtney	MP
Mr Mowl	PSF
Mr Bush Mr Calder Mr McManus Mr McNicol Mr Ko	IR
Mr P R H Allen Ms French	C&E

BUDGET SECRET

SECRET

Pen. Unused pos'n

Rt (2) are ok or
on [illegible] 2*
(practical effects)

Car scales:
"tools of trade"

B.L.O.

Keep under review
Phase in [illegible]
& [illegible]

SECRET

SCORECARD OF 16 FEBRUARY 1989

TABLE 1: DIRECT EFFECTS OF BUDGET MEASURES

		£ million		yield (+)/cost (-)
		1989-90		1990-91
		Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
1.	Freeze excise duties	nil	-1225	-1320
2.	Reduce duty on unleaded petrol; surcharge 2 star	- 30	- 30	- 75
3.	VED: coaches and lorries	+ 40	+ 40	+ 40
4.	VAT: non-domestic construction etc	+ 315	+ 315	+ 540
5.	Index IT thresholds	-1465	nil	nil
6.	Increase car scales by 20 per cent	+ 90	+ 90	+ 110
7.	CT: raise small companies thresholds	- neg	- neg	- 35
Savings				
8.	Abolish stamp duty on shares from 1/4/90	nil	nil	- 850
9.	Life assurance	- 20	- 20	+ 45
10.	Pensions, PEPs, Share Schemes, Unit Trusts	- 5	- 5	- 10
Other				
11.	Schedule E: receipts basis	- 60	- 60	- 80
12.	PRT: incremental investment relief	- 10	- 10	- 20
13.	VAT: bad debts, registration, etc	- 105	- 105	- 270
14.	Miscellaneous starters	- 65	- 30	+ 40
15.	TOTAL	-1315	-1040	-1885

Para 15 Statement of 16/2 has +30

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SCORECARD OF 16 FEBRUARY 1989

NOTES TO TABLE 1

Estimated cost (-) or yield (+) in £ million from indexed base unless otherwise indicated. Indexation 6.8 per cent.

Figures slightly revised this week in line with new forecast and new employment figures.

1. **Excise duties**

	1989-90	1990-91
Petrol, derv etc	- 545	- 580
VED	- 190	- 210
Tobacco	- 235	- 250
Alcohol	- 255	- 280
Total	**-1225**	**-1320**

Freeze reduces RPI by 0.48 percentage points compared with base forecast.

2. **Unleaded petrol**

	1989-90	1990-91
Reduce tax by enough to make unleaded 2p a litre cheaper than 4 star, if reduction passed on to consumers	- 30	- 60
Surcharge 2 star (and 3 star) to make it as expensive as 4 star	-neg*	- 15

*cost of extra unleaded take-up balanced by extra yield from 2-star.

Customs checking precise duty changes needed. Main problem is to establish how pump prices differ now between fuels. Paper for Overview 27 February.

Cost depends on take-up. No significant RPI effect.

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SCORECARD OF 16 FEBRUARY 1989

3. **VED: coaches and lorries**

+20 for buses and coaches, +20 for rigid heavy goods vehicles. Over 70 VED rates abolished. No direct RPI effect.

4. **VAT: non-domestic construction etc**

		1989-90			1990-91		
		Private sector	Public sector	Total	Private sector	Public sector	Total
Construction							
- new	(1)	15	250	265	20	325	345
- option to tax	(2)	20	10	30	40	35	75
Fuel and power	(3)	nil	nil	nil	15	80	95
Sewerage/water	(3)	nil	nil	nil	neg	neg	neg
News services	(1)	5	neg	5	5	neg	5
Protective boots and helmets	(1)	neg	neg	neg	neg	neg	neg
Minor property changes	(1)	15	neg	15	20	neg	20
TOTAL		55	260	315	100	440	540

Assuming implementation dates of (1) 1 April 1989
(2) 1 August 1989
(3) 1 July 1990

No impact effect on RPI, because no direct effect on prices to final consumers.

SCORECARD OF 16 FEBRUARY 1989

5. Index income tax thresholds

Cost of illustrative alternatives, in place of line 5:

	1989-90		1990-91
	non-indexed base	indexed base	indexed base
Increase thresholds by 10 per cent	-2,130	- 665	- 925
Reduce basic rate by 1p (with indexation)	-2,865	-1,400	-1,725

6. Increase car scales by 20 per cent

No change in structure of car scales. No allowance for behavioural effects (likely to be small).

7. Corporation tax: raise small companies thresholds

50 per cent increase in profits limits for small companies' CT rate of 25 per cent.

- Rate available on profits up to £150,000 (instead of £100,000).
- Benefit not fully withdrawn until profits £750,000 (instead of £500,000).

Reduces CT for about 23,000 companies.

Cost of 1 per cent off main CT rate: -10, -400, building up to -570.

a/c of how many with profits > £100,000?

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SCORECARD OF 16 FEBRUARY 1989

8. Abolish stamp duty on shares from 1/1/90

See cover note.

Cost depends on Stock Exchange turn-over and share prices. Net of extra yield from CGT, CT, VAT and Income Tax, as a result of increase in transactions: assumptions under examination, and subject to revision.

If abolition from 1/1/90, cost in place of line 8: -140, -900.

9. Life assurance

From 1/1/90:

- Life Assurance Policy Duty abolished
- rate on policy holders' income and gains cut to 25 per cent
- expenses from pensions business only deductible from pensions profit
- relief for acquisition expenses spread over 7 years, but change phased in 4 steps.

10. Pensions, PEPs, Share Schemes, Unit Trusts

	1989-90		1990-91
	non-indexed base	indexed base	indexed base
Pensions	neg	neg	neg
PEPs	- 5	- 5	- 10
Employee Share Schemes	- neg	- neg	- neg
ESOPs	- neg	- neg	- neg
Unit Trusts	nil	nil	- neg
Total	- 5	- 5	- 10

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SCORECARD OF 16 FEBRUARY 1989

Pensions

- cash limit of £60,000 on earnings on which tax-privileged pensions can be paid: so maximum privileged pension of £40,000, maximum tax free lump sum of £90,000; any excess taxed;
- limits apply only to new pension scheme members; indexed to prices;
- increase in percentage of earnings payable to personal pensions attracting tax relief, subject to cash limit.

PEPs

- increase in limit on total annual investment from £3,000 to £4,800, and on investment in unit and investment trusts from £750 to £2,400. Full year cost in long term of -30.

was this original PEP limit?

Employee share schemes

- increase FA 1978 all-employee share scheme limit from £1,250 or 10 per cent of salary to £2,000 or 10 per cent
- increase FA 1980 all-employee SAYE share scheme limit from £100 to £150 per month
- increase statutory limit on share price discount for FA 1980 schemes.
- annual cost expected to build up to between 5 and 10.

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SCORECARD OF 16 FEBRUARY 1989

ESOPS

- corporation tax relief on company contributions to employee benefit trusts. Could build up to -20.

Unit Trusts

- reduce CT rate on unfranked income from 35 to 25 per cent from January 1990.

11. **Schedule E: receipts basis**

Cost is transitional. Yields +10 in 1991-92 and +50 in 1992-93.

12. **PRT: incremental investment relief**

Assumes behavioural effects - ie increased development expenditure. Cost reduced since last week because extra expenditure now expected to start later. Expected to have yield after 1990-91.

13. **VAT bad debts, registration etc**

	1989-90	1990-91
Bad debt relief	- 50	-150
Simplification of registration rules	- 35	-100
Revision of default surcharge	- 20	- 20

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SCORECARD OF 16 FEBRUARY 1989

14. Miscellaneous Starters

See Table 2.

15. Total direct effects

Not same as effects on PSDR.

MP estimate total call of Budget measures on fiscal adjustment -810, -1070.

NB

(relative to 5p on duty)

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SCORECARD OF 16 FEBRUARY 1989

TABLE 2: MISCELLANEOUS STARTERS (I.E. LINE 14 OF TABLE 1)

Table contains only those starters which cost or yield £5 million a year or more

FB Starter number	Proposal	£ million 1989-90 Changes from a non-indexed base	Changes from an indexed base	yield (+)/cost (-) 1990-91 Changes from an indexed base
Decided				
32	VAT: charities	- 5	- 5	- 5
40	VAT: r + d cars	- 5	- 5	- 5
107	Relocation costs	+ 5	+ 5	+ 30
Part of 100	Age allowances:			
	- over 75s	- 10	- 10	- 15
	- reduce marginal withdrawal rate	- 5	- 5	- 5
115	Employees' material interest	- neg	- neg	- 5
116	PRP	- 10	- 10	- 15
154	Over 60s private medical insurance	nil	nil	- 40
204	BES: withdraw relief on loans to buy shares	+ neg	+ neg	+ 5
206	Close company legislation	- neg	- neg	- neg
216	CGT: unincorporated businesses trading losses	nil	nil	- 35
251	CGT: freeze exemption limit	nil	nil	+ 10
252	CGT: abolish tax deferral on gifts	+ neg	+ neg	+ 25
259	IHT: index threshold	- 35	nil	nil
261	IHT: instruments of variation	+ 5	+ 5	+ 15
453	Deep discounted bonds (COBO)	nil	nil	+ 15
633	Sale of numberplates	+ neg	+ neg	+ 10
650	ITV levy	nil	nil	+ 60
Decisions needed				
151	Covenanted membership subscriptions	- 5	- 5	- 5
TOTAL		- 65	- 30	+ 40

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~~SCORECARD OF 16 FEBRUARY 1989~~

NOTES TO TABLE 2

1. Details in starter reference sheets, under Finance Bill Starter number in first column.

2. Table omits following starters which protect existing revenue:

119 **Mixed resident and non-resident trusts**

254 **CGT: non-resident companies trading in the UK**

264 **CGT: avoidance on sale of subsidiaries**

400 **Tax deductible from tax credit payments to US companies**

These have a cost if not implemented.

3. Starter 100, **age allowances:** Scorecard shows cost of indexing over 80s' allowance and extending it to all over 75. Alternatives:

- increase allowance for over 80s by 10 per cent: cost becomes -10, -10
- double index allowance for over 80s: cost becomes -15, -20.

4. Starter 116, **PRP:** includes effects of changes announced 3 February.

5. Starter 154, **private medical insurance:** announced 31 January. Cost revised to reflect decision on high rate relief.

6. Starter 216, **CGT: unincorporated businesses' trading losses:** cost uncertain (range -25 to -50). Assumes change does not apply to gains realised before 1989-90. Full year effect could be -50 to -100.

7. Starter 453, **COBO:** now includes index linked bonds with life of no more than 3 years.

Shd this be 5 yrs? [illegible]

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8. Starter 633, sale of number plates: cost revised on more cautious estimate of sales and prices.

9. The following starters still in play are expected to have nil or negligible cost or yield in 1989-90 and 1990-91:

2	Excise: power to estimate revenue duties payable
3	Excise: restriction of duty-paid blending of made-wine
4	Excise: measurement and declaration of original gravity of beer
5	Excise: misdescription of substances as beer
6	Excise: oil duties relief
34	Raise VAT threshold from £22,100 to £23,600
36	Right to repayment of VAT/excise duties and consequential changes
39	Duty and tax relief for diplomats and visiting forces
60	Prosecution time limits
61	Seizure at export of probable cash proceeds of drug trafficking
62	London Port banking: amendment to CEMA Section 17
63	Unauthorised disclosure of confidential information (C & E)
103	Secure accommodation
114	Taxation of employee priority in company flotations
118	Trusts
158	Charities: payroll giving limit
205	ACT: change in ownership
207	Capital allowances at sports grounds
209	Capital allowances: pre-consolidation amendments
212	Reopening of claims etc
213	Extension of pre-trading expenditure relief
218	Lloyd's stock lending
255	CGT: technical changes associated with rebasing
256	CGT: chattels exemption
262	CGT: sterling non-qualifying corporate bonds
263	Gifts to housing associations
404	Tax charge on switching investments in offshore funds (Umbrella funds)
450	Keith committee: administrative improvements
451	Sub-contractor tax scheme
452	Unauthorised disclosure of confidential information (IR)

SCORECARD OF 16 FEBRUARY 1989

453 Deep discounted government and para-statal bonds

455 Electricity privatisation: miscellaneous taxation provisions

601 VED: trade licensing

602 VED: special types

605 VED: recovery vehicles

606 VED: dishonoured cheques

631 VED: update reference to "registration book"

632 VED: grass cutting vehicles

651 Government stock: small estates

652 Gilts redemption monies: new procedures

654 Redemption 3% 1986-1996: wind-up of Annuities Account and Sinking Fund

655 Power to use NLF money to purchase and cancel gilt edged securities ahead of redemption

656 National Savings: abolition of minimum interest rate provision

657 National Savings: restriction of investment and ordinary accounts to personal holders

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SCORECARD OF 16 FEBRUARY 1989

TABLE 3: STAFFING EFFECTS

		Effect in man-year terms in 1989-90	1990-91
1.	Freeze excise duties	nil	nil
2.	Reduce duty on unleaded petrol	nil	nil
3.	VED: coaches and lorries	nil	nil
4.	VAT: non-domestic construction etc	+ 45	+ 130
5.	Index IT thresholds	+ neg	+ 20
6.	Increase car scales by 20 per cent	nil	+ 10
7.	CT: raise small companies thresholds	nil	nil
Savings			
8.	Abolish stamp duty on shares from 1/4/90	- nil	- 30
9.	Life assurance	+ neg	+ neg
10.	Pensions, PEPs, Share Schemes, Unit trusts	+ neg	+ neg
Other			
11.	Schedule E: receipts basis	+ 10	+ 40
12.	PRT: incremental investment relief	nil	nil
13.	VAT: bad debts, registration, etc	+ 10	+ 20
14.	Other starters	+ 15	+ 55
15.	TOTAL	+ 80	+ 245

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NOTES TO TABLE 3

These are the Revenue Departments' preliminary estimates.

On line 4, Customs have provision in the PES baseline for extending VAT to non-domestic construction etc.

Line 11 would save 100 staff in 1991-92 and 175 in 1992-93.

Line 14 breaks down as follows:

	1989-90	1990-91
Over 60s medical insurance (includes setting-up costs in 1989-90)*	+ 10	+ 25
Index IHT threshold	+ 5	+ 10
CGT: freeze exemption limit	nil	+ 10
CGT: set off trading losses**	+ neg	+ 5
No change in threshold for stamp duty on housing***	nil	+ 5
TOTAL	+ 15	+ 55

* +45 in subsequent years.

** up to +10 by 1991-92.

*** +10 in subsequent years.

ITEM 2

CAR TAX RELIEF

BUDGET CONFIDENTIAL

JEFFERSON-SMITH → CH/EX 16/2

Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-382 5011

P Jefferson Smith
Deputy Chairman

FROM: P JEFFERSON SMITH

DATE: 16 FEBRUARY 1989

CHANCELLOR

CAR TAX RELIEF ON CARS SUPPLIED TO MOTABILITY FOR LEASING

You asked for further information regarding the above proposal.

Take up of present reliefs

1. DSS tell us that Motability currently own about 67,500 vehicles which are either on lease or the subject of a hire-purchase agreement with the disabled owner. Vehicle purchases in 1987 and 1988 totalled 17,500 and 28,400 respectively; approximately two-thirds being subsequently leased and one-third sold on hire purchase to disabled persons. We understand that Motability has the capacity to process a maximum of 40,000 vehicles per annum. The revenue cost of a relief on car tax for leased vehicles would be roughly £5m in 1989-90 and £10m in 1990-91. This could, of course, increase if the leasing became more attractive as a result of any concession. The concession would be worth about £400 per car, and Motability could be expected to pass it on in lower initial payments and insurance charges, thus increasing the uptake of the scheme.

Distribution:

Chief Secretary	Mr A C S Allan	Chairman) C & E
Financial Secretary	Mr Macpherson	Mr Finlinson)
Paymaster General	Miss Simpson	Mr Wilmott)
Economic Secretary	Mrs Chaplin	Mr Nissen)
Sir Peter Middleton	Mr Tyrie	Dr McFarlane)
Sir Terence Burns	Mr Call	Mr Allen)
Mr Anson		Mr Holloway)
Dame Anne Mueller	Sir Anthony Battishill) IR	Mr Deedman)
Mr Wicks	Mr Beighton)	
Mr Hardcastle	Mr Isaac)	
Mr Byatt	Mr Painter)	
Mr Scholar	Mr Bush)	
Mr Culpin	Mr Calder)	
Mr Gilhooly	Mr McManus)	
Mr Michie		
Mr Pickford		
Mr Riley		
Mr Sedgwick		
Mr Matthews		

2. We cannot give a figure for the number of disabled drivers, ie disabled persons holding a driving licence. However, DSS say that 565,000 persons claim mobility allowance, and these are the people eligible to get cars from Motability. This figure includes non-drivers, eg those under-age, but the mobility scheme extends to the provision of vehicles for disabled driver and non-driver alike (ie including those wishing to use the vehicle as a passenger). Mobility allowance will be £24.40 a week from 1 April.

Scope of present reliefs

3. It may be helpful to summarise the existing reliefs.

4. There is complete relief from VAT and car tax on vehicles "designed or substantially and permanently adapted for the carriage of a .... disabled person in a wheelchair or on a stretcher." This applies whether the car is hired or purchased. The eligible population must be very small. Because of the cost of conversion, in relation to the tax relieved, the relief is effectively self-policing.

5. The cost of adapting a vehicle to suit the needs of a disabled person is relieved of VAT by zero-rating the supply.

6. Vehicles used exclusively by a disabled person in receipt of a mobility allowance are exempt from vehicle excise duty.

7. At present, neither VAT nor car tax is relieved on cars purchased by the disabled, other than those for wheelchair or stretcher travellers, even though the cars may have some degree of adaptation. This is essentially for reasons of control: it would be very difficult to check on subsequent use and disposal of the cars which may be ordinary production models, so as to prevent disabled people from abusing the scheme by purchase and rapid resale. The difficulty is both of official resources and of appearing to hassle the disabled.

8. Where Motability buy the vehicles (VAT and car tax paid) for leasing to the disabled, VAT can be reclaimed as input tax in the normal way. Since the hire of vehicles to the disabled has since 1984 been a zero-rated supply, VAT is effectively relieved.

Why no car tax relief?

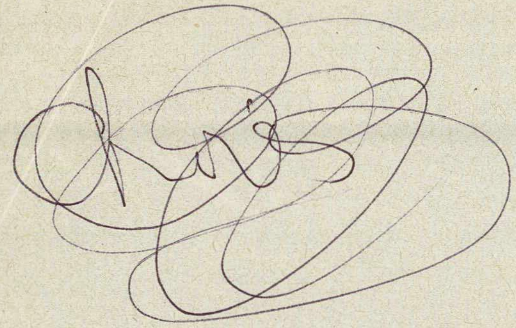
9. Relief from car tax on vehicles bought by Motability for leasing has previously been refused partly on grounds of revenue cost and partly for control reasons. Car tax is a single stage tax charged on manufacture and it is impractical to police subsequent use. If there was a concession for Motability leased cars, this would be given once for all, when the cars were acquired. It would seem desirable to stipulate that the relief was conditional on the leasing being for a three year period.

Form of Legislation

10. In the note for the previous Overview, we advised that the relief could be given by Order. In view of the need to set conditions, primary legislation may be required. If you wish to proceed with this relief, we will consider this point further.

P JEFFERSON SMITH

NICS + EQUAL
PENSION AGE



 COPY NO 20 OF 36 COPIES

FROM: J F GILHOOLY

DATE: 9 February 1989

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Pickford
Mr Riley
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Mr A C S Allan
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Mr Call

Sir Anthony Battishill)
Mr Beighton)
Mr Isaac)
Mr Painter) IR
Mr Bush)
Mr Calder)
Mr McManus)

Mr Unwin)
Mr Jefferson Smith) C&E
Mr P R H Allen)

LOLLIPOPS

We have done out usual annual trawl of Customs, the Revenue and the Treasury (including Treasury Ministers and Special Advisers), for measures which are cheap, popular and simple to draft. We have turned up only three, detailed at Annex A.

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2. The crop is thin this year, mainly because existing starters already include lollipops: for example, Starter 32 (VAT and Charities), Starter 100 (additional relief for the over 75s or over 80s and reducing the marginal withdrawal rate for age allowance), Starter 158 (doubling the limit for payroll giving). Some were on the lollipop list for the 1988 Budget, but deferred to this year.

3. The three possibilities are:

(a) **A stamp duty relief relating to intra-group transfers of property.**

This would undoubtedly be welcomed by representative bodies such as the CBI and the Law Society, who press for it each year in their Budget representations. It has very little popular appeal, but the Revenue advise that the cost would be little, the staff cost negligible and very little Finance Bill space would be needed.

(b) **Extend duty exemption for small-scale bingo**

This would raise (by say a quarter) the prize limit above which small-scale bingo becomes liable to duty. The cost would be under £2m in a full year, the change could be made by order and there would be negligible effects on Customs' staffing and on traders' compliance costs. The commercial halls, however, would oppose - they oppose the existing exemption for non-commercial bingo.

(c) **Car tax relief on cars supplied to Motability for leasing**

You have considered this in the past, and wanted it brought forward to look at again this year. It meets the Lollipop criteria, but would

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increase Motability's privileges compared with those available to the disabled generally. Cost would be about £7½ million.

Fuller details of these three ideas are set out in Annex A.

4. None of the three looks irresistibly attractive for this year and you may feel that they are not worth pursing, given that there are already several Lollipops included in the existing starters.

5. Finally, I should mention one other proposal, not strictly a Lollipop, but turned up in the trawl. Starter 110 would increase from £100 to £150 the monthly limit for participants in the FA 1980 all employee SAYE-related share option scheme. The present facility is confined to savings in Building Societies and the DNS. MG have proposed extending it to banks too. We are pursuing that separately with the Revenue, and will submit separately about it to the Financial Secretary.

J F GILHOOLY

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ANNEX A

A. Stamp duty group relief

Existing stamp duty law provides exemption from the normal 1 per cent charge when land or other property is transferred between companies in the same group. (The same provision likewise cancels the 0.5 per cent payable on intra-group transfers of shares; but this particular duty is to be abolished altogether from 1 January 1990.)

The relief for transfers between associated companies does not extend to the lease duty charge, which applies on the grant of a new lease. And in order to qualify the two companies involved must pass a more stringent ownership test than is usual elsewhere in tax law: 90 per cent, not 75 per cent, ownership is required. The case for extending the relief and relaxing the ownership test was aired in a 1983 Revenue consultative document. Since then the major representative bodies have continued to press on both these fronts. Meeting their points by extending the relief to lease duty and reducing the ownership percentage to 75 per cent would have some revenue cost, though this is likely to be modest. Any staff cost would be negligible and the Finance Bill drafting short and simple.

B Extend duty exemption for small scale bingo

Small scale bingo, played mainly in non-profit-making clubs, is exempt from duty unless the stakes or prizes exceed £400 on one day or £1,000 in a week. If the limits are exceeded, all bingo in the club becomes dutiable for a period of 13 weeks. Most clubs operate successfully within the limits but the Committee of Registered Clubs Association (CORCA) has argued in recent years that they should be increased to reflect their loss in value since 1982 and that there should

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be a reduction in the chargeable period. Strong Parliamentary support has been organised and a new clause was put down at Committee stage of the 1988 Finance Bill to increase the exemption limits to £500 (daily) and £1400 (weekly); the clause would also have reduced the chargeable period from 13 weeks to 4.

If Ministers wished a concession could be included in the Budget proposals. We suggest suitable increases would be from £1,000 to £1,250 in the weekly limit and from £400 to £500 in the daily limit. This could be accompanied by a reduction from 13 to 9 weeks in the liability period of a club which exceeds the exemption limits. The objectives of the period are to prevent frequent registering and deregistering of clubs and to provide a deterrent to too many "boom" weeks. Customs and Excise could cope with a 9 weeks period. The revenue cost of these changes should be less than £2 million in a full year. Changes in small scale exemption limits can be made by Order. Effects on staffing and on traders' compliance costs would be negligible.

The Bingo Association of Great Britain, representing the commercial halls, is opposed to existing (and further) duty exemption for non-commercial bingo.

C. Car tax relief on cars supplied to Motability for leasing

Motability received very generous concessions in 1984 - deliberately over-compensating them for other tax changes - which, since they took the form of zero rating for leasing charges, gave considerable help to those choosing to lease, not buy, from Motability. The Chancellor decided not to make this further limited concession then, but said he would not rule it out for the future. Revenue cost would be £7.5m at the present volume of leasing (car tax only as VAT relief already applies). The change would be made by Treasury Order. As far as we are aware there is no real pressure for this. If given, the concession would increase Motability's privileges compared with those available to the disabled generally.

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FROM: J P MCINTYRE
DATE: 20 February 1989

MR ANSON

Ch/
Relevant to review
20/2

cc PPS
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Miss Peirson
Mr Gilhooly
Mr S Matthews
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call
Sir A Battishill IR
Mr Jefferson-Smith IR
PS/IR
PS/Customs

CAR TAX RELIEF ON CARS SUPPLIED TO MOTABILITY

You asked for ST comments on Mr Jefferson-Smith's minute of 16 February.

2. The key question is how far this concession might ease the pressure for higher expenditure on disability benefits arising from the OPCS reports. I think the answer is: a little, though there must be a risk that it would simply be pocketed now and forgotten by the time the government announces its response to OPCS, perhaps in the Autumn.

3. The following may be helpful background in the decision:-

(i) Take-up of Mobility Allowance (Mob A), the benefit which entitles disabled people to get cars from Motability, has been rising strongly, from 95,000 in 1978-79 to 530,000 this year. DSS expect further growth, to 675,000 by 1991-92.

Expenditure has increased from £47 million in 1978-79 to £665 million this year.

(ii) Mob A is available to people who are unable or virtually unable to walk. It does not have to be spent on wheelchairs, specially adapted cars etc. So a rise in the numbers receiving Mob A does not necessarily lead to a proportionate increase in people with Motability cars.

(iii) Car tax relief on Motability cars would make Mob A a more attractive benefit, because Mob A would be the ticket to the tax relief. So Mob A take-up and expenditure might increase as a result.

(iv) OPCS has shown that the average extra living costs faced by disabled people are <u>less</u> than the existing levels of extra cost benefits like Mob A. (eg for the most severely disabled, these extra costs averaged £11 a week in 1985. Mob A is now over £24 a week.)

(v) We have announced 3 concessions on disability benefits in recent months, two of direct relevance here:

* an increase in the maximum age for receipt of Mob A from 75 to 80, partly to ensure that those coming up to 75 and still making payments to Motability would not be forced to give up their cars because of the loss of income from Mob A;

* a £5 million special donation to Motability (in 1988-89);

* an increase in the income support premium payable to disabled people over 60 (from October 1989) as part of the poorer pensioners package. Single people will get an extra £2.50 a week; couples £3.50. (The poorer disabled <u>under</u> 60 gained about £70 million a year under the April 1988 reforms.) In addition, DSS makes continuing contributions to Motability administration costs.

4. On the whole, I doubt whether the public expenditure interest strongly favours this concession. In one respect (iii above), it would even be adverse. In any case, we have done quite a lot for Motability recently. Perhaps it could be looked at again next year, if we were under pressure to do more in response to OPCS.

JM

J P MCINTYRE

ITEM 3

COPY NO. 1 OF 20

NOTE OF MEETING 13 FEB

MINUTES OF A MEETING HELD IN THE CHANCELLOR'S ROOM
HM TREASURY, AT 6.00 PM ON MONDAY 13 FEBRUARY 1989

Present

Chancellor
Financial Secretary
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Sharples
Miss Hay
Mr Ford
Mrs Chaplin

Sir A Battishill - IR
Mr Beighton - IR
Mr Haigh - IR
Mr Deacon - IR
Mr Newstead - IR

Mr Newton - Government Actuary's Department

LIFE ASSURANCE

Papers: Mr Deacon's note of 9 February; Mr Gilhooly's note of 10 February.

The Chancellor invited the meeting to consider the options summarised in the papers. In preliminary discussion, Mr Newton confirmed that he was content with the calculations set out in the papers. It was noted that the calculations assumed 7½ per cent growth per annum. The yield figures were at constant 1990 prices. The yield in Year 1 was lower in the ten year spread than in the seven year spread in the Tables only because of the way the particular phasing packages had been put together; the annual yield could be altered if Ministers wished.

2. Mr Newton said that GAD's main concern was that any changes should be phased in, to give companies time to adjust. He was more concerned with the impact of the changes in the first year or two than with the later years, by which time the companies should have set in train whatever adjustments they judged desirable. He added that, if Ministers chose one of the "high start" options, he did not believe this should cause unreasonable difficulties.

3. The meeting considered various possible combinations of spreading and phasing. Mr Beighton argued that the industry might react quite favourably to the figures in Schedule C of Mr Deacon's note. Although the industry would not welcome bringing acquisition expenses into tax, this would be offset to some extent by the reduction in tax rates. Mr Haigh confirmed that the "establishments" basis of taxation meant that subsidiaries of UK companies operating in other EC countries would not be put at a disadvantage to their local competitors by the changes envisaged. Mr Deacon said that the companies most affected by ring-fencing of pensions expenses would be those which combined pensions and other business: these were the companies which had gained the largest "uncovenanted" benefit from the present arrangements. Mr Newstead said that it would be the most efficient companies which were likely to gain most from the overall package.

4. After some discussion, it was agreed to go ahead on the basis of a "high start" package, with four steps and a seven year spread. It was noted that the end result of such a package would not be greatly different from that achieved by confining any change to abolishing LAPD, and ring-fencing pensions expenses. However, other things apart, it was necessary to reduce tax rates because of the need to make changes in the taxation of unit trusts, and this provided a justification for the wider package. It was noted that the full year mature yield of the package would be around £225 million.

5. It was <u>agreed</u> that the start date for abolishing LAPD should be 1 January 1990.

J M G TAYLOR

14 February 1989

Distribution

Those present
PS/Economic Secretary
Sir P Middleton
Mr Tyrie

ITEM
7

RESIDENCE

FST 17/2

BUDGET CONFIDENTIAL

docs 4.17.02.89

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY

DATE: 17 February 1989

CHANCELLOR

cc: Paymaster General
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gieve
Mr Gilhooly
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Isaac)
Mr Houghton) IR
Mr Bryce)
PS/IR

RESIDENCE

I have discussed with officials a possible receipts basis of assessment to strenghten and/or replace the current remittance basis for the foreign income and gains of non-domiciled residents. The idea is discussed in the Revenue papers of 3 February.

My view is that such a scheme would be very difficult. A receipts basis sounds attractive, since it (at least superficially) eliminates the capital/income divide which bedevils the remittance basis (remitted income is taxed, but remitted capital is not). However, as the papers show, if we are not to penalise genuine inward investment into the UK, there has to be some sort of let-out for some sorts of capital receipt. In which case we have to reinvent the wheel by drawing the line again.

From that starting point we are, with inexorable logic, drawn into the whole paraphernalia of a segregated account; an inventory of assets; exemptions for qualifying assets, temporary imports and exports; special rules for gifts and legacies; and anti-avoidance provisions for benefits and loans. Such a system would I am sure be caricatured as an Orwellian nightmare of intrusion and policing. And it would add considerable compliance costs, not least in the need for the regular valuation of assets. Moreover, the "fallback" of being able to adopt worldwide income does not strike me as being very attractive, whatever its merits in logic (giving a let-out for the person remitting <u>only</u> genuine capital for instance). To have as a fallback an option we have already been forced to reject would be difficult to sell!

I did consider whether we could skirt around the capital/ income divide and tax <u>all</u> receipts, albeit at a low rate. But that does not solve the problem for people remitting only capital, who would be justified in complaining loudly. Nor would it stop (non-taxable) transfers into the UK in years of non-residence. In short, it would be both ineffectual and resented.

This is disappointing. Without a receipts basis for the non-domiciled resident, we are left with the minimalist possibilities set out in paragraph 9 of Mr Houghton's paper; the residence rules themselves, anti-avoidance measures such as dual contracts, the CGT one-year drop-out and Reed v Clark, and preventing the ceased source device. There is also the option of taxing the non-domiciled <u>British</u> resident on a worldwide income basis. Though that would require a comprehensive yet reasonable definition of "British", and would not be easy.

Ch

We could drop <u>presentation</u> from this week's agenda. A fuller note from Robert for a substantive discussion next week?

AB

Ch

In the light of all this, I have been thinking about what you can say in the Budget speech. My suggested line would be:

No mths of
Coshn

- most grateful for all the responses to the consultative document;

- but some people have asked for further consultation in certain areas (deliberately vague);

- and so we have decided to continue the process to see what can be done about them;

- however, we have definitely decided not to pursue the worldwide income approach;

- nevertheless, there are specific things which we intend to put right whatever happens (those in the paragraph above).

I see no alternative to this approach. A further period of consultation may yield some ideas, particularly since many of those complaining about the worldwide income approach also suggest instead a strengthened remittance basis. We could see what they can come up with.

I still believe that the worldwide income basis is the right way to tax non-domiciled residents. It did occur to me that if we had a 17 out of 20 year test (instead of the 7 of out 10 proposed in the consultative document), it would be very difficult for anyone to justify resisting the worldwide income approach. That would produce some (small amount of) revenue; and it would establish a principle which future Treasury Ministers could tighten later. But it would not get round the objections on disclosure. So I suspect that other people would object to it.

R.C.M.J.

pp NORMAN LAMONT

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Ch/ To be aware. We await FST's advice.
3/2

ISAAC 3/2

FROM: A J G ISAAC
3 February 1989

FINANCIAL SECRETARY

RESIDENCE: A RECEIPTS BASIS

1. The attached minutes report the result of further work here on

- what a receipts basis might look like and

- what could be said on this matter in the Budget Statement, if you decide to proceed with this approach.

2. As the notes explain, we have taken the work a good deal further. But some important work remains to be completed before we could advise you to consider a firm decision to go ahead.

---

cc PS/Chancellor
PS/Paymaster General
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gieve
Mr Gilhooly
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)
Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Houghton
Mr Lewis
Mr Bryce
Mr Cayley
Mr Elliott
Mr Phalp
Mr Thomas
Mr Davison
Mr S C Jones (Bootle)
Mr Richardson
PS/IR

GENERAL BACKGROUND

3. In my earlier note to you, I tried to emphasise the need for "balance". Perhaps I should here expand that thought.

4. First, we are not so naive as to be looking for full effectiveness. As you know from other work, a small minority of the seriously rich people with income wholly or mainly derived from UK sources (a not implausible rule of thumb, from the little we have been able to measure so far, might not perhaps be more than one in ten) contrive to pay little or no income tax. Under any conceivable tax system, there will be a larger margin of (legal and illegal) non-compliance amongst the seriously rich and internationally mobile.

5. As against that (I need hardly say) any major reform of the tax treatment in this area is likely to be complex, time-consuming and controversial. We could not advise Ministers to embark on a new consultative process, or new legislation, if the prospect remained - at the end - that ~~in which~~ only a small minority of these people paid any significant UK tax.

6. By the same token, you will not wish to commit yourself to a further consultative process, unless you see your way fairly clearly through to a productive conclusion.

NATURE OF A RECEIPTS BASIS

7. As I said earlier, the concept of a "receipts basis" is pretty simple. You do not require the non-domiciled foreigner to declare his worldwide income. Instead, you tax him on what he brings into the country. It follows that you do not enquire into the origin of the money or money's worth he brings into the country from abroad: whether it was from income, or capital, or gifts, or loans. Everything is a receipt, and everything is taxable. If the non-domiciled foreigner does not like that - if

he wants to argue that a sum of money came out of his original capital, or a gift from relatives, and not out of income - then he has the alternative of the world-income approach available to him (although he cannot jump from one basis to another as the circumstances suit).

8. All this is a radical jettisoning of conventional tax concepts. I myself do not find it unthinkable - or indeed all that difficult to present, as such; and we know that people like John Avery Jones and John Chown have been attracted by the concept. But there are (inevitably) lots of complexities. And there are a number of vital pressure points, which you will wish to consider very carefully before committing yourself even to a further stage in the consultative process.

9. To these I now turn.

CAPITAL INVESTMENT

10. We still feel (though John Avery Jones' initial reaction was rather more robust) that we shall need to provide some easement for major capital investments in the UK, not just for the initial year or years immediately after the taxpayer comes here, but over a longer period. Our preferred answer to that is the "segregated account". The thought here is that:

- the taxpayer can bring as much money as he wishes from abroad to purchase major capital assets here (qualifying assets) without paying tax on the remittances as a "receipt";

- income and gains on UK assets within the segregated account are subject to income tax and capital gains tax in the normal way;

- subject to that, the taxpayer can sell and reinvest the proceeds in other qualifying assets, without paying tax on the proceeds as "receipts";

- However, if he sells an asset and takes the money out of the segregated account to finance his living expenses here, the money is at that stage treated as a "receipt" and taxed accordingly.

In effect, payments into and out of the segregated account are treated in much the same way as payments to or from abroad.

11. For this approach to work, we need a definition of qualifying assets which is

- broad enough to comprise the major capital investments which cannot reasonably be included in the basis for a receipts tax;

- but not so broad as to allow normal living expenses to be sheltered from tax, or to threaten an intolerable reporting and monitoring burden.

12. The notes outline some difficult decisions needed here. Our work so far does not minimise these difficulties, but does not so far suggest that they are likely to be unmanageable.

ASSOCIATED TRANSACTIONS

13. Any tax base - even worldwide income, though in a different form - has to tackle the problem of associated transactions. These cover the huge variety of means whereby the taxpayer's living costs are funded, not by himself in person, but by trusts, companies acting on his behalf, by reciprocal arrangements and so forth. One of the most difficult areas here is the treatment of loans (which may be from abroad, or from an ostensibly UK source, or a mixture of the two); as the notes explain, there is still some urgent work to complete here. At the top end of the market we are dealing with people here for whom formal distinctions between income and capital can be unreal.

PHYSICAL ASSETS

14. We need rules to deal with physical assets imported into this country. Otherwise

- legal avoidance will be so easy as to destroy the purpose of the new rules; and

- there will also be a tax incentive for people to switch their purchases from a UK to an overseas supplier;

leading to the same kind of inherent risk for which people have criticised the worldwide income approach: driving business out of the UK, but collecting no worthwhile new tax.

15. The present remittance approach is in principle apt for goods brought into this country and sold here. As the notes explain, there is more work to be done, and some discussion with Customs, on a realistic (compromise) approach to goods purchased abroad for consumption here. This is supremely an area where we cannot ~~seek~~ to make the scheme watertight, but cannot afford to leave the flood-gates open.

TAX BURDEN

16. Beyond all these technical (but crucial) matters there lies the major question: would the big non-domiciled foreigners resident here be prepared to live with any significantly more effective tax system?

17. You have had messages (in particular on behalf of the Greeks), saying that they would be prepared to pay a reasonable tax bill related to the money they spend here - provided that they are not required to declare their worldwide income. But in giving that message, the Greeks may well not have envisaged the possibility that we should be seeking to catch within the tax net the money that they bring into this country from the multitude of

overseas trusts and companies that they control. The question is whether the Greeks, and people like them, would be prepared to face the disclosure that would be required to establish the total amount of money brought into this country by them and on their behalf - and to pay the tax bills that would follow.

18. The object, and only justification, of tax reform would be to make most of these people pay a tax bill in some reasonable relationship to the money they bring into this country and spend. If this goes below the Greeks' bottom line - if they say that they will leave the country, rather than pay <u>any</u> substantial amount of tax - would Ministers be prepared to see that consequence?

19. If not, there remain the relatively minor options for tidying up discussed in Mr Houghton's note.

20. You may wish to discuss.

A J G ISAAC

CONFIDENTIAL

Inland Revenue

International Division
Somerset House

FROM: B T HOUGHTON
3 FEBRUARY 1989

1. Mr Isaac

2. Financial Secretary

HOUGHTON 3/2

RESIDENCE: RECEIPTS BASIS

1. The Chancellor has asked us to examine the possibilities for tightening up the remittance basis as part of a possible 1990 residence package. The minutes of 22 December from Mr Isaac and myself described in broad outline how this might be done by introducing a new receipts basis. You suggested that we should work this up prior to discussion. This has now been done in the papers attached (Mr Bryce's submission with Mr Richardson's annex). As you will see we have not been able to take this quite to completion; more work needs to be done on gifts, loans, imports (on which we will have to consult Customs and Excise) and the valuing of assets in the segregated account. The assessment of this basis as a feasible approach to dealing with the deficiencies of the present system will determine what can be said on the residence question in the Budget Speech.

---

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

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

2. Although this is still work in progress we thought you would like an opportunity of taking stock to see whether the scheme was developing along the right lines.

3. It is clear from the description of the new receipts basis that it cannot be a simple structure. Even with the complex arrangements outlined in the attachments, the evasion potential and the leakages may be substantial. Nonetheless the ultimate test will be whether it produces a significant addition to the yield of the present remittance basis.

4. In this context the idea of minimum tax charge based on a proportion of receipts may have some attraction although it is not an approach which we have generally thought desirable.

Reactions to a Receipts Basis

5. A key consideration will be the public reaction to the new receipts basis. Two factors are of particular importance in this connection. First the effect of the new scheme on the tax take. If the scheme is really effective it may increase perhaps substantially the tax burden on non domiciled residents. This would have been one of the effects of a world income approach and was resented for this reason. Will the new receipts basis be subject to the same opposition? Will it founder on the opposition of the Greek and related communities or will they be prepared to pay more UK tax provided that it is on terms which are acceptable to them? The signals received have been ambiguous on this. Secondly will the new receipts basis be too intrusive, much as the world income basis would have been in relation to the world affairs of particular groups of taxpayers? Again in the Greek context would the new receipts basis require such a degree of disclosure (eg in relation to benefits enjoyed from non resident trusts or gifts received) that they would find this basis as objectionable as the world income basis? These are the key political judgments on which the viability of the new scheme depends.

6. The new approach could also be made to appear exceptionally severe as compared with the basis on which domiciled residents are taxed. It would seek to charge at full United Kingdom income tax rates what were in truth capital imports and (possibly) gifts, windfalls and legacies and loans. This goes well beyond any normal concept of taxable income and allowing double taxation relief only by deduction would be represented as a further deprivation. But against this the concept of deductible expenditure on qualifying asset purchases is a substantial relief.

7. There are a number of worrying pressure points within the new scheme. The coverage of the segregated account, the test of connection for benefits purposes and the level of the minimum proportionate charge (if adopted) will all be likely to be subject to pressure over the coming years. The question is whether the scheme could withstand critical examination in another consultative exercise. This raises two separate questions. The first is simply the political viability of the scheme considered in paragraph 5. The second is whether technically the scheme has the makings of an approach which can be operated reasonably effectively in relation to its yield. We may be moving towards an affirmative answer on the second question but if the answer on the first question is no then there seems little point in taking the work further.

<u>Fall-Back</u>

9. This raises the question of a fall-back position. If following further consultation Ministers decided that the new receipts basis was not on or decided <u>now</u> that it was not a starter what could we fall back on? There is very little left. The 3/5 year window approach has very little to commend it and it would not be defensible against all the obvious criticisms that can be made of it. There remains only a bottom line package consisting of:-

- The residence rules (incorporating the abolition of the available accommodation rule subject to a, say, 60 day test - ie if there is accommodation here and the user is present for 60 days or more in the year he is resident here);

- Specific anti avoidance measures - these could include dual contracts, CGT one year drop out, Reed v Clark;

- Preventing the ceased source device.

- A world income basis* for the non domiciled British resident.

But this package might appear rather unimpressive because the main area of avoidance (the capital/income exploitation) would not have been dealt with and practitioners would go on exploiting the remittance basis much as they have done in the past.

10. The decision therefore centres on the nature of the Budget announcement. If this follows the lines proposed in Mr Bryce's minute it would lead to a further round of consultations focused on the receipts basis (possibly with draft clauses). But if this came to grief for very much the same reasons as the world income approach failed the exercise as a whole would not seem very effective with the centrepiece of the new approach - the receipts basis - falling by the wayside.

11. An alternative would be to make a substantial change of direction towards a lower profile package (on the lines of that described in paragraph 9 above) for 1990 preceded by consultation. The only means of countering the major area

* This is not the only case in which the concept of world income would have to be maintained. We have not been able to dispense with it entirely in the receipts basis scheme but it would only be for the purpose of providing a <u>lesser</u> measure of liability (see paragraph 6 of the Annex).

of abuse (capital v income exploitation) would be by increased compliance effort (this amounts to little more than seeing that the procedures adopted for running dual bank accounts for instance were meticulously observed).

12. As has already been noted, the financial effects of this low level package (even with only the limited removal of the available accommodation rule) are not predictable and there can be no guarantee that it would not cost some money and (because of the failure to remove the available accommodation rule entirely), it might not be particularly well received. It would of course always be possible to do nothing on residence but there is undoubtedly a general expectation of at least some change in the residence rules and there would be disappointment if nothing came of the whole exercise.

13. Would you like to discuss?

B T HOUGHTON

CONFIDENTIAL

Inland Revenue

International Division
Somerset House

FROM: J P B BRYCE
DATE: 3 FEBRUARY 1989

1. MR HOUGHTON Mr 3/2. Pl. see accompanying note.
2. MR ISAAC 2/2
3. FINANCIAL SECRETARY

BRYCE 3/2

RESIDENCE: RECEIPTS BASIS

1. In our earlier notes of 22 December, we outlined the general shape of a possible receipts basis; you indicated that you would wish to hold a meeting on this when our thinking was more advanced.

Background

2. Now that it has been decided not to subject those with a foreign domicile to tax on their world income (with the possible exception of UK citizens), the Chancellor agreed with your recommendation - at the meeting on 21 December - that work should be done on strengthening the remittance basis with a view to legislation in 1990.

3. You will recall that the remittance basis suffers from 2 basic weaknesses:

- it does not apply to remittances of capital which are used instead of income to finance ordinary living expenses here, and

- where income is remitted, there must be a continuing source to sustain a tax charge.

The effect of these weaknesses - to which attention was drawn in the consultative document - is that substantial sums of money can be received in the UK without giving rise to any tax charge here.

4. We have therefore been examining the possibility of tightening up the remittance basis so that the tax liability of foreign domiciled individuals is more closely related to their lifestyle here. This is breaking new ground - no other country attempts to do this in any realistic way (Switzerland uses evidence of wealth as a proxy but this is an unattractive approach).

Outline Scheme

5. The note attached fills in some of the details of a possible scheme. There still remain a considerable number of loose ends but I hope that it gives you sufficient information to reach a decision on whether it is worth our continuing to develop it in detail.

6. The basic approach of the scheme is to impose tax on all amounts received in this country from overseas and on all benefits which are enjoyed in the UK out of foreign assets; it applies therefore not only to financial remittances but also to assets which are brought into the country and to any benefits which are provided by an overseas trust or company.

7. This would be too draconian as it stands. So an adjustment is needed for receipts from abroad which are used to purchase certain capital assets here like immovable property, quoted securities and business interests (this is called the "segregated account").

Sensitive Areas

8. There are a number of areas of the scheme which combine sensitivity and complexity to a rare degree, even in matters of taxation.

- the whole concept of the "segregated account". The object of this account is to exempt from the charge remittances from abroad used to purchase large items of capital expenditure. There would be no charge on such a remittance unless and until the asset was sold and the proceeds were not used to purchase another qualifying asset or remitted abroad. At the extreme, the qualifying assets are fairly obvious eg real property and equity investment. The treatment of other assets is less obvious, eg the purchase of a lease for say 5 years, bearer bonds, cash in a deposit account or depreciating assets like plant and machinery. In the absence of any generally acceptable criteria for the definition of qualifying assets, this would be a continuous pressure point in the scheme. Moreover, an inventory of qualifying assets would need to be maintained and updated as necessary as assets were bought and sold. This would be an unwelcome new complexity but might be acceptable in the context of an overall relieving provision.

- the treatment of assets brought into the country. Clearly, it would be a nonsense for the scheme only to apply to cash or near cash - even the present remittance basis goes wider. By the same token, a system which required the valuation of all assets which were brought into this country would be wholly unacceptable. To some extent, this problem could be met by providing a de minimis limit for assets of relatively little value and, at the other extreme, works of art or expensive items of jewellery might be regarded as qualifying assets in the segregated account. We would intend to speak to Customs and Excise to see whether their experience suggests a feasible way of dealing with the remaining assets which do not fall into these categories.

- loans. This is a crucial part of the scheme since living on credit would be the most obvious way of avoiding the bringing of any money into the country for living expenses. The logic of the scheme would require tax to be charged on a loan which was secured or otherwise obtained on the basis of an individual's overseas assets or those within the segregated account; a loan which related only to UK assets outside the segregated account could not be regarded as an overseas remittance. But this elusive - and in some cases illusory - distinction would be extremely difficult to administer or define in statute. We are considering this further but without an acceptable solution to this problem the efficacy of the scheme as a whole must come into question.

- legacies and gifts. To be comprehensive, the defintion of receipts must be widely drawn. This means that receipts which are not otherwise subject to UK tax eg gifts and legacies would be brought into charge. Thus a non-domiciled resident would be liable on receipts which attract no income tax liability in the hands of a domiciled resident.

Minimum tax

9. We referred in an earlier note (of 20 January on the minimum tax) that there might be something to be said within a receipts basis of taxation for a minimum basis of liability which provided that a percentage of receipts would always be taxable.

10. As we pointed out, one advantage of a minimum tax concept in this area is that the tax charge could never be greater than receipts and that, it would bear some correlation with an individual's circumstances.

11. Against that,

- it might be difficult to defend establishing a new, complex, basis of establishing liability to UK tax while at the same time imposing a highly arbitrary liability on those who took advantage of the very reliefs which had been carefully put in place.

- in the context of this kind of scheme, a minimum tax is unlikely to achieve very much since it would be dependent on an effective definition of overseas remittances. But this is the most difficult area of the outline scheme. If the definition is inadequate for one purpose it will not provide an effective basis for a minimum charge.

Alternative approaches

12. Nevertheless, there may be some attraction in a much more rough and ready scheme than that which is outlined in the Annex. If it is decided that there should be further consultation in this area it might be worth also considering the possibilities of:

- introducing an initial period (say, 3/5 years) during which tax was charged only on UK income - remittances of either income or capital could be made without incurring any liability to UK tax. But after this period, all remittances would be charged to tax irrespective of their source or the use to which they were put; and

- imposing tax on a proportion of total receipts, again without attempting to identify whether they are in the form of income or capital or what they were used to purchase.

13. We do not ourselves favour either of these approaches since they could give rise to hard cases and they smack of very rough justice. And, in any event, both approaches require a definition of receipts - which is the most tricky area in the outline scheme. But it may be that they have some attraction for outsiders who would find the complexity of the outline scheme as presently drawn up rather daunting.

14. Another possible - and much less ambitious - approach would be to remove the "source" rule from the present remittance basis - enabling remittances of income to be more effectively taxed. This would be no more than a cosmetic change since the well advised would simply turn to the other available routes of receiving remittances here without incurring a tax charge. Nevertheless, it could be presented as a step in the direction of tightening up the present basis. And this could be accompanied by measures to reduce the availability of the remittance basis to categories of individuals who currently enjoy it. Consideration has already been given to the possibility of withdrawing it from UK citizens who are not domiciled here and this might be extended to British subjects who are not ordinarily resident here.

Budget announcement

15. As decided at the Overview meeting on Monday, early consideration now needs to be given to the form of words for the Chancellor to use in his Budget Statement to explain the precise position we have reached. Clearly, the terms of this statement must depend on your reaction to the implications of tightening up the remittance basis, but we suggest that the Chancellor's statement would need to contain the following elements:

- the consultative document was the starting point for a wide ranging review of the residence rules and the basis of liability in the UK. It provided a broad framework for moving forward to a simpler, more certain and more equitable basis;

- there was general support for a rationalisation of the residence rules but considerable concern was expressed about the implications of moving to a world income basis of liability for all those who are not domiciled here. Tax reform must take account of wider economic and social implications and, in the light of the representations which were received, we have decided not to pursue the world income approach for those who are not domiciled here and do not have links of citizenship with this country;

- but there was general recognition that the present basis of liability is unsatisfactory and I am therefore proposing to continue the consultation process to determine an acceptable, effective and equitable basis of taxing remittances to this country.

- until these further consultations have been completed I do not intend to take any action in this area. The issues of residence and basis of liability are at the heart of the tax system and the implications of changing the present basis require the most careful consideration before changes are introduced.

Conclusion

16. There is no doubt that to impose an effective, but equitable charge on remittances is a very tricky exercise. And if it is too draconian or imposes high compliance costs it is likely to run into the same heavy seas which resulted in the loss of the world income approach. There is clearly much more work to be done but it would be very helpful to have your initial reaction to the outline scheme so that we can begin to chart the way forward in what we are all agreed is a tricky and sensitive area.

J P B BRYCE

CONFIDENTIAL

ANNEX

RECEIPTS BASIS

OUTLINE

1. The receipts basis would replace the present remittance basis charge on the foreign income and gains of non-UK domiciled residents.

2. Under the receipts basis an individual would be liable to tax on all "receipts" from overseas in a year, less expenditure on "qualifying assets" in that year. It would be immaterial whether the receipts came from income or capital.

3. "Receipts" would be broadly defined to include not only financial remittances from overseas but also such items as loans, gifts, legacies, and other assets which are brought into this country. "Qualifying assets" would include such items as houses and land in the UK, and quoted shares.

4. Expenditure on qualifying assets would form a "segregated expenditure account". If an asset in the account was sold, the proceeds would be taxable as a receipt. (This might be subject to a ceiling equal to the value of the asset when it originally entered the account). If the proceeds were rolled over into the purchase of another qualifying asset there would be no charge until the second asset was sold (and so on). There would be no charge if the proceeds were remitted abroad.

It is for consideration whether

CXC

5. A receipts basis would not affect the taxation of UK source income and gains. Tax would continue to be paid on such income as it arose and as gains were realised,

regardless of how the income or disposal proceeds were spent, or whether it arose on items inside or outside the segregated expenditure account.

6. It would be necessary for an individual to be able to elect to be taxed in the normal way on worldwide income rather than on the receipts basis. This is because, for an individual living off foreign capital, the receipts basis could result in a charge in excess of that which would arise under the worldwide income basis. In this context the worldwide income basis would in effect be available as a relief measure. To prevent avoidance through individuals switching between the receipts basis and the worldwide income basis, the election would need to be irrevocable.

7. This annex considers:

- how "receipts" might be defined;
- what assets might be regarded as "qualifying assets"; and
- a number of related matters.

RECEIPTS

8. For a receipts basis to be effective, the definition of a receipt would need to be wide.

(i) Cash

9. At the most basic level all cash brought into the country would be regarded as a receipt. (The case of

gifts, legacies and similar cash receipts is considered separately in paragraphs 16 and 17 below).

(ii) Assets

10. A receipts basis that only looked at cash could be avoided by:

- buying items outside the UK that were for use in the UK (this might for instance involve going to Paris to buy a Rolls Royce, or buying from a UK dealer but being billed abroad); and

- converting overseas money into an asset which was then brought into the UK and sold.

It would therefore be necessary to take assets into account in a definition of receipts. (Gifts of assets are considered separately below, at paragraphs 16 and 17, together with gifts of cash).

11. A comprehensive approach would be to regard all assets brought into the country as being receipts. In that event, all assets would need to be valued on importation and a charge levied accordingly. The only derogations from this would be:

- if the asset was a qualifying asset that could enter the segregated expenditure account; or

- if the asset had been acquired some years before the individual became resident in this country.

In both these cases no charge would arise unless and until the asset was sold at a time when the individual was resident in the UK.

12. Special rules would be needed (and it might be possible to draw on rules in this area used by Customs and Excise) for:

- temporary exports (the Rolls Royce bought here, taken on holiday to Nice, and brought back would need to be excluded from the charge);

- temporary imports (the racehorse brought here for the Gold Cup; and - provided the proceeds were taken out of the country - the Renoir brought here for auction at Sothebys).

13. An approach which required all assets to be valued on importation would be too burdensome to be acceptable, and would clearly need to be accompanied by some de minimis limit - this could be on the lines of ignoring all items below the value of say (£2000). (But, if any assets below the de minimis limit were later disposed of while the individual was resident in the UK, it would seem sensible to tax the proceeds as a receipt). This would not however overcome the many practical problems of valuation which would result.

14. An alternative approach therefore would in all cases be to regard as a receipt only the proceeds from the disposal of an asset which was brought into this country. A work of art which was brought in from overseas would then never give rise to a tax charge if it were not disposed of. This would extend to all imported assets the special treatment under the first approach for assets held for a long time prior to an individual becoming resident here, assets in the segregated expenditure account and assets below the de minimis limit. On the face of it, this would be the more attractive approach but it would leave open the possibility of avoiding a charge by carrying out

all one's substantial spending - fur coats etc - abroad. A system which encouraged people to buy overseas rather than in the UK would seem rather curious.

15. There is no doubt that, to provide for a more effective remittance basis, assets would have to be included. And there [is] may be no real alternative to some form of valuation of assets at the point at which they are brought into this country. At first sight, the practical and political implications of this look considerable, even with some de minimis limitation. However, it may be that it would involve an individual in doing little more than he may already do for Customs and Excise. Before putting a firm proposal to you on this point we shall need to consult with Customs.

(iii) Gifts, legacies and other similar receipts

16. Gifts, legacies and other similar receipts from abroad, whether in the form of cash or assets, would be a sensitive area. The underlying principle of the receipts basis would mean that they should be regarded as receipts and come within the charge to tax. But since they are not taxable under our general principles of taxation, there is a strong case for excluding them. Against that however:

- if an individual wished he could elect to be taxed on worldwide income on normal taxation principles;

- it would be a matter of swings and roundabouts. Balanced against the taxation of gifts would for instance be the fact that receipts in what would normally be regarded as being a taxable form (eg foreign bank interest) would not be liable if spent on qualifying assets; and

- it would be very hard to distinguish between genuine gifts and artificial arrangements where (for instance) an individual channelled his own foreign income through the hands of a relative or other third party.

17. The potential for leakage if gifts and so on were not regarded as receipts, and the inconsistency with the underlying principle of the receipts basis of not doing so, suggests that they should be taxable, even though it would mean bringing into charge amounts which would not be taxable in the hands of other UK residents. Nevertheless, it might be appropriate to exclude gifts of low value.

(iv) Benefits

18. To avoid making a receipt on his own account, an individual could arrange for (say) a foreign trust or company to act as a cover. So for instance an individual could place foreign income in a foreign company which then used the money to buy a Rolls Royce for the individual's use in the UK.

19. A charge would therefore need to be levied on benefits (other than those connected with the provision of qualifying assets) provided by foreign entities. The charge would need to extend not only to benefits enjoyed by the individual, but to those enjoyed by individuals connected with him (eg wife and close family). The charge could be based on the annual value of the benefit, in a similar way to the existing provisions for benefits provided to directors and higher paid employees of UK employers.

(v) Loans

20. An alternative to bringing into the country cash and assets held outright would be to borrow money to fund UK consumption. In the case of money borrowed abroad this would not be a problem, since like any other receipt of cash it would be liable when brought into the UK; if later repaid out of UK money, the repayment would have to be treated as a negative receipt. Money borrowed in the UK, however, would present a more difficult problem.

21. Three main types of UK loan would need to be considered:

(i) where an individual borrows money "on the strength" of his UK income and UK assets (other than those in the segregated expenditure account);

(ii) where an individual borrows money "on the strength" of his UK assets in the segregated expenditure account; and

(iii) where an individual borrows money "on the strength" of his foreign assets.

22. The first category would only be a problem if the loan was run up during a period of residence here and then repaid with foreign income in a year of non-residence. This is considered further below (paragraphs 37 and 38) in relation to timing problems generally.

23. The other two categories would require specific legislation. Like loans from abroad, they would need to be treated as receipts, and any repayments as negative

receipts. If they were not treated as receipts an individual could (for instance) bring cash into the UK, buy a qualifying asset, obtain a loan against the asset and use the loan to fund his living expenses.

24. The aim of any provision would be to catch loans that an individual would not have been able to borrow (from a lender acting at arm's length) if one were to assume that the individual's only income was his UK income and his only assets were his UK assets. This is not an easy concept and we are not at present in a position to advise you on whether a workable definition can be produced; we are currently carrying out more work.

25. If it does not prove possible to make a distinction on these lines between different types of UK loans the alternatives would be to:

- regard all UK loans as outside the definition of "receipts" (and therefore not taxable);

- regard only UK loans secured against foreign assets and assets in the segregated expenditure account as being within the definition of "receipts" (and therefore taxable); or

- regard all UK loans as within the definition of "receipts" (and therefore taxable).

26. The first option would leave such a large hole as to make the receipts basis worthless.

27. The second option would close the hole in part, but it might well not close it enough to make the receipts basis viable. Our initial feeling is that a significant number of foreign domiciled residents are likely to be of

sufficient standing to be able to obtain very considerable unsecured loans. (But again, more work needs to be done before a firm view can be taken).

28. The third option would block the hole but may well be seen as going too far. For instance, to tax a foreign executive on his UK building society mortgage, obtained on the basis of his UK salary, could be hard to defend. It would also go against the underlying principle of the receipts basis, since there would be no connection with receipts from overseas.

(vi) Disposal of assets in the segregated expenditure account

29. This is considered further below (paragraphs 33 to 35) in the context of the workings of the segregated expenditure account. Briefly, the disposal of an asset in the account would be regarded as giving rise to a charge. This could be approached in one of two ways:

(i) either, the disposal proceeds could be taxed in full. (In effect the original receipt used to buy the asset would be regarded as never having entered the country, and instead the disposal proceeds would be treated as a receipt crossing the border);

(ii) or, the disposal proceeds would be taxed only up to an amount equal to the value of the asset when it entered the account. (In effect the original receipt used to buy the asset would be regarded as having entered the country and being a taxable receipt, but the charge would be deferred until the disposal of the asset).

30. The first approach might be the simpler, since it would not require an asset to be valued when it entered the account. But it might be regarded as less compatible, than the second approach, with taxing as UK source income and gains any income arising in respect of the asset while it was in the account and any gains on the disposal of the asset. This is because in effect under the first approach the asset would be regarded as outside the country, whereas under the second approach it would be regarded as being inside the country. (The choice between the two approaches is a second order matter and not central to a decision in principle about the receipts basis).

31. Under either approach the sale proceeds of the asset could be rolled over to purchase a second qualifying asset and no charge would arise until the second asset was sold (and so on). No charge would arise if the sale proceeds were taken out of the country, since they would not be available for consumption in the UK.

32. Rules would be needed regarding the interaction with the capital gains tax provisions.

SEGREGATED EXPENDITURE ACCOUNT

(i) Qualifying Assets

33. Qualifying assets would collectively form the segregated expenditure account. The purpose of the account would be to narrow what might otherwise be regarded as an unjustifiably broad base of charge (ie all receipts whether from income or capital). Decisions on what assets to regard as qualifying ones would depend on how far it was felt necessary to go in narrowing the base. Assets that might be included in the account would be:

- all immovable property in the UK; (this might need to include all but the very shortest of leases - maybe 5 years or more - if the London property market was not to be significantly affected);

- heritage items;

- securities of all kinds quoted on a recognised exchange; and

- business interests (eg investments in the small business sector. This might, exceptionally, include depreciating assets - but only if they were used for the purposes of a trade, and only to the extent that they qualified for capital allowances).

34. Areas of difficulty would arise not only with the definition of assets which formed the segregated account but more particularly with those assets capable of straddling the border between investment and consumption: for instance, works of art and jewellery. The more the definition of qualifying assets leaned towards consumption, and away from investment, the lower the revenue yield of the receipts basis.

35. As well as the segregated expenditure account it might be necessary to have a "segregated cash account". This would consist of UK bank (and similar) accounts which an individual designated as being used only for the purpose of depositing money received from abroad and the disposal proceeds of assets in the segregated expenditure account. No tax charge would arise on receipts going into the account until they were withdrawn from the account; and no charge would arise at all if the money was sent abroad when

withdrawn. The aim here would be to ensure that there was no tax disincentive against investing money in the UK.

(ii) Allocation of expenditure

36. UK source income and gains would remain taxable in full, on the normal basis. It would be immaterial whether the money was spent on qualifying assets or on consumption. Rules would therefore be needed to allocate expenditure on qualifying assets between that met out of UK income and gains (taxable), and that met out of foreign receipts (not taxable). The most straightforward approach might be to regard expenditure on qualifying assets as always met out of foreign receipts in preference to UK income and gains. (No relief would be available for expenditure on qualifying assets which exceeded foreign receipts).

TIMING

37. A potential problem with a receipts basis would be the avoidance of a charge by transferring money and assets to the UK in years of non-residence for use in years of residence. This would take the form of:

- transferring sums ahead of taking up residence;
- dropping out of residence for a year, transferring sums in that year, and then taking up residence again; or
- after ceasing permanently to be resident, transferring sums to repay loans and debts built up during the period of residence.

38. If it was felt that the avoidance opportunities would be too great if counter measures were not taken, an approach might be to:

- tax in the first year of residence, receipts of the previous year; and

- tax in a year of non-residence following a year of residence, receipts in the year of non-residence. (But collecting the tax from a non-resident might be difficult).

DOUBLE TAXATION RELIEF

39. One of the objectives of a receipts basis would be to avoid the need (which is a major stumbling block with the present remittance basis) of having to identify the source giving rise to a foreign receipt. However, as a consequence it would not be possible to identify for double taxation relief purposes what foreign tax had been paid in respect of any income or gains received here. The present double taxation relief rules, which give relief against UK tax for foreign tax paid on the same source of income, could not therefore operate. Special rules would be needed.

40. There would be two main approaches:

(i) either, a credit could be given for any foreign tax paid on income or gains which did not exceed the amount of the receipt (grossed up to take account of the overseas tax); or

(ii) a simpler approach would be to ignore foreign tax and bring in only the actual receipts in the calculation of the UK tax due. Credit would not then be given against UK tax for the foreign tax (but it would effectively be given as a deduction in computing the amount liable to UK tax). If an individual wanted to claim credit relief for foreign tax he would have to elect to be taxed on worldwide income.

41. With either approach, consideration would need to be given to the interaction with the UK's obligations under double taxation agreements.

Personal reliefs

42. When the amount of the receipts subject to UK tax for the year had been determined, it would be for consideration whether they should be treated - like income under the remittance basis - as UK income in the normal way against which the normal personal reliefs could be set. The alternative approach would be to "ring-fence" this particular amount and regard it as entirely separate from any other income. Since the latter approach could have a harsh effect on those with virtually no UK income, and could put them in a worse position than those not resident in this country, it would seem preferable to regard the amount chargeable in the same way as other UK income.

TRANSITIONAL MEASURES

43. Transitional measures would be necessary for individuals who are currently taxable on the remittance basis, who would become taxable on the receipts basis, and who already have qualifying capital assets here. Without special rules it would be open to an individual to bed and breakfast the assets and claim that new cash receipts brought into the country were being used to buy the assets. If in any year an individual disposed of a UK asset which he bought here before the receipts basis came

into effect, it would be necessary to assume that any new expenditure on a qualifying asset was met out of the proceeds of the disposal in preference to new receipts from abroad.

44. Transitional measures would also be necessary for individuals moving from the receipts basis to the worldwide income basis, and vice-versa.

FROM: A C S ALLAN
DATE: 10 February 1989

CHIEF SECRETARY
FINANCIAL SECRETARY
PAYMASTER GENERAL
ECONOMIC SECRETARY
SIR P MIDDLETON
SIR T BURNS
MR ANSON
DAME A MUELLER
MR WICKS
MR HARDCASTLE
MR BYATT
MR SCHOLAR
MR CULPIN
MR SEDGWICK
MR RILEY
MR MACPHERSON
MISS J SIMPSON
MRS CHAPLIN
MR TYRIE
MR CALL
SIR A BATTISHILL IR
MR BEIGHTON IR
MR ISAAC IR
MR PAINTER IR
MR UNWIN C&E
MR JEFFERSON SMITH C&E

cc Mr Gilhooly
Mr Matthews
Mr G Bush - IR
PS/IR
Mr P R H Allen - C&E

Mr Monck (item(iv))
Mr Odling-Smee (item (iv))
Mr McGivern - IR (item (vi))
Mr Corlett - IR (items (iv)&(vi))
Mr Kuczys - IR (item (vi))
Mr Luce (item (vi))
Mr L Harris (item (vi))
Mr P Lewis - IR (item (v))
Miss M Hill IR (item (iv))
Mr Jenkins (Parly Counsel) (item (i))

BUDGET OVERVIEW MEETING: AGENDA FOR FOURTH OVERVIEW MEETING ON MONDAY 13 FEBRUARY

... I attach the agenda for the fourth overview meeting, on Monday 13 February at 3.00pm.

ACSA

A C S ALLAN

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AGENDA FOR FOURTH OVERVIEW MEETING: MONDAY, 13 FEBRUARY 1989

Main items

(i) Budget Scorecard:

(a) Scorecard circulated by Mr Culpin on 9 February. (Discussion to include state of play on instructions to Parliamentary Counsel)

(b) Mr Riley's note of 9 February on the package and the fiscal adjustment.

(ii) Ministerial Budget Representations:

Mr K Sedgwick's note of 9 February

(iii) Lollipops:

Mr Gilhooly's note of 9 February

(iv) Stamp Duty:

Mr Monck's note of 9 February on privatisation and the Stock Exchange

(v) NICs on subsidised loans:

Mr Macpherson's note of 9 February

Other Items

(vi) Pensions

Mr Kuczys' and Mr Hinton's notes of 9 February

(vii) Rent-a-room

Mr McGivern's note of 8 February to the Financial Secretary, on tax relief for resident landlords.

BUDGET
SCORECARD

ITEM
1

fp.nh/tp/7 BUDGET SECRET COP.NO. 18 OF 36 COPIES

FROM: MISS T A M POLLOCK
DATE: 9 February 1989

1. MR CULPIN
2. CHANCELLOR OF THE EXCHEQUER

5-6 pages dropped.

206 pages to go - of which 49-50 yet to reach Counsel.

RC 7/2

cc Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General
Sir Peter Middleton
Sir Terence Burns
Mr J Anson
Dame Anne Mueller
Mr N Wicks
Mr Hardcastle
Mr I Byatt
Mr M Scholar
Mr C Riley
Mr P Sedgwick
Mr A C S Allan
Mr S Matthews
Mr N Macpherson
Miss J Simpson
Miss M Hay
Mr G Michie
Mrs J Chaplin
Mr A Tyrie
Mr M Call

Sir Anthony Battishill
Mr Beighton)
Mr Isaac) IR
Mr Painter)
Mr Bush)

Mr Unwin)
Mr Jefferson Smith) C&E
Mr P R H Allen

Mr Jenkins - Parly Counsel

BUDGET OVERVIEW MEETING 13 FEBRUARY: BUDGET STARTERS

Since your last meeting on Budget starters (30 January) 6 starters have been dropped. There have been 5 new Revenue starters:

Number 204 - Business Expansion Scheme (previously dropped)
216 - Set-off of trading losses against capital gains
217 - Tax relief for residential landlords
218 - Lloyds Stock lending
264 - Capital Gains Avoidance on sale of subsidiaries.

STATE OF PLAY WITH PARLIAMENTARY COUNSEL

	Instructions not yet with Counsel	Being drafted by Counsel	Drafting completed	TOTAL
INLAND REVENUE				
- no of starters	15	25	12	52
- no of pages	30¾	122½	3½	156¾
CUSTOMS AND EXCISE				
- no of starters	2	9	5	16
- no of pages	14	28½	1¼	43¾
TREASURY & TRANSPORT				
- no of starters	*1	10	5	16
- no of pages	4½	5¾	¾	11
T O T A L				
- no of starters	18	44	22	84
- no of pages	49¼	156¾	5½	211½

NOTES: As for Table 1

* Home Office starter (ITV Levy)

There are currently 84 live starters. Of these:

22 starters with around 5½ pages have been drafted by Counsel.
44 starters with around 156¾ pages are being drafted by Counsel.
18 starters with around 49¼ pages have not been seen by Counsel.

2. The attached table sets out in more detail the state of play with Parliamentary Counsel.

3. The following list describes those starters still awaiting instructions to Counsel:

Inland Revenue

No	Title	No of Pages
100	Income Tax	2/3
103	Benefits in kind: misc 2	1
104	Benefits in kind: car and car fuel benefit	1½
110	Schedule E: Lump sum payments	1-2
113	ESOPs	3
118	Trusts: general review	1-2
*119	Mixed residence and non-resident trusts	4-5
152	PEPs	¼
205	Advance Corporation Tax (change of ownership, surrender)	2
216	Set-off of trading losses against Capital Gains	1¼
217	Tax relief for residential landlords	1¼
218	Lloyds Stock lending	¼
259	IHT: threshold and rate	½
*264	Capital Gains Avoidance on Sale of Subsidiaries	6-12
455	Electricity privatisation: misc tax provisions	2-3

Customs & Excise

1	Excise Duty rates (inc VED)	13½
+61	Seizure at export of probable cash proceeds of drug trafficking	½

* To be included at Committee stage.

\+ A further submission is awaited and this may also be introduced at Committee stage.

Home Office

650	ITV Levy	4-5

MISS T A M POLLOCK

SCORECARD/cov.minute

BUDGET SECRET
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BUDGET

COPY NO 1 OF 44 COPIES

FROM: ROBERT CULPIN
DATE: 9 February 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Macpherson
Miss Simpson
Miss Wallace
Mrs Chaplin
Mr Tyrie
Mr Call

Sir Anthony Battishill)
Mr Beighton)
Mr Isaac)IR
Mr Painter)

Mr Unwin)
Mr Jefferson Smith)C&E

SECRET

B.L.O.

BUDGET SCORECARD

I attach the Scorecard for the Overview on 13 February.

RC

SECRET

ROBERT CULPIN

BUDGET SECRET
BUDGET LIST ONLY

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Additional copies for Scorecard work:

Mr Gilhooly	)	
Mr Flanagan	)	FP
Mr O'Donnell	)	
Mr Matthews	)	ETS
Mr Pickford	)	EB
Mr Davies	)	MP
Dr Courtney	)	
Mr Mowl	)	PSF
Mr Bush	)	
Mr Calder	)	
Mr McManus	)	IR
Mr McNicol	)	
Mr Ko	)	
Mr P R H Allen	)	C&E
Ms French	)	

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SCORECARD OF 9 FEBRUARY 1989

TABLE 1: DIRECT EFFECTS OF BUDGET MEASURES

		£ million 1989-90		yield (+)/cost (-) 1990-91
		Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
1.	Freeze excise duties	nil	-1225	-1325
2.	Reduce duty on unleaded petrol; surcharge on 2 star	- 30	- 30	- 75
3.	VED: coaches and lorries	+ 40	+ 40	+ 40
4.	VAT: non-domestic construction etc	+ 315	+ 315	+ 540
5.	Index IT thresholds	-1455	nil	nil
6.	Increase car scales by 20 per cent	+ 90	+ 90	+ 110
7.	CT: raise small companies thresholds	- neg	- neg	- 35
Savings				
8.	Abolish stamp duty on shares from 1/1/90	- 150	- 150 as (ASB)	- 970
9.	Life assurance	- 20	- 20	- 10
10.	Pensions, PEPs, Share Schemes, Unit Trusts	- 5	- 5	- 20
Other				
11.	Schedule E: receipts basis	- 60	- 60	- 80
12.	PRT: incremental investment relief	- 40	- 40	- 40
13.	VAT: bad debts, registration, etc	- 95	- 95	- 270
14.	Miscellaneous starters	- 35	nil	+ 80
15.	TOTAL	-1445	-1180	-2055

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NOTES TO TABLE 1

Estimated cost (-) or yield (+) in £ million from indexed base unless otherwise indicated. Indexation 6.8 per cent.

1. Excise duties

	1989-90	1990-91
Petrol, derv etc	- 545	- 580
VED	- 190	- 210
Tobacco	- 235	- 255
Alcohol	- 255	- 280
Total	-1225	-1325

Freeze reduces RPI by 0.48 percentage points compared with base forecast.

2. Unleaded petrol

	1989-90	1990-91
Reduce tax by enough to make unleaded 2p a litre cheaper than 4 star, if reduction passed on to consumers	- 30	- 60
Surcharge 2 star to make it as expensive as 4 star	-neg*	- 15

*cost of extra unleaded take-up balanced by extra yield from 2-star.

Customs checking precise duty changes needed. Main problem is to establish how pump prices differ now between fuels.

Cost depends on take-up. No significant RPI effect.

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SCORECARD OF 9 FEBRUARY 1989

3. VED: coaches and lorries

+20 for buses and coaches, +20 for rigid heavy goods vehicles. Over 70 VED rates abolished. No direct RPI effect.

4. VAT: non-domestic construction etc

		1989-90			1990-91		
		Private sector	Public sector	Total	Private sector	Public sector	Total
Construction							
- new	(1)	15	250	265	20	325	345
- option to tax	(2)	20	10	30	40	35	75
Fuel and power	(3)	nil	nil	nil	15	80	95
Sewerage/water	(3)	nil	nil	nil	neg	neg	neg
News services	(1)	5	neg	5	5	neg	5
Protective boots and helmets	(1)	neg	neg	neg	neg	neg	neg
Minor property changes	(1)	15	neg	15	20	neg	20
TOTAL		**55**	**260**	**315**	**100**	**440**	**540**

Assuming implementation dates of (1) 1 April 1989
(2) 1 August 1989
(3) 1 July 1990

No impact effect on RPI, because no direct effect on prices to final consumers.

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5. Index income tax thresholds

Figures subject to revision in mid-February.

Cost of illustrative alternatives, in place of line 5:

	1989-90		1990-91
	non-indexed base	indexed base	indexed base
Increase thresholds by 10 per cent	-2,100	- 645	- 900
Reduce basic rate by 1p (with indexation)	-2,855	-1,400	-1,725

6. Increase car scales by 20 per cent

No change in structure of car scales. No allowance for behavioural effects (likely to be small).

7. Corporation tax: raise small companies thresholds

50 per cent increase in profits limits for small companies' CT rate of 25 per cent.

- Rate available on profits up to £150,000 (instead of £100,000).

- Benefit not fully withdrawn until profits £750,000 (instead of £500,000).

Reduces CT for about 23,000 companies.

Cost of 1 per cent off main CT rate: -10, -400, building up to -570.

SCORECARD OF 9 FEBRUARY 1989

8. Abolish stamp duty on shares from 1/1/90

Cost depends on Stock Exchange turn-over. Net of extra yield on CGT, CT, VAT and Income Tax, as result of increase in transactions. (Total extra yield +50 in 1990-91.)

Cost from other abolition dates, in place of line 8:

	1989-90	1990-91
1/11/89	- 280	- 970
1/12/89	- 215	- 970
1/ 4/90	nil	- 930

9. Life assurance

1989-90 firm: -20 for abolition of Life Assurance Policy Duty, with Stamp Duty, from 1/1/90.

1990-91 provisional: -50 for reducing tax rates etc, +40 on expenses. Variants in Deacon 9 February.

10. Pensions, PEPs, Share Schemes, Unit Trusts

	1989-90		1990-91
	non-indexed base	indexed base	indexed base
Pensions	neg	neg	neg
PEPs	- 5	- 5	- 10
Employee Share Schemes	- neg	- neg	- neg
ESOPs	- neg	- neg	- neg
Unit Trusts	nil	nil	- 10
Total	- 5	- 5	- 20

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Pensions

- cash limit of £60,000 on earnings on which tax-privileged pensions can be paid: so maximum privileged pension of £40,000, maximum tax free lump sum of £90,000; any excess taxed;

- limits apply only to new pension scheme members; indexed to prices;

- increase in percentage of earnings payable to personal pensions attracting tax relief, subject to cash limit.

PEPs

- increase in limit on total annual investment from £3,000 to £4,800, and on investment in unit and investment trusts from £750 to £2,400. Full year cost in long term of -30.

Employee share schemes

- increase FA 1978 all-employee share scheme limit from £1,250 or 10 per cent of salary to £2,000 or 10 per cent

- increase FA 1980 all-employee SAYE share scheme limit from £100 to £150 per month

- increase statutory limit on share price discount for FA 1980 schemes.

- annual cost expected to build up to between 5 and 10.

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SCORECARD OF 9 FEBRUARY 1989

ESOPS

- corporation tax relief on company contributions to employee benefit trusts. Could build up to -20.

Unit Trusts

- reduce CT rate on unfranked income from 35 to 25 per cent from January 1990.

11. Schedule E: receipts basis

Cost is transitional. Yields +10 in 1991-92 and +50 in 1992-93.

12. PRT: incremental investment relief

Assumes behavioural effects - ie increased development expenditure. Expected to have yield after 1990-91.

13. VAT bad debts, registration etc

	1989-90	1990-91
Bad debt relief	- 50	-150
Simplification of registration rules	- 35	-100
Revision of default surcharge	- 10	- 20

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14. Miscellaneous Starters

See Table 2.

15. Total direct effects

Not same as effects on PSDR.

MP estimate total call of Budget measures on fiscal adjustment -960, -1250: see Riley 9 February.

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SCORECARD OF 9 FEBRUARY 1989

TABLE 2: MISCELLANEOUS STARTERS (I.E. LINE 14 OF TABLE 1)

Table contains only those starters which cost or yield £5 million a year or more

FB Starter number	Proposal	£ million 1989-90 Changes from a non-indexed base	Changes from an indexed base	yield (+)/cost (-) 1990-91 Changes from an indexed base
Decided				
32	VAT: charities	- 5	- 5	- 5
40	VAT: r + d cars	- 5	- 5	- 5
107	Relocation costs	+ 5	+ 5	+ 30
Part of 100	Age allowances:			
	- over 75s	- 10	- 10	- 15
	- reduce marginal withdrawal rate	- 5	- 5	- 5
116	PRP	- 10	- 10	- 15
154	Over 60s private medical insurance	nil	nil	- 40
204	BES: withdraw relief on loans to buy shares	+ neg	+ neg	+ 5
206	Close company legislation	- neg	- neg	- neg
216	CGT: unincorporated businesses trading losses	nil	nil	- 35
251	CGT: freeze exemption limit	nil	nil	+ 10
252	CGT: abolish tax deferral on gifts	+ neg	+ neg	+ 25
259	IHT: index threshold	- 35	nil	nil
261	IHT: instruments of variation	+ neg	+ neg	+ 10
633	Sale of numberplates	+ neg	+ neg	+ 30
650	ITV levy	nil	nil	+ 60
Decisions needed				
110	Schedule E: lump sum payments	+ 45	+ 45	+ 50
151	Covenanted membership subscriptions	- 5	- 5	- 5
217	Rent-a-room	- 10	- 10	- 15
TOTAL		- 35	nil	+ 80

NOTES TO TABLE 2

1. Details in starter reference sheets, under Finance Bill Starter number in first column.

2. Table omits following starters which protect existing revenue:

119 **Mixed resident and non-resident trusts**

254 **CGT: non-resident companies trading in the UK**

264 **CGT: avoidance on sale of subsidiaries**

400 **Tax deductible from tax credit payments to US companies**

These have a cost if not implemented.

3. Starter 100, **age allowances:** Scorecard shows cost of indexing over 80s' allowance and extending it to all over 75. Alternatives:

- increase allowance for over 80s by 10 per cent: cost becomes -10, -10
- double index allowance for over 80s: cost becomes -15, -20.

4. Starter 116, **PRP:** includes effects of changes announced 3 February.

5. Starter 154, **private medical insurance:** announced 31 January. Cost revised to reflect decision on high rate relief.

6. Starter 216, **CGT: unincorporated businesses' trading losses:** cost uncertain (range -25 to -50). Assumes change does not apply to gains realised before 1989-90. Full year effect could be -50 to -100.

7. Starter 217: **Rent-a-room:** assumes annual exempt limit of £5,000 per landlord. Lower exemption of £3,000 would cost -10, -10. See Elliot of 8 February.

8. The following starters still in play are expected to have nil or negligible cost or yield in 1989-90 and 1990-91:

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~~SCORECARD OF 9 FEBRUARY 1989~~

2	Excise: power to estimate revenue duties payable
3	Excise: restriction of duty-paid blending of made-wine
4	Excise: measurement and declaration of original gravity of beer
5	Excise: misdescription of substances as beer
6	Excise: oil duties relief
34	Raise VAT threshold from £22,100 to £23,600
36	Right to repayment of VAT/excise duties and consequential changes
39	Duty and tax relief for diplomats and visiting forces
60	Prosecution time limits
61	Seizure at export of probable cash proceeds of drug trafficking
62	London Port banking: amendment to CEMA Section 17
63	Unauthorised disclosure of confidential information (C & E)
114	Taxation of employee priority in company flotations
115	Employees' material interest
118	Trusts
155	Friendly Societies Protection Scheme
158	Charities: payroll giving limit
207	Capital allowances at sports grounds
209	Capital allowances: pre-consolidation amendments
212	Reopening of claims etc
213	Extension of pre-trading expenditure relief
218	Lloyd's stock lending
255	CGT: technical changes associated with rebasing
256	CGT: chattels exemption
262	CGT: sterling non-qualifying corporate bonds
404	Tax charge on switching investments in offshore funds (Umbrella funds)
450	Keith committee: administrative improvements
451	Sub-contractor tax scheme
452	Unauthorised disclosure of confidential information (IR)
453	Deep discounted government and para-statal bonds
454	Electronic payment of dividends
455	Electricity privatisation: miscellaneous taxation provisions
601	VED: trade licensing
602	VED: special types
605	VED: recovery vehicles
606	VED: dishonoured cheques
631	VED: update reference to "registration book"
632	VED: grass cutting vehicles

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SCORECARD OF 9 FEBRUARY 1989

651 Government stock: small estates

652 Gilts redemption monies: new procedures

654 Redemption 3% 1986-1996: wind-up of Annuities Account and Sinking Fund

655 Power to use NLF money to purchase and cancel gilt edged securities ahead of redemption

656 National Savings: abolition of minimum interest rate provision

657 National Savings: restriction of investment and ordinary accounts to personal holders

\- NICs on subsidised loans

9. **NICs on subsidised loans:** +30 in 1991-92. See Macpherson 9 February.

SCORECARD OF 9 FEBRUARY 1989

TABLE 3: STAFFING EFFECTS

		Effect in man-year terms in 1989-90	1990-91
1.	Freeze excise duties	nil	nil
2.	Reduce duty on unleaded petrol	nil	nil
3.	VED: coaches and lorries	nil	nil
4.	VAT: non-domestic construction etc	+ 45	+ 130
5.	Index IT thresholds	+ neg	+ 20
6.	Increase car scales by 20 per cent	nil	+ 10
7.	CT: raise small companies thresholds	nil	nil
Savings			
8.	Abolish stamp duty on shares from 1/1/90	- neg	- 40
9.	Life assurance	+ neg	+ neg
10.	Pensions, PEPs, Share Schemes, Unit trusts	+ neg	+ neg
Other			
11.	Schedule E: receipts basis	+ 10	+ 40
12.	PRT: incremental investment relief	nil	nil
13.	VAT: bad debts, registration, etc	+ 10	+ 20
14.	Other starters	+ 30	+ 65
15.	TOTAL	+ 95	+ 245

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NOTES TO TABLE 3

These are the Revenue Departments' preliminary estimates.

Table does not yet include manpower effects of Starter 217, rent-a-room.

NICs on subsidised loans would have no manpower effects for the Revenue. Effects on DSS staffing not yet known.

On line 4, Customs have provision in the PES baseline for extending VAT to non-domestic construction etc.

Line 11 would save 100 staff in 1991-92 and 175 in 1992-93.

Line 14 breaks down as follows:

	1989-90	1990-91
Schedule E: lump sum payments	+ 5	+ 10
Over 60s medical insurance (includes setting-up costs in 1989-90)*	+ 10	+ 25
Index IHT threshold	+ 5	+ 10
CGT: freeze exemption limit	nil	+ 10
No change in threshold for stamp duty on housing	+ 10	+ 10
Total	+ 30	+ 65

* +45 in subsequent years, mainly due to higher rate relief being available to all payers whether they are paying for themselves or for others.

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(b)
RILEY → CH/EX 9/2

COPY NO 16 OF 37 COPIES

FROM: C J RILEY
DATE: 9 February 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr A C S Allan
Mr Davies
Mr Gilhooly
Mr Matthews
Mr Macpherson
Miss Simpson
Mr Courtney
Mr Flanagan
Mrs Chaplin
Mr Tyrie
Mr Call

Sir Anthony Battishill)
Mr Beighton)
Mr Isaac) IR
Mr Painter)
Mr Calder)

Mr Unwin)
Mr Jefferson Smith) C&E
Mr Allen)

THE PACKAGE AND THE FISCAL ADJUSTMENT

I attach a note on this, as requested at the last Overview meeting.

C J RILEY

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THE PACKAGE AND THE FISCAL ADJUSTMENT

The Scorecard contains estimates of the claim made by the present package on the fiscal adjustment. These are lower than the total direct effect on revenue set out in table 1, especially in 1990-91.

£ billion	**1989-90**	**1990-91**
Direct effect on revenue	1.2	2.1
Claim on fiscal adjustment	1.0	1.3
Fiscal adjustment in the January forecast	1.5	1.5

Background and definitions

2. The direct effects aim to capture the impact of the measures on revenue for a given tax base. In some cases, where they are quantitatively significant, allowance is made for behavioural effects. But no allowance is made for second round effects, occurring for example as a consequence of changes in incomes, prices or other macroeconomic variables.

3. The claim on the fiscal adjustment takes into account our best estimate of the second round effects, as well as the direct effects, using simulation results from the Treasury model. The calculations assume that:

- the PSBR is held fixed at the values in the January forecast by means of variations in the basic rate of income tax;

- money GDP is held on the path in the January forecast by adjustments in interest rates.

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4. The January forecast allowed for a cut in income taxes in 1989-90 worth £1½ billion, also taking the form of a reduction in the basic rate. The call on the fiscal adjustment shown in the Scorecard gives our estimate of how much of that £1½ billion would have to be used up to finance the present package, assuming the post-Budget paths for the PSDR and money GDP were as in the January forecast. The figures suggest that we need to use up only about £1 billion in 1989-90 and £1¼ billion in 1990-91; the implication is that in the absence of other changes to the forecast, the PSDR would turn out somewhat higher than shown in January.

5. Differences between direct effects and the call on the fiscal adjustment are often relatively small, because they reflect only the macroeconomic impact of a switch between one form of taxation or expenditure (the Budget measures) and another (the basic rate). But they are not always small. The call on the fiscal adjustment will tend to be lower than the direct effects insofar as:

- the package has a more favourable effect on inflation that a cut in the basic rate, so allowing a more favourable split of money GDP between output and prices;

- the package shifts activity, expenditure or saving into more highly taxed areas than does a change in the basic rate.

6. In practice the first of these sources of difference tends to be more important than the second. Lower inflation tends to reduce both tax revenue and public expenditure; the precise effects depend on the source of the reduction in inflation and the extent to which cash limits are biting on public expenditure. But the consequential increase in output raises revenue, and reduces expenditure mainly through lower social security payments. The net effect is to improve the financial position of the public sector and limit the call on the fiscal adjustment.

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7. One final point on methodology which is of particular relevance to the present package. When indirect taxes are changed, we assume that money GDP is held fixed at factor cost rather than market prices. This reflects the view that the Government would usually aim to accommodate any shift in indirect taxes on the price level, rather than force an offsetting adjustment on tax-exclusive prices and hence nominal incomes. This mirrors the assumption underlying the direct effects, adopted for the first time in the ready-reckoners in the 1988 Autumn Statement, that consumers' expenditure is held fixed at factor cost.

The present package

8. The paragraphs which follow describe how the call on the fiscal adjustment differs from the direct effects on revenue for the main measures, or groups of measures, in the package as it currently stands. The figures are shown in the table below.

£ million, yield (+)/cost(-)
changes from an indexed base

Measures (lines in Scorecard)	Direct Effects 1989-90	Direct Effects 1990-91	Call on fiscal adjustment 1989-90	Call on fiscal adjustment 1990-91
Freeze excise duties (1)	-1225	-1325	-1060	- 590
VAT: Non-domestic construction etc (4)	+ 315	+ 540	+ 310	+ 540
Savings package (8-10)	- 175	-1000	- 120	- 920
Other measures	- 95	- 270	- 90	- 280
Totals	-1180	-2055	- 960	-1250

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(i) **Excise duties**

9. The freezing of excise duties accounts for essentially all the difference for the package as a whole. A reduction in excise duties (relative to the revalorisation assumed in the forecast) has a more favourable effect on inflation in the short term than does the cut in the basic rate of income tax assumed in the forecast. Although we assume that the direct effect of the non-revalorisation of excise duties is accommodated in lower money GDP, the knock-on effects of the lower price level on pay settlements mean an improvement in the split of factor cost money GDP between output and prices. This improves the public finances, as already noted, and the call on the fiscal adjustment is lower than the direct revenue effect. The difference is particularly large in the second year.

(ii) **VAT on non-domestic construction etc**

10. There is almost no difference between the estimated call on the fiscal adjustment and the direct revenue effects of the proposed extension of VAT coverage. The VAT paid by the public sector feeds directly into central government revenue and has no impact on the price level. The January forecast already allows for the estimated impact on public expenditure; neither the direct revenue effect given in the Scorecard nor the call on the fiscal adjustment net off this extra expenditure.

11. The increase in VAT paid by the private sector is expected to have little immediate impact on the price level. There is no direct RPI effect; and those in the private sector paying the extra VAT will be in exempt or partly exempt categories, and they are not expected to pass the extra cost on directly.

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(iii) **The savings package**

12. The estimated call on the fiscal adjustment due to the savings package is less than the direct revenue effect. A substantial part of the net reduction in tax accrues to financial institutions, and this in itself would lead to lower spending and lower tax receipts than a cut in income tax. However we expect that announcement of the abolition of stamp duty on share dealings will give an immediate boost to share prices, raising personal sector wealth. This will raise consumer spending relative to GDP, and hence revenues from expenditure taxes. The rise in share prices will also increase stamp duty and CGT receipts over the remainder of calendar year 1989.

(iv) **Other measures**

13. The net effect of the remaining measures on both revenue and the fiscal adjustment are small.

Conclusion

14. Our estimates indicate that the call on the fiscal adjustment due to the package is smaller than the direct effect on revenue, and is not much greater in 1990-91 than in 1989-90. The main difference from the direct revenue effect arises from the freezing of the excise duties. An implication of the figures is that not all of the fiscal adjustment in the January forecast needs to be used up.

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MINISTERIAL
BUDGET REPS.

ITEM
2

fp.nh/ks/71 **BUDGET CONFIDENTIAL**

FROM: K SEDGWICK
DATE: 9 February 1989

1. **MR MICHIE**
2. **MR CULPIN**
3. **CHANCELLOR OF THE EXCHEQUER**

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Riley
Mr Sedgwick
Mr Gilhooly
Mr Matthews
Mr A C S Allan
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir Anthony Battishill)
Mr Beigthon) IR
Mr Isaac)
Mr Painter)

Mr Unwin) C&E
Mr Jefferson Smith)

SEGDWICK → CH/EX 9/2

MINISTERIAL BUDGET REPRESENTATIONS

At Monday's overview you may wish to run through the representations received from Ministerial colleagues; what follows is a brief summary of the main points of those representations received to date.

K SEDGWICK
FP Division

SECRETARY OF STATE FOR TRADE & INDUSTRY AND SECRETARY OF STATE FOR EDUCATION & SCIENCE

SECRETARY OF STATE FOR THE ENVIRONMENT

MINISTER OF STATE FOR THE ARTS

SECRETARY OF STATE FOR NORTHERN IRELAND

SECRETARY OF STATE FOR SCOTLAND

SECRETARY OF STATE FOR WALES

MINISTER OF STATE FOR DEPARTMENT OF ENERGY

SECRETARY OF STATE FOR HEALTH

SECRETARY OF STATE FOR EMPLOYMENT

SECRETARY OF STATE FOR TRANSPORT

MINISTER OF AGRICULTURE, FISHERIES AND FOOD

SECRETARY OF STATE FOR TRADE & INDUSTRY

SECRETARY OF STATE FOR TRADE AND INDUSTRY AND SECRETARY OF STATE FOR EDUCATION AND SCIENCE

Tax Treatment of gifts to educational establishments - Lord Young and Mr Baker wrote to you on 20 December proposing a new relief for one-off gifts by individuals and a number of changes to the rules for company gifts and donations. The new reliefs would be available only to gifts to educational establishments. Lord Young contends that the Government's attempts to encourage private funding is being hindered by tax "disincentives to generosity". The theme running through the proposals is that there is a gap in the tax relief market which covenants and payroll giving do not cover.

Lord Young and Kenneth Baker's proposals are supported by Malcolm Rifkind, Peter Walker and Tom King. Richard Luce would also like to see the measures extended to the Arts (supported by Mr King).

You and the Financial Secretary met Lord Young and Kenneth Baker. You have provisionally decided not to adopt any of their proposals.

SECRETARY OF STATE FOR DEPARTMENT OF ENVIRONMENT

Nicholas Ridley wrote to you on 9 December with a number of proposals -

Housing

Tax relief for residential landlords Mr Ridley's main proposal, a possible allowance for residents who let out spare rooms, is to be considered as a starter - No 217 tax relief for residential landlords.
Supported by Mr Rifkind and Mr Walker.

Rural Housing Associations (CGT and IHT) - free or cheap disposals of land to registered housing associations are treated for tax purposes as a sale at the full residential market value rather than at the price paid. DOE have argued that this is anomalous and deters such transfers. The Financial Secretary has recommended that this starter be included, No 263 Gifts to Housing Associations.

Mortgage Tax Relief - Mr Ridley would like it extended to cover repair costs for tenants buying homes listed under the Housing Defects Act.
Not supported by Mr Walker.

Urban Regeneration

Enterprise Zones - the cost of demolishing and rebuilding buildings within Enterprise Zones attracts 100 per cent first year capital allowances. This has added to overheating in the construction sector on the Isle of Dogs and could become a problem elsewhere once the first generation of Enterprise Zones ends its life. Mr Ridley has proposed restricting the 100 per cent allowance to one per site rather than one per building.

Urban Development Corporations - Mr Ridley proposes a special tax treatment for these bodies, allowing them tax relief for expenditure on the costs of providing infrastructure, e.g. transport facilities on land they are developing, which is not allowed to private developers. He argues that the private sector developers are not required to provide such infrastucture and are therefore an inappropriate model for the taxation of UDC's.
Supported by Mr Walker.

Environment Protection

Energy - In considering action on the green house effect Mr Ridley stresses the need to ensure that the relative price of energy reflects fully all the costs that energy consumption is imposing, particularly in the case of fossil fuels.

Unleaded Petrol - increase differential in favour of unleaded petrol. Mr Morrison and Lord Young agree. Mr Rifkind would like to see the differential at 4p pl.

The Heritage

Mr Ridley has requested careful consideration of the Historic Houses Association's representations relating to the rules applied to maintenance funds for heritage property held in trust (and exempted from IHT) on (a) widening the approved purpose of a maintenance fund to cover developing the property in order to provide extra income for maintenance; (b) rolling up capital gains tax within a fund; and (c) exempting income from the maintenance fund from the additional rate of tax.

Sport

Mr Ridley would welcome charitable status for governing bodies of sports and their representative organisations.

SECRETARY OF STATE FOR NORTHERN IRELAND

Tobacco Duty - Mr King wrote to you on 24 November asking that any increase in tobacco duty be restricted to the level of inflation.

SECRETARY OF STATE FOR SCOTLAND

Mr Rifkind's private secretary wrote to Alex Allan on 19 January with Mr Rifkind's representations -

Scotch Whisky Industry - Mr Rifkind draws attention to the points made by the Scotch Whisky Association, i.e. - the introduction of a statutory maturation allowance for Corporation Tax purposes, an extension to the period of excise duty deferment from 4 to 8 weeks, and for changes to the taxation structure to provide that all alcoholic drinks are subject to taxation at the same rate per degree of alcohol content. Although he would not expect to see significant changes to all 3 proposals he does support some relaxation in the tax regime to sustain and build on the Industry's recent recovery.

Petrol Duty - Any increase in petrol duty should not be above the rate of inflation.

Tax relief on home improvement loans - Mr Rifkind suggests that tax relief on home improvement loans, which can be shown to have been applied for approved categories of work, should be restored. Mr Rifkind understands that Building Societies and other lenders might be prepared to undertake the administration and monitoring of such a scheme at their own expense. If not possible to go that far, Mr Rifkind suggests looking at allowing tax relief on replacement loans or on loans taken out within 12 months of purchase.

Tax relief on market rents - Mr Rifkind suggests that market rent payments be treated similarly to mortgage repayments for income tax purposes.

Tobacco Duty - No increase in duty on cigars.

MINISTER OF STATE FOR DEPARTMENT OF ENERGY

Oil - The Treasury, Energy and IR inter-departmental group have been looking at the possible oil starters. Mr Morrison has written to the Economic Secretary with his views on oil taxation. The only oil starter to be included is No 353 PRT: relief for incremental oil field investment.

SECRETARY OF STATE FOR HEALTH

Tobacco Duty - Mr Clarke wrote to you on 4 January asking for "a return to 1986 levels of duty on cigarettes".

SECRETARY OF STATE FOR EMPLOYMENT

Mr Fowler wrote to you on 5 January stating that his overriding concern is to ensure that as many people as possible get back into employment. He raises these proposals -

Unemployment and Poverty Traps - an adjustment to National Insurance contribution rates would be a more cost-effective way of alleviating the unemployment and poverty traps than raising tax thresholds. Mr Fowler states that he will be sending the Chancellor a note on this shortly. (The note has not yet arrived)*.

* I doubt if it will. This was a wheeze of his officials. R

Training Incentives - possible changes to the tax rules to improve the position of individuals who pay for their own training. You wrote to Mr Fowler on 2 February asking him not to hold out hope of an extension in tax reliefs for training this year. Instead you suggested that officials from each of the interested parties should undertake a comprehensive review of the position in the light of developments since 1987.

Child care facilities - The tax rules should not unfairly penalise certain women (i.e. those who earn above the P11D limit) who take advantage of the child care facilities provided by their employers.
The Ministerial Group on Women's Issues will be discussing child care facilities at its next meeting. A Treasury paper prepared for this meeting recommends no changes in the tax system.

SECRETARY OF STATE FOR TRANSPORT

Shipping and IR's consultative document on Residence - Mr Channon wrote to you on 18 January commenting on the Budget representations made by the General Council of British Shipping which proposed measures to encourage investment in either new or good-quality second hand ships. Mr Channon is not convinced that any of their proposals are necessary. Mr Channon also raised his concern about the possible threat to shipping interests posed by the Inland Revenue's proposals on residence.

MINISTER OF AGRICULTURE, FISHERIES AND FOOD

Mr MacGregor wrote to you on 5 December, in particular, about Capital Gains Tax and its effect on the agricultural industry. His proposals are as follows -

Capital Gains Tax

Essential that agricultural landlords should be able to take advantage of roll over provisions available to other businesses.
The provision of retirement relief against CGT would encourage older landlords to hand over to younger generation.
Annual exemption of CGT - allow those with "lumpy assets" (not

only agriculture) to carry forward annual exemption for a number of years.

Milk Quotas - look again at problem of acquisition value of quotas.

__Farming and market gardening__ - These are the only businesses prevented from setting losses against other trading income when such losses have occurred for more than five consecutive years. Strong grounds for abolishing section of 397 of Taxes Act 1988.

__Alcoholic Drinks__ - Continue to resist pressure to increase duties on alcoholic drink. Supports case for reducing differential between rate of duty on beer/wine and spirits. Steps to bring cider and beer duties in line should be very gradual.

<u>The Financial Secretary has looked at Mr MacGregor's proposals, and concluded that it is a very weak list.</u>

SECRETARY OF STATE FOR TRADE AND INDUSTRY

Lord Young wrote to you on 15 December making a number of proposals -

__Savings__ - Measures to encourage savings (mentions PEPs but no specific proposals).

__Training__ - extension of extra statutory concession (and put on statutory basis) giving an employee tax relief for incidental expenses of training courses of 4 weeks or longer where employer pays basic fee. Extension to cover all employer funded courses. Proposes new relief for employee financing his own professional or management training - possibly limited to pursuit of approved qualifications.

__Collaborative R&D__ - Proposes that R&D carried out by a consortium which is not yet trading should be deemed to be trading so that relief for initial costs can be obtained against consortium members' other profits.

Company cars - argues for restraint in pushing up car scales to protect "middle managers" (who have not benefited substantially from cuts in tax rates), although accepts case in logic for increasing car scales to improve neutrality.
If car scales to be significantly increased, then argues for removal of restrictions of writing down allowances for expensive cars and for allowance against VAT on company's products and services of input VAT on purchase of cars.

Company purchase of own shares - proposes that purchases of own shares through a market makers should be exempt from rule which treats POS as a distribution and therefore liable to ACT.

Stamp duty - proposes abolition of stamp duty and stamp duty reserve tax on securities to maintain London's competitive position.

Lord Young also makes a number of technical representations. Of these one is under consideration as a possible starter - Starter No 217 Set off trading losses against capital gains.

LOLLIPOPS

ITEM 3

 COPY NO 1 OF 36 COPIES

FROM: J F GILHOOLY

DATE: 9 February 1989

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Pickford
Mr Riley
Mr Sedgwick
Mr Matthews
Mr A C S Allan
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir Anthony Battishill)
Mr Beighton)
Mr Isaac)
Mr Painter) IR
Mr Bush)
Mr Calder)
Mr McManus)

Mr Unwin)
Mr Jefferson Smith) C&E
Mr P R H Allen)

LOLLIPOPS

We have done out usual annual trawl of Customs, the Revenue and the Treasury (including Treasury Ministers and Special Advisers), for measures which are cheap, popular and simple to draft. We have turned up only three, detailed at Annex A.

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2. The crop is thin this year, mainly because existing starters already include lollipops: for example, Starter 32 (VAT and Charities), Starter 100 (additional relief for the over 75s or over 80s and reducing the marginal withdrawal rate for age allowance), Starter 158 (doubling the limit for payroll giving). Some were on the lollipop list for the 1988 Budget, but deferred to this year.

3. The three possibilities are:

(a) **A stamp duty relief relating to intra-group transfers of property.**

This would undoubtedly be welcomed by representative bodies such as the CBI and the Law Society, who press for it each year in their Budget representations. It has very little popular appeal, but the Revenue advise that the cost would be little, the staff cost negligible and very little Finance Bill space would be needed.

(b) **Extend duty exemption for small-scale bingo**

This would raise (by say a quarter) the prize limit above which small-scale bingo becomes liable to duty. The cost would be under £2m in a full year, the change could be made by order and there would be negligible effects on Customs' staffing and on traders' compliance costs. The commercial halls, however, would oppose - they oppose the existing exemption for non-commercial bingo.

(c) **Car tax relief on cars supplied to Motability for leasing**

You have considered this in the past, and wanted it brought forward to look at again this year. It meets the Lollipop criteria, but would

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increase Motability's privileges compared with those available to the disabled generally. Cost would be about £7½ million.

Fuller details of these three ideas are set out in Annex A.

4. None of the three looks irresistibly attractive for this year and you may feel that they are not worth pursing, given that there are already several Lollipops included in the existing starters.

5. Finally, I should mention one other proposal, not strictly a Lollipop, but turned up in the trawl. Starter 110 would increase from £100 to £150 the monthly limit for participants in the FA 1980 all employee SAYE-related share option scheme. The present facility is confined to savings in Building Societies and the DNS. MG have proposed extending it to banks too. We are pursuing that separately with the Revenue, and will submit separately about it to the Financial Secretary.

J F GILHOOLY

ANNEX A

A. Stamp duty group relief

Existing stamp duty law provides exemption from the normal 1 per cent charge when land or other property is transferred between companies in the same group. (The same provision likewise cancels the 0.5 per cent payable on intra-group transfers of shares; but this particular duty is to be abolished altogether from 1 January 1990.)

The relief for transfers between associated companies does not extend to the lease duty charge, which applies on the grant of a new lease. And in order to qualify the two companies involved must pass a more stringent ownership test than is usual elsewhere in tax law: 90 per cent, not 75 per cent, ownership is required. The case for extending the relief and relaxing the ownership test was aired in a 1983 Revenue consultative document. Since then the major representative bodies have continued to press on both these fronts. Meeting their points by extending the relief to lease duty and reducing the ownership percentage to 75 per cent would have some revenue cost, though this is likely to be modest. Any staff cost would be negligible and the Finance Bill drafting short and simple.

B Extend duty exemption for small scale bingo

Small scale bingo, played mainly in non-profit-making clubs, is exempt from duty unless the stakes or prizes exceed £400 on one day or £1,000 in a week. If the limits are exceeded, all bingo in the club becomes dutiable for a period of 13 weeks. Most clubs operate successfully within the limits but the Committee of Registered Clubs Association (CORCA) has argued in recent years that they should be increased to reflect their loss in value since 1982 and that there should

SECRET

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be a reduction in the chargeable period. Strong Parliamentary support has been organised and a new clause was put down at Committee stage of the 1988 Finance Bill to increase the exemption limits to £500 (daily) and £1400 (weekly); the clause would also have reduced the chargeable period from 13 weeks to 4.

If Ministers wished a concession could be included in the Budget proposals. We suggest suitable increases would be from £1,000 to £1,250 in the weekly limit and from £400 to £500 in the daily limit. This could be accompanied by a reduction from 13 to 9 weeks in the liability period of a club which exceeds the exemption limits. The objectives of the period are to prevent frequent registering and deregistering of clubs and to provide a deterrent to too many "boom" weeks. Customs and Excise could cope with a 9 weeks period. The revenue cost of these changes should be less than £2 million in a full year. Changes in small scale exemption limits can be made by Order. Effects on staffing and on traders' compliance costs would be negligible.

The Bingo Association of Great Britain, representing the commercial halls, is opposed to existing (and further) duty exemption for non-commercial bingo.

C. Car tax relief on cars supplied to Motability for leasing

Motability received very generous concessions in 1984 - deliberately over-compensating them for other tax changes - which, since they took the form of zero rating for leasing charges, gave considerable help to those choosing to lease, not buy, from Motability. The Chancellor decided not to make this further limited concession then, but said he would not rule it out for the future. Revenue cost would be £7.5m at the present volume of leasing (car tax only as VAT relief already applies). The change would be made by Treasury Order. As far as we are aware there is no real pressure for this. If given, the concession would increase Motability's privileges compared with those available to the disabled generally.

STAMP
DUTY

ITEM
4

NICS ON
SUBSIDISED
LOANS

ITEM
5

fp.ac.macpherson/13

COPY NO 1 OF 33

FROM: N I MACPHERSON

DATE: 9 February 1989

Rc 9/2

1. MR CULPIN
2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Riley
Mr Sedgwick
Mr Gilhooly
Mr Matthews
Mr McIntyre
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill)
Mr Beighton)
Mr Isaac) IR
Mr Painter)
Mr Massingale)
Mr Fraser)

Mr Unwin)
Mr Jefferson Smith) C&E

Mr Jenkins - OPC

NICS ON SUBSIDISED LOANS

You asked for a detailed specification of how employers' NICs could be imposed on the benefit derived from subsidised loans. (Annex A contains some facts on the extent of subsidised loans.) This note has been produced in consultation with the Inland Revenue.

2. Briefly, the employer's NIC liability should be :

$$NIC\ (i_m - i_s)\ S$$

where NIC = NIC rate
i_m = market interest rate
i_s = subsidised interest rate
S = subsidised loan (£)

The problem is to define each of these variables and then to find a way of collecting the NICs.

NIC Rate

3. To keep it simple, we suggest a flat rate of 10.45 per cent, the standard employer's rate.

4. DSS would not need to keep any contribution records. The employer's NIC would not give any benefit entitlement, which is the position now for employers' NICs generally. And it would not be eligible for the contracted out rebate: the precedents for this are employers' NICs paid in respect of earnings above the UEL or of those employees past retirement age.

5. Charging the standard NIC rate may result in complaints from employers who lend to employees in the reduced rate bands. However, to have different rates for different loans would be excessively complicated. Employers always have the option of paying the subsidy in cash.

Market Interest Rate

6. The Inland Revenue already use an "official rate" for charging the benefit of subsidised loans to income tax. It is set at 1½ per cent above base rate and currently stands at 14½ per cent. It applies to all types of cheap loans and may appear somewhat harsh on mortgage loans, particularly at

times like the present when the differential between mortgage rates and base rates is low. The current differential of ½ to ¾ per cent means that mortgage rates are lower than the official rate; if the scheme was already in operation, NICs would be being charged even if the employer was giving loans at the market rate. There would, however, be times when the official rate would appear generous, for example last summer when the base rate-mortgage rate differential was over two per cent.

7. If the official rate is thought too rough and ready, it may be possible to use the average mortgage rate over the year, since the NIC charge will be collected in arrears after the year end (see paragraph 12 below). The average building society rate calculated monthly by the Building Society Commission and published in Financial Statistics is an obvious candidate. But it might look odd to use this for NICs while using the official rate for income tax purposes.

Subsidised Interest Rate

8. Few employers charge a single subsidised rate. Rates vary depending on the employee and the size of the loan. Rather than asking employers to work out each individual's interest rate, we propose that they aggregate total employee interest payments. The formula in paragraph 2 would then become:

$$.1045 \times £(i_m S - \text{employee interest payments})$$

Subsidised Loans

9. The first question is whether all subsidised loans should be covered or just subsidised housing loans. Covering all loans would be consistent with the Revenue's approach to income tax and is easier to ring-fence. The disadvantage is that small loans, say for season tickets, would be liable to

NICs and more employees, including some in the public sector, would be affected. A de minimis exemption whereby employees with loans of under £1000 were excluded could solve this problem. This would increase the compliance costs for employers if NICs were being collected on an aggregate basis: instead of looking at the total loan stock outstanding, they would have to sift out the small loans. However, we would not force them to make use of the exemption.

10. The second question is whether the charge should apply to existing and new loans or new loans only. The latter approach would involve a long transitional period, greater compliance costs and many years before revenue built up. The behavioural impact would be confined to the margin. The former approach would cause a greater outcry but also a greater behavioural response, which is after all the objective of the proposal. There are few precedents in this area, but when we extended NICs to payment in gilts, there was no let out for people already receiving these payments.

11. The third question is how the stock of loans outstanding would be calculated. For income tax purposes, the Revenue give two options which could be adapted for NICs: either the average of the loans outstanding at the beginning of the year and the end of the year <u>or</u> the average daily loan outstanding. The Revenue also ensure that where employers contract out the provision of subsidised loans to other financial institutions there is no escape from a benefit in kind charge. We suggest similar approaches for NICs.

<u>**Administration**</u>

12. We suggest the following:

- NICs would be collected in bulk on the total of a company's loans. Employers would not need to break down loans by employee (unless they wanted to make use of the de minimis exemption);

- Employers who gave loans to their employees would submit a payment document to the Inland Revenue once a year. It would accompany the end of year return for income tax and NICs which has to be submitted by 19 April.

- Employers would calculate their NICs on loans bill (a prototype form is shown in Annex B), add the liability to their general NICs liability and enter it in the total, which is already in the end of year return form;

- The NICs on loans liability would be calculated on a calendar year basis. A financial year basis would only give employers 14 days to work out their liability at a time when they are already under pressure. (The four months lag before payment could also give an opportunity to publish the 'official' rate for the year.) In years when the employer's NIC rate changed in April an average rate would be published,

- The Revenue would forward the NICs on loans document to DSS. It would be up to DSS to carry out general policing and auditing as they do with other NICs.

13. We think this approach to collecting NICs could work, although we cannot be certain until DSS have been consulted. They are unlikely to welcome the administrative burden.

14. If an annual NIC charge becomes accepted, a mechanism will be in place for charging employers' NICs on other benefits, in particular cars, some time in the future.

15. We have looked at the alternative approach of building on P11D forms but do not think it is viable. P11D forms:

- are returned with a long and variable lag;
- have to be filled out on an individual employee basis;
- are not aggregated for companies, either by companies themselves or by the Revenue;
- only cover employees and directors earning over £8,500 pa;
- do not involve the employer calculating the employee's tax liability;
- are not passed to the DSS;
- are already complex enough.

Timing and Legislation

16. National Insurance changes cannot be enacted through the Finance Bill; they require social security legislation. Although it may be possible to introduce NICs on loans via secondary legislation, we rather doubt it. There are no precedents for annual charging and collection of Class 1 NICs. Primary legislation is almost certainly necessary. We are too late for this session; the aim is for the current Social Security bill to leave Committee on 9 March. Another social security bill is planned for the next session but it is unlikely to be passed into law until the summer of 1990.

17. If you announce the proposal in the Budget, this may allow the charge to take effect from 1 January 1990. By the time it is collected, April 1991, the legislation would be in place. Parliamentary Counsel advise that there are plenty of precedents for a tax change talking effect before the legislation is enacted. However, DSS lawyers may be less happy.

18. A 1 January 1990 start date would mean a nil yield in 1989-90 and 1990-91 and a £30 million yield in 1991-92.

Consultation

19. The proposal to charge NICs on loans is clearly sensitive. We have, of course, not consulted DSS at all. However, if you decide to go ahead, we need to check that the proposal can work both administratively and legally. It would therefore be helpful if you would consult Mr Moore at some time soon, and if you agree, ask him to give us a short list of DSS officials we could consult on the same basis as last year. We need to talk to practitioners rather than policymakers.

CONCLUSION

20. We would be grateful for answers to the following questions:

a) Do you want to charge NICs on subsidised loans?

b) If so, are you content with the general approach outlined in this note?

In particular:

c) Do you want to charge a flat rate 10.45 per cent?

d) Do you want to cover all loans or just mortgages?

e) Do you want to offer a de minimis exemption?

f) Do you want to apply the charge to all loans and not just new ones?

g) Are you happy with the "official" rate benchmark for the market rate? Or do you want some other measure based on average mortgage rates?

h) Is an aggregate charge in April based on the preceding calendar year acceptable?

i) How do you want to handle consultation?

Nick Macpherson

N I MACPHERSON

BUDGET SECRET

ANNEX A : EXTENT OF SUBSIDISED LOANS

In January 1988

- about 260,000 subsidised mortgages extant, about 3.3 per cent of the total;
- average subsidised mortgage about £24,000;
- total outstanding debt on subsidised mortgages £6¼ billion;
- about 50,000 people had mortgages of over £30,000;
- average interest rate of 5 per cent, compared to a market rate of 10.5 per cent;
- total net value of subsidies to employees around £340 million.

Since January 1988, new mortgages will have been larger on average.

2. No available estimate of extent of subsidised loans generally. Based on P11D returns (only from those earning more than £8,500 a year) in 1985-86

- 56,000 people taxed on total £55 million benefit from subsidised loans
- includes those taxed on benefit from element of subsidised mortgage exceeding £30,000 (probably very few then)
- excludes cases where benefit of subsidised loan less than £200 a year.

A N N E X B

ANNUAL RETURN : NICS ON SUBSIDISED LOANS

(1) What were your total outstanding loans to employees on average in 1990 in £?

(2) The official (or market rate) was Y per cent in 1990. What is Y per cent of (1) in £?

(3) What were the aggregate gross interest payments of your employees to you in 1990?

(4) Subtract (3) from (2).

(5) Your NIC liability is 10.45 per cent of (4). Please include it in your end of year return for NICs, income tax etc. to the Inland Revenue.

'TOP UP'
PENSIONS

BUDGET CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC

2 February 1989

FINANCIAL SECRETARY

PENSIONS: REFORM

1. Mr Kuczys' note below picks up the remit that we were given at last week's Overview.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Luce
Mr L Harris
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Unwin)
Mr Jefferson Smith) C&E
Mr P R H Allen)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr Keelty
Mr Hinton
Mr Cooke
PS/IR

2. He discusses a number of options, all based on the "adapted" approach to the taxation of top-up pensions. Each is possible. I think that the choice between them is very much a matter of political judgment. But we now need a decision.

3. For what it is worth, I feel that the final option, which I understand attracts Mrs Chaplin - a new regime for unfunded pensions - may be worth thinking about. The more that we try to tailor special regimes to special situations - funded schemes, employer contributions, employee contributions, etc - the more that we have to build in Inland Revenue limits, rules and restrictions, which may then appear hard to reconcile with the theme of "deregulation" - and which even then may not be proof against abuse. As an administrative operation, we do not see any of this as unmanageable. But the remaining approach - if I may call it the "Chaplin" solution - cuts the Gordian knot. It provides employers with a new, and absolutely straightforward, facility to top up their employees' pensions, with no statutory limits, and no Revenue rules. For what it is worth, it fits in most readily with the big public sector schemes; and the legislation looks short and easy.

4. Of course, this approach has to face the question: why no special rules for funded schemes? The best answer would, perhaps, be the truth. Front-end loading leads you into the need for rules and limits. The alternative (back-end relief) leads you into the presentational and other problems of the "classical" approach, with at least two wholly incompatible systems for pensions running side by side. Better, a simple approach, with no bureaucracy.

5. Under the "Chaplin" approach, there would, of course, be no question of outlawing funded schemes. Employers are now free to pay money into insurance policies, bank or building society accounts, or buy equities on their employees' behalf; and employees are free to pay their own money into savings schemes of this kind. They can do this to provide for their retirement, or

their children's education, or the "holiday of a lifetime". But the normal tax rules would then apply. The employee would save out of his post-tax income; and he would be liable to tax on the money paid by the employer on his behalf (we have been talking in terms of a "benefit in kind", but we are actually talking about cash payments). As we have said, no new legislation would be needed for this purpose; but the practicality would be likely to drive employers strongly in the direction of money purchase schemes if they wanted to fund.

6. In brief, we have here the classic trade-off between fine tuning and simplicity. Is the price of simplicity too high?

A J G ISAAC

BUDGET CONFIDENTIAL

FROM: MRS JUDITH CHAPLIN
3rd February 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Anson
Sir Terence Burns
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr Macpherson
Miss J Simpson
Mr Tyrie
Mr Call

Sir A Battishill IR
Mr Beighton IR
Mr Isaac IR
Mr Painter IR

Mr Unwin C&E
Mr Jefferson Smith C&E

PENSIONS: REFORM

The original "Chaplin" approach was rather more iconoclastic than the "Isaac/Chaplin" option. It was: why are we creating a new animal - the unprivileged top-up pension scheme - when there are plenty of ways already that employers can do their employees' savings for them if that is what they both want? I appreciate that may appear too radical a change, and that we need to give the appearance that things can go on as before only un-tax-privileged and unregulated.

2. However, the availability of other ways that employers can save for their employees does counter the arguments against pay-as-you-go schemes.

i. If the argument against an unfunded scheme is that employers will not wish to build up liabilities without concomitant assets to pay those liabilities, then the answer is that employers can use the other savings vehicles such as those suggested in paragraph 5 of John Isaac's paper.

ii. Nor does the approach prescribe the method used as Tony Kuczys suggests for those other ways of savings are available. The "Isaac/Chaplin" approach merely suggests a method an employer can use if he wishes to continue provision similar to that provided now.

3. I think it would be a pity to lose this change from the Budget. Limiting the tax privilege of pension savings is a major reform, and if it can be done without a plethora of regulations a major deregulatory measure. It continues your policy of reducing tax reliefs to enable the tax rate itself to be lower.

4. It is unlikely to be able to be attacked as reducing savings, for those affected are on the level of salaries where they are likely anyway to be saving in other ways. It therefore changes the structure rather than the absolute amount and in ways which are desirable.

5. It also shifts the balance between occupational pension schemes and personal pensions. I think it is disappointing that employers have encouraged so energetically employees to stay within final salary occupational pensions schemes. Those setting up new schemes may well consider, since they can no longer guarantee a two-thirds final salary pension through their funded scheme at all salary levels, that they might as well set up a money purchase scheme which gives no commitment in relation to final salary. The two methods will be competing more fairly. For this reason the occupational pension scheme providers will probably not like it, but I think the gain in freeing up the whole pension area is worthwhile.

6. One of the major benefits of the simple route is that there will be no encouragement to run one particular form of additional provision. There will therefore be less pressure within the public sector to set up a formal "top-up" scheme, and more choice on how to compensate for the loss of pension right by those on higher salaries.

JC

JUDITH CHAPLIN

BUDGET CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS
2 FEBRUARY 1989

1. MR ISAAC 2.2

2. FINANCIAL SECRETARY

kuczys → FST 2/2

TAX REGIME FOR NON-APPROVED ("TOP-UP") RETIREMENT ARRANGEMENTS

1. At the Overview meeting on 30 January, it was agreed that further work on the tax regime for "top-up" pensions should be based on the "adapted income tax" approach. This further paper sets out a range of options, all variants of the adapted approach. The choice between them depends on the desired trade-off between, on the one hand, freedom from regulation and restriction; and, on the other, limiting scope for abuse.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Luce
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Miss J Simpson
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Mr Tyrie
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Mr Unwin)
Mr Jefferson Smith) C & E
Mr P R H Allen)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr M Hodgson
Mr Keelty
Mr Hinton
Mr Cooke
Miss Dougharty
PS/IR

Background

2. You will recall that the purpose of top-up pensions is three-fold:

a. A few employers will want to offer some employees a pension greater than the normal two-thirds final salary.

b. Rather more employers will want to provide a full two-thirds pension in circumstances where the tax rules do not allow it - eg where the employee joins late in his career (the mobility issue) and/or retires early.

c. For employees joining schemes after Budget Day, employers may want to pension earnings over £60,000.

3. In all cases, we want to be able to say that employers can do whatever they want: we will remove the absurdity that the Inland Revenue prevents them from doing so. On the one hand, they should not get more tax relief to cushion the cost, beyond the extra tax relief an employer gets if he decides to pay an employee more salary. On the other hand, the tax regime must not be so unattractive that "decoupling" is seen as a hollow sham.

4. The "adapted" approach means pensions in payment are fully taxed (no tax-free lump sum) and build-up (if there is a fund) is taxed. But the corollary is that tax relief should be given for contributions to a fund (if there is one), otherwise the result would be penal. The approach may therefore involve giving tax relief, even though the overall result is no "privilege". Moreover, the relief is front-ended. This is true even where the only "relief" is to remove the benefit in kind charge which would otherwise apply to employer contributions.

5. The idea was that top-up pensions would be unregulated - free of all Revenue controls. In the most important sense, of course, they will be: there will be no limit whatsoever on the

pension which can be paid via this route. But it was recognised at the Overview meeting that there may have to be some safeguards. They are very much the rules that are necessary with any front-end relief, whether for pensions, PEPs, BES or anything else (such as some of the options looked at for PEPs).

6. In particular it was suggested at the Overview meeting that, where a scheme was pre-funded:

a. there should be a ban on loan-backs, "self-investment" and connected transactions;

b. there should be a ban on benefits other than on retirement or death; and

c. schemes should be managed by an approved on-shore intermediary who would be responsible for payments of tax.

7. None of this would in any way restrict what pensions could be paid, or how they should be funded. The rules would be there to prevent people (a) getting the tax relief on contributions without really parting with the money; and (b) enjoying benefits without paying the exit charge. In particular, subparagraph c. is not saying that the intermediary has to be an investment manager (although he might be that as well): the analogy here is with PEP plan managers.

8. Annex A, by Mr Hinton, sets out in more detail the way these restrictions would work (as requested by the Financial Secretary). Annex B (also by Mr Hinton) is in response to the point the Economic Secretary made at the Overview meeting, about someone who moves, say, to Spain on retirement.

9. Where a scheme is a pay-as-you-go one, with no pre-funding, there is no "front-end relief"; none of the problems arise; and none of the above restrictions would bite. This

would be the case for many public service schemes, but would be a route open to the private sector as well.

10. Even with these safeguards, there is a problem with employee contributions. If these attract tax relief without limit then the possibility arises of a highly paid executive being able to wash all his earnings through a scheme, postponing (or worse) tax on those earnings, so that in the year he does it the tax due on a salary of £1 million could be nil. (In principle, something similar could be done through employer contributions, and "salary sacrifice" by the employee (see paragraph 14). But it would be less transparent.) The question is whether that is acceptable; and, if not, what could be done to prevent it?

The Options

11. The rest of this paper looks at a series of variants of the adapted approach. At one extreme is the variant which the Chancellor asked us to look at in the Overview meeting: unlimited relief for employee contributions. This provides the minimal level of restriction on top-up schemes, but the greatest risk of abuse. In between come the two possibilities suggested in my earlier note (no employee relief, favoured by Mr Scholar; or a 15 per cent limit, which the Chief Secretary was more in favour of) and a further option, supported by Mr Culpin (deferral of employer's deduction). Finally, at the other end of the spectrum, we could solve all problems by providing relief only for top-up schemes that are unfunded, or "pay-as-you-go". Mrs Chaplin sees some attraction in that. The differences between the options are summarised in paragraph 22.

OPTION A: UNLIMITED EMPLOYEE RELIEF: THE "OVERVIEW OPTION"

12. This is described in paragraph 12 of the Overview Minutes. Full relief would be allowed without limit for employee (and employer) contributions.

Advantages:

- equal treatment of employer and employee contributions

- in principle, represents considerable deregulation, with no limits on benefits or contributions

- does not push employers towards unfunded or non-contributory schemes.

Disadvantages:

- presentationally, it would look odd to allow individuals unlimited front-end relief for contributions to pensions, while PEPs (for example) are not front-end loaded, and are strictly limited. (PEPs are more favourably treated overall because of the tax-free build up, but people might take some convincing.)

- even assuming that the exit charge could be made to stick, the Opposition would highlight cases, real or hypothetical, of high-paid employees paying little or no tax on £1 million-plus salaries. (The small print, pointing out that, in theory, there will be an increased tax charge on benefits paid, will tend to be ignored.)

- although, in the long-run, the relief should be revenue-neutral, in the early years there will be a net flow into such schemes. The effect will be to alter the FSBR entry for the pensions package as a whole from "negligible" to a significant cost (our guesstimate is of the order of £10 or £20 million).

- because the risks are great, we would need to monitor top-up schemes more closely under this option than the others. The (paradoxical) result is that the "less regulated" approach would mean more Revenue involvement.

Appraisal: This is a very high risk approach. The "deregulation" it offers is more apparent than real. Having considered it more since the Overview meeting, we remain very uneasy about it.

OPTION B: A 15 PER CENT LIMIT ON EMPLOYEES: THE "CHIEF SECRETARY OPTION"

13. Under this option, employees would get relief, but only on contributions up to 15 per cent of earnings. This would cover the vast majority of cases, since top-up schemes are likely to be largely paid for by employers. There is no particular magic about the figure of 15 per cent, except that it applies now to tax privileged schemes. We could make it very simple by not taking account of employee contributions to privileged pensions. An alternative, but similar sort of rule might be to require that employee contributions are at least matched by employer ones.

Advantages

- sets a limit on how much income can be "washed"
- unlikely to bite in practice on most schemes
- permits executives to be seen to be making a contribution to their top-up schemes
- could be run through the net pay arrangement
- not a significant complication

Disadvantages

- retains a Revenue limit in a supposedly deregulated regime
- it appears illogical to put a limit on something which is supposed to carry no tax privilege

- involves some discrimination (which is already present in the approved regime) as between employee and employer contributions

- still requires the restrictions described in paragraph 6 and Annex A.

Appraisal: Although this option looks odd, it does represent an administratively simple compromise which deals with most of the problems, and is likely to be regarded as reasonable by the pensions industry.

OPTION C: NO RELIEF FOR EMPLOYEES: THE "SCHOLAR OPTION"

14. Under this option there would be full relief for employer contributions but no relief for contributions by employees. Employee contributions would be allowed, but would be penally taxed (no relief on input, tax on build up, tax on exit). Even so, an employee who made a small contribution, so as to be seen to be contributing to his top-up pension, might still be getting a very good deal overall. There would be nothing to prevent "salary sacrifice" - for example, an employee forgoing a pay rise or a bonus in return for an increase in employer contributions on which he would face no tax charge. Otherwise, employees might be more attracted to making their own savings arrangements (through a PEP, or even ordinary direct investment) rather than adding to their occupational pensions.

Advantages

- clear and simple: no Revenue limit

- no washing of income (except through "salary sacrifice")

- unlikely to cause distress in practice, since top-up schemes are likely to be mostly employer-funded by choice, and the "salary sacrifice" route is available

Disadvantages

- very clear discrimination between employer and employee contributions

- in practice, could lead to top-up schemes being non-contributory even where the main scheme (for all the workforce) requires employee contributions - ie creates an executive perk. But this is not uncommon even now.

- alternatively, to avoid appearance of a perk, employees will be forced into a penally taxed regime.

- as with the previous options, still requires the paragraph 6/Annex A restrictions.

Appraisal: The option has the virtue of greater simplicity: in some ways it could be easier to present no relief in a "deregulated" scheme than limited relief. In other ways, however, it looks a bit harsh.

OPTION D: DEFERRED TAX DEDUCTION FOR EMPLOYER: THE "CULPIN OPTION"

15. This was the option we started off with in the Revenue last year, when trying to come up with a regime which gave the same fiscal privilege - and no more - as the tax treatment of remuneration before retirement. The proposal is that, as with Option C, there would be no relief for employee contributions and no benefit in kind charge in respect of employer contributions. The difference is that the employer would get a deduction only when he pays a pension (and when the employee pays tax on what he receives). (In practice, therefore, this removes front-end relief in many cases - but not where, eg, the employer is "tax exhausted".) For a pay-as-you-go scheme this is the result anyway. It amounts to saying

that if the employer chooses to prefund that is his affair; but he gets no deduction in advance. Overall, what this option amounts to is the "Scholar option," with the employer deduction deferred.

16. The legislation to achieve the result (no deduction until pension paid) would, however, be quite complex. We should need to override the general Schedule D rules (in this area they are in case law, not statute, and old case law at that). Otherwise the normal rules would give the employer a deduction for pre-funding payments, matched by a benefit in kind charge on the employee. For all the other options the legislation would be self-contained; here we would be straying into non-pensions territory.

17. In addition, the legislation would need to cater for the situation in which the benefits are made by a trust funded by employer contributions, after the funding employer has ceased to exist or the trade transferred. Quite complicated provisions would be needed to make sure that a deduction could be obtained - there would otherwise be potential for a taxation on benefits for which no corresponding tax relief was available for contributions. But this would give rise to scope for contrived cessations of business ("phoenix companies") to secure immediate relief with the prospect of complex and lengthy anti-avoidance legislation.

18. We would need to deal with some possibilities which lie in between pre-funding and pay-as-you-go. For example, it is not uncommon for employers to buy an annuity for an employee when he retires. (According to press reports BT did just this for Sir G Jefferson last year, at a cost of £500,000.) Since the employee only receives his annuity, and pays tax on it, over his retirement, which can be 20 years or more, the strict logic of this option would involve spreading the employer's deduction over a similar period. In practice, however, it would be easier to allow the full deduction in the year the annuity comes into payment.

Advantages

- effectively no front-end relief in many cases, so no need in those cases for most of the safeguards set out in paragraph 6 and Annex A

- equality of treatment for employer and employee contributions: no relief at the time contributions are made

Disadvantages

- legislation more complicated
- still need the Annex A safeguards in some cases
- likely to lead to most top-up schemes being unfunded

- if employers were nonetheless pressed by employees to pre-fund, for security, they would be squeezed hard (making payments now with relief perhaps years later). There would be complaints that "decoupling" was being wrecked by the Revenue.

Appraisal: despite its initial attraction, and some undoubted advantages, this option will be unattractive to employers. Better to go the whole way in this direction, which is what the next option does.

OPTION E: BAN PRE-FUNDING: THE "CHAPLIN OPTION"

19. There is a way to cut through all the problems of front-end relief, which only arise if there is pre-funding, by requiring top-up schemes to be pay-as-you-go arrangements if they want to come within the tax regime on offer - as they almost certainly would. If any "pre-funding" were provided, normal tax rules would apply (unlike in the Culpin option), with the employee being taxed on money the employer "saved" for him. Mrs Chaplin has suggested that this might be the answer to the problems of the other approaches.

20. The practical effects might not be very different from Option D. But the legislation would be much simpler. On the other hand, it looks rather odd to be effectively prescribing the financing arrangements of deregulated pensions, when we do not do so for the approved variety.

Advantages:

- clear and simple
- no front-end relief, so no problems
- question of employee contributions does not arise
- removes any public sector/private sector distinctions, since all will be unfunded

Disadvantages:

- looks rather odd to prescribe x form of "deregulated" pension scheme
- may cut across more general policy arguments against unfunded arrangements
- may not satisfy employees, especially if employer is shaky (eg could deter the troubleshooter an ailing company wants to recruit to rescue it)

Appraisal: This certainly solves any tax problems. But could it be justified?

Summary of options

21. All the options are variants of the "adapted" approach. As you work through from A to E:

a. the rules are more and more prescribed; but

x I am not sure that you need to 'prescribe' – see my covering note. (signature)

b. the need for Revenue controls of the sort in Annex A gets less and less.

Broadly, the controls on investment that go with front-end relief are needed for options A, B and C; and at least in some circumstances ~~Some controls are still required~~ for Option D; none for Option E. Options A to D involve legislating away the benefit in kind charge (which would otherwise apply in the case of unapproved pension schemes) on employer contributions. Only Option D tampers with the employer's deduction.

22. The following table summarises the position:

Option	Employee contributions	Employer contributions	Investment controls
A	Relief in full	Employer gets deduction; but no BIK charge on employee	Yes
B	Limited relief		Yes
C	No relief		Yes
D	No relief	Deferred employer deduction, no BIK charge	Yes in Some circumstances
E	Not applicable	Not applicable (but deduction for pensions paid)	No

Controlling directors

23. Controlling directors remain a worry. They can determine: (a) whether contributions should be by the employee (themselves) or the employer (also themselves); (b) the level of contributions; and (c) unless the fund is strictly at arm's length, how the contributions are to be invested or used. They will receive plenty of advice on how to exploit any opportunities in top-up schemes (as they have with present privileged schemes).

24. The requirement that top-up schemes should be managed by an approved on-shore fund is a minimum essential safeguard. Having to lock away the profits until retirement should curb controlling directors' enthusiasm: what they look for above all else is a way of retaining the tax-relieved "contributions" in the business. But even if the arm's-length rules prove effective in practice, controlling directors will still be able to strip out all their surplus profits, by way of unlimited tax-relieved "employer contributions" under options A, B and C - provided they are prepared to wait for their benefits. Only options D and E, which prevent any relief for pre-funded employer contributions, would totally safeguard against both blatant exploitation and the (perfectly legal) minimisation of corporation tax.

Conclusion

25. These 5 options are not exhaustive, but they illustrate the range of variants of the "adapted" approach. In particular, there is a number of variants on Option B (15 per cent limit), with different percentages, or alternative approaches such as requiring at least half of total contributions to come from the employer. Or perhaps, just expressing it differently on "minimum tax" lines: "No-one may reduce his taxable income in any year by more than 15 per cent, by making contributions to (unapproved) pension schemes". That way, it is a restriction on the individual, not on the (deregulated) scheme, which can accept higher contributions (without relief).

26. There are, in addition, options (already looked at) which do not fit the "adapted" approach. In my previous paper (of 26 January, at paragraphs 20 and 21) we looked at a hybrid where:

a. the adapted approach applied to unfunded schemes and non-contributory schemes; but

b. the classical approach applied to contributory funded schemes (which are the only ones that give rise to the problem of income washing).

But that has presentational problems of its own.

27. We are now reaching the stage at which we must have a decision: time for instructing Counsel is already very tight. If we do not have in place a reasonably attractive "non-privileged" regime, the Chancellor will not be able to offer "de-coupling" as a worthwhile initiative. In that case the £60,000 cap cannot really be sustained, and in turn the simplification package below £60,000 would fall. Against that background, Ministers will wish to consider how serious are the disadvantages of the various options.

A W KUCZYS

ANNEX A

INLAND REVENUE CONTROLS ON FUNDED TOP-UP SCHEMES

1. This Annex describes the controls that will be required to safeguard the tax reliefs available under Options A, B and C and D of the main paper. The aim has been to keep Revenue involvement with the running of the schemes to the minimum possible. But, under these three options, some controls are essential in order to avoid abuses.

Form of schemes

2. Top-up schemes will all fall within two main types:

   a. unfunded Pay-as-you-go schemes (which will be the most common approach in the public services); and

   b. funded schemes where the employer and, perhaps, the employee put money aside in advance of retirement.

Unfunded schemes

3. Under the adapted approach, these schemes should give rise to no difficulties. The employer will obtain a corporation tax deduction for the benefits paid to the retired employee, and will deduct Schedule E income tax at source from the payments.

4. Controls on unfunded schemes will therefore be limited to periodical PAYE audit checks.

Funded schemes

5. Under Options A to D, front end tax relief will be given to a greater or lesser extent on contributions. Non-privileged top-up schemes cannot in that case be completely unregulated. It would be necessary to specify that the scheme should provide benefits for employees and their families only on death or retirement, and to make sure that this happens. These conditions will be set out in the legislation.

6. To prevent money being re-circulated by the employer, two further restrictions will be necessary. The funds will need to be alienated from the employer and employee; and transactions such as loanbacks, self-investment and connected-person transactions will need banning. These further restrictions will also be prescribed in the legislation.

7. In summary the main conditions for tax relief on contributions will be:

- alienation of funds from employers and employees;
- a ban on loanbacks etc;
- a ban on benefits other than on retirement or death.

Alienation

8. Alienation will involve the funds being administered by an independent third party who would assume responsibility for the management of the scheme. We would expect organisations like those authorised to set up personal pension schemes (e.g insurance companies, banks, building societies etc) to be involved. With the exception of the ban on loanbacks, etc, there will be no Revenue requirements as to how the funds should be managed. It would therefore be completely acceptable for the administrator to follow an investment policy chosen (or directed) by the employer or employee, if that is what is wished.

9. And with the involvement of an independent administrator it will be much easier for the Revenue to adopt a "hands-off" approach to compliance controls. We expect that a self-certification approach whereby the administrator confirms that the scheme meets the statutory requirements will be sufficient to trigger the tax reliefs on contributions.

10. But as a fall-back measure, some sample checks on these certificates may be necessary. The penalty for breaches of the rules would be withdrawal of tax relief already given. We believe this to be a powerful deterrent (since it would produce a penal tax result).

11. The scheme administrator will also be the person responsible for deducting tax from all benefits paid under the scheme. Alienation of funds enables the Revenue to concentrate the few checks needed on the scheme administrator, and minimise our involvement with either the employer or the employee.

Employee contributions

12. If tax relief is given for employee contributions (Options A and B), some additional restrictions are necessary. (If there is no tax relief there need be no restrictions whatever on the payment of contributions.)

13. For the purpose of the administrative controls it is presumed that there will be a limit on tax relieved employee contributions (Option B). The previous paper suggested a 15 per cent limit (covering aggregate contributions to approved and non-approved schemes). A limit set at this level is consistent with those that apply to contributions to tax exempt pension schemes. As tax relief will be available automatically through the 'net pay' arrangements under PAYE the procedures involved will be straightforward to operate. Controls here would be limited to a check at the time of PAYE audits.

14. If aggregation of contributions looks too complicated, an alternative would be to allow tax relief up to 15% of earnings (disregarding other tax relieved pension contributions). This is simpler to calculate and more generous, but would still be monitored through PAYE audit.

15. The simplest solution is, however, to allow no tax relief for employee contributions (Option C).

Other approaches

16. If tax relief for employee contributions is deferred until the benefits are paid (as suggested by Mr Culpin), some of the controls described in this note will still be required. There will continue to be a clear administrative advantage in the funds being alienated, Much ~~tighter~~ the same checks would o~~therwise~~ be needed on the administration of the scheme (to ensure that the funds do not leak to the employee in a tax free form before retirement). The only control probably not required would be the ban on loanbacks to the employer, etc.

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ANNEX B

TOP-UP PENSIONS: OVERSEAS RESIDENTS

1. At last Monday's overview meeting, the Economic Secretary asked about the tax treatment of top-up benefits where the employee retires abroad.

General

2. There are no general exemptions from income tax under the Taxes Act for pensioners resident overseas, even if their employment was outside the UK. There are, however, 3 ways in which a pensioner who is resident abroad may claim relief from income tax:

   i. By concession where a large part of the employee's service was undertaken abroad.

   ii. Under a double taxation agreement between the UK and the country of residence.

   iii. By claiming a proportion of the normal personal allowances available to a person resident in the UK.

3. Of these three ways of claiming tax relief, only the double taxation agreement route seems a likely means of avoiding tax on top-up benefits.

Double taxation agreements

4. It is a general principle under modern double taxation agreements for the country of source to give up its right to taxation of a pension in favour of the country of residence. Where double taxation agreements take this form (e.g. Spain), it would be possible for the pensioner to claim exemption from UK income tax on pension benefits. This is, of course, a result of the double taxation treaties that have been negotiated rather than an effect of the legislation on top-up pension schemes.

5. As the UK is not any longer among the countries charging a high rate of tax it is unlikely that many people would emigrate on retirement just for tax reasons. And, in any event, even where exemption under a double taxation agreement is claimed, the pensioner gains no advantage: he pays, say, Spanish tax instead of UK tax.

6. Finally, there would be no tax advantage to be gained from retiring to a tax haven like the Channel Islands or the Isle of Man. The double taxation agreements with these places do not cover pensions (which will therefore continue to be taxable in the UK - at the appropriate marginal rate). The only tax reliefs available in these cases will be through a claim for a proportion of the normal personal allowances.

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BUDGET CONFIDENTIAL

FROM: L J HARRIS

DATE: 2 FEBRUARY 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Kelly
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Customs and Excise

Mr Unwin
Mr Jefferson Smith
Mr P R H Allen

Inland Revenue

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr Keetly
Mr Hinton
Mr Cooke
PS/IR

HARRIS → CH/EX 2/2

PUBLIC SERVICE PENSION SCHEMES

This note summarises our understanding of the position reached at last Monday's meeting on the proposed tax treatment of public service pensions, and discusses how the changes which you are contemplating could be implemented and presented as consistent with the treatment of private sector schemes.

The general approach

2. You have provisionally decided to limit the existing tax privileges to pensions generated by incomes of less than £60,000, implying a maximum tax free lump sum of £90,000 (although in some cases, such as the judges, the lump sum cap will be much lower, and will not be affected by length of service). Non-privileged benefits above those limits would have to be provided by separate to-up

schemes, managed by an independent intermediary, eg pension trustees. As at present, employers' contributions would not be taxed, but there would be no relief for the investment income of funded schemes. Tax would be payable on all pensions as now, and also on lump sums from the top up schemes above the cap. Loanbacks and the payment of benefits other than for retirement or death would be prohibited. There would be no upper limit on benefits, but the tax relieved maximum employee contribution of 15% would remain.

3. Subject to any changes in the general approach, and in detailed tax arrangements, the consequences for the public services are as follows.

The public services

4. You will want to ensure that the public service schemes follow this pattern as closely as possible (bearing in mind that they are largely unfunded and some are non-contributory), and that any departures from it are publicly defensible. On the four specific issues listed in paragraph 25 of Mr Luce's minute of 27 January, you decided that:

(i) the adapted approach should apply to both public and private sector schemes;

(ii) pensions above and below the cap would be taxed, as at present. The part of the lump sum derived from earnings above £60,000 would be subject to tax, but there would be no adjustment of benefits or accrual rates to reflect the loss of tax privileges on the build-up in funded schemes (provisionally estimated in Mr Luce's note to be worth 3% on contributions or 10% on benefits for the top slice). Private sector employers will need to contribute more to pension funds, if they are to maintain current pension benefits for their senior staff; with unfunded schemes public service employers will not have to do so. Since only those who joined the relevant public service scheme after Budget Day would be affected (and then only when their salaries passed the £60,000 cap), the logical consequence of any attempt to adjust pay to reflect the new tax regime would be differential salary rates at the most senior levels over a long transitional period;

(iii) three changes will need to be made for the public services:

(a) amend scheme rules to preclude benefits accruing on earnings above £60,000, for new entrants;

(b) implement top up schemes

(c) amend letters of appointments, staff handbooks and pension scheme leaflets;

For most schemes, (a) and (b) will require the relevant Secretary of State to make regulations. But primary legislation will be needed for the judges, and the Treasury will have to amend the PCSPS scheme rules.

There are timing and legal considerations. The Finance Bill will override private sector scheme rules, but will not apply to the statutory public service schemes. Because of Budget confidentiality, it will not be possible to undertake even (a), until some time after Budget Day. (The PCSPS could however arrange to have a suitable amendment scheme ready for immediate approval, and the local government scheme will be caught by the Finance Bill.) Schemes will be able to move quickly on (c), but (b) will need carefully considered arrangements, taking account of the private sector's response. Scheme managers could perhaps be required to ensure that any taxable excess was clearly identified from Budget Day onwards.

(iv) you would consult the Lord Chancellor before Budget Day about the application of the new regime to the judges. Amending the existing judicial arrangements and setting up a separate up-up scheme would require primary legislation. But, as with the other public service schemes, taxation of the part of the lump sum deriving from earnings above £60,000 for newly appointed judges is intended to apply from Budget Day. The judges may be expected to argue for lump sums to be paid at 1½ (rather than one) times earnings, and this could give you the opportunity to press the Lord Chancellor to apply the 1987 increase in the accrual period from 15 to 20 years as soon as possible.

Presentation and public reaction

5. There are bound to be some public and Parliamentary suspicions that the differing impact of these proposals on funded and unfunded schemes will underpin the privileged position widely believed to be enjoyed by public servants in the pension area. These will not be easy to dispel, although the decisions to go for the adapted rather than the classical approach and to have top-up schemes in the public services will mean that a possible disparity of treatment between real and notional employee contributions will not now arise. The likelihood is that any significant worsening of private sector scheme benefits for key employees under the new regime will be corrected over time by more generous employer contributions to the top-up schemes or by salary increases; but that is hardly a trend which you can be seen to encourage.

6. In any event, the announcement about the statutory public service schemes will need to be made separately that could be done by the Paymaster General. The defensive arguments will have to be that only a very few people in the public services will be affected one way or another by the changes (529, including the 224 NHS consultants); that there will be a long transitional period; that the taxation of the lump sum will eventually represent a significant diminution of benefits for those who do not have reserved rights (a Permanent Secretary who retired with 40 years service and who was a higher rate taxpayer would pay £4,000 tax on a lump sum of £100,000); that public service top-up schemes would be transparent; and that the Government would be keeping an eye on pension trends in the public and private sectors, and inviting the TSRB and the other Review Bodies to take any advantage demonstrably enjoyed by public servants into account in advising on salary levels.

7. In summary:

(i) opting for the adapted scheme greatly simplifies public service pension arrangements, and removes one disparity between contributory and non-contributory schemes, but leaves the theoretical problem for unfunded schemes of the non-taxation of notional investment income in non-existent funds;

(ii) we can introduce public service top-up schemes to facilitate the taxation of the excess lump sum, but there will be some delay after Budget Day in making and laying the scheme amendments or, in the case of the judges, amending the Judicial Pensions Act 1981;

(iii) nevertheless, we are exploring urgently various methods by which the taxation of the lump sums concerned can be made to bite, at any rate in principle, from Budget Day, without awaiting the establishment of formal top-up schemes; and

(iv) alleged disparities of tax treatment between public and private sector schemes may attract some criticism, which can be countered by reference to the scale of the problem, the fact that there will be top-up schemes for the public services, the length of the transition, the impact of lump sum taxation on those affected, and the role of the TSRB.

Leonard Harris

L J HARRIS

BUDGET CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS
26 JANUARY 1989

Overview (+ [illegible])

This paper - which has been discussed with Mr Isaac - is for the Overview on Monday.

1. MR CORLETT [illegible] 26/1

2. FINANCIAL SECRETARY

KUCZYS → FST 26/1

TAX REGIME FOR NON-APPROVED ("TOP-UP") RETIREMENT ARRANGEMENTS

1. At the overview meeting on 16 January, you undertook to look further at the issues affecting the choice of tax regime for "top-up" pensions (or lump sums). This note does that. The first part - looking at the "adapted" approach in more detail - is largely Mr Hinton's work.

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Luce
Mr L Harris
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Unwin)
Mr Jefferson Smith) C & E
Mr P R H Allen)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr Keelty
Mr Hinton
Mr Cooke
PS/IR

6007.

2. Removing the link between Revenue limits and maximum pensions is a cornerstone of this year's pensions package. There are a number of different forms the "non-privileged" tax regime could take. The consensus at the meeting was that the "adapted" income tax approach described in Mr Isaac's note of 12 January was best <u>if</u> sufficient defences (which were not over burdensome) could be erected to protect the tax reliefs.

<u>An outline "adapted" tax regime</u>

3. We have looked in more detail at what would be required to make an adapted income tax approach work. Such an approach involves:

- allowing tax relief for contributions;
- taxing investment build-up;
- taxing in full all withdrawals from the scheme.

4. There are two advantages of this approach to the tax regime for top-up schemes. The main point is that it is presentationally consistent with the tax treatment of approved pension schemes (ie relief for input and taxation of benefits). It also avoids some of the problems associated with the"classical" approach, namely the need to run a benefit-in-kind charge and the perception that tax would be paid <u>now</u> for a benefit enjoyed in the <u>future</u>.

5. The objectives set for the tax regime are that it should:

i. not create new tax loopholes;

ii. allow maximum freedom for employers and employees; and

iii. involve the minimum additional work for the Revenue in monitoring schemes.

6. These objectives can, we think, be met through a tax regime which keeps the rules to the minimum, but sets them in statute, and provides sufficient penalties to act as a deterrent against breaching them.

7. The rules need to reflect the fact that there are risks with allowing tax deductions for contributions to top-up schemes. In particular, the relief on <u>input</u> is a temptation to some people to manipulate, to avoid the matching charge on exit. Examples of how this might be done are loanbacks and investments in, say, holiday homes or luxury cars available to the employee. These problems will be greatest if top-up schemes are open to controlling directors. But there is also plenty of scope for manipulation more generally by non-controlling directors and senior executives who are in a position to influence those administering the pension scheme.

<u>- non-controlling directors and senior executives</u>

8. It should generally be possible to erect safeguards which would effectively block these devices, certainly in the case of "arm's length" (ie non-controlling) employees. We anticipate that the legislation should make it a condition of tax relief that the scheme rules should:

i. prohibit <u>all</u> ways of providing an immediate return to the employee ("loanbacks", investment in "pride of possession" assets which the employee can enjoy, purchase of assets from the employee, etc); and

ii. require that the scheme could provide benefits <u>only</u> on retirement and death, and in no other circumstances.

9. These controls would be further strengthened through a provision that charged <u>all</u> withdrawals or provision of benefits from the fund to tax under Schedule E (or treated payments to the employer as part of taxable profits). The penalty for breaches of the rules would be withdrawal of tax

relief already given. This would produce a penal result (since benefits would still be taxed) of tax on input, tax on build-up, and tax on exit. It should therefore be a considerable deterrent.

- controlling directors

10. The problem of controlling directors could be tackled in one of two ways.

11. First, employer contributions on behalf of controlling directors are unlikely to qualify for tax relief unless the legislation specifically provides for it. This is because of a decision of the Courts that such contributions were not an allowable business expense.* The absence of tax relief for employer contributions would make top-up schemes worthwhile for controlling directors only insofar as they, as employees, paid their own contributions. Coupled with our recommendation below that employee contributions in general should either attract no tax relief, or be strictly limited, the effect would be at least to limit the attraction of top-up schemes to controlling directors.

12. The limited attraction to controlling directors of this form of pension tax relief could be defended on the basis that they are able to build up capital for retirement through their company, and enjoy valuable concessions through CGT retirement relief. These benefits are not available to senior executives and other key employees of public companies - who are the target group for this legislation.

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* The absence of a statutory provision giving employers an entitlement to a deduction for their contributions would have no effect on schemes for arm's length employees and directors of public companies. The ordinary Schedule D rules governing deductions from business profits would operate to allow tax relief automatically.

13. Alternatively, if Ministers do <u>not</u> consider that the implied exclusion of controlling directors could be defended, then we would recommend that (in their case at least) the legislation should require the funds to be "institutionalised" - perhaps through the same bodies authorised to provide personal pensions (insurance companies, unit trusts, banks and building societies.) That would effectively take the use of those funds out of the hands of the directors and should largely eliminate the danger of manipulation. It would also be for consideration whether, as an added protection, an independent trustee should be required (as is the case for tax-privileged controlling director schemes) - possibly for <u>all</u> top-up schemes.

<u>- employee contributions</u>

14. A further issue is whether tax relief should be allowed for <u>employee</u> contributions (specific legislation will be needed to achieve this result). Logically, if <u>employer</u> contributions are exempt from a benefit in kind charge, then <u>employee</u> contributions should attract tax relief. But there is a risk that, with <u>no limits</u> on "top-up" pensions, some employees will reduce their taxable earnings to nil, by piling money into pension arrangements, and living off capital. They would thus <u>postpone</u> large amounts of tax, perhaps for a considerable time. As they did so, they would build up a strong incentive to avoid or evade the eventual large tax bill on withdrawal.

15. If there were no tax relief for employee contributions, the risks of manipulation would be lessened. It would also simplify the work involved in administering the tax arrangements. The answer to criticism of this tough approach would be that top-up schemes will be employer sponsored and are likely to be an offer only to key employees. It is therefore likely that the employer would normally meet the whole cost. Moreover, it will still be possible for employees to make "salary sacrifices", ie give up part of their salary in return for an <u>employer</u> contribution to the scheme.

16. Nevertheless it may be presentationally awkward not to provide tax relief to employees: it might be argued that we were imposing a tax penalty on contributory schemes. In that case we would suggest that a limit on such contributions, of 15 per cent of earnings, will be necessary to stop, for example, a pools winner deferring tax on all his earnings. Such a limit already exists for employee contributions to <u>tax-approved</u> occupational pension schemes, and could, without too much damage to the "deregulatory" theme, be carried over to the new regime (the 15 per cent limit would cover aggregate contributions to approved and non-approved schemes).

[illegible]

<u>- summary</u>

17. The legislation for the adapted approach should be manageable. It would contain all the necessary qualifications for relief. There would be no discretion given to the Revenue - thus avoiding some of the problems with existing approved schemes. And it should be possible to neutralise the tax abuses which are a feature of the approved schemes tax regime without draconian controls.

18. However, the price to be paid for relief on contributions is that "non-privileged" schemes could not be <u>completely</u> unregulated. In particular, there would need to be:

- a <u>ban</u> on loan-backs, "self investment" and connected transactions;

- a <u>ban</u> on benefits other than on retirement or death;

- <u>either</u> (a) very limited relief for controlling directors <u>or</u> (b) "institutionalised" funds;

- <u>either</u> (a) no tax relief for employee contributions <u>or</u> (b) a limit on contributions (including any contributions to approved schemes) of 15 per cent of earnings; and

- perhaps, a <u>requirement</u> that schemes should have an independent trustee.

19. There would also be Inheritance Tax implications, not dealt with in this note. (These might arise with the "classical approach" too). We are exploring these with IHT colleagues, and will report further.

<u>Other approaches</u>

20. The Chancellor has also asked (Mr Allan's note of 17 January) that two further options should be considered. The <u>first</u> of these was a <u>hybrid scheme</u>, where the "adapted income tax" approach was used for schemes where the employee did <u>not</u> make any contribution, but the "classical" approach was used where there <u>was</u> an employee contribution. This would deal with the problem considered in paragraph 14 above and, as the Chancellor points out, remove the scope for the employee to defer tax by "washing" his income through a top-up pension scheme: under the "classical" approach there is no deferral of tax.

21. However, this hybrid scheme would not deal with the other risks inherent in the adapted approach. In particular, it would not discourage manipulation by controlling directors (for whom "employee" and "employer" contributions amount to much the same thing) and by other senior employees (who will be able to call on the ingenuity of the company's tax advisers). And having both types of scheme, classical <u>and</u> adapted, in existence, with some pensions being taxable and others exempt, would be legislatively complex, difficult to present, and liable to cause confusion. On the whole, we would suggest that either of the measures suggested above - no relief at all for employee contributions, or a 15 per cent limit - would be preferable as a means of preventing "income washing" by employees.

22. The second option in Mr Allan's note is the full-blooded "classical" approach, where an individual would be taxed on the full imputed benefit in kind even where the scheme runs on "pay as you go" lines (ie, is unfunded). That is arguably the full logic of the "classical" approach, and would ensure equality of misery between (a) employees (typically in the private sector) in funded top-up schemes, and (b) those (perhaps in the public sector) in unfunded arrangements. But it means that not only would employees be taxed on money they were not now receiving; it would be "notional" money they were not receiving! As the Chancellor recognises, the notional employer contributions would have to be calculated actuarially - and for each individual employee. We doubt whether this is really practicable.

23. For this reason, we believe the only practical way of implementing the "classical" approach would be by a second hybrid route. This is, in fact, the "classical" approach envisaged in Mr Isaac's earlier note. Where arrangements were funded, the classical approach would operate: no relief for contributions, and no tax on pensions. But where, as in the public sector, pay-as-you-go schemes operate, it would be simpler to treat these very much like earnings before retirement - giving the employer a deduction, and taxing the former employee on the pension he receives. This, of course, looks much more like the "adapted" approach.

24. Again, having both approaches in operation would be awkward presentationally, and cause confusion. One person might build up "top-up" entitlements from more than one employment, so one pension could be taxed and another exempt. And Mrs Chaplin has pointed out that someone (eg a senior civil servant) in an unfunded top-up scheme might appear to be more favourably treated than his (private sector) counterpart in a funded scheme. This is because the civil servant would not face a benefit in kind charge on the build up of his pension entitlement (although, on the other hand, his pension would be taxed, perhaps at a lower rate, which partially redresses the balance).

25. We see difficulties, therefore, with either of the approaches suggested in Mr Allan's note - and, indeed, with the "second hybrid" considered above.

Compliance

26. There is some administrative work for the tax office network no matter what tax regime is adopted.

27. The "classical" approach involves

- running a "compounded" benefit in kind charge, possibly self-assessed by employers; and perhaps

- scrutinising accounts to see whether there are payments which should be disallowed.

28. Under the adapted regime some additional scrutiny of scheme accounts will be needed to make sure that withdrawals are properly taxed. And some other checks might be needed - for example, to confirm that no benefits were permitted other than on retirement or death. Otherwise, however, we would aim for a "hands off" approach with as little Revenue involvement as possible.

29. Under either approach there will need to be a District responsible for the scheme who will deal with the assessment of untaxed investment income or capital gains as the fund builds up.

Conclusion

30. Neither a "classical" nor an "adapted" approach is problem-free. The same is true of the various possible hybrids and variants. Of the possible options, the adapted approach has the advantages that:

i. it would (like the classical approach) represent liberalisation in the sense that there would be no limit on benefits;

ii. it is easier to present, and closer to the treatment of tax-approved pension schemes; and

iii. it avoids the particular difficulties of any form of benefit-in-kind charge, arising well before pension is paid.

31. At the Overview Meeting, Ministers felt that this approach was preferable, if the necessary safeguards were not too onerous and off-putting. This paper has set out the safeguards we think would be necessary. It suggests that the adapted approach could be made reasonably secure, without impossibly unattractive restrictions. On the other hand, there would be some regulation of non-privileged pensions, as the price to be paid for tax relief on contributions. The penalty for flagrant breaches of the rules would be fairly draconian: withdrawal of tax relief on contributions, with pensions also taxable. In practice, this should be a deterrent which rarely has to be deployed.

32. If Ministers conclude that this is the best approach, there are two issues for decision:

i. should controlling directors be denied tax relief on employer contributions; or should their (or all) top-up funds be "institutionalised"?

ii. should there be no tax relief on employee contributions; or should such contributions be allowed with tax relief, but only up to 15 per cent of salary?

AWK

A W KUCZYS

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FROM: A C S ALLAN
DATE: 17 January 1989

1. Jonathan
2 pmg

PS/FINANCIAL SECRETARY

cc Overview cast list
Mr Luce
Mr L J Harris
Mr Dixon
Mr Gilhooly
Mr McIntyre

Mr Corlett - IR
Mr Kuczys - IR

ACSA
PS/FST
17/1

TOP-UP PENSIONS AND LUMP SUMS

At the overview meeting yesterday, the Financial Secretary was asked to look further at the issues affecting the choice between the "classical" approach and the "adapted income tax" approach for dealing with top-up pensions and lump sums.

2. Although it was generally agreed that the "adapted income tax" approach had many advantages, some concern was expressed about the anti-avoidance provisions which would be needed. The Chancellor would be grateful if, when considering these points, the Financial Secretary could look at two further options:

(i) A hybrid scheme, where the "adjusted income tax" approach was used for schemes where the employee did not made any contribution, and where the "classical" approach was used where there was an employee contribution. This would reduce the need for anti-avoidance provisions for "adjusted income tax" schemes, since there would be no scope for the employee to "wash" large portions of his income through such a scheme.

(ii) A full blooded "classical" approach, where an individual would be taxed on the full imputed benefit in kind even where there were no employer contributions (ie. an actuarial calculation would be made of the premiums required to fund the benefits to be provided, and the employee would be taxed on the value of the calculated premiums). This would, of course, particularly affect public sector schemes.

ACSA

A C S ALLAN

OVERVIEW CAST LIST

CHANCELLOR
CHIEF SECRETARY
FINANCIAL SECRETARY
PAYMASTER GENERAL
ECONOMIC SECRETARY
SIR P MIDDLETON
SIR T BURNS
MR ANSON
DAME ANNE MUELLER
MR WICKS
MR HARDCASTLE
MR BYATT
MR SCHOLAR
MR CULPIN
MR SEDGWICK
MR RILEY
MR MACPHERSON
MISS J SIMPSON
MRS CHAPLIN
MR TYRIE
MR CALL
SIR A BATTISHILL IR
MR BEIGHTON IR
MR ISAAC IR
MR PAINTER IR
MR UNWIN C&E
MR JEFFERSON SMITH C&E

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Discuss 'Adapt' [illegible] scheme [illegible] to 'clawed'. (But no X)

For overview folder

FROM: A J G ISAAC
12 January 1989

FINANCIAL SECRETARY

DORNEYWOOD: TOP-UP PENSIONS

1. I understand that a question was asked at Dorneywood: what would be the tax treatment of "top-up" pensions or lump sums paid by an employer (in particular an employer such as a Government Department) operating a non-contributory unfunded pension scheme.

GENERAL BACKGROUND

2. As you will remember, the general proposition is

- approved schemes: it will be the rule that approved pension schemes can operate only within "Revenue

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir T Burns
Dame Anne Mueller
Mr Scholar
Mr Byatt
Mr Culpin
Mr Luce
Mr Harris
Mr Riley
Mr Gilhooly
Mr Dixon
Mr McIntyre
Mr MacPherson
Mrs Chaplin
Mr Tyrie
Sir A Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Lusk
Mr Kuczys
Mr Hinton
Mr Cooke
PS/IR

ISAAC TO FST 12 JAN

limits". Thus - subject, of course, to the transitional safeguards - approved pension schemes will need to apply the new £60,000 earnings "cap" both to pensions and to lump sums. This will apply whether the schemes are funded or unfunded, contributory or non-contributory. (Where a pension scheme is funded, contributions (both employers' and employees') will be limited to what is needed to fund the new limited benefits accordingly);

- top-up schemes: employers will be free to pay additional amounts ("top-up" benefits) both by way of pension and of lump sum. But these benefits will attract no tax privilege. They will have to be handled quite separately and distinctly from any payments made by an approved pension scheme. (If an employer wishes to set up a fund to finance "top-up" benefits, it will need to be distinct from the approved fund.)

UNFUNDED "TOP-UP" BENEFITS

3. For unfunded schemes, "unprivileged" tax treatment is simple and straightforward:

- the employer is entitled to tax relief (against his corporation tax or Schedule D tax liability) for the cost of "top-up" pensions or lump sums, when he pays these to his employees;

- the employees are liable to income tax on the full amount of the pension payments or lump sums, when they receive them. (There is no proposal for "top slicing", when an employee receives a particularly large lump sum in a single year.)

FUNDED SCHEMES

4. In theory, there are two main ways in which it would be possible to arrange for the non-privileged tax treatment of "top-up" benefits within a funded scheme:.

- What might be called a "classical" income tax treatment and

- an "adapted" income tax treatment.

Either approach can be directed to remove all tax privilege from "top-up" pensions and to yield the same (positive) tax wedge.

5. As promised in Mr Corlett's and Mr Kuczys' papers of 30 November, we shall be letting you have a full note shortly. At this stage, however, it may be helpful to summarise the main outlines. (see X)

- <u>Funded schemes - a "classical approach"</u>

6. Under a "classical" approach, the arrangements might be:

(a) The employer would get tax relief in respect of his contributions to the fund.

(b) The employee would pay his contributions (if allowed) to the fund out of post-tax income; and he would be liable to a "benefit in kind" charge in respect of any contributions paid on his behalf by the employer.

(c) The fund would be liable to tax on all its income and gains.

(d) But the employee would not as a rule be liable to income tax on his "top-up" pension and lump sum.

So far as the employee's contributions are concerned, this is exactly the regime he faces when investing directly in (say) equities: purchase out of taxed income, income and capital gains tax on the investment proceeds (ie the build-up) and no tax on cashing in.

7. The differences from the present pension system are of course at (b), (c) and (d) above.

8. The major problem arises at (b). It would require - and this is essential if the scheme is to hold water - the employer and the Revenue to identify and charge as a "benefit in kind" the value of all pension contributions paid by an employer on behalf of an individual employee. But, for the reasons which we have all discussed at great length, there is no clear or firm basis, within an occupational pension scheme on a defined benefit basis, on which to allocate employers' contributions in this way between individual employees.

9. A "classical" approach would therefore seem likely to require (as in our earlier discussions on the Byatt proposals)

either a rule to compound the employee's "benefit in kind" charge by taxing the employer at a flat rate on his total contributions to the unprivileged funds. This avoids the need to identify how much the employer is contributing in respect of each individual employee. (Thus, for example, assuming that the top-up beneficiaries will be higher-rate taxpayers, the equivalent of a 40% tax charge on the "gross" income received by an employee would be to charge the employer 67% on the "net");

or to allow top-up benefits only on a "money purchase" basis. Under these arrangements it could be straightforward to identify how much is paid in respect of each individual employee. (But the arrangements would then lose perhaps their main attraction, in that they would not allow employeers to offer(s) "two-thirds final salary" pensions to favoured employees above the £60,000 earnings cap.)

An adapted income tax approach

10. Where "top-up" benefits are funded, the arrangements under an "adapted" approach would be

- the employer gets tax relief (as in the "classical" approach) in respect of his contributions to the fund;

- however, the employee is not taxed on his contributions. That is, he can make his contribution to the pension fund out of income before tax; and he is not taxed on the value of his employer's contributions as a "benefit in kind"; X

- the income and capital gains of the "top-up" pension fund are taxable (as in the "classical" approach);

- however, the employee is liable to income tax on the full amount of pension payments and lump sums (as in unfunded schemes and as in paragraph 3 above).

11. Instead of "taxing" the input, the output would be taxed. In economic terms the result is the same. As with other "front-end loaded" schemes, effective rules would need to be devised and enforced to catch loan-backs or other attempts to re-circulate capital for the sake of tax relief, investment in "pride of possession" objects, etc etc.

THE DORNEYWOOD CASE

12. As I have said, either of the new arrangements could in principle yield the same effective tax result (tax wedge). For example, in the case (I think mentioned at Dorneywood) of an additional lump sum paid by an employer (such as the Government) with a non-funded non-contributory pension scheme, they would differ in only one respect from the present arrangements, At present, the entire lump sum is tax-free. Under the new arrangements any excess of the lump sum - over and above that amount allowed under the earnings "cap" - would be taxable in full.

13. The full implications - and the options - for the public sector will be the subject of a paper by Superannuation Division and the Revenue later this month.

CJel.

A J G ISAAC

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS

12 JANUARY 1989

1. MR CORLETT [initials] 12/1

2. FINANCIAL SECRETARY

DORNEYWOOD: PENSIONS AND JOB CHANGES

1. I understand that, at Dorneywood, there was discussion of the case where someone left one employer for another, but stayed in the first employer's pension scheme, and continued to contribute to it, and to accrue benefits under it. This gave rise to two questions:

a. is this possible under present rules?

b. if it is, does that provide a way of avoiding the proposed transitional rules for the Budget pensions changes?

I am grateful to Mr Cooke for much of what follows.

KUCZYS TO FST 12 JAN

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cc	Chancellor of the Exchequer	Sir A Battishill
	Chief Secretary	Mr Isaac
	Paymaster General	Mr Bush
	Economic Secretary	Mr Corlett
	Sir Peter Middleton	Mr Lusk
	Sir T Burns	Mr Kuczys
	Dame Anne Mueller	Mr Hinton
	Mr Wicks	Mr Cooke
	Mr Scholar	PS/IR
	Mr Culpin	
	Mr Luce	
	Mr Harris	
	Mr Dixon	
	Mr MacPherson	
	Mrs Chaplin	
	Mr Tyrie	

2. There is a provision which would help in some circumstances: the "temporary absence" rule. This allows an employee on secondment to remain a member of his original employer's scheme, to continue to contribute to it, and to accrue benefits as if he were still in service with that employer. The limitations on this provision are:

1. there should be an expectation of return to the original employer; and

2. the period of absence should not exceed three years, unless the secondment is to a UK Government Department (or to work of "national importance").

Staying in the first employer's scheme does, of course, require that employer's co-operation, and normally that is unlikely to be forthcoming except in the circumstances described above.

3. If for any reason, however - perhaps to avoid a possible conflict of interest - the individual has to resign from his first employment, and sever his connections with that employer, then he must leave that pension scheme. The only possible further provision of benefits for the ex-employee is augmentation by the employer within the limits applicable to his completed service. This position flows from the statutory prescribed conditions for approval which require schemes to be established for the sole purpose of providing benefits in relation to service as an employee.

4. The position after "de-coupling" is not likely to change in respect of approved schemes. There would be, however, no barrier to continued contributions by an ex-employee to an unapproved scheme; but because of the non-privileged tax treatment this is unlikely to be attractive.

5. Given the constraints on the "temporary absence" rule set out in paragraph 2 above, we do not think there will be any

scope for avoiding the post Budget regime by artificially remaining a member of an approved scheme of the previous employer.

6. To sum up:

1. If you resign from an employment, you cannot remain in the (tax-privileged) pension scheme that goes with it.

2. If you are seconded, you can.

3. We do not see any serious scope for avoiding the transitional rules proposed for the Budget measures.

7. There are, of course, other options open to someone who resigns and comes to work in Government: a transfer into the civil service scheme; frozen benefits in the old scheme plus separate entitlement under the civil service scheme; or a personal pension. Anyone in this position would want professional advice.

AWK

A W KUCZYS

pf.dc.82

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Bf 13/1 (for minutes folder)

FROM M C SCHOLAR
DATE 11 JANUARY 1989

SIR PETER MIDDLETON

CL
This is on agenda for Monday's Overview. AA NBJ

cc Chancellor
Mr Culpin

SCHOLAR TO PEM 11 JAN

PENSIONS

You asked me to follow up the discussion at Dorneywood.

2. I took a meeting yesterday with the Revenue and with Superannuation here. I have also had a discussion with Mr Luce. The Revenue and - later - Superannuation will put up papers on this. But you may like to have this quick preview.

3. First, the Revenue can draft the legislation in such a way as to avoid its whole purpose being defeated by a loophole which would allow an employee to change jobs (other than in a secondment) but to remain in his original pension fund.

4. On the main point, the Revenue had been toying with the idea of making contributions to the non-privileged fund non-tax-exempt; taxing the build-up within the fund; but not taxing the lump sum or pension above the £90,000 or £60,000 limit. Hence Sir A Battishill's remarks about taxing the contributions as benefits-in-kind.

5. But this looks very difficult, and perhaps impossible, particularly for non-contributory schemes. It would be better (this, I think is the Revenue's view now) to do it the other way round: make the contributions tax-exempt whether they are in the tax-privileged fund or not; tax the build-up within the non-privileged fund; and tax both the pension and any lump sum above £90,000. No benefit-in-kind charge would then arise (the legislation would have to provide for this explicitly).

6. The critical point, it seems to me, is that it should not be more attractive to remunerate people through an unprivileged fund than it is by paying them directly. On the scheme in paragraph 5 above the tax advantage you got from the tax-free nature of the payment into the fund would be cancelled by the charge you paid when the pension or lump sum was released (except to the extent that your marginal rate was 40 per cent going in and 25 per cent going out; not many people would be in this category).

7. On the public sector we clearly need first to establish how the tax rules generally would work. If we followed the approach in paragraph 5 above I think the best option would be to pay whatever lump sum in excess of £90,000, and whatever pension in excess of £40,000, the salary generated, to grant tax relief on all the contributions (if there are contributions) as now, to tax all the pension as now, but to tax the lump sum in excess of £90,000. But there clearly could be other options, either more or less generous to you and Robin Butler's successors in 40 or so years' time.

MCS

M C SCHOLAR

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: C W CORLETT
FAX No. 438 6766
EXTN. 6614
30 November 1988

1. MR ISAAC

2. CHANCELLOR OF THE EXCHEQUER

PENSIONS (STARTER 153)

1. Following your pensions meeting on 26 October a lot of work has been done here on seeing how the various decisions hang together, and on working up further ideas and options in detail.

2. Mr Kuczys' note is to let you see how the package as a whole is emerging. As he says, no decisions are required at this stage - though it is of course an opportunity for you to intervene if you felt we were getting off course anywhere.

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

Mr Battishill
Mr Isaac
Mr Bush
Mr Lusk
Mr Eason
Mr Kuczys
Mr Hinton
Miss Dougharty
PS/IR
Mr Corlett

3. The general picture is, I think, rather promising. There is the prospect of quite a bit of useful simplification and tidying-up, to go with the cutting back of excessive relief. Notes seeking decisions on the details will now follow quickly, and be sent to the Financial Secretary.

C W CORLETT

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS
30 November 1988

1. MR CORLETT

2. CHANCELLOR

TAXATION OF PENSIONS (STARTER 153)

1. This note requires no detailed action or decisions. It does two things:

a. It sets out the <u>core package</u> on pensions which you decided on at your meeting on 26 October, and reflects on how comfortably the component elements sit together. You and others may find this useful as an aide memoire when considering other possibilities for the Budget. We have been developing our thinking a bit since the meeting, and you will want to see how the package is looking before we start sending instructions to Counsel.

b. It also trails a series of <u>more detailed papers</u>, which Mr Hinton is preparing, and which we will be sending the Financial Secretary over the next couple of weeks. These deal with points left open at your 26 October meeting, with some new proposals you may want to consider including in the package, and with various second order points.

KUCZYS TO CX 30 NOV

<u>Core Package</u>

2. At your meeting, you decided on the following measures:

a. <u>Decoupling</u>: no longer will Government effectively dictate the maximum pension someone can have; but there will be limits on tax relief. This paves the way for:

b. A pension cap: the maximum tax privileged pension would be £40,000 (or, if that were thought too severe, £60,000);

c. No accelerated accrual above earnings of £60,000; and

d. A lump sum cap: the maximum tax free lump sum would be £90,000 (currently £150,000).

3. In fact, b., c. and d. above can be achieved by a single change - an "earnings cap" of £60,000. That is, earnings above £60,000 would be ignored for the purposes of calculating the permitted tax privileged pension. The less severe alternative would be achieved by an "earnings cap" of £90,000. The effect of these two caps may be summarised as follows:

	Cap based on earnings of	Number of employees affected*	Max pension before commutation	Max tax-free lump sum	Max pension after commutation
A.	£60,000	50,000	£40,000	£90,000	c. £30,000
B.	£90,000	15,000	£60,000	£135,000	c. £45,000
C.	£75,000	?	£50,000	£112,500	c. £37,500

(Mr Culpin suggested indexing the pension cap but not the lump sum cap: that could not be achieved so straightforwardly).

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* ignoring transitional provisions, which would keep the number actually affected rather smaller for the first few years.

4. You also decided that:

- the earnings limit should be indexed (by reference to price inflation);

- averaging, for those affected, should continue to be over the final 3 years; and

- accelerated accrual should continue to be available (for pensions and for lump sums) just as now (but subject to the new cap).

(We do, however, have a proposal for a minor change, tightening up slightly the rules for accelerated accrual of lump sums).

5. This overall package certainly looks workable (even with the lower, £60,000, cap). It has the attraction of simplicity. And it will be relatively easy to present positively: "You can have whatever pension you want, but there is a limit to how much help any one individual will receive through the tax system." The losers will, by definition, not be able to arouse much sympathy. Apart from some grumbles (see paragraph 7 below) we would not expect the pensions industry to be particularly hostile. The effect on the public sector will be slight (about 500 out of the 50,000 earning over £60,000 are public servants).

6. On the other hand, the package must not be over-sold. Its impact will be confined to a relatively small group, particularly in the early years while transitional provisions are working through and before the £60,000 figure is eroded by real earnings growth. The yield will be around £5 million. But these limitations are perhaps inevitable with a proposal that stays clearly this side of the Green Paper line.

7. The pensions industry may complain, however, about yet another set of (minor) changes on top of all the others they have had to digest (many outside the tax field) over the past few years. Your assurance that this is your "last word" on pensions will be helpful here. But beyond that we have some suggestions, under the heading of simplification, considered below, which might help to make the changes more readily accepted, at a small cost.

8. Overall, we see no reason not to go ahead with the package, on the basis of an earnings cap of £60,000.

Points left open

9. Although the "core package" was settled at your meeting, a number of issues were left undecided:

a. First, you asked for more work to be done on uprating early leavers' benefits in line with earnings. Mr Culpin is pursuing this separately. You did not see it as necessarily part of the 1989 Budget package.

b. Second, the transition - to whom should the package apply? There are two options:

i. the 1987 precedent would let out existing members of existing schemes; and

ii. the tougher alternative, suggested at your meeting, would give existing members protection only up to Budget Day earnings levels. Future pay increases, over £60,000, would not give rise to additional tax privileged pension.

Transitional arrangements

10. These options for the transition will be considered in the first of Mr Hinton's papers. Our conclusion is that the tougher alternative has some serious drawbacks. It could be

open to charges of retrospection (where someone claimed an expectation that their salary would rise above £60,000). It would be quite complicated for pension schemes to administer, particularly in conjunction with the lower (£60,000) earnings cap (which affects more people than a higher cap). On the other hand, the 1987 approach will bring people increasingly into the new rules as they change jobs (and so become "new members"): perhaps 50 per cent of those potentially affected will be after 7 years. And, if the package includes some changes which are advantageous (see under simplification below), some people may opt for the new regime. Clearly there is a danger that this sort of transition will lock people in, and harm job mobility, but we think "decoupling" will largely deal with that. So, on balance, we shall be recommending the 1987 approach.

Personal pensions

11. The appropriate treatment of personal pensions was also left open, and this will be the subject of Mr Hinton's second paper. At your meeting you said you wanted to induce - but not compel - controlling directors and others to leave the occupational pension regime for money purchase personal pensions. We see three broad options for achieving this:

i. Not to apply the new £60,000 earnings cap to personal pensions;

ii. To introduce a higher cap than for occupational schemes; or

iii. To have the same earnings cap but increase allowable contributions as a percentage of earnings.

12. You were initially attracted to i. but, at your meeting, a number of objections were raised. It would look like pretty blatant discrimination against the occupational

pensions movement - if not an outright attack on them. The danger is that it would sour the reception of the whole package.

13. There is some justification for approach ii. But it could still be difficult to present. The third approach is the one Mr Isaac raised at your meeting. We think there is a good case for this. For people towards the end of their career, in a good occupational scheme, the implied rate of contributions to fund their final salary benefits is quite likely to be significantly in excess of the 20 to 27.5 per cent of earnings permitted to similar people in a personal pension scheme. A change in the schedule of contribution rates also has the advantage that it is something some parts of the industry have asked for. We shall, therefore, be recommending this approach in the paper for the Financial Secretary, which will include some possible new contribution rate scales. (NB. These higher percentage limits would be effectively cash-limited by the £60,000 earnings cap.)

Controlling directors

14. The Financial Secretary wanted (and you agreed) to keep on the table the option of expelling controlling directors from the occupational pension regime. We will be putting a separate paper to the Financial Secretary setting out a range of options, from expulsion (which could be politically sensitive) through to tighter restrictions on self-investment by controlling directors' schemes (which goes with your approach of encouraging rather than compelling them to switch to personal pensions).

Simplification

15. Another major subject to be covered in Mr Hinton's papers is simplification of the pensions tax rules. For shorthand, we tend to talk about the tax limit on occupational pensions as being two-thirds of final salary. But, while that is the overall limit, it is by no means the whole story. There are limits on rate of accrual, so that

someone with less than 20 years' service cannot have a full two-thirds pension. There are rules about when a pension scheme has to take account of benefits earned through previous employments, and when it can ignore them. There are special rules for those who take early retirement. When, say, the early retirement and accelerated accrual rules interact, the result can be complex for the pension scheme administrator and confusing for the pension scheme member.

16. The question we have been considering is whether the proposed £60,000 earnings cap would make it possible to ease some of the present rules without the worry that any relaxation would mostly benefit the highly paid who will exploit it to the full. We think the earnings cap <u>does</u> make a difference. On the other hand, we have assumed you would not want to go so far down this particular road that you were effectively reversing the tightening up (for example, of the accelerated accrual rules) that took place in 1987; or so that the small yield of the overall package became a significant cost.

17. What we have come up with, therefore, is a fairly modest set of relaxations which would make the tax privileged pensions regime a bit simpler for schemes to administer and members to understand, <u>and</u> slightly more generous in some circumstances. These changes would be welcomed by the pensions industry, and would help secure a good reception for the overall package. They could also help to speed the transition, if we stipulated that those earning over £60,000 could only take advantage of these sweeteners if they also became subject to the £60,000 cap - even though they might be existing scheme members. Some would find this worthwhile on balance.

<u>Further papers</u>

18. We will also be letting the Financial Secretary have notes on a number of other topics in the near future.

19. First, the two other points left open at your meeting. As already mentioned, there is the question of controlling directors to be settled. And neither you nor the Financial Secretary was very happy with our earlier proposal on freestanding AVCs. We will be looking again at that, and suggesting some alternative options (although I fear that nothing we can come up with will be entirely satisfactory).

20. In addition we will want to cover exactly what the tax regime for non-privileged pensions should be. Perhaps surprisingly, this is proving to be one of the trickiest areas to resolve, affecting a number of other parts of the tax code. Clearly, any lump sum from a "decoupled" scheme should be taxed. Beyond that, however, there is more than one possible approach to ensuring there is no tax privilege. Our benchmark will be the tax treatment of ordinary remuneration, where there is no time lag between the employer getting a deduction for wages paid, and employees paying tax on their pay. And we would want to avoid involvement with "decoupled" schemes in the sense of needing to vet their rules.

21. Finally, we will want to propose a few minor "house-keeping" changes in the tax regime, which could be swept up in the overall package.

Conclusion

22. This note has been for information. But the forth-coming papers by Mr Hinton will call for decisions. If the detailed recommendations are agreed, then the overall pensions package will consist of:

a. the "core" proposals: decoupling, and a £60,000 earnings cap;

b. a transition probably on 1987 lines;

c. some simplification of the tax rules for occupational schemes;

d. for personal pensions, the same £60,000 earnings cap, but higher percentage contribution limits;

e. some tightening up on controlling directors' schemes, probably short of taking them out of the occupational regime altogether;

f. something on freestanding AVCs; and

g. one or two minor bits of housekeeping.

23. Such a package would be broadly revenue neutral. But, within that, some "ordinary" employees who are rather hard-done by under the present rules would gain from simplification, as would those in personal pensions, at the expense of the very highly paid.

24. As far as staffing in the Revenue is concerned, the only thing which would have a significant impact on the Superannuation Funds Office would be compelling controlling directors to leave the occupational regime. Apart from that, however, the package should result eventually in a small easing of workload, as a consequence of simplification - although there would be additional work in the short term.

25. On compliance costs, simplification should result in a slight easing of the burden on employers' schemes, as should any change in the freestanding AVC rules (which the Deregulation Unit have been taking an interest in). And, of course, the core of the package is deregulation - freeing employers and employees to make whatever pension provision they see fit.

26. Finally, it is too early to say with any certainty what <u>legislation</u> will be required. We will be starting to instruct Counsel on parts of the package very soon. But the necessary Clauses are unlikely to be either short or simple.

AWK

A W KUCZYS

PUBLIC SERVICE SCHEMES

PERSONAL AND
BUDGET CONFIDENTIAL

ACSA → TYRIE 2/2

FROM: A C S ALLAN
DATE: 2 February 1989

MR TYRIE cc Mrs Chaplin

THE PENSIONS PACKAGE: PUBLIC SERVICE SCHEMES

The Chancellor was grateful for your minute of 30 January. He felt that what we do with public service pensions will need to depend, inter alia, on what we decide to do for the standard funded occupational scheme. But on almost any scenario, he thought that your scenario for freezing civil service pensions at the salary limit went too far.

ACSA

A C S ALLAN

cst.rj/docs/30.1.3

PERSONAL AND BUDGET CONFIDENTIAL

Ch
I don't agree with this at all, but then I wouldn't be expected to. AA

FROM: A G TYRIE
DATE: 30 January 1989
cc: Judith Chaplin

TYRIE → CHEX 30/1

CHANCELLOR

THE PENSIONS PACKAGE: PUBLIC SERVICE SCHEMES

May I have another go explaining why I do not think that (ii) of Tom Luce's note is the right course to take?

2. Everyone is agreed that the lump sum should be taxed. The question is: what should be done as the quid pro quo for the restriction of "top ups" in the private sector, for Civil Servants above the £60,000 ceiling?

3. I think that asking the TSRB to take this into account would be sweeping the issue under the carpet because I can't believe pay bodies would deliver. Fairer, but messy, would be to announce that salaries above the ceiling were to be increased by less than the general Civil Service increase and publishing the actuarial calculation.

4. <u>Pensions and Civil Service Reform</u>. More generally, it does strike me that, if this pension reform goes ahead, we have an opportunity to start to redress the abuses (perceived and real) of the public sector schemes. At the same time we could go a long way towards grasping the nettle of job security and the lack of interchange between the private and public sectors.

X 5. Why not freeze Civil Service pensions at the salary limit? If it were found that there were retention problems then pay Civil Servants more and let them choose whether to take it as taxed income or start their own personal pension plans.

6. The benefits in the long run would be considerable:

- Slowly but steadily (as the gap between earnings and prices widened) more and more Civil Servants would be brought into pension arrangements which involved top ups.

But on almost any scenario X goes too far.

- The value of (the abuse created by) index linking would slowly be eroded at the top end.

- The principle that Civil Service pensions can be on all fours with everyone else's would have been established.

- Eventually, labour mobility, in and out, at the top end of the Service would become very much easier, with the enormous "cultural" benefits that would confer.

7. Of course, this would carry a public expenditure cost. But it would be money well spent if it began to establish some market principles in the labour market for Civil Servants, albeit at the top end and very gradually.

8. All this is very difficult to discuss at an Overview in front of four Permanent Secretaries and the serried ranks of their heirs-apparent. Perhaps it is something for Ministers after Prayers.

pp RJ

A G TYRIE

BUDGET CONFIDENTIAL

FROM T R H LUCE
27 JANUARY 1989
ROOM 54/1
EXT 4544

LUCE → CHEX 27/1

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Harris
Mr Kelly
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Customs and Excise

Mr Unwin
Mr Jefferson Smith
Mr P R H Allen

Inland Revenue

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr Keelty
Mr Hinton
Mr Cooke
PS/IR

THE CORE PENSIONS PACKAGE: PUBLIC SERVICE SCHEMES

I attach a note on behalf of Superannuation Division. It reflects consultation with the Revenue.

2 The main issues are summarised in paragraph 25.

TL.

T R H LUCE

THE CORE PENSIONS PACKAGE: PUBLIC SERVICE SCHEMES

Note by Superannuation Division

1. This paper sets out the main implications for senior public service pensions of the £60,000 cap. It assesses the viability of the "classical" and "adjusted" alternative tax regimes for public service pensioners at these levels, and explores the options for top-up schemes.

Background

2. Public servants will account for only 1 per cent of the 50,000 people that the Inland Revenue say will in due course be affected by the new arrangements. The main public service groups are:-

NHS consultants	305
Judiciary	104
Civil Servants	44
Armed Forces	20
Local Government	5 (?)
Metropolitan Police Commissioner	1
Board Members	50
Total	**529**

Two Ministerial Offices would also be affected at current levels of pay though their present occupants would get transitional protection - the Prime Minister (salary rate £64,000) and the Lord Chancellor (£87,000).

3. Inland Revenue estimate that 25% of the 50,000 potentially affected would be subject to the new rules after 3-4 years, 50% within 7 years, and 75% after 15 years. Generally speaking, it will take longer for the cap to bite in the public services than elsewhere because there is less job interchange. However, there will quickly be individual cases without transitional protection in most public service schemes and in any case the Government will wish to make clear at the outset that the new arrangements will bite on public services as elsewhere. (Some special public service transitional problems are explored in paragraph 21 below.)

<u>General application</u>

4. We have already advised that there is no good reason for exempting senior public servants from the new regime though the Government will face the same problems as other employers over its effects on senior appointments; and because public service remuneration terms are public knowledge they may be harder to handle. The problems are whether to offer "top-up" schemes, whether those schemes should include employer-financed compensation for the loss of tax privilege; and how, more generally, such schemes should be financed. We deal first with the "classical" versus the "adjusted" issue; and then the more general options about top-up schemes.

Classical or adjusted

5. For earnings above the cap, the classical approach brings contributions and fund investment income within tax, but leaves benefits as they are. The adjusted approach would have no direct effect on contributions but would bring lump sum benefits within tax. They both have in common that fund investment income would (or should) come within tax; and that no change is implied for the tax position of annuitised benefits (which are already taxed).

6. The most important characteristic of major public service schemes is that all except local government are pay-as-you-go; and some of them are non-contributory as well (Judges, Civil Service, Armed Forces). There are examples of both outside the public services, particularly at these high levels of earning; but they will not draw the same public attention as the Government's own schemes.

7. In the public services, as elsewhere, there is no technical difficulty about taxing lump sums. The public service issue is how easy it would be to bring contributions into tax (required only in the classical approach) and to give effect to the taxation of fund income (required in both).

8. In non-contributory schemes, it is the absence of a clear and certain contribution rate which gives the biggest problem and creates particular difficulty in the "classical" regime. When a pension scheme is non-contributory, the pay of its members is assumed to be <u>net</u> in superannuation terms - i.e. it is lower than it would have been had the pension scheme been contributory.

This means that before the implied employee contribution rate, or the implied total employee/employer contribution, could be taxed (by removing present exemptions or as a benefit-in-kind) we should have to establish with reasonable certainty what these implied contributions actually are. It is possible to do this with a fair degree of plausibility through actuarial analysis but the arrangements would inevitably lack the public transparency and staff acceptability that comes with open and accepted employer and employee contribution rates. This would be a serious difficulty in the three major non-contributory schemes. From our perspective, it weighs very strongly against the classical approach.

9. The adjusted approach would create no direct and major problem on the contributions side. But if adopted in full it would cause difficulties in all unfunded schemes because with pay-as-you-go financing there is no actual investment income from which tax privilege could be withdrawn. Full implementation of the adjusted approach would therefore need some proxy action for the loss of tax privilege on investment income in funded schemes. In an actuarial sense, this would not be difficult. Some of the public service schemes are notionally funded, which means that the Government Actuary creates a paper fund which is given a rate of investment return assuming tax exemption. In those cases, the Actuary would simply substitute a rate of return net rather than gross of tax. Even in cases - the majority at these levels - where there is no notional fund, the Actuary still makes assessments to bring implied contributions and expected benefits into a broad balance and this assessment makes assumptions about

investment returns of implied income which could be similarly adjusted.

10. Though a bit messy to explain in public the senior public service pension adjustments necessary under the adjusted regime would be less complex and more easily defensible to the groups concerned than the changes that would be required if the classical regime were to bite fully on them. However even the adjusted regime, if applied in full, would not altogether escape the difficulty over the relationship between implied contribution rates and benefit levels because the substitution of a less favourable rate of return in the intervening "contribution investment" phase would in principle require either some increase in implied contribution rates (i.e. in non-contributory schemes, some reduction in pay) or a compensating reduction in benefits. Any attempts to make these adjustments at the pay/contribution end of the process would run up against the same difficulties as would be encountered with the classical approach. However, the scale of adjustment necessary to benefits might be small enough to be taken on details of benefit entitlement rather than degradations of major benefits.

11. A simpler alternative in unfunded schemes would be to ignore the investment income point and simply tax the lump sums. This seems to have been implied in Mr Isaac's minute of 12 January to the Financial Secretary (paras 3 and 12). From our perspective, it is much preferable. It would make the adjusted approach problem-free in a technical sense.

12. However, it would mean that, compared to funded schemes, those financed "pay-as-you-go" escaped the full rigour of the new regime. Their advantage would not be insignificant - a very rough tentative estimate suggests that it might be equal to a 3% contribution change or more than 10% in benefit value (on the £60,000 + top slice only).

13. The easier route might be misinterpreted as going soft on the top echelons of the public services, even though there may be as many or more top people in private sector unfunded schemes.

Top-up schemes

14. The private sector's response to the new regime is unpredictable and likely to be very variable. Ideally, the Government would want to wait and see what general pattern emerges. But we doubt whether we could wait for long because in all schemes there would quickly be some individual senior appointments of people who were not already scheme members.

15. The first issue is whether the public services should have any top-up schemes at all. We suspect it would be difficult to avoid them. Many private firms are likely to have top-up arrangements of one kind or another. Recruitment and retention of key senior people would be adversely affected if none were available in public services. Even though all existing staff would be protected, it would be hard to justify - notably to the review bodies - the withdrawal of a remuneration benefit now represented by the employer's contribution in contributory

schemes; and the even larger loss in non-contributory schemes (where pay is already net of an implied pension contribution).

16. If top-up arrangements are necessary, they will affect two groups:-

(i) those whose remuneration is personally negotiated, i.e. public service board members and high level imports from the private sector into the Civil Service, the NHS and occasionally other services.

(ii) the main groups of senior "regulars" (mainly Permanent Secretaries, generals/admirals, NHS consultants and judges).

17. For the people with personally negotiated remuneration, no special or formal top-up schemes will be necessary. We can simply negotiate remuneration packages with them individually as we do now. They will, however, pitch their demands higher not least because in leaving private sector jobs for the public sector some will lose transitional protection. They may tend, therefore, to be more expensive and some already familiar presentational and relativities problems will get worse.

18. For the regulars' schemes, there will be no great problem if Ministers (a) adopt the "adjusted" tax regime for everyone and (b) accept - in spite of the arguments in paragraph 12 above - that merely bringing "above cap" lump sums into tax was sufficient for unfunded schemes. We would have to set up a special scheme for

all pension benefits derived from earnings above the cap. But it could be exactly the same as the schemes for fully privileged earnings; and the change would occur only when the lump sum was paid net rather than free of tax.

19. But if Ministers consider that the full effects of the new tax regime should bear on unfunded as well as funded schemes, the top-up schemes would need to reflect the less favourable relationship between contributions (real or implied) and benefits that come from withdrawing tax privilege from scheme investment revenues (real or assumed). As suggested above this could might be achieved by relatively minor adverse changes in entitlement terms.

20. We shall make detailed proposals as quickly as possible after the outstanding issues on the general tax regime have been settled. In principle, we recommend that the top-up schemes should keep as close as possible to the main tax-privileged schemes - i.e. contribution and funding arrangements should generally be the same. No-one is particularly comfortable about the lack of open contribution arrangements that we have inherited in some schemes. But introduce different contribution arrangements just for the top slices of peoples' earnings would gratuitously complicate matters.

<u>Transitional Arrangements</u>

21. Parliamentary Counsel is likely to advise that the Finance

Bill cannot be used to enforce the necessary changes on most public service statutory schemes (the exception is local government). In most cases (NHS, Armed Forces, Civil Service) the sponsor departments would have to lay regulations under the Superannuation Acts.

22. There is no great difficulty about this in most cases; but by law the regulations cannot be retrospective in effect. This means either that we should have to instruct the departments concerned to prepare regulations for laying on Budget Day; or that the new regime will have to start later in most public services (perhaps by a handful of months). A later public service start might be acceptable provided it was not too delayed. But the Government would need to make clear on Budget Day that the regime would bite properly on public services as soon as possible.

23. There is a special problem with the judges' scheme which, alone amongst public services, needs primary legislation before the changes could be made. This means that changes in the judicial scheme would have to wait at least until autumn 1990. We could expect enormous resistance from the Lord Chancellor. All Lord Chancellors have argued that barristers lose so much money when they go on the bench that any interference with the extremely generous judicial pension scheme is out of the question. ! LCD has so far refused to apply the 1987 increase in the minimum accrual period from 15 to 20 years.

24. If the Chancellor wished to say on Budget Day that the new regime would apply across the public services as soon as possible, he would probably have to square the Lord Chancellor first. There may be a case for some prior consultation with Armed Forces and Health Ministers too.

Issues

25. Ministers are invited to:-

(i) note that the classical regime would be very hard to apply convincingly in unfunded schemes

(ii) say whether they would be content, under the adjusted approach, to confine its unfunded scheme effects to taxing the lump sums; or whether they want to have the equivalent of removing tax privilege from investment income as well

(iii) say whether they accept that "top-up schemes will probably be necessary in public services. If so, we will do further work on the details once the tax regime is settled

(iv) note the timing problems for the public services; and consider whether they should discuss matters in advance of the Budget with the Lord Chancellor and perhaps some other Ministers.

27 January 1989

BUDGET CONFIDENTIAL

Rvwn

Inland Revenue

Savings and
Investment Division
Somerset House

KUCZYS → CH/EX 9/2

FROM: A W KUCZYS
DATE: 9 February 1989

1. MR ~~ISAAC~~ 9.2

2. CHANCELLOR

TAX REGIME FOR NON-APPROVED ("TOP-UP") PENSIONS

1. This note reviews the position reached on "top-up" pensions, following the Overview meeting on 6 February. It describes the <u>two</u> liberalisations we will be introducing, and then considers the various ways in which employers and employees might go about providing top-up pensions.

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Luce
Mr L Harris
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Unwin)
Mr Jefferson Smith) C & E
Mr P R H Allen)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr M Hodgson
Mr Keelty
Mr Hinton
Mr Cooke
Miss Dougharty
PS/IR

De-coupling

2. At the Overview meeting, the Economic Secretary asked what it was we were allowing employers to do, which they cannot do now.

3. There is a tax regime set out in the legislation now for non-approved pension schemes. It is described in paragraph 7 below. But it is not used in practice. Employers and employees will always want to make maximum use of the tax-privileged regime before even considering setting up a non-approved scheme. But then, if they do set up a non-approved scheme so that the combined total benefits exceed the tax privilege limits, they lose the tax privileges of the main scheme.

4. The only way an employer, at present, can provide top-up pensions above the tax privilege limits is by paying them on an entirely non-contractual ex gratia basis. (By definition, therefore, they cannot be funded). This may not be attractive to the employees concerned. In particular, it may not be sufficient to entice a senior executive, nearing retirement, to give up his present (secure) employment and pension, and work for another employer. So job mobility is probably being harmed.

5. The first liberalisation - "decoupling" - which Ministers agreed in the Autumn, is that we should repeal the provision (paragraph 3 above) which effectively prohibits top-up pensions now. In future, employers will be free to pay whatever unprivileged pensions they want, without jeopardising the tax benefits of their main scheme. This is a measure of real deregulation.

Non-approved regime

6. De-coupling will only provide a genuine new opportunity, however, if there is a reasonable regime for unapproved pensions. As noted above, there is a regime on the Statute Book now. And, since the decision at the

Overview meeting was that, so far as possible, top-up pensions should be subject to existing rules, it is worth setting out what those rules are.

7. The present non-approved regime works as follows:

<u>Contributions</u> i. <u>Funded schemes</u>: employee contributions attract no tax relief; and employees pay tax under Schedule E on any employer contributions.

ii. <u>Unfunded schemes</u>: employees pay tax under Schedule E on the <u>estimated</u> cost of providing the benefits - ie on the <u>notional</u> contributions which would be paid if the scheme were funded.

<u>Build-up</u> iii. <u>Funded schemes</u>: fund income and gains are taxed

<u>Benefits</u> iv. The <u>capital</u> in the pension fund (representing the post-tax savings of the employee, and the post-tax income and gains derived) may be taken out tax-free. If that capital is used to buy an annuity, the usual rules apply. (Exceptionally, if the ~~funds~~ fund pays a <u>pension</u> direct, it is taxed in full as income.)

8. The pensions tax legislation has nothing to say about whether or when the <u>employer</u> gets a deduction for his contributions. This is a question of Schedule D case law - in particular, as Mr Culpin said at the last meeting, the case of <u>Owen v Southern Railway of Peru</u>. Broadly, the employer gets a deduction if:

a. an obligation exists <u>now</u> to pay pensions in the future; and

b. the amount needed to be set aside <u>now</u> to provide for the future liability can be accurately quantified under the techniques of established accountancy practice.

The employer does not need to "alienate" the contributions (ie pay them over to an intermediary), although he may choose to do so.

9. Clearly, the regime described in paragraph 7 gives rise to a number of difficulties, for example:

i. If a final salary scheme is set up for more than one employee, how is the employer contribution in respect of an individual employee to be calculated - and taxed? (We met this problem with the "Byatt scheme" last year).

ii. The treatment of unfunded ("pay-as-you-go") arrangements looks especially difficult, in that it involves calculating, and taxing, a notional contribution.

iii. Where the benefits emerge directly as <u>pension</u>, the overall tax treatment (no relief on contributions, taxed build-up, and taxed exit) is <u>penal</u> rather than "unprivileged". (As noted above, however, this result is avoided if the employer or employee purchases an actuarially equivalent annuity.)

10. Since there are no (intentionally) unapproved schemes at present, these difficulties have until now been academic. But if de-coupling is to have any real effect, we cannot simply rest on this regime. A second liberalisation is needed.

Pay-as-you-go schemes

11. The "Isaac/Chaplin" proposal provides this necessary further step - the second liberalisation. It makes a practical possibility of the simplest form of top-up pension - the pay-as-you-go approach - which would be virtually impracticable under the legislation as it stands. And it still, of course, leaves open the other possible routes under the existing provisions.

12. What the Isaac/Chaplin proposal does is to provide that if a scheme is a pay-as-you-go one, pensions will be taxed just like pay. The employer will get a deduction as he pays the pension, and the former employee will pay tax on what he receives, as he receives it. We will need to legislate to remove the result in paragraph 7(ii) above, of needing to tax notional contributions, and to tax all receipts instead. The legislation should be fairly straightforward.

13. My note of 12 February was wrong in suggesting that we would have to ban funded top-up schemes. This is neither necessary nor, I think, what Mr Isaac and Mrs Chaplin intended. But given the simplicity of this new treatment of pay-as-you-go schemes, against the treatment under existing law of unapproved funded schemes, it seems likely that most employers will opt for the pay-as-you-go route - at any rate in the early years, while the amounts involved in top-up arrangements remain small. Top-up schemes in the public sector are also likely to be pay-as-you-go, so there would be equality of treatment as between public and private sector schemes.

but later further ahead...

14. The Isaac/Chaplin option, therefore:

- is deregulatory

- provides a simple new option for those who want to take advantage of it

- does not take away any options which are there already

- maximises conformity between public and private sectors.

Funded Arrangements

And pro-savs (& desirable)

15. Nonetheless, it must be recognised that pay-as-you-go will not suit everyone. Some employees will want the security of a fund, independent of the employer, out of which top-up pensions will be paid. And as the value of the £60,000 earnings cap falls, relative to earnings, and the transitional provisions work through - so that top-up schemes become more significant - employers may prefer to fund for the future liabilities they are accruing. In that case, employers and employees will still have the non-privileged regime described in paragraph 7, which in effect provides the same tax treatment as an employee savings scheme arranged by the employer.

16. Is this unacceptable? In at least one type of arrangement the result would be manageable and reasonably straightforward. That is, a money purchase scheme providing capital sums on retirement, which can be used to purchase an annuity. In money purchase schemes, each employee effectively has an "account" in which his savings are invested. He knows exactly how much is paid into the scheme, because it either comes out of his taxed income (employee contributions) or, he pays tax on it as if it had been paid to him first (employer contributions).

17. What comes out at retirement is entirely determined by investment performance. It cannot be paid directly in pension form (which would produce a penal tax result). But if the employee wants a pension, he can simply use the lump sum to buy a "purchased life annuity" - a pension which is deemed to be partly a return of capital (tax-free) and partly interest earned after retirement (taxed).

18. In practice, such a regime is so transparent that it seems likely that some employees would prefer to have the employer contributions (on which they pay tax anyway) paid as salary, and make their own savings arrangements. That may be considered a desirable result. In other cases, however, employers may want (for management or "paternal" reasons) to retain a measure of responsibility for their ex-employees' retirement income.

or worse, as the case may be

19. The annex to this paper sets out other possible routes employers and employees might adopt, and the tax consequences. Some do not look attractive - but that follows from existing legislation. In other cases we need to guard against the possibility of the employer getting a deduction under the Schedule D rules <u>without</u> the employee being taxed. We are doing further work on this (and considering whether any further legislation is needed); and also looking into the NIC position in each case.

<u>Conclusion</u>

20. Decoupling, and legislating for the Isaac/Chaplin option, would offer two significant liberalisations from the present position. It would not remove <u>all</u> the difficulties in the present (unused) regime for unapproved pensions. But it would not add to them, and the difficulties only arise if employers and employees choose the more problematic routes. The necessary legislation should be straightforward.

21. There would be at least two worthwhile options open to employers and employees:

1. Employers could run pay-as-you-go top-up schemes, with employees paying tax on pensions when paid. This would be the best way of providing final salary benefits, and is likely to be the form of top-up scheme adopted in the public sector. But it may not look quite so attractive in the long term, as top-up pensions become more significant.

2. Employers could offer money purchase funded schemes. Employees would pay tax on contributions paid in, just as if they had received the money in salary and then saved out of taxed income. This will be so transparent that employees may prefer to have the money and make their own savings arrangements.

A radical thought

22. No-one would be prevented from setting up alternative arrangements, but they would have to take account of the tax consequences under existing law.

A W KUCZYS

ANNEX

TOP-UP PENSIONS: POSSIBLE ROUTES

1. This annex looks at the various possible ways in which employers and employees could go about providing top-up pensions, and the tax consequences under existing law of each. It does not cover NIC consequences.

2. There will be no restrictions on how top-up schemes are set up, but the tax consequences will make some routes more attractive than others.

A. Unfunded arrangements

i. Pure Pay-As-You-Go

Benefits are promised in advance, no accounts reserve is set up and a pension or lump sum retirement benefit is paid on the employee's retirement on a pay-as-you-go basis.

Tax treatment: Employer gets deduction as payments of pension are made. But employees are taxed on notional contributions. (The "Isaac/Chaplin" proposal will change this so that employees are taxed instead on pensions they receive.)

ii. Pay-as-you-go with specific reserve

As in i, but employer sets up a special reserve in the accounts to meet the future liability to pay benefits to particular employees.

Tax treatment: Employer could get deduction when making reserve, if legal obligation to provide the benefit exists then and a sufficiently accurate figure can be computed. Treatment of employees as in i.

iii. Pay-as-you-go with general reserve

As in i, but a general reserve is set up to provide benefits to, say, "such, if any, of my employees whose earnings exceed £60,000".

Tax treatment: Employer should only get deduction as he pays the pension (as in i.). Employees treated as in i.

B. Funded Arrangements

iv. Employer Fund

The employer builds up a fund of money, e.g. in a bank account, which it administers in its own name. The fund will be used to provide the retirement benefits for either

a. particular named employees, or

b. such employees selected by the employer at their retirement.

Tax treatment:

a. named employees: The employer should get a deduction for sums set aside, and the employees should pay tax on those sums. The employer will be required to apportion sums between employees - in practice this is likely to lead to money purchase arrangements.

b. unspecified employees: The employer should not get a deduction until pensions are paid; employees should pay tax on pensions received. NB More work needed here: might require legislation to secure this result.

v. Trust fund

As in iv, but the fund is alienated from the employer and held under trust for employees as in a) and b) above.

Tax treatment: Broadly, the result should be as for iv. a. and b. But there is a danger that the employer might successfully obtain a deduction in case b., where it is hard to pin a tax charge on particular employees. More work needed; might require legislation to secure right result.

vi. Deferred annuity

The employer makes payment to a deferred annuity or endowment assurance policy due to mature on the employee's retirement.

Tax treatment: The employer is effectively paying for the employee's savings - eg by paying his life assurance premiums. The tax treatment should be exactly the same as if the employee had been paid the money and then saved it himself, viz. the employer gets a deduction for making the payments, and the employee pays tax on them. There is no further tax to pay on retirement; if an annuity is bought, "purchased life annuity" treatment applies.

C. Hybrid Arrangements

vii. "Hancock Annuities"

The scheme may be funded or unfunded, for a particular member or an open category of employees; but as each person retires the pension is secured by purchasing an annuity from an insurance company.

Tax treatment: the precise results would depend on the detailed arrangements, but generally follow iv. a. and b., and v. a. and b. above. The employer would get his deduction (at latest) when purchasing the annuity, even though the employee's tax on the pension would be spread over retirement, so there would be some timing advantage, but not an unacceptable one. Purchase of an annuity without pre-funding is quite common now, and likely to be used in the top-up field.

D. Life Assurance arrangements

viii. Death benefits

The scheme is used only to provide death in service cover through either term assurance or whole life policies.

Tax treatment: this should follow vi. above. We shall need to watch the IHT consequences of the resulting payment to the member's Estate (or his dependants).

BUDGET CONFIDENTIAL

Orwin-

FROM: J D HINTON
DATE: 9 FEBRUARY 1989

HINTON → ALLAN 9/2

1. MR ISAAC 9.2

2. PS/CHANCELLOR (MR ALLAN)

TOP-UP PENSIONS: A FALL-BACK OPTION

1. You asked whether, if an acceptable tax regime for non-privileged pensions <u>cannot</u> be found and thus the rest of the pensions package falls, it would be possible to introduce a tighter cap on tax-free lump sums.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Luce
Mr L Harris
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Unwin)
Mr Jefferson-Smith) C & E
Mr P R H Allen)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr H Thompson
Mr M Hodgson
Mr Kuczys
Mr Keelty
Mr Hinton
Mr Cooke
Miss Dougharty
PS/IR

Implications for the pensions package

2. Before examining this possibility it might be worth considering whether dropping plans for a non-privileged pensions tax regime would in fact cause the rest of the package to fail.

3. The introduction of non-privileged pensions has been seen as the key to the following changes in the tax treatment of pensions:

i. the introduction of an earnings cap to be set at £60,000 (which limits the maximum pension to £40,000 and maximum lump sum to £90,000). Without top-up schemes this earnings cap would bite harshly on high earners, and might be very difficult to present.

ii. The earnings cap will enable the benefit limit rules on early retirements to be simplified and relaxed. The cost of this simplification would be difficult to justify if there was no cap on tax-privileged pensions.

iii. The absence of a corresponding earnings cap for personal pension contributions would limit the scope for significant improvement in personal pension contribution rates (and would mean keeping the £150,000 cap on personal pension lump sums - see paragraph 8 below).

iv. The remaining elements of the package - other than the changes proposed for free-standing AVC schemes - are mainly minor tidying up measures. But they may still just be worth legislating for in their own right.

4. How much of the package could survive the loss of a decoupled tax regime involves difficult judgements, but it seems likely that an earnings cap as low as £60,000 could be

particularly difficult to present. In addition, it would do nothing to meet the concerns expressed by the pensions industry about the effect on job mobility claimed to have been caused by the 1987 pensions measures - non-privileged top-up schemes offer a solution to this problem (and to the Lord Chancellor's difficulties with the judges).

A tighter lump sum cap

5. The idea for a tighter cap would be to keep the present overall limits on lump sums (ie these allow pension schemes to pay tax-free lump sums of up to 1.5 times final salary or £150,000, if less), but to tax any commutation over, say, £90,000 or perhaps some lower figure. This can be illustrated through an example:

> An employee has a final remuneration of £100,000, has completed 20 years service and accrued a maximum two-thirds final salary pension. Under the post March 1987 tax rules he is entitled to a lump sum of £100,000 x 1.5 = £150,000.
>
> £90,000 of the lump sum would be tax-free. But, the remaining £60,000 would be chargeable at marginal rates.

6. It is possible to legislate for this result, but the legislation would not be straightforward. People would look for ways to reduce or avoid the tax charge - perhaps through setting up a series of artificial employments. It would therefore be necessary to set up anti-avoidance devices to prevent this. There would also be problems for public service schemes. With these, members have a proportion of their benefits paid as of right in lump sum form. So public servants could not choose to take less in lump sum in order to avoid the tax charge. This might be considered discriminatory and could lead to pressure for public service pension schemes to be restructured along private sector lines.

7. Even a limited change of this nature raises the same transitional issues as the more radical proposals in the present package. And for very much the same reasons as it was chosen then, the 1987 approach (ie applying the new rules only to new members who join a scheme on or after Budget Day) will be the best solution (despite the impact on job-mobility for those people who prize the tax-free nature of their lump sums).

8. There is also a read across to personal pensions. With them the maximum lump sum is the lesser of one-quarter of the value of the member's benefits or £150,000. Whatever rule was set for occupational lump sums should also apply to personal pensions. But because the £150,000 lump sum (for practical reasons) applies separately to each arrangement under a scheme, it would not be possible to make the tax charge watertight. It is because of just this problem that we propose, and the Financial Secretary has agreed, to use the earnings cap on personal pension contributions as a reason for removing the (unworkable) £150,000 limit on lump sums.

9. But, perhaps, the biggest hurdle that would need overcoming is the 1985 Green Paper pledge (Hansard extract attached). Taxing lump sum benefits is not expressly caught by the pledge, but it does seem to suggest that their tax treatment is safe this side of a Green Paper. Paradoxically, it looks easier to over-ride pension scheme rules so that they cannot pay benefits above a certain level, than just to tax recipients on the excess. The precedent of the 1987 changes shows that the package already agreed, including the £60,000 earnings cap, will not cross into Green Paper territory.

Conclusion

10. Any measure directed at the "anomalous but much loved" tax-free lump sum is sure to be controversial. The suggested tax charge will also have structural weaknesses if

extended (which it must be) to personal pensions. And taxing a part of the lump sum at marginal rates will not, of itself, remove tax privilege because of the tax-free build-up enjoyed by the scheme funds. Finally, there is the problem of the 1985 Green Paper pledge. All in all we find it difficult to see this option as an easy fall back.

JHinton

J D HINTON

[Mr. Lawson]

There is therefore a strong case for changing to a new system of personal allowances more suited to today's economic and social needs. Under this, everyone, man or woman, married or single, would have the same standard allowance; but if either a wife or a husband were unable to make full use of their allowance, the unused portion could be transferred, if they so wished, to their partner.

This reform would produce a more logical and straightforward system. Far more people could be taken out of the poverty and unemployment traps, and indeed taken out of tax altogether, for a given sum of overall tax relief than is possible under the present system. It would end the present discrimination against the family where the wife feels it right to stay at home, which increasingly nowadays means discrimination against the family with young children.

Husbands and wives would each be taxed separately on their own income irrespective of the income of the other. The aggregation for tax purposes of a wife's earned income and investment income with her husband's would end, thus removing what has become an increasing source of resentment among women.

The Green Paper will set out full details of the proposals I have just outlined, as a basis for public discussion. After an appropriate period for consultation, it would be possible to legislate in 1987 and have a system on these lines in place by the end of the decade.

There is also a case for changing the tax treatment of pension funds, as part of a thorough-going reform of the tax treatment of personal savings generally. Any fundamental reform of this kind would, in the same way, need to be preceded by the publication of a Green Paper.

The House will, I am sure, be interested to learn that I have no such Green Paper in mind.

Nor, indeed, despite the unparalleled pre-Budget agitation, do any of the detailed proposals in my Budget affect the tax-deductibility of pension fund contributions, the tax-free nature of pension fund income and capital gains, or the anomalous but much-loved tax-free lump sum.

Meanwhile, I have a number of other important proposals for tax reform to announce today, which will both simplify the system and encourage enterprise.

First, on Capital gains tax, last year I was unable to do anything about the acknowledged defects of this tax, notably its combination of unfairness and complexity, and undertook to come back to it this year. This I now do.

I have decided that the right way to reform capital gains tax is to build on the important changes made by my predecessor three years ago when he introduced the 1982 indexation relief. That relief, valuable though it is, and increasingly valuable as it will become, suffers from three serious limitations.

First, indexation does not cover the first 12 months of the ownership of an asset. This provision was introduced to discourage the short-term conversion of income into capital, but it has made the tax very much more complicated for the taxpayer. I am now in a position to remedy this defect. Hon. Members will recall that I announced last month measures to put an end to the practice known as bond washing, the principal device for converting income into less heavily taxed capital gains. Having done that, I now propose to abolish the 12-month rule. So far as most disposals are concerned, this will take effect from 6 April. In the case of certain fixed interest securities, however, the rule will need to remain in being until the anti-bond-washing provisions take effect on 28 February 1986.

Second, the indexation does not at present extend to losses. I propose to remove this restriction.

Thirdly, the present indexation provision unfairly discriminates against those who acquired their assets prior to 1982. For them, the allowance is based not on the 1982 value of the asset but on its original cost. I now propose to remedy that injustice. The indexation allowance will henceforth be based on March 1982 values. Capital gains made prior to 1982 will still not be indexed, of course, but at least all purely inflationary gains made since that date will now be free of tax, irrespective of when the asset was acquired.

That three-pronged reform of capital gains tax will produce a fairer tax, make life simpler for the taxpayer, help the efficient working of the capital markets, relieve the burden on family businesses and encourage risk-taking and enterprise. Combined with the statutory indexation of the exempt amount, which will rise in 1985-86 to £5,900, these changes will remove some 15,000 taxpayers from liability altogether. Increasingly, the tax will be levied on real and not inflationary gains. With these reforms, I believe that the tax is now on a broadly acceptable and sustainable basis. The combined cost of the threefold reform I have announced is £155 million in a full year; but none of it falls in 1985-86.

I turn next to the stamp duties. Following widespread consultation, I have decided that the time has come to simplify and modernise these ancient duties. I propose in this Budget to sweep away 15 separate duties, including the contract note duty and the 1 per cent. duty on gifts. Altogether, the changes I am proposing should reduce by over 40 per cent. the number of documents which require to be stamped.

My final proposal for reform concerns development land tax. This is a particularly complex tax, which was introduced in response to the problem of soaring land values at a time of high inflation. Its chief practical effect is to discourage the bringing forward of land for development. This disincentive effect will grow as the gap widens between the 60 per cent. rate of development land tax and a corporation tax rate which is on the way down to 35 per cent.

I have therefore decided to abolish development land tax altogether, with immediate effect. At the same time, I propose to cancel all deferred charges under the tax. The net cost will be some £20 million in 1985-86 and £50 million in a full year. That compares, incidentally, with a collection cost of some £5 million a year. Development gains will, of course, continue to be subject to income tax, corporation tax and capital gains tax, in the same way as any other income or capital gains.

The abolition of development land tax will, I am sure, be especially welcomed by the building and construction industry. It will also remove no fewer than 200 pages of highly complex legislation from the statute book. This follows the abolition of the national insurance surcharge and the investment income surcharge in last year's Budget —three unwanted taxes swept away in two years.

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BUDGET OVERVIEW MINUTES 6/2

RECORD OF THE THIRD BUDGET OVERVIEW MEETING: AT 3.00 PM ON MONDAY 6 FEBRUARY 1989

Present

Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr L J Harris (Item 4 only)
Mr Sedgwick
Mr Riley
Mr Gilhooly (Items 1-4 only)*
Mr Matthews (Items 1- 4 only)*
Mr Neilson (Item 5 only)
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR (Items 1&2 only)*
Mr Corlett - IR (Item 4 only)
Mr McGivern - IR (Item 5 only)
Mr P Lewis (Item 5 only)
Mr Cayley (Items 5 & 6 only)
Mr Farmer (Item 5 only)
Mr Kuczys - IR (Item 4 only)

Mr Jefferson Smith - C&E
Mr Wilmott - C&E (Item 2 only)

(* receive full minutes)

B.L.O.

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Papers:

(i) **Budget Scorecard:**

Mr Culpin's note of 2 February.

(ii) **Unleaded Petrol:**

Mr Wilmott's note of 2 February; Mr Matthews' note of 2 February.

(iii) **Unauthorised Disclosure of Confidential Information**

Mr G Bush's and Mr Hutton's notes of 27 January; PS/FST's note of 30 January.

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(iv) **Pensions**

Mr Isaac's and Mr Kuczys' notes of 2 February; Mr L J Harris' note of 2 February.

(v) **ESOPs**

Mr Painter's and Mr Lewis' notes of 2 February.

(vi) **CGT and gifts**

Mr Cayley's note of 2 February; PS/Chancellor's note of 2 February; Mr Cayley's note of 31 January.

Scorecard

In discussion, the following points were raised:

(i) The Chancellor asked about the basis of the +£200 figure for 1990-91 arising from the life assurance changes. It was explained that this was a notional figure; the actual figure would, depending on the package chosen, fall between £0 and £200 million for 1990-91.

(ii) The Chancellor asked for a breakdown of the call on the fiscal adjustment in 1989-90 and in 1990-91 of the main Budget measures .

Unleaded petrol

2. The Chancellor said that he would want to give a clear explanation in the Budget Speech of the full implications of the changes in petrol duty.

3. The Chancellor noted that the UK already ranked third in the EC league in terms of the differentials in favour of unleaded petrol. If any of the Options A to D were pursued, the UK would

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move into second place. The practical choices were between Option A (increase the present tax differential for unleaded to 2p a litre; increase the duty on two star leaded to make it at least as expensive as four star leaded) and Option B (as A, but with no change in the duty on two star leaded). There was little purpose in cutting duty on unleaded petrol by any more than was necessary, since there was likely in any case to be a large increase in the consumption of unleaded petrol over the next couple of years.

4. The <u>Economic Secretary</u> thought there was also a case for not making any change to the duty on unleaded petrol and confining the Budget changes to imposing a punitive duty on two star. This might be more effective than Customs & Excise envisaged. Once garages had switched their two star pumps to unleaded, the difference in leaded and unleaded prices would be plain and easy to advertise. It was noted, however, that this option would be harder to present in the Budget.

5. After a brief discussion, <u>it was agreed</u> to go ahead on the basis of Option A. The Department of the Environment would need advance notification, particularly of the proposals on two star petrol, so that they could plan their information campaign accordingly; the Chancellor would see Mr Ridley soon. Other Departments (eg Energy and Transport) would be informed later, as necessary. They could be told the likely differentials between leaded and unleaded duty. But not the absolute amounts.

6. The <u>Chancellor</u> asked Customs for a note on what vehicles or other equipment could run only on two star leaded petrol and not on either unleaded or four star leaded.

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Unauthorised disclosure

7. Sir A Battishill said that the papers represented the joint views of the Revenue and Customs. The interests of the two Departments were very similar. The Departments would want the protecting powers to be focused not on the confidentiality of information to Government, but on the confidentiality of information to individuals. The Revenue wished to protect the following categories of information: that which was given to them by individuals; that which was derived from that information; that which was sent back to taxpayers in response to that information; the judgements in the Department which were made on the basis of that information; and information from third parties about individual taxpayers. There were a number of categories of information which the Revenue would also like to protect which were not directly related to its work, eg information on national insurance contributions; and information acquired by the Valuers on rating. It might be harder to extend privilege to the latter category, and he would not wish to press the need for protection further than was essential.

8. The Chancellor asked for a note on the position in other comparable countries; in particular, whether there was a clear distinction between the protection of information held by fiscs and the protection of other Government information.

9. Mr Jefferson Smith said that the Customs position was similar to the Revenue. Customs would, however, wish the protection powers to extend beyond strictly tax matters to other legitimate Customs interests (eg licences, drugs).

10. After a short discussion, the approach proposed by the Revenue and Customs was agreed; it was important that the sanctions should apply, so far as was possible, to former

officials as well as current ones. The Chancellor asked the Financial Secretary and the Economic Secretary to sort out the remaining details. He would then minute the Prime Minister and other interested Ministers (such as the Home Secretary and the Attorney General). We should aim for a pre-Budget announcement, probably during the passage of the Official Secrets Bill, which should be linked with the similar announcement planned for the arrangements to protect social security information.

Pensions

11. The Chancellor noted that Mr Kuczys' paper set out a range of options for the future tax regime for non-approved ("top-up") retirement arrangements. He was, provisionally, attracted to Option E. It was noted that the genesis of this approach lay in the need to put a cap on tax privileged pensions. Alternative approaches were either presentationally impossible or required elaborate rules to avoid exploitation, which would be difficult to implement in the context of deregulation. Hence this approach, which rested on the notion that, so far as possible, top-up pensions should be subject to existing rules.

12. In discussion, the following points were made:

(i) companies would be able to get full CT relief for specific contributions to an individual's top-up pension, and the money would then be taxed as income in the hands of the individual. This would not apply to more generalised provisions. This followed existing tax rules;

(ii) at present, companies could pay contributions into an unprivileged fund, but an individual pension could not

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exceed the total cap even if it combined privileged and unprivileged elements. Under this Option, there would be no limit to the unprivileged element;

(iii) over time, one effect of Option E might be to encourage the development of money purchase schemes. There would be an incentive for individuals to take their employers' pension contribution as pay, and invest it directly themselves;

(iv) if possible, the employers' contribution should be taxed in the hands of employees through the PAYE and not the P11D system. Employer NICs should, in principle, be chargeable;

(v) it could be argued that this proposal represented an incentive to pay-as-you-go schemes at the expense of funded schemes. However, all the proposal did was to remove existing tax privileges. The greater security inherent in funded schemes would still apply;

(vi) the impact of Option E should be set in perspective. It would in the main apply to earnings above the £60,000 ceiling, which would itself be indexed;

(vii) the £60,000 cap meant that the rules for schemes below that level could be simplified, for example for those taking early retirement.

13. The <u>Chancellor</u>, summing up, said that Option E would undoubtedly be highly controversial. He was convinced, however, that we should go ahead on this basis. The details of the scheme should be worked up quickly. A "child's guide" should be prepared.

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14. The Chancellor noted that Option E would dispose of the presentational problems in relation to public service pensions. The problem of judicial pensions remained, however, and he would need to speak to the Lord Chancellor shortly. He asked for a brief to be provided for that meeting.

<u>ESOPs</u>

15. The Financial Secretary said that three forms of relief were under discussion as ways of encouraging ESOPs. These were: Corporation Tax relief on company contributions to an employee benefit trust; CGT relief for the proprietor selling his shares to an employee benefit trust; and CGT and additional income tax relief for build-ups within the employee benefit trust. There was a clear case for doing the first of these. Of the remaining two, he strongly favoured the second, which would, if implemented, make a substantial contribution to increasing the attractiveness of ESOPs. But the Revenue had advised that it would not be possible to devise a sufficiently watertight approach in time for this year's Finance Bill.

16. Mr Painter said that the difficulty lay in the need to protect against abuse. There was considerable scope for manipulation of Corporation Tax relief, but it should be possible to draft legislation in time for this year's Finance Bill. The CGT reliefs were, however, particularly open to abuse and it would be very difficult to sort out what was necessary and draft legislation this year. The difficulty of confining changes to Corporation Tax relief was that this would seem small beer. Much lobbying had, nonetheless, concentrated on this relief.

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17. In discussion, the following points were made:

(i) complicated anti-avoidance measures could be defended where a relief to help "genuine" ESOPs was being provided;

(ii) rollover relief, rather than complete CGT exemption, was all that would be needed to remove the disincentive on transferring shares to ESOPs. But that would create a precedent by expanding rollover relief well beyond its present definition, and would in practice amount to virtual exemption anyway;

(iii) the Revenue's would have difficulties in preparing the Corporation Tax clauses in time for the Bill as published given the work also needed on the proposed provisions for CGT trading relief and for rent-a-room.

18. The Chancellor said it was unfortunate that it would not be possible to take all the steps which might be desirable. He was, however, prepared to leave the CGT changes to another year provided that the Corporation Tax changes could be brought into the Finance Bill as published, without harming progress on the CGT trading relief and rent-a-room proposals. The Financial Secretary should also consider whether or not a time-limit on distributions was required and, if so, what period that should be.

CGT and gifts

19. In a brief discussion, it was agreed to proceed with the present proposal on the basis set out in the papers. The

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possibility of maintaining relief for agricultural landlords should, however, be kept as a possible concession at Committee stage.

ACSA

A C S ALLAN

7 February 1989

Distribution

Those present
Mr Anson
Mr C D Butler (Item 3 only)
Mr Luce (Item 4 only)

PS/IR
Mr Unwin - C&E
Mr P R H Allen - C&E

(Note: All members of the permanent Overview cast receive the full minutes, even where they did not attend all the items).

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