PART FOUR

MT.

SECRET

CONFIDENTIAL FILING

Interim Report of the Working Group on Tax and Savings

Tax Relief for Housing

Green Paper of Taxation of Husband and Wife.

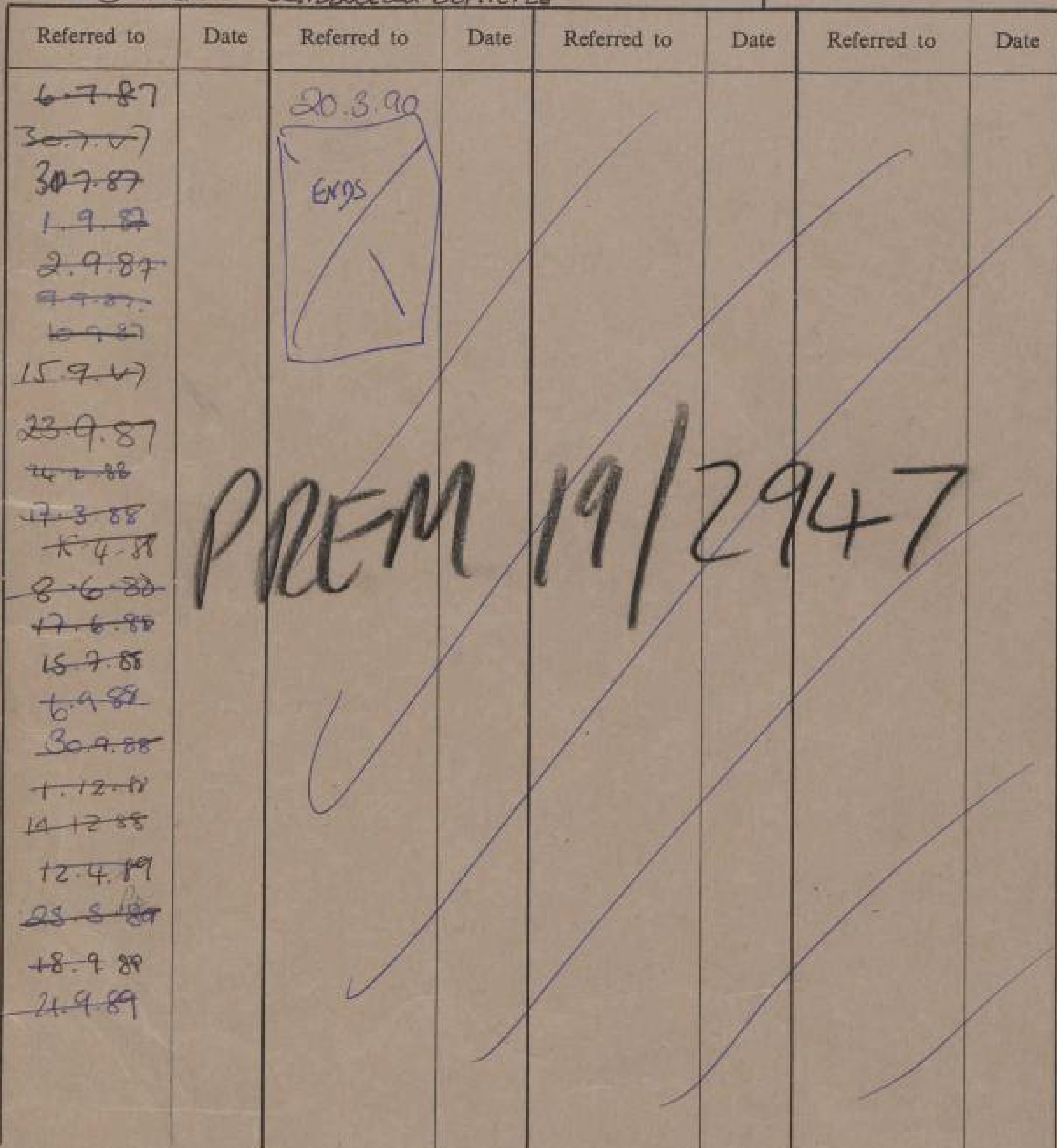
[IN ATTACHED FOLDER: ① INLAND REVENUE CONSULTATIVE DOCUMENT "THE TAXATION OF LIFE ASSURANCE"]

② PAPERS ON RESIDENCE and DOMICILE

ECONOMIC POLICY

PART 1: MARCH 1980

PART 4: JULY 1987.



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PART 4 ends:-

PG to EST's office 19.3.90

PART 5 begins:-

DM to MMT 22-5-90

BUDGET CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

19 March 1990

NATIONAL SAVINGS CHANGES

Thank you for your letter of 16 March concerning the announcements the Chancellor will be making tomorrow, which the Prime Minister has seen and noted.

PAUL GRAY

Miss Gina Haskins,
Economic Secretary's Office,
H. M. Treasury

BUDGET CONFIDENTIAL

KK

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BUDGET CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister

16 March 1990

Dear Paul,

NATIONAL SAVINGS CHANGES

This is to confirm that, in the context of measures to stimulate savings, the Chancellor will be announcing in his Budget speech on Tuesday increases of 1% in the interest rates on National Savings Income and Deposit Bonds (from 12.5 per cent to 13.5 per cent) and the National Savings Investment Account (from 11.75 per cent to 12.75 per cent).

The Income and Bond increase will take effect on 4 May (together with a similar increase in the rate on Deposit Bonds which are no longer on sale, though many investors still hold them) since six weeks' notice of a change is required by the prospectuses. The Investment Account increase will take effect on 3 April.

These increases follow recent movements in banks' and building societies' retail deposit rates and maintain the relative position of the National Savings products in the market.

The Chancellor will also be announcing in his speech that the DNS will be introducing later this year a new Series of the Capital Bond, with simpler arrangements for paying tax on interest. The new Bond cannot go on sale until the Finance Bill, which will provide for the improved tax treatment, receives Royal Assent. As a result, we cannot announce now what the return on the new Bond will be. But we intend that it should be more attractive in relation to other rates than the current Series is at present.

Yours sincerely,
Gina Haskins

GINA HASKINS
Private Secretary

WITH COMPLIMENTS

Lord Hanson

12513 cdp

THE ECONOMIST MARCH 3 1990

BAGEHOT

Till the pips squeak?

WHAT will Labour do to taxes if it wins the next election? Hints have just come from the shadow chancellor, Mr John Smith, praising a Fabian Society booklet "The Reform of Direct Taxation". It was written by a team which included several former Labour advisers.

The Fabian booklet recommends a "social security tax" on investment income and capital gains; slashing the annual exemption for capital-gains tax from £5,000 to £1,000; reimposing the tax at death; and cutting the retirement relief on capital-gains tax by 80%. The current 40% rate for inheritance tax would be replaced either by a capital transfer tax of up to 60%, or by a lifetime capital-receipts tax, probably at income-tax rates.

Incentives for savers, such as the Business Expansion Scheme and the personal equity plans, would be abolished. Tax advantages for the self-employed would be removed. Mr Smith praises the paper as demonstrating "that a fairer tax system can be both realistic and desirable". Hmmm. If those proposals were to become official Labour policy, the Tories would have a field day.

There is, however, one Tory wheeze which Labour secretly likes. It hankers after a tax which would give the government a flexible way of taxing business; which would redistribute from the rich south to the poorer north; and would be biased in favour of manufacturers and against retailers. It already exists: it is, of course, the Tories' new uniform business rate. Labour policy is to abolish it: but the more senior Labour MPs gaze on this particular Tory tax, the more they love it.

GR - p.a. No further action.

H. H. THYSSEN-BORNEMISZA

6976 CASTAGNOLA (SCHWEIZ)
VILLA FAVORITA - TEL 51 66 21

21st September 1989
HTB/uk

Prime Minister

I see no point in, or need for, any further reply.

The Rt.Hon Margaret Thatcher
10, Downing Street
London SW 1

Dear Prime Minister,

Thank you for your letter of 25th August. I appreciate the points that you make in your letter. However, there is no doubt that if the Inland Revenue is legally correct in the approach which it has adopted the consequences which I have referred to are bound to follow.

Thank you again for the detailed response to my enquiry.

With sincerest regards,

H.H. Thyssen-Bornenemisza

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

18 September 1989

Dear Duncan,

PRIVATE MEDICAL INSURANCE: DAILY TELEGRAPH ARTICLE

Thank you for your letter of 14 September, enclosing briefing on the Daily Telegraph article. The Prime Minister has seen this material which she has noted without comment.

Yours,
Paul

Paul Gray

Duncan Sparkes, Esq.,
H.M. Treasury.

chex.jp/ds1/63

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

14 September 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister[2]

On the basis of yesterday's Telegraph article I was concerned the Inland Revenue might be unduly restricting access to the medical tax relief. But I think this explanation of Treasury Ministers' decision on the main point at issue seems reasonable.

PRCG 14/9

Dear Paul,

PRIVATE MEDICAL INSURANCE: DAILY TELEGRAPH ARTICLE

You asked me yesterday to provide briefing on an article that appeared in the Daily Telegraph alleging that the Inland Revenue were standing in the way of granting tax relief on most private medical insurance policies.

I attach a submission by Mr Kuczys (Inland Revenue) which I trust will be helpful.

Yours,

Duncan.

DUNCAN SPARKES
Assistant Private Secretary

Inland Revenue

Savings and
Investment Division
Somerset House

From: A W KUCZYS
Date: 13 September 1989

Not available

1. MR CORLETT
2. PS/CHANCELLOR (Mr Sparkes)

PRIVATE MEDICAL INSURANCE: DAILY TELEGRAPH ARTICLE

1. As requested, I attach a briefing note by Mr Walker and Miss Lees on the article (attached) which appeared in this morning's Daily Telegraph. If the Chancellor is content, this could be passed on to No 10.

2. The article, apparently inspired by Private Patients Plan (PPP), gives a very distorted picture of the discussions we have been having with the medical insurance industry (including PPP). The main "problem" referred to - that policies which pay a cash benefit where the insured individual opts for NHS instead of private treatment - is not, of course, an "Inland Revenue ruling" at all. Rather, it was a Ministerial decision, announced by the Financial Secretary in the Summer. And (as the Telegraph article goes on to say) the reason for it is quite clear: there would be absolutely no advantage to the Government in giving tax relief for insurance which encouraged people _not_ to have private treatment but to use the NHS instead.

---

c.c PS/Chief Secretary
PS/Financial Secretary
Mr Culpin
Mr Saunders
Mr O'Donnell
Mr Ritchie
Mr Tyrie
Mr Isaac (o/r)
Mr Corlett
Mr Eason
Mr Kuczys
Miss McFarlane
Mrs Mellor
Mr Walker
Miss Lees
PS/IR

Misc3 AWK1

3. It may be true that many policies will need amending to comply with this and other rules. But the modifications needed will be quite straightforward. The indications from the other insurers we have been talking to is that they will have amended policies ready in time for the new tax relief to get off to a good start next April - which was the purpose of having the discussions.

A W KUCZYS

DAILY TELEGRAPH ARTICLE ON TAX RELIEF FOR PRIVATE MEDICAL INSURANCE

Main allegations

- "Inland Revenue ruling" will prevent schemes which offer NHS cash benefits from qualifying for tax relief.
- Inland Revenue "threatening to withhold tax relief" for contracts which cover treatment abroad or pay for air ambulance to UK.
- Administrative complexity of scheme may prevent insurers introducing relief by 1990.

Background

- Government announced tax relief for private medical insurance premiums for those aged 60 and over in White Paper "Working for Patients" published 31 January 1989. Relief to take effect from 6 April 1990.
- Main legislation introducing relief in Finance Act 1989. Regulations on details of scheme to be laid before Parliament in Autumn.
- Inland Revenue officials have held discussions with insurance industry about details of scheme.

Treasury Ministers have announced that:-

i. private medical insurance contracts offering cash benefits where treatment received under NHS will not attract tax relief.

ii. treatment must normally take place in UK. No decision has yet been taken about cover for incidental treatment abroad and air ambulance.

Comment

Treasury Ministers ruled out policies which offer cash benefits while undergoing NHS treatment because they encourage people to take their treatment free in the NHS rather than privately. As most policies aimed at the retired are currently of this kind, the tax relief would have been of little use in relieving pressure on the NHS if this feature remained. Removing this benefit from policies should not be difficult for insurers: all contracts are annual, and policy changes are frequently made at the annual renewal point. Nor should this change lead to increased premiums.

As for overseas treatment and repatriation by air ambulance, Treasury Ministers have announced that the main thrust of policies must be to offer treatment in the UK; but the possibility of allowing incidental cover for treatment while abroad on holiday or business, and for air ambulance services, has not been ruled out. Inland Revenue officials are certainly not "threatening to withhold tax relief" from policies which offer these benefits.

On complex administration, the insurance industry will have the new task of giving tax relief at source; but the rules for this are being kept very straightforward. No reason whatever why scheme should not get off to a good start next April.

AJW7 AJW268

NEW

Tax relief rejected on most health policies

By David Fletcher
Health Services
Correspondent

TAX RELIEF on private health insurance premiums for the over-60s, to be introduced by the Government in April in what was heralded as a major boost for private medicine, will apply to only a very limited number of health insurance policies, it was disclosed yesterday.

Stricter-than-expected interpretation of the rules by the Inland Revenue means that the most popular policies offered by provident associations and the big insurers will not qualify for the expected savings of about £250 a year.

Bupa, the biggest health insurer, has only one major policy which will qualify for tax relief and Private Patient Plan, the second biggest health insurer, has none at all.

Both associations complained that discussions with the Inland Revenue are proving so protracted and the administration of tax relief so complex that it is uncertain whether the scheme can be introduced by April.

The problem has been caused by an Inland Revenue ruling that policies will not be eligible for tax relief if they provide a cash benefit for patients treated on the NHS.

This effectively rules out most health insurance policies which typically offer a £30-a-day cash payment to privately-insured patients who opt for NHS treatment rather than go into a private hospital.

It will also hit the increasingly popular and growing number of cut-price policies which provide private care only if NHS treatment is not available within six weeks.

Inland Revenue officials argue that the purpose of tax relief is to encourage the over-60s to use private medicine and so ease the burden on the NHS. Giving tax relief on policies which give patients an incentive to use the NHS would, they argue, run counter to this aim.

They are also threatening to withhold tax relief from policies which offer treatment abroad or which pay to fly a patient back to Britain in an air ambulance if they are taken ill overseas.

Mr Roy Clarke, managing director of Bupa insurance, said: "These rules mean there are very few policies on the market which will qualify for tax relief without some changes.

"I would not say that tax relief has turned sour but there is certainly a level of disappointment over the way it is being operated."

He said consideration was being given either to the modification of existing policies for the over-60s or the introduction of new policies tailor-made to qualify for tax relief.

Mr Roy Forman, managing director of PPP, said there would be a substantial reduction in cover offered to private patients if companies had to withdraw cash benefits, cease overseas cover and refuse repatriation from abroad in order to offer policies which qualified for tax relief.

There was also a danger that premiums for the over-60s would rise in devising policies for them which would qualify for tax relief.

"It is a much over-simplified view to think introduction of tax relief for the over-60s means a cut in premiums of 25-40 per cent," said Mr Forman. "Administration of the scheme is proving so complex there is very real doubt whether the April deadline can be met."

Grant withdrawn

Derby's Labour-controlled county council yesterday withdrew an annual £14,000 grant to the County Cricket Club, for school coaching, because the captain, Kim Barnett, is joining the South Africa winter tour. The council will set up its own coaching scheme.

£1·1m soap order

The British Soap Company, of Bicester, Oxon, is to ship 14 million bars of soap weighing 2,000 tons to Russia. The order is worth £1·1 million.

'Less choice' for pregnant women under NHS reforms

By Our Health Services Correspondent

WOMEN will have less choice of where to have a baby, where to obtain gynaecology services or where to get family planning advice under the Government's proposed NHS reforms, the Labour party claimed yesterday.

Miss Harriet Harman, Labour shadow Health Minister, said in a report that under the present NHS system a woman could choose whether to have her baby in a local hospital or at a hospital in a different district which provided the sort of care she wanted.

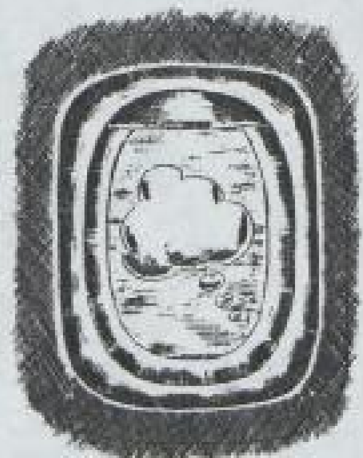
She said that choice would be withdrawn under the NHS reforms. A woman registered with a GP practice which held its own budget would have to have her baby in the hospital with which the practice had a contract.

If her GP was not in a budget-holding practice, she would have to have her baby in the hospital with which the district health authority had a contract.

"In both cases the decision will have been made at the start of the financial year without any reference to the individual woman's preferences."

Mr David Mellor, the Health Minister, said last night: "Our proposals will, in fact, provide more choice for patients and be more responsive to their views."

Whoever heard of a 'plane o



Did Alan Bennett think up his latest openi

Econ PR

Tarzalini

Spring 8 \

FILE

SH

10 DOWNING STREET

LONDON SW1A 2AA

CC HMT
Also B/R 15/9/89
VB

THE PRIME MINISTER

25 August 1989

Dear Baron Thyssen,

Thank you for your letter of 28 July about the tax treatment of people who are resident but not domiciled in the United Kingdom.

I entirely agree with your general point that those who come to this country from overseas to carry on business and other activities here often make an important contribution, both economically and socially. We certainly have no wish to see them leave. And the tax reforms this Government has introduced, in particular by greatly reducing rates of personal tax have, I am sure, reinforced the attractions of living and working in the United Kingdom.

You mention the situation where people who are resident in the United Kingdom for tax purposes but do not have a United Kingdom domicile hold personal wealth through non-resident companies. By doing so they shift overseas the value of their house or other property in the United Kingdom so that there is no potential liability to Inheritance Tax. As you say it has not always been appreciated by some who have made arrangements of this kind that a liability to income tax can arise on the annual value of the accommodation provided for the individual by the company.

Inevitably in arrangements of this nature involving quite technical tax issues there are often differing interpretations of the relevant tax law and I understand that

VLB

some commentators have questioned the Inland Revenue's view of how it applies in the circumstances I have outlined. I am sure you will understand that in applying the law the Revenue has to follow the legal advice it receives. It is, of course, open to anyone assessed to tax in circumstances like this to take the matter to appeal before the independent Appeal Commissioners and the Courts.

Meanwhile, I can assure you that the Revenue has kept Treasury Ministers fully informed of these developments and, in particular, with their knowledge and approval has been at pains to be fair, and to be seen to be fair, in its handling of perhaps unexpected liabilities for past years.

Kind regards.

Yours sincerely

Margaret Thatcher

Baron H. H. Thyssen Bornemisza de Kaszon

chex.ps/jmt/78 **CONFIDENTIAL**

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

21 August 1989

Dominic Morris Esq
PS/Prime Minister
10 Downing Street
LONDON SW1

Dear Dominic

LETTER OF 28 JULY FROM BARON THYSSEN BORNEMISZA DE KASZON

... I attach a draft reply for the Prime Minister to send to Baron Thyssen.

Baron Thyssen's letter stems from the view of the Board of Inland Revenue, acting on legal advice and with Treasury Ministers' approval, that the legislation on the taxation of the benefit of employer-provided living accommodation can apply to non-domiciled but UK resident individuals who own homes through the medium of a non-resident company.

A relatively sophisticated tax planning arrangement can be involved in which the individual places his house in the ownership of a company resident off-shore. He thus ceases to own the home and becomes the owner of shares in the non-resident company. In effect he shifts the value of the assets off-shore. If he is non-domiciled - and therefore liable to UK tax only on his UK assets - he escapes Inheritance Tax.

But because in this sort of arrangement he usually retains full control of the company which owns the house he comes within the definition of a director of the company for tax purposes. The Revenue's legal advice is that the better view of the law, which they would be justified in arguing before the Courts if necessary, is that a taxable benefit can arise in these circumstances. The income tax charge arises, where it does so, on a fairly technical point. Given the circumstances however - an equally technical artificial device to avoid Inheritance Tax on property situated in this country - Treasury Ministers have seen no good grounds for changing the law.

As it is a point which taxpayers, even with professional help, might well have overlooked however, the Revenue decided, again

with Ministers' approval, to phase in the liability for past years where it had not previously made its views of the law known to a particular taxpayer. This will considerably temper the impact in some cases and is perhaps itself the best indication that there is no desire to apply the change with excessive zeal.

It was recognised that the Revenue's view of the law was quite likely to be questioned, perhaps on appeal to the Courts, and that some particularly wealthy and influential people would be affected. The broader background is, as the Baron says, that there are indeed a number of ways in which the tax law as it stands favours the non-domiciled UK resident. Among these is the exemption from inheritance tax of land and property in this country, if owned through the channel of a non-resident company. But there is no special exemption for the income tax liability which can follow in this (often rather artificial) kind of case; and in all the circumstances Treasury Ministers were not persuaded that there is a case for legislating to grant an exemption. Baron Thyssen has not asked the Prime Minister to take up his particular case, which is still under consideration in the Revenue. The Revenue have however confirmed that they have seen no evidence that it, or similar cases, is being pursued with undue zeal.

Yours ever

Jonathan Taylor

J M G TAYLOR
Private Secretary

chex.ps/jmt/81

August 1989

Baron Thyssen Bornemisza De Kaszon
Villa Favorita
6976 Castagnola
Switzerland

Thank you for your letter of 28 July about the tax treatment of people who are resident but not domiciled in the UK.

I entirely agree with your general point that those who come to this country from overseas to carry on business and other activities here often make an important contribution, both economically and socially. We certainly have no wish to see them leave. And the tax reforms this Government has introduced, in particular by greatly reducing rates of personal tax~~, in particular the higher rates,~~ have, I am sure, reinforced the attractions of living and working in the UK.

You mention the situation where people who are resident in the UK for tax purposes but do not have a UK domicile hold personal wealth through non-resident companies. By doing so they shift overseas the value of their house or other property in the UK so that there is no potential liability to Inheritance Tax. As you say it has not always been appreciated by some who have made arrangements of this mind that a liability to income tax can arise on the annual value of the accommodation provided for the individual by the company.

Inevitably in arrangements of this nature involving quite technical tax issues there are often differing interpretations of the relevant tax law and I understand that some commentators have questioned the Inland Revenue's view of how it applies in the circumstances I have outlined. But I am sure you will understand that in applying the law the Revenue has to follow the legal advice in receives. It is, of course, open to anyone assessed to tax in circumstances like this to take the matter to appeal before the independent Appeal Commissioners and the Courts.

Meanwhile, I can assure you that the Revenue has kept Treasury Ministers fully informed of these developments and, in particular, with their knowledge and approval has been at pains to be fair, and to be seen to be fair, in its handling of perhaps unexpected liabilities for past years.

Baron THYSSEN
18/8

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 August 1989

I attach a copy of a letter which the Prime Minister has received from Baron Thyssen Bornemisza de Kaszon.

I should be grateful if you could provide a draft reply, for the Prime Minister's signature, to reach me by 18 August.

PAUL GRAY

Duncan Sparkes, Esq.,
H M Treasury

R4/8 rec del

H. H. THYSSEN-BORNEMISZA

6976 CASTAGNOLA (SCHWEIZ)
VILLA FAVORITA - TEL 51 66 21

July 28th, 1989. Switzerland

The Rt.Hon. Margaret Thatcher
Prime Minister
10, Downing Street
GB - London SW1

Dear Prime Minister,

I am writing to you upon a matter which may have far-reaching consequences for the United Kingdom in general and for London in particular.

As you are no doubt aware, the United Kingdom tax system offers considerable benefits to non-domiciled residents of this country: the benefits attract - and are no doubt intended to attract - many foreign people to London.

Accordingly these benefits at least contribute to, and may be the cause of, London's roles as a global financial centre, as the world's greatest art market and as a shipping market: they assist in underpinning the London property market; they help to bring foreign investment and economic growth to this country.

For a number of reasons non-domiciled individuals tend to hold their wealth through companies from which they derive benefits: the source of these benefits is the ownership of assets and is not in any way related to an employment.

Nonetheless, the Inland Revenue has recently begun to claim that the provision of these benefits gives rise to employment-related charges to income tax: the tax being sought is very substantial and bears no relationship to the links which many non-domiciled individuals have with this country.

I should mention, so as to make full disclosure, that I have had claims of this sort made against me.

That, however, is not why I am writing to you: indeed I am advised - and I believe my advisers are correct - that claims of this sort are wrong in law.

Rather I am writing to you because I believe that this sort of claim against non-domiciled people is becoming more widespread, and the matter may soon give cause for concern in the whole non-domiciled community: after all foreign people who have been attracted here by a tax system designed for that purpose understandably find it unattractive to be pressed, occasionally with excessive zeal, with claims which are not logical and which they are told by their advisers are wrong in law.

My concern is that if these unattractive claims are pressed too often, much of the United Kingdom's attraction to non-domiciliaries will be lost and they will leave in great numbers.

I hope you will not mind that I have written to you on the point: I believe that the Inland Revenue's current attitude could well provoke an exodus of non-domiciled individuals which would cause very great damage to the interest of the United Kingdom; I thought it right to bring the matter to your personal attention.

With sincerest regards,

H.H. Thyssen-Bornemisza

Baron H.H. Thyssen Bornemisza de Kaszon

PERSONAL

1. John Whittingdale - to see
2. CF - pa.

PRIME MINISTER

ABOLITION OF CLOSE COMPANY APPORTIONMENT

You should be aware that we have been getting an increasing number of letters about the Budget and Finance Bill proposals to abolish close company apportionment. I gather from John Whittingdale this has also been causing some concern on the Party front.

But Norman Lamont has now decided to modify the proposals and, as far as I can gather, this should meet the principle concerns that have been expressed. You may like to glance at the attached copy of yesterday's Inland Revenue Press Release announcing the changes.

PAUL GRAY

26 May 1989

SLH/44

PERSONAL

INLAND REVENUE

Press Release

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

[3x] 25 May 1989

ABOLITION OF CLOSE COMPANY APPORTIONMENT

The Chancellor announced in his Budget a proposal to abolish close company apportionment. (This involves taxing individuals on the undistributed income of close companies in which they have an interest.) As a result the vast majority of close companies, several hundred thousand in total, will no longer be concerned with the risk of any form of apportionment. The Chancellor said that there was a continuing need to guard against the avoidance of tax on investment income by channelling it through a closely controlled investment company. So he proposed a special tax regime for close investment-holding companies.

In reply to a Parliamentary Question, the Financial Secretary to the Treasury, the rt hon Norman Lamont MP, announced today that he would bring forward amendments to this proposed regime to make it much simpler, while guarding against tax avoidance. This press release describes the main points that will be covered.

DETAILS

Parliamentary Question

1. The Financial Secretary was asked what representations he had received about the provisions in the Finance Bill concerning close investment-holding companies. He made the following reply.

"We have received a number of representations.

The purpose of the provisions concerning close investment-holding companies (CICs) is to enable the highly complex and lengthy legislation about close company apportionment to be abolished while preventing the avoidance of tax on investment income and capital gains by an individual placing personal investments in a closely controlled investment company. There is general agreement on these objectives.

/The approach of

The approach of the provisions in the Finance Bill is to tax CICs like individuals, so far as possible. However, although there have been some misunderstandings of the effect of the provisions, we are persuaded that this approach has its own difficulties and could place some close companies at a competitive disadvantage in comparison with non-close competitors. This was not the intention. We therefore propose to bring forward amendments.

We have no doubt that the right approach remains to abolish apportionment and replace it by an appropriate tax charge on the company. We now propose that CICs will continue to be taxed like other companies, with the normal reliefs for interest and expenses. But, whatever the level of their profits, they will no longer receive the benefit of the small companies rate and so will be taxed at 35 per cent. This approach will result in rules that are simpler than both the old apportionment provisions and the provisions in the Bill. And it will protect the Exchequer since under existing law there is a further tax charge if an investor withdraws accumulated profits from a company or sells his or her shares.

We also propose to amend the definition of a CIC. No trading company (including a dealing company) will be a CIC. The existing apportionment provisions recognise that property investment companies may need to retain income for the purposes of the business and in practice these companies are little affected by apportionment - so these too will not be CICs. These changes will give a much simpler regime for taxing CICs, while guarding against tax avoidance.

An Inland Revenue press release is being issued today giving further details of the proposals. The necessary amendments for the Committee stage of the Finance Bill will be put down as soon as possible."

Definition of a close investment-holding company (CIC)

2. Under the proposed legislation, a close company will not be a CIC if it is a 'trading company' or a 'member of a trading group'. The press release published on 13 April ('Abolition of close company apportionment') announced some proposed refinements of the definitions in Clause 100 of the Finance Bill. The proposed further modifications are as follows.

- trading company

3. Clause 100(2)(a) provides that a company can be a 'trading company' for an accounting period if its business consists wholly or mainly of trading. This will be modified so that the test becomes that the company exists wholly or mainly for the purpose of trading. As a result, a company will not necessarily have to trade in an accounting period in order to satisfy this test.

4. Clause 100(2)(b) says that a company is not a trading company if its investment income exceeds its trading income plus

/its trading deductions

its trading deductions which are chargeable under Schedule E (eg, wages and salaries paid to employees). This rule will be dropped (there will therefore be no need for the modification for financial traders announced in paragraph 2 of the press release of 13 April). Instead there will be a requirement that the trade must be carried on on a commercial basis. (There is a similar requirement elsewhere in the tax system - Section 393(5), ICTA prevents a trading loss being set against the company's profits unless the trade was being carried on on a commercial basis.)

- member of a trading group

5. Paragraph 4 of the press release of 13 April announced that the definition in Clause 100(4)(a) would be modified so that a simple holding company of a trading group, or one which also makes loans to subsidiary trading companies, will be treated as a member of a trading group. The test would also be modified so that it could be satisfied by a company with only one subsidiary trading company.

6. The definition will be further extended to include cases where the company holds property used by trading subsidiaries or provides other services to them, or itself carries on a trade. If a subsidiary is itself a member of a trading group it will be treated in the same way as a trading subsidiary. This will mean that if the top company in a group simply holds shares in a subsidiary which has trading subsidiaries and is itself a member of a trading group, the top company will also be a member of a trading group.

- dealing

7. Clause 100(5) says that companies which deal in land, shares or securities are not trading companies. This exclusion will be dropped so that a company which deals will be treated in the same way as a company which carries on any other trade.

- property investment companies

8. It is proposed that a company which carries on property investment on a commercial basis will, like a trading company, not be treated as a CIC. The same treatment will follow for a company which both invests in property and trades, and for a member of a trading group where the subsidiaries are property investment companies. This means that the parent company of a property investment group, or a mixed property investment and trading group, will not be a CIC.

Consequences of being a CIC

9. The provisions in the Finance Bill, very broadly, sought to align the tax treatment of a CIC with that of an individual investor. It is proposed that the treatment should instead, so far as possible, follow the main company tax regime. Thus, a CIC will be taxed on its profits in the normal way, with no special restriction on the deductibility of interest payments, annual payments or management expenses. However, the small companies

/rate of corporation

rate of corporation tax (currently 25 per cent) will not be available to it. Instead it will be taxed at the main rate of corporation tax (currently 35 per cent). As a result of this change, Clauses 102 to 106 will be deleted and Clause 101 will be amended so that it only denies the benefit of the small companies rate.

10. In certain circumstances the recipient of a dividend or other distribution from a CIC will not be entitled to be paid the tax credit (as would otherwise be possible if the recipient had unused tax allowances). Clause 107 provides for a restriction on the payment to a UK resident individual of a tax credit attaching to a dividend. This will be amended so that it also applies to non-dividend distributions (for example, the purchase by a CIC of its own shares). But the restriction will apply only if there would otherwise be a tax advantage.

Life policies held by CICs

11. Where a life policy is held by a close company the policy proceeds have come within the apportionment rules, but there has been no charge on the company itself. Clause 86 and Schedule 9 of the Finance Bill introduce a corporation tax charge in respect of policies taken out on or after Budget day, and also a modified charge in respect of policies taken out before Budget day in the case of CICs only. Schedule 9 will be amended to remove this charge on 'pre-Budget' policies - this is consistent with the policy of taxing a CIC on its profits in the normal way.

Amendments

12. The necessary amendments for the Committee stage of the Finance Bill will be put down as soon as possible. There will also be amendments to existing tax legislation which are consequential on the abolition of apportionment.

NOTES FOR EDITORS

1. The Budget day press release ('Abolition of close company apportionment') gave a brief description of the existing apportionment legislation. The modified CIC provisions will be much shorter and simpler. Furthermore, the apportionment legislation applied potentially to the investment income of several hundred thousand trading companies. But the CIC provisions will apply only to the much smaller number of close companies (less than five per cent of the total) which are mainly concerned with passive investments (for example, in shares or securities).

2. As the Budget day press release explained, only half of a company's income from property can be apportioned. And there is excluded any amount which the company requires to repair or improve any investment properties which it owns. In consequence, property investment companies are little affected by apportionment - the total yield from them being less than £2 million a year.

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

12 April 1989

NATIONAL SAVINGS

Thank you for your letter of 11 April, which the Prime Minister has seen and noted.

PAUL GRAY

Miss Sheila James,
Economic Secretary's Office,
H.M. Treasury.

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CSPU

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UNCLASSIFIED

Treasury Chambers, Parliament Street, SWIP 3AG

Prime Minister ?

Paul Gray Esq
10 Downing Street
LONDON
SW1

PRCG 12/4

11 April 1989

Dear Paul,

NATIONAL SAVINGS

This is to let you know that the Department for National Savings will announce at noon on Wednesday, 12 April that the minimum purchase of Premium Bonds by adults is to be increased from £10 to £100 from 1 July 1989. However, the £10 minimum will be retained for parents and grandparents making gifts to minors. The smallest multiple in which bonds may be purchased is only to be increased from £5 to £10 in both cases.

This action will help to make the Premium Bond operation less costly and more efficient to run. There will be savings in both staff resources and payments to Girobank and Royal Mails.

The Department for National Savings will announce at the same time that National Savings Gift Tokens and Premium Bond Gift Tokens will be withdrawn from sale at close of business on 30 June 1989.

As with the new Premium Bond minimum, the abolition of the Gift Tokens scheme is one of a number of measures the Department is taking to reduce its running costs.

Yours,

Sheila

S M A JAMES
PRIVATE SECRETARY

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the department for Enterprise

nbpm   ccPU

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The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt. Hon. Nigel Lawson, M.P.
Chancellor of the Exchequer
Parliament Street,
London SW1P 3AG

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5422
Our ref PBlAKE
Your ref
Date 20 December 1988

Dear Nigel,

RESIDENCE IN THE UK: INLAND REVENUE CONSULTATIVE DOCUMENT

In July, the Inland Revenue published a consultative document setting out proposals to change the definition of UK residence for tax purposes. If implemented, these proposals will have a major impact on the tax position of a large number of people who are resident, but not domiciled, in the UK for tax purposes.

There has been a very strong reaction to the proposals. I myself have received representations from a wide range of organisations, including the Institute of Directors, the Chase Manhattan Bank, the Baltic Exchange and several of the international chambers of commerce in London (Italian, German, Norwegian, Swedish); and my Ministerial colleagues here in DTI have been similarly approached. I have also seen the Foreign Secretary's minute to you of 14 December, and the letter of 12 December from No.10 to your Private Secretary recording the US Ambassador's intervention.

The burden of these representations is that implementation of the proposals would make residence in the UK much less atttractive from a tax point of view for many people who make an important contribution to the economy. These include foreign nationals who are long term UK residents but are not domiciled here (including a group of Greek and Norwegian shipowners whose activities generate a large volume of business for firms supplying financial and other services to the shipping industry); foreign nationals on short term postings to the UK; the wealthier overseas students; and

foreigners coming here for long term medical treatment. Most of these could quite easily reduce the time they spent in the UK, or avoid coming here at all, if the tax environment became unfavourable. The result would be a loss of economic activity, and of tax revenue.

At present, our low rates of personal and corporate taxation give us an edge over our European competitors in attracting new investment from third countries, and in retaining existing investment; but it would not take much to erode our advantage, and we know that other European countries are reviewing their own tax regimes with 1992 in mind. Whatever the merits of the Inland Revenue proposals in terms of clarity and equity, all that I have heard suggests that they would not be in our economic interest. I hope that you will weigh the evidence very carefully on the overall economic impact of the proposals before reaching a conclusion on them.

I am copying this letter to the Prime Minister, to Geoffrey Howe and to Paul Channon.

Yours ever,

David

FCS/88/222

CHANCELLOR OF THE EXCHEQUER

Proposed changes in UK Tax Regulations

1. We spoke last week about the Inland Revenue's Consultative Document "Residence in the UK: The Scope of UK Taxation for Individuals", issued on 28 July. We are both familiar, from past experience, with the difficulties involved in trying to rationalise the effects of our residence rules on income tax liability. I quite see the general argument for reform of the present arrangements and have no wish to stand in the way of it. But I am mindful too of the wider implications of what is proposed, for foreign communities with bases in the UK.

2. We have had several indications of concern. The Americans have spoken to the Prime Minister. The Greeks have spoken to me, and we have had signals that the Scandinavians are worried. Shaikh Khalifa of Bahrain raised the matter with the Prime Minister in October. Concern is therefore already fairly widespread, and I suspect we shall hear more.

/3.

3. There may well be some element of misunderstanding about what is being considered. However, the concern of all foreign residents over any proposal to abolish the "remittance basis" form of relief is very real. Despite our present, relatively low tax rates, if they now become subject to UK tax on all or part of their worldwide income and gains, foreigners who now make a useful contribution to our economy may be driven out of the UK. We could risk losing not only wealthy individuals. American or Japanese corporations, for example, could be discouraged from locating their European headquarters in the UK. I understand that the Bank of England is concerned about a possible erosion of London's position as a financial centre. If we lost these foreign interests, we should of course lose the revenue that they currently contribute, which could offset any additional revenue that might be raised by the reform; but we should of course be losing more than that as well.

4. There is also - although this is not the biggest of my concerns - a possible European Community angle. When the Inland Revenue's proposals are somewhat firmer we will need to be sure that they do not either discourage people from exercising their rights of free movement under the Treaty, or discriminate against people exercising such rights.

5. Finally, there also remains a question in our minds about double taxation, and how we ensure that given the prospect of worldwide earnings tax liability, people will not be bitten twice. This is something that I believe is

/of

of particular concern in the US. We can expect vigorous lobbying once the transition to the new Administration is completed.

6. I well understand, as I have already said, why this kind of problem needs to be tackled from time to time; but it is important to avoid tilting the balance too far away from existing arrangements with which people have come to feel at ease.

7. I am copying this minute to the Prime Minister, David Young, Sir Robin Butler and Robin Leigh Pemberton.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

14 December 1988

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ssPC

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

12 December 1988

PRIME MINISTER'S MEETING WITH THE AMERICAN AMBASSADOR: TAX MATTERS

When the Prime Minister saw Ambassasdor Price this afternoon to receive his representations about the choice of the new tank for the British army, he took the opportunity to mention the letter which he had sent to the Chancellor about the Government's Green Paper on Residence and Domicile and the adverse impact which this could have on American companies and individuals in this country. The Prime Minister commented that there had been a large number of very firm representations made on the subject, which the Government would have to take into account.

I am copying this letter to Lyn Parker (Foreign and Commonwealth Office) and Neil Thornton (Department of Trade and Industry).

(C. D. POWELL)

CDP

Alex Allan, Esq.,
HM Treasury.

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file DTI

bc: BG

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

9 December 1988

NATIONAL SAVINGS INTEREST RATES

Thank you for your letter of 8 December about the planned announcement of increases in the interest rates on National Savings Income and Deposit Bonds and the National Savings Bank Investment Account. The Prime Minister has seen and noted these changes.

PAUL GRAY

Miss S. M. A. James
Office of the Economic Secretary
HM Treasury

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Treasury Chambers, Parliament Street, SW1P 3AG

Paul Gray Esq
10 Downing Street
LONDON
SW1

8 December 1988

Dear Paul,

NATIONAL SAVINGS INTEREST RATES

I am writing to let you know that the Department for National Savings will be announcing at 10.00 a.m. on Friday 9 December increases of 3/4 per cent in the interest rates on National Savings Income and Deposit Bonds (from 10 3/4 per cent to 11 1/2 per cent) and the National Savings Bank Investment Account (from 10 per cent to 10 3/4 per cent). Deposit Bonds are no longer on sale, but we need to adjust the rate for existing bondholders.

These changes are a response to the recent increase in bank base rates, and anticipate the increase in retail rates we expect the banks and building societies to make shortly. The Income and Deposit Bond increases will take effect on 22 January, since six weeks' notice of change is required in the Regulations. The Investment Account increase will take effect on 23 December.

Yours,

S M A JAMES
PRIVATE SECRETARY

dti

the department for Enterprise

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The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
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Direct line 215 5422
Our ref PS3BRT
Your ref
Date 1 December 1988

Dear Nigel.

TAXATION OF PERSONAL SAVINGS INSTRUMENTS AND LIFE INSURANCE

You will no doubt soon be considering your proposals for the taxation of life insurance in the light of the replies to the Inland Revenue Consultative Document on Life Insurance Taxation. I am writing now to let you have my views.

My main concern is that we are all devoting enormous effort, both within the UK and within Europe, to levelling the playing fields in regulatory matters and removing the obstacles to free trade in financial services; but what we achieve is often dwarfed by differences in the tax treatment both between UK savings instruments and between the UK and other EC countries. I am therefore reluctant to endorse any radical change in the tax structure for any one part of the personal savings field like life insurance unless it is consistent with moving towards tax neutraility and transparency between the various instruments of personal savings <u>within</u> the UK, and consistent also with our efforts to open up the markets for these instruments <u>between</u> the UK and the rest of the EC.

I recognise that it is very easy to make a general statement like this, and very difficult to put it into practice. For one thing, we cannot simply freeze the tax structure until we can devise a perfectly level playing field both within the UK

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and across Europe. For another, there may well be instances where we have to choose, in the shorter term, between seeking consistency of treatment between savings instruments within the UK, and seeking consistency of treatement between the UK and the EC for a particular savings instrument like life assurance or unit trusts (Francis Maude is writing separately on the latter to Norman Lamont).

Nevertheless, the tension between our collective efforts in the regulatory field and the severe problem in the tax field seems to me of such importance that we ought now to adopt a two-pronged approach:

a) we should initiate a major review (and I fear it really will be major) of the taxation of savings instruments and other financial services, in the context of fiscal neutrality, regulatory developments in the UK, and 1992; and

b) we should meanwhile not make structural changes in taxation arrangements in this field, and limit ourselves to patching and mending the present system where we have to do so.

In the particular case of life insurance, we are as you know entering negotiations on the first stage of harmonisation and liberalisation directives. Our industry is in general highly efficient by international standards; but our comparative advantage is fully offset by the more favourable tax regime applying generally in Europe. There is a particular problem about our own taxation arrangements for inward and outward life service business designed to compensate for this; I am concerned that these arrangements should not be vulnerable to challenge in due course on the grounds that they are discriminatory. In a related field (general insurance) the French Finance Minister, M.Beregovoy, has already signalled his intention to reduce premium taxes for certain property and casualty risks to increase the competitiveness of the French insurance industry after the implementation of the Non-Life Insurance Directive. The French are reported also to have focussed on the domestic tax changes necessary to make their financial services industry more competitive (the Lebègue Report).

Life insurance does not have any special case for favourable tax treatment, and I do not support the traditional argument that it deserves special arrangements because of its social value or the difficulty of selling long term protection. The industry does, however, face major adjustments - including

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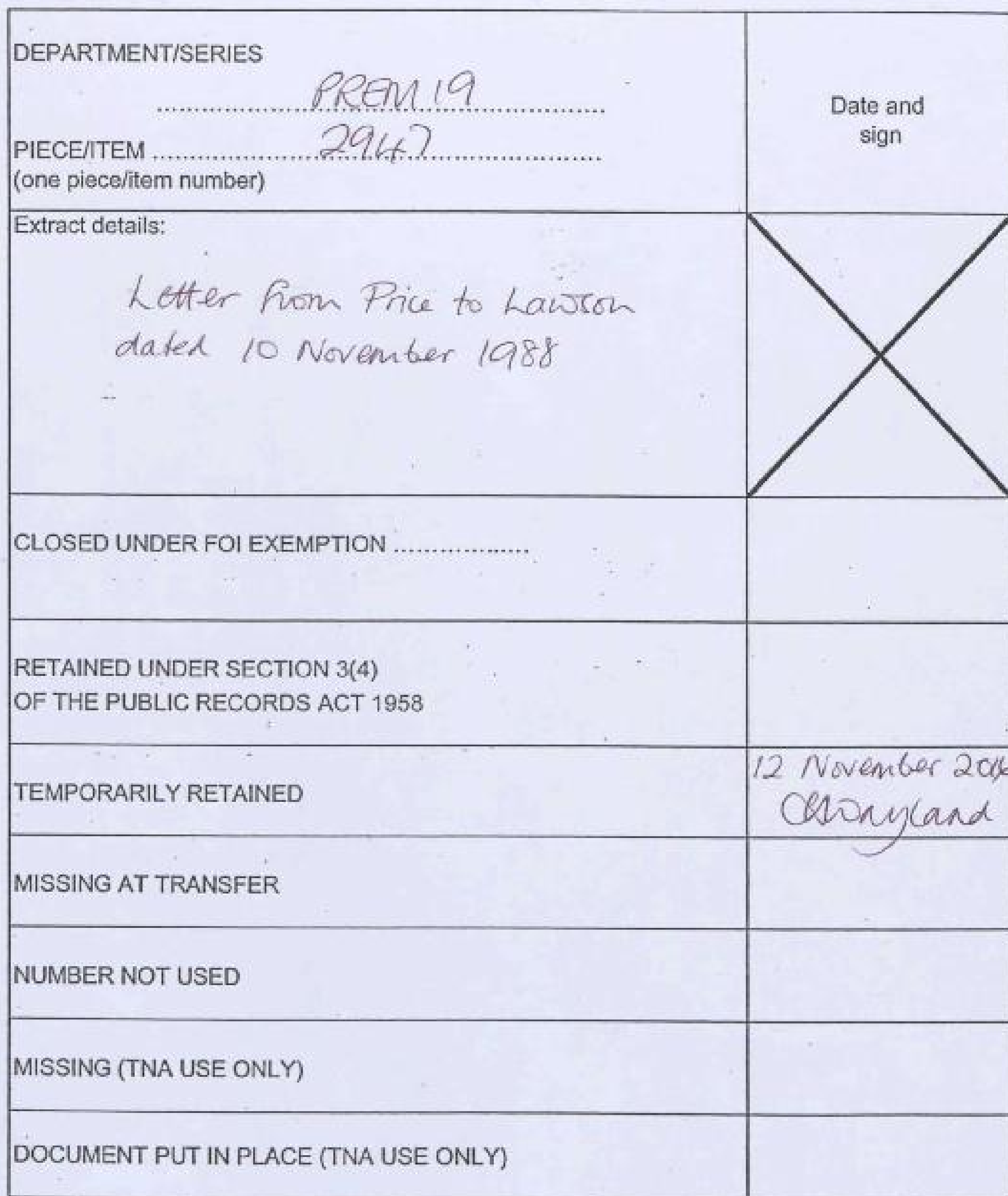
particularly the requirements of the Financial Services Act which looks likely (by enforcing disclosure of commissions) to reduce the role of independent intermediaries, and (because of the 'best advice' requirements) to put pressure on the smaller life offices. On prudential grounds I would want those adjustments to take place in an orderly fashion, and adequate consultative and transitional arrangements would be important in correcting anomalies in the present tax arrangements. But my main proposition is that we need a more radical look at the full field before making structural changes going beyond the correction of anomalies, which a particular eye to 1992. My Department stands ready to assist in any way it can.

I am sending copies of this letter to the Prime Minister, the Foreign and Commonwealth Secretary, the Governor of the Bank of England and Sir Robin Butler.

Ecow Bli Taxt

Sang 1-4

The National Archives



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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 10 October 1988

The Prime Minister wants the Chancellor to see the enclosed copy of a letter which she has received from the American Chamber of Commerce in the United Kingdom about proposed changes in the taxation of foreign residents in the United Kingdom. Apparently they discussed it last week.

Charles Powell

Alex Allan, Esq.,
HM Treasury.

AMERICAN CHAMBER OF COMMERCE (UNITED KINGDOM)

INCORPORATED WITH LIMITED LIABILITY IN THE DISTRICT OF COLUMBIA U.S.A.

75 Brook St, London, W1Y 2EB. Telephone: 01-493 0381. Telex: 23675 Amcham G

AN AFFILIATE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, WASHINGTON, D.C.
MEMBER OF THE EUROPEAN COUNCIL OF AMERICAN CHAMBERS OF COMMERCE

4th October, 1988.

The Rt. Hon. Margaret Thatcher, MP
10, Downing Street,
London, SW1.

Dear Prime Minister,

It was a great pleasure to see you and Denis at Iona and Peter Carrington's last Saturday evening. I very much appreciated hearing your views on so many subjects.

Further to our discussion, I would emphasise again the adverse impact on the American business community of the legislation proposed by the Inland Revenue to change the scope of U.K. taxation for foreign residents of the United Kingdom. As I told you, my friends in the American community earnestly hope that the present system will be kept. They say that the far-reaching changes proposed would profoundly alter their attitude toward investment in the United Kingdom. Particularly, they would affect the financial services sector where so many Americans work.

I was reassured by your comments to me on this matter, and I hope the proposals will be abandoned in the interest of maintaining the United Kingdom at the centre of American trade and financial activity in Europe.

With all best wishes,

Sincerely,

Edward Streator

Edward Streator
Advisory Director

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SS28SL1

ELIZABETH HOUSE
YORK ROAD
LONDON SE1 7PH
01-934 9000

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

30th September 1988

Dear Nigel,

In my letter of 6th September I raised with you what could be the repercussive effects of extending tax allowances to private health care and the consequent effects to education.

Our friends in the Institute of Economic Affairs have brought out a booklet by Professor Anthony Flew advocating tax credits for education. It is a rather strange scheme which involves a half-way move to vouchers but would in the first stage, in effect, introduce tax allowances for people who choose to send their children to private schools. The clear object is to increase the number of private schools by giving these tax advantages to parents.

I think this is just a taste of the different ideas that will be promoted if we were to extend tax relief. It may be that you will decide to do this for health service reasons. However, if we do, we must be very clear how it can be ring-fenced. I am still of the opinion that a very strong campaign will develop amongst our own supporters for tax relief on private education. I am copying this letter only to the Prime Minister and to Kenneth Clarke.

Yours,

Kenneth

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DAILY EXPRESS Tuesday September

Tax lure call in move to boost private schools

By WILL STEWART
Education Correspondent

CHANCELLOR Nigel Lawson was urged yesterday to allow parents huge tax "credits" towards school fees.

Parents could claim up to £1,750-a-year on getting top-grade independent schooling.

The radical plan to open up private schools to thousands more pupils was called for by the right-wing Institute of Economic Affairs.

The aim is to give greater choice to parents and encourage more private schools to open —so raising standards.

Professor Antony Flew of Reading University, who proposes the scheme in a new booklet Education Tax Credits, claims it would not be a major burden on the Treasury.

It would simply mean switching cash from the State sector to the private sector for those parents who chose the tax credit option, says the professor.

Voucher

Parents earning over a certain amount, perhaps £30,000, would not qualify.

The Chancellor would be able to fix the exact amount of tax credit, which would be paid in the form of a voucher but Prof Flew said it should be between 50-75 per cent of average private school day fees.

"It must be enough to encourage a worthwhile number of people to think: 'I can now go private'," he added.

Eventually, Professor Flew wants to see State schools competing in the market place, with parents choosing to "spend" fees either in comprehensive or the independent sector.

Parents would be able to top-up the basic level of their voucher.

The scheme would run alongside the present Assisted Places Scheme, allowing pupils from less well-off families to win places at top private schools.

Tuesday, September 27, 1988

FINANCIAL TIMES

Right-wing body suggests tax credits for education

By David Thomas, Education Correspondent

THE GOVERNMENT should introduce education tax credits to encourage people from poorer backgrounds to go to independent schools, according to a pamphlet published today by the Institute of Economic Affairs, the right-wing think tank.

The institute sees the proposal as a halfway house to the introduction of the full educational voucher scheme it has championed.

Under the institute's proposals, education tax credits would be given to parents whose children were at independent schools.

The credit would reduce parents' tax liability. In cases where the parents' income was too low to make them liable for tax, the credit would be paid direct to the parents.

The pamphlet suggests the credit might initially be restricted to parents with low incomes. The point of that is to spread the social base of independent schools and avoid the charge that the credit would disproportionately benefit the wealthy.

The pamphlet does not give any indication of how much the scheme might cost.

However, Professor Antony Flew, the pamphlet's author, suggested that the credit might be set initially at up to 75 per cent of school fees. Annual fees in public schools range up to about £7,050 and in preparatory schools up to about £5,400.

Prof Flew argued that the cost to the exchequer would be minimised by reductions in state school spending. He acknowledged that the proposals went against the Government's belief in cutting tax allowances.

Education Tax Credits. IEA, 2 Lord North Street, London SW1P 3LB. £2.50 incl. p&p.

Econ Pol: Tax + Savings
Pt 4

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ELIZABETH HOUSE
YORK ROAD
LONDON SE1 7PH
01-934 9000

Prime Minister[2]

You will wish to be aware of this.

RRCG 7/9

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1A 3AG

6 September 1988

Dear Nigel,

I have seen some recent comments in newspapers suggesting that you may be considering the introduction of some system of tax relief for contributions to private health insurance schemes. This relief might be of a general nature, or limited to elderly people only. If this is being considered I hope you will bear in mind the possible repercussions of such a change for the private education sector.

The thrust of your fiscal reforms has been to reduce the amount of special allowances both in corporate and personal taxation, and I very strongly support this. If some tax incentive is now to be given to private health insurance I think that it will be very difficult to stop there. It is likely that we will both be pressed to extend tax relief for private education as well. There are currently many parents who make very substantial sacrifices - and infinitely greater financial contributions than are paid for private health care - to send their children to independent schools; and this number is increasing strongly at the moment. The current expenditure on private school fees could be as much as £2bn.

It would I suppose be possible to mount a short-term argument that we see health care as so important that we would limit new tax relief just to this area. But I have to say that in my view a campaign would start very quickly, principally if not exclusively among our own supporters, for similar tax benefits to be applied to school fees. I could see quite a strong campaign for this running by the next election. We would then have to consider very carefully the arguments which we advanced as to why tax relief was appropriate for one aspect of personal expenditure on a social provision but not for another.

There is another, and particularly difficult, point to address. When parents pay for school fees they are not making any call on the public education services although they continue to support these through their taxes. When people take out health insurance they usually continue to use part of the NHS - usually the GP service. Fee paying parents would therefore claim that they have a stronger case for tax relief since their payments relieve the State totally of its obligation to educate their children.

You will recall that in our Education Reforms I specifically excluded the possibility of tax relief and decided to go for a much more fundamental change, by giving parents of children who go to State schools the opportunity of controlling in a much more direct and personal way the very substantial sums of public money which are provided for education. This is the whole philosophy behind the Grant Maintained Schools and the City Technology Colleges. The purpose behind this is to improve schools by involving parents and employers - the beneficiaries, if you like - in the management of schools by giving them a much greater say over the public money which is spent on their behalf. This, you will appreciate, is a very different approach from that which gives tax incentives to those who wish to contract out of State provision.

I am copying this letter only to the Prime Minister and to Kenneth Clarke.

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PRIME MINISTER

TAX TREATMENT OF RESIDENTS AND DOMICILE

— in attached Folder (2)

I attach the papers on this issue which you have discussed briefly with the Chancellor a couple of times.

As you requested the Treasury have provided a number of background papers on this review as well as the consultation document itself. I have also obtained today from the Inland Revenue, as you asked, relevant sections of Simon (I hope I have got the right ones).

I cannot claim to have mastered this subject. You will have the advantage of starting from your previous experience in this area.

I suggest you might want to tackle the papers in the following order:

✓ Flag A - The Chancellor's covering minute.

✓ Flag B - A quick flick through Simon to refresh your memory of the history.

Flag C - The draft consultative document.

I think this gives quite a good summary of the history and the problems; and pages 34-42 bring together the broad approach recommended and its implications.

Also in the folder are some of the earlier Inland Revenue documents. These are of some interest in showing how the review has evolved, but I am not sure that they add much to the other documents.

To my untutored eye the papers set out a strong case for rationalising the present rather chaotic system; and the approach that emerges has a good deal of logic to it. But

changes in this area could give rise to vocal opposition from those who would be well able to publicise their case.

Are you content for the Treasury to proceed with publication of the consultation document?

No

PRCG.

PAUL GRAY
15 July 1988

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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

RESIDENCE

I mentioned to you last week that a consultative document has been prepared setting out a number of proposed changes to the residence rules for income tax purposes. I attach a copy. You also asked to see a selection of background papers, and these are in the attached folder.

Rules for residence

The main proposals in the document concern the rules determining whether an individual is to be regarded as a resident in the UK for tax purposes. The existing regime is complex and exceedingly difficult to understand; it has developed piecemeal since 1799 through changes in statute law, Court decisions and ad hoc Revenue practices and concessions. The consultative document proposes a new approach with fewer tests, which can be satisfied simply and objectively. It seeks generally to reduce the burden of the system on the taxpayer.

In outline the changes proposed are as follows. As now, anyone who is here for 183 days or more in a tax year will be regarded as resident for that year. The new element is that the rules for those who are here for less than that period will take into account a proportion of the number of days here in the preceding two years. And we shall get rid of the rule that an individual who has accommodation available for his use here is resident here in any year in which he steps into the country. This is a change which could be much help to our own expatriates, among others.

There will be some other significant gainers from a rationalisation of the rules on these lines - in particular, it will be possible to stay in this country for up to about 4 months each year without becoming resident here for tax purposes. This is obviously very important for those coming to visit their families here - a concern which was put to you by Sir David Wolfson a little time ago. There will, of course, be others who are not UK residents now but will become resident under the new rules, but I do not see these as giving rise to difficulties. We shall not be breaking new ground here. The US system has much in common with what is proposed.

Intermediate basis

The present regime, as you know, also includes the concepts of ordinary residence and domicile which lead to certain individuals being taxed on the "remittance basis" - which limits UK tax liability to UK source income plus any foreign income which is brought into the country. This basis is riddled with anomalies and for the well-advised taxpayer it provides the opportunity to pay little or no UK tax, whereas someone proceeding in a more straightforward manner might be paying tax.

In this area we have two proposals:

First, to introduce a concept of "fiscal connection" which will mean that after an individual has been resident here for 7 out of the previous 14 years, he will be liable to UK tax on his world-wide income and gains.

Second, for those who are resident here but not "fiscally connected" to replace the remittance basis by a more effective charge but one which is still more favourable than that which applies to other residents. Here the document suggests two possible approaches - one based on a wider definition of remittance and the other based on a percentage of world-wide income.

These proposals would affect two particular groups. First, there are the non-UK domiciled people who have lived here for many years,

in some cases for the whole of their lives, but who continue to be taxed on their overseas income only to the extent that it is remitted here. We do not know how many people there are in this group, but undoubtedly they include some who make a significant contribution to the quality of life in this country. But with the latest reduction in our tax rates it is difficult to see on what basis a special long-term regime can be justified for them. Their position is much the same as that of other long-term residents. Clearly, there should be a transitional period to allow an adjustment to an increased UK tax liability. But after that period is over, they should be taxed like all other UK residents.

The second group is rather different. These are primarily the foreign executives and others who come here for 5-7 years in connection with an employment or profession here. We do not want to discourage these people from coming here, and their position can be distinguished from that of the long term resident. They ought to pay tax here on earnings which arise here but, there are both equitable and economic grounds to continue to provide some intermediate basis of taxation for this group.

Finally, the document floats some possibilities for dealing with avoidance of the present rules - and which would still be possible with the new rules - where a person leaves this country for say a year, disposes of assets with substantial gains and then returns here. This exploitation of the rules brings the system into disrepute, especially in certain well-publicised cases - and although the amounts at stake are not large, it should not be allowed to continue.

Summary

On earlier occasions when issues of this sort have been tackled - the last major occasion was in 1974 - rates of tax had reached up to 83 per cent and 98 per cent. The circumstances are now totally transformed and our rates are at least broadly

equivalent, and mostly lower than those of other countries. Insofar as we levy a more effective tax charge the loser may be the tax authorities of other countries rather than individual taxpayers.

The proposals will inevitably be criticised by those who will find that their UK liability would be increased as a result - and there is indeed likely to be an extra £50 million of revenue raised overall. But the main impact of the changes will be to produce a fairer, more comprehensive and coherent system, more in line with that in other countries.

I would propose that when we issue the document we should give a clear indication of our intention to legislate on the lines proposed. I do not think it is necessary to give a firm commitment to do so in 1989 although that would be my preference. This points to the early issue of the document and asking for comments by the middle of November. Even this period may be criticised by some as being too short, but I think it does give a reasonable opportunity for those affected to frame their views.

I would be glad of your approval to go ahead on that basis.

[NL]
11 July 1988

RA

PRIME MINISTER

JOHN BUTTERFILL'S AMENDMENTS TO FINANCE BILL FOR RETIREMENT ANNUITIES

You are aware of John Butterfill's proposals, which have attracted strong backbench support, to extend tax relief to loans taken out by elderly annuitants, under which the interest was rolled up rather than paid year by year. This has been argued as a means of substantially increasing the possibilities for elderly people to take equity out of their houses and boost their incomes for the last few years of their lives.

The Treasury has been considering this idea carefully, but has now come down against it. The Financial Secretary informed the Whips last night that the Government would be resisting the Butterfill amendments. I gather the Financial Secretary has also now spoken to Mr Butterfill, who was disappointed but not unduly surprised. He has confirmed that he would withdraw his new clauses after tomorrow's debate, as long as the Financial Secretary makes some sympathetic noises.

You may like to glance at the attached material that summarises the Treasury's objections. Although, initially, I saw considerable attraction in the Butterfill approach, I now conclude that the Treasury case is a strong one. I would not place enormous weight on the objections of principle. To my mind, the crucial points are:

- Schemes providing for rolling up of interest would only be attractive to people with houses of above-average value;

- There is nothing to stop people with sufficient equity in their house opting for a rolling up scheme without the benefit of tax relief. This of itself could substantially boost their incomes;

- Also providing tax relief would in fact provide only marginal extra net income. The size of this additional benefit is not sufficient to overcome the various objections of principle the Treasury adduce.

PRCG.

PAUL GRAY

28 June 1988

DS3AAA

4370/012

JOHN BUTTERFILL'S NEW CLAUSES: KEY POINTS

What the scheme would do

Mortgage interest relief is already available to elderly people who borrow money to buy retirement annuities. This proposal would extend relief to loans taken out where interest was not in fact paid by the elderly annuitant, but was rolled up and paid after his death. Nevertheless, the tax relief would be paid year by year to the lenders.

Points to make

(i) **The scheme would be objectionable in principle:** it would involve giving tax relief years before interest was actually paid by anyone. This would be a major break with existing tax principles, with far-reaching implications for other parts of the tax system.

(ii) **Deferred schemes do not help poorer pensioners:** the proposals would not raise the net incomes of pensioners with houses worth the national average or below. These people would be better off with an existing scheme for which tax relief is available.

(iii) **Tax relief is not necessary in practice:** the proposals would be of some help to people with houses worth more than the national average, but those people could benefit significantly already by taking out a deferred interest scheme without tax relief. It is the rolling up of interest and not tax relief which gives the main benefit to the pensioner.

(iv) **Tax relief would not go to the pensioners:** deferred schemes place a larger burden on the heirs who have to repay the compounded interest plus the original loan. So what tax relief would do would be to:

(a) help the heirs by slightly reducing the size of the debt;

(b) compensate the lenders for not receiving interest payments until the death of the annuitant.

Conclusion

Deferred interest schemes may have a part to play in helping elderly pensioners realise some of the equity in their homes. But they only benefit relatively wealthy pensioners, mainly in the South East of the country. Tax relief would not affect significantly the attractiveness of these schemes to the elderly, nor would it signficantly increase the number of pensioners for whom a deferred interest scheme would be better than an existing home annuity scheme. No case has therefore been made out for an extension of mortgage interest relief to deferred interest schemes - an extension with far-reaching implications for the tax system - at a time when the Government is seeking to limit rather than add to specific tax breaks.

1. The basic idea behind these new clauses is to allow elderly people who own their own homes and have paid off their mortgages to provide themselves with an increased annual income by releasing some of the equity in their homes.

2. There are existing schemes under which mortgage lenders are prepared to advance, usually, the lesser of £30,000 or 80 per cent of the value of the home. Interest only is payable during the life of the borrower and the capital is repaid by the personal representatives of the estate after his death.

3. If the borrower is aged 65 or over and uses the mortgage advance to purchase a life annuity he is entitled to tax relief on the interest payable up to the £30,000 ceiling.

4. In practice the annuities are frequently for the benefit of a couple, usually married but not necessarily so and continue for the life of the later survivor. For prudential reasons the schemes are available only to couples whose combined age is 150 years or more. The life expectancy of a 75 year old woman is over 10 years.

5. An annuity purchased in these circumstances with a loan of £30,000 would produce an annual income net of tax of about £4,150. But the annuitant has to pay the interest on the mortgage advance of £30,000 which at 10 per cent is £3,000 gross or £2,250 net of basic rate tax at 25 per cent. Under the MIRAS scheme the lender receives £2,250 from the annuitant and then claims the basic rate tax of £750 from the Revenue. The annuitant is left with a net income of £1,900 (£4,150 less £2,250).

6. Clearly if the lender were prepared to defer charging interest until after the death of the annuitant his annual income would be increased substantially. But rolling up the interest and capitalising it into the debt would result in a £30,000 advance compounding to about £78,000 after ten years even if the interest rate were held at 10 per cent.

7. Because the debt would compound in this way lenders have said they would be prepared to advance no more than the lesser of £30,000 or 30 per cent of house value if interest is deferred. Thus only a person owning a house with £100,000 or more would receive the maximum benefit by being able to borrow as much as under the present scheme. By deferring the interest the person with the £100,000 house would not have to pay net annual interest of £2,250 and his income would therefore increase from £1,900 to £4,150.

8. By contrast a 30 per cent advance on a house worth £46,000 (or less) which is greater than the current UK average house price would purchase an annuity yielding an income which even with no interest payable is less than the present scheme yields.

9. There is nothing to prevent lenders making mortgage advances to elderly people and deferring the interest until after their death. By relieving them of the burden of paying interest the income of those with higher value houses could be increased. As they would not be paying any interest no tax relief would be allowable. The interest would be payable after their death by the personal representatives.

10. These new clauses not only seek to allow tax relief on the interest paid by the personal representatives on behalf of the heirs who are of course not the borrowers but also seek to obtain that relief year by year during the life of the annuitant perhaps for many years before any interest is paid.

11. In simple terms taking an advance of £30,000 the interest at 10 per cent is £3,000. If, as under the present scheme, the annuitant pays the interest he deducts tax at the basic rate of 25 per cent and actually pays £2,250. The lender then reclaims the tax relief of £750 from the Revenue. The purpose of these new clauses is to ensure that the Revenue continues to hand over the £750 year by year to the lender although the £2,250 is not paid. As only £2,250 rather than £3,000 would then be rolled-up each year the compounded debt to the personal representatives after 10 years would be about £66,000 rather than the £78,000 mentioned in paragraph 5.

12. By making a smaller advance of just over £25,000 without tax relief the compounded debt with the same risk for the lender could be kept at £66,000. This would purchase a slightly smaller annuity yielding about £3,500 per year. Thus at no greater risk and without tax relief annuitants' income would be increased from £1,900 to £3,500. Alternatively if the lenders insist that they must have an annual return they could continue to receive £750 each year by simply deferring three-quarters of the interest. The borrower would then pay £562 each year (£750 less basic rate tax of £188) and the Revenue would hand over the £188. This would increase the annuitants income by £1,688 per year and again only £2,250 deferred interest would be rolled-up.

13. It is thus clear that the greater benefit to annuitants with higher value houses derives from deferring interest. Tax relief would make a favourable arrangement rather more favourable for those with higher value houses but people with houses of average or less value would derive no benefit whether or not tax relief was available. The tax relief suggested is entirely artificial. It would involve granting relief to an unknown person (the eventual personal representative) who had not borrowed the money and years before any payment of interest was made.

14. The motives of Allied Dunbar and others promoting this scheme are therefore questionable. They would be receiving what in effect is an annual tax subsidy from the Revenue which is not necessary either to reduce the risk or increase their cashflow. It might therefore simply be designed to appear to lessen the impact of higher interest charges. Higher interest rates would carry more tax relief but would also increase the compounded debt.

15. There are alternative schemes such as reversionary loans and interest only loans on which there is no tax relief which enable people to release the equity in their homes. Financial institutions marketing these schemes have made representations opposing the granting of further tax concessions to home annuity loans.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

17 June 1988

I have seen a copy of Tokyo telegram number 607 about the request from Mainichi Broadcasting for interviews with the Prime Minister and the Chancellor for a television programme about the reform of the British tax system. I think this is one which the Prime Minister would prefer to leave to the Chancellor, if he is willing to do it.

I am copying this letter to Alex Allan (HM Treasury).

Charles Powell

R. N. Peirce, Esq.,
Foreign and Commonwealth Office.

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FOR FED, NEWS DEPT AND INFORMATION DEPT

REQUESTS FOR INTERVIEWS WITH MRS THATCHER AND MR LAWSON

1. MAINICHI BROADCASTING (MB), AN AFFILIATE OF TBS, ONE OF JAPAN'S MAJOR COMMERCIAL TV NETWORKS, HAS BEEN COMMISSIONED BY THE JAPANESE PRIME MINISTER'S OFFICE TO MAKE A 60 MINUTE FEATURE PROGRAMME.ABOUT THE LESSONS TO BE LEARNT BY JAPAN FROM THE REFORM OF THE BRITISH TAX SYSTEM UNDER MRS THATCHER. THE PROGRAMME IS SCHEDULED FOR BROADCASTING IN EARLY SEPTEMBER WHEN THE DEBATE IN THE DIET ON THE JAPANESE GOVERNMENT'S TAX REFORM BILL WILL BE IN FULL SWING. MB HOPE THAT THE PROGRAMME WILL HAVE A NATIONWIDE AUDIENCE OF 15 MILLION.

2. MB PLAN TO SEND A TEAM TO THE UK IN EARLY JULY TO GATHER MATERIAL. THEY HAVE REQUESTED 15-30 MINUTE INTERVIEWS WITH THE PRIME MINISTER AND THE CHANCELLOR OF THE EXCHEQUER TO TAKE PLACE ANY TIME DURING THE PERIOD 6-20 JULY. (COPIES OF MB'S REQUESTS FOLLOW BY FAX TO FED).

3. MB'S DECISION, AT THE BIDDING OF THE JAPANESE PRIME MINISTER'S OFFICE, TO SINGLE OUT BRITISH EXPERIENCE WITH TAX REFORM AS BEING MOST RELEVANT TO JAPAN'S OWN TAX REFORM PROGRAMME IS FURTHER INDICATION OF THE KEEN INTEREST IN JAPAN IN BRITAIN'S ECONOMIC REVIVAL. IT IS RECOGNITION OF OUR LEADING POSITION AMONGT THE ECONOMIC REFORMERS IN EUROPE. THE PROGRAMME WOULD PROVIDE AN IDEAL VEHICLE FOR REINFORCING THE MESSAGE ABOUT THE UK'S ECONOMIC RECOVERY.

4. I HOPE THEREFORE THAT EITHER THE PRIME MINISTER OR THE CHANCELLOR (OR POSSIBLY EVEN BOTH) CAN AGREE TO THIS REQUEST. THE CHANCELLOR'S RECENT WRITTEN INTERVIEW WITH THE NIHON KEIZAI APPEARED ON THE FRONT PAGE ON 12 JUNE. THIS IS FURTHER PROOF THAT BRITISH VIEWS ON ECONOMIC MATTERS RECEIVE CLOSE ATTENTION.

5. IF AN INTERVIEW TAKES PLACE, MINISTERS WILL WISH TO BEAR IN MIND THAT THE PROGRAMME WILL BE BROADCAST AT A TIME WHEN THE DEBATE ABOUT TAX REFORM IN JAPAN MAY BE REACHING A SENSITIVE STAGE. THEY WILL THEREFORE NEED TO BE ON THEIR GUARD AGAINST ANY LEADING QUESTIONS

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ABOUT WHAT REFORMS JAPAN SHOULD ADOPT.

6. MB IS KEEN FOR AN EARLY REPLY

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From the Private Secretary

8 June 1988

THE TAXATION OF LIFE ASSURANCE: CONSULTATIVE DOCUMENT

Thank you for your letter of 7 June, which the Prime Minister and the Chancellor discussed at their bilateral this afternoon. The Prime Minister is content for the Chancellor to proceed with a consultative document on the basis proposed.

Paul Gray

Alex Allan Esq
HM Treasury.

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cc BG
BWP

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

7 June 1988

Paul Gray
10 Downing Street
LONDON SW1

Dear Paul

THE TAXATION OF LIFE ASSURANCE: CONSULTATIVE DOCUMENT

During the passage of the Finance (No 2) Bill last year, the Chief Secretary announced our intention to take a general look at the tax arrangements for life assurance. I attach the relevant Hansard extract. The Inland Revenue have since then been taking forward this review. The industry is of course aware that the work has been going on, and has been expecting us to publish a consultative document for some time. We are now ready to do so.

The life assurance industry has changed considerably in recent years, with a continuing shift away from pure life cover. Simple life cover now takes up a steadily diminishing share of its business. The industry has increasingly become one which offers various investment vehicles, as an alternative to other sorts of personal investment such as unit trusts or direct investment in shares.

The current tax regime for the life assurance industry has grown up piecemeal. The basic rules were settled in the 1920s:

- policy holders were not liable to tax on any sum they received. All tax on the investment returns and other profits was collected from the life offices;
- the life offices' tax liabilities were based primarily on their investment income minus their management expenses.

These elements remain at the heart of the current regime, though the rules have been modified to match developments in the industry and in the tax system, including the introduction of Capital Gains Tax. Capital gains are apportioned between a shareholders' element, chargeable at the full Corporation Tax rate like other corporate capital gains, and a policy holders' element, chargeable at 30 per cent. Policy benefits in the hands of the policy holder

are specifically exempted from CGT. New provisions have also been introduced to deal with the increasing tendency for life assurance to be used as an investment vehicle.

The effect of these rules has been to give the life assurance industry a tax regime that is very different from the regime for any other form of personal investment: one that is extremely generous in aggregate but very uneven in its incidence between different companies.

The main reason for this lies in the treatment of initial expenses. The formula used for life offices is much more generous than is available for comparable initial costs in the case of other investment products or of direct investment. Life offices' initial costs are very large, and tax relief is given in full and at once - compared with unit trusts, for example, where the initial costs can be offset only against capital gains (if any) as and when the investment is disposed of. The generous treatment for life offices means that, for an office that is growing rapidly - so that expenses from new business are large compared with income and gains due to existing business - the relief can and often does wipe out tax liability altogether.

There are numerous other more technical weaknesses in the present tax regime. Some life companies have found other ways to shelter their income or their gains, for example through the use of re-insurance and captive unit trusts. And even where companies do make provision for expected capital gains tax liabilities (thus reducing benefits paid to policy holders), the money mostly stays in the companies' reserves and does not reach the Exchequer.

The conclusion of the review is that there is a clear case for considering how the tax regime for the industry might be tightened. The Inland Revenue are therefore planning to publish a draft consultation paper which describes the current position, and then suggests two options for change. In both of them, investment linked policies would be put broadly on all fours with unit trusts. For other policies, there would be either be a completely different system of taxation based on a charge on the policy holders' interests, together with a separate charge on the offices' profits, or else there would be a reform of the current system, which would provide a less favourable treatment for initial expenses and which would tidy up some of the other unsatisfactory features.

It is clear that any changes to the current tax regime would potentially cause the life assurance industry to be taxed a good deal more heavily. They would therefore be bound to lobby heavily against both the options in the consultative document. But the present system is clearly indefensible. The industry has a tax regime, created some sixty years ago, which means it pays less tax in aggregate than any other industry. And it is inequitable between different life offices: at present, some pay no tax at all even though they make very significant profits. It will be difficult for the industry to justify this state of affairs.

The Chancellor proposes to issue this consultative document as soon as possible. This would leave open the possibility of legislation next year. If the Prime Minister has any points on this, the Chancellor will be ready to discuss them at his bilateral tomorrow.

Yours
Alex

A C S ALLAN

[Mr. Major]

to another syndicate with the provisions for outstanding liabilities made by insurance companies. The revised clause meets Lloyd's anxieties about the form of the original clause.

Mr. Robert Adley (Christchurch): I am not a name at Lloyd's, but I am considering becoming one. Is my hon. Friend aware that the view taken of the agreement that he has announced differs markedly between the "establishment", if I may so put it, at Lloyd's and a number of individual underwriting agencies? My hon. Friend used the word "unique" to describe the situation of Lloyd's names. Does he accept that the contribution made by Lloyd's is also unique and depends entirely on people's willingness to submit all that they own or possess to certain risks? Before commending even the amended Bill to the House, will my hon. Friend please take care to ensure that it will not so damage Lloyd's that large numbers of names resign their membership, thus depriving the country, not to mention the individual names, of a unique organisation?

Mr. Major: I certainly agree with my hon. Friend about the contribution of Lloyd's. Lloyd's has certainly made a substantial contribution. It is a major force in world insurance markets and is a substantial contributor to invisible exports. It is also a major contributor to London as a world financial centre. It would be no part of our policy to damage the reputation of Lloyd's or to ensure that it was treated anything other than fairly. We believe that the proposed arrangements in the Bill will strike a fair balance between the interests of the taxpayer and the interests of Lloyd's and the members of the syndicates.

We believe that the revised clause meets Lloyd's anxieties about the form of the original clause. It now provides a free-standing test for the tax deductibility for reinsurance to close. The test is that the figure must be a fair and reasonable value of the liabilities, designed to produce neither a profit nor a loss to the Lloyd's members who assume the outstanding liabilities.

In its revised form, the clause meets the twin objectives I set out a moment ago. It meets the objective of ensuring that the tax deductibility of reinsurance to close can be properly reviewed by the tax inspector, but it does so in a way which is fair to Lloyd's. It takes account of the special features of Lloyd's reinsurance to close arrangements, and meets its concerns about the proposals in their original form.

There is another important modification we have introduced that I wish to mention.

Mr. Dennis Skinner (Bolsover): Before the Chief Secretary leaves the point about Lloyd's, what would he say to the man in the street who has no interest in Lloyd's, who has found himself out of a job, who has not been rescued by the Government, who has not been guilty of any fraud or crime like those in Lloyd's, who has not been part of a process in which £40 million has been fiddled and in which the fraud squad has not been involved because of the self-regulation applying at Lloyd's which is their system of law, when he found that the Tory Government were proposing to change the law to suit those people who have done nothing whatsoever about the massive fiddle that has taken place at Lloyd's to induce the Inland Revenue—the taxpayer—to provide sums of money as a means of rescue? Would it be fair to say that the man in the street would say, "I thought that this Government didn't believe in throwing money at things"? Today the Government are throwing money at Lloyd's and the names involved.

Mr. Major: The hon. Gentleman frequently see things that others cannot. On this occasion he has done so again.

With regard to the first part of the hon. Gentleman's remarks, I would say to the mythical man in the street that much of what the hon. Gentleman has said has nothing whatsoever to do with the contents of this Finance Bill. I would say to the hon. Gentleman and to his mythical friend in the street that the legislation that we propose tightens the present position. It is effective. The test that we propose is fair to the taxpayer and to Lloyd's. It is wholly misleading of the hon. Gentleman to suggest otherwise.

Mr. Skinner: The Minister is fiddling the figures to bail them out using taxpayers' money.

Mr. Major: I said a moment ago that the hon. Gentleman can always see things that others cannot. If he had been at the walls of Jericho when they fell, he would have blamed the Government for poor maintenance.

We have introduced another important modification to the Bill's provisions on the taxation of companies' capital gains. As the House will know, we received a number of representations about the impact of this change on the life assurance industry. The particular point of concern was whether the change to charging gains at the main corporation tax rate should apply to the gains which life assurance companies earn for their policyholders. We considered this issue very carefully and concluded that we needed to take a general look at the tax arrangements for life assurance which have developed piecemeal over a long period.

There will be a full opportunity for the life assurance industry and other interested parties to contribute to the review. In an area as complex as this, the exercise is bound to take time but the Inland Revenue will be initiating consultations as speedily as possible. In the meantime, we have decided that the tax rates on gains earned for policyholders should remain at 30 per cent. pending the outcome of the review.

Mr. Jerry Wiggin (Weston-super-Mare): It can be validly argued that clause 75 is retrospective taxation on all life insurance policyholders. In the light of his welcome assurance that the industry will now be consulted on the entire taxation process, will my right hon. Friend give further thought to postponing the introduction of clause 75 until the review has taken place?

Mr. Major: I am afraid that I cannot give my hon. Friend that assurance. The proposition that I have just put before the House is very limited, and I fear that I am unable to go further on this occasion.

Mr. Terence Higgins (Worthing): I raised this matter on Second Reading on the pre-election Bill. But will my right hon. Friend consider carefully the point about retrospection? Does he accept that there ought not to be any element of retrospection when changes of this kind are made?

Mr. Major: I shall bear in mind what my hon. Friend has said. However, I cannot add anything to what I said a moment ago.

THE TAXATION OF LIFE ASSURANCE

A consultative document

Price £5

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INTRODUCTION

1.1 This consultative document is intended to carry forward the review of life assurance taxation to which the Chief Secretary to the Treasury, the Rt Hon. John Major MP referred on 8 July 1987 during the course of proceedings on the Finance (No.2) Bill 1987. He said that, in considering the appropriate rate of tax on capital gains realised by life offices, Treasury Ministers had

> "concluded that we needed to take a general look at the tax arrangements for life assurance which have developed piecemeal over a long period" (Official Report, Vol 119, Col 362).

Scope of the review

1.2 The review is primarily concerned with the tax charge on the life assurance business of life offices and with the tax treatment of the associated policy benefits in the hands of policy holders. It also covers some issues arising in the tax treatment of life assurance commissions receivable, and stamp duty on life policies.

Contents of the document

1.3 The document starts with a brief description of the industry and its products; compares life assurance with other forms of personal saving; and sets out the objectives to which a tax regime for life assurance might be directed. It then goes on to describe the development of the current tax regime and assess its performance in practice. In the light of this, the document puts forward for consideration three main options for taxing life offices. This is followed by a discussion of the possible form of a future exit charge on policy holders. Next, the document considers the possible effect of the more important issues arising on the tax treatment of foreign offices writing business in the United Kingdom and UK offices writing business abroad. It concludes with a brief survey of the central options, picking out the issues requiring decisions.

1.4 Supporting material in Annexes A to F includes a brief statistical outline of the life assurance industry with graphs; a commentary on the industry's recent tax position drawn from industry statistics and from a survey of Inland Revenue records; a brief discussion of the two specialised topics mentioned above; and a glossary.

1.5 It has been assumed throughout that the wider tax regime, and in particular the treatment of other financial institutions and financial products, reflects the proposals announced in the 1988 Budget.

1.6 Discussion in the document concentrates on the broad structure of the tax regime for life assurance and particular technical issues are examined only to the extent that they have substantial tax effects for a significant proportion of life offices or life policies. Any further technical details in the operation of the current regime which are not addressed in this paper will be considered in the course of further work on the review.

1.7 Representations are invited on the matters discussed in this paper, and on any other issue in the taxation of life assurance. They should be forwarded by Monday 31 October 1988 to

The Board of Inland Revenue
Life Assurance Review
Room 130, New Wing
Somerset House
London
WC2R 1LB

THE NATURE OF LIFE ASSURANCE

2.1 Life assurance shares a number of characteristics with other forms of insurance. For example, it involves a contractual relationship under which the insurer assumes a contingent liability in return for the payment of a premium by the policy holder. It is different from other forms of insurance in that the benefit provided by the contract is payable on a specified contingency, related to human life. It is not, unlike policies of indemnity, directly related to a specific financial loss.

2.2 Benefits payable under a policy of life assurance are contractual and do not in law bear any relation to any particular part of the resources of the life office. Because of the long term nature of most life policies, investment by the life office is inherent in the conduct of life assurance business. The income, and more recently the gains, derived from investment have been regarded in the United Kingdom as a proper subject of taxation, so that policy holders' benefits are presumed to be paid out of an undivided taxed fund.

2.3 Because of the dominant role played by the investment of a life office's funds, life assurance is regarded in many cases as a form of saving. The protection and savings factors are however inseparable both in law and in fact. The payment of a specified benefit may involve both an element of redistribution of funds between policy holders (for example, when the policy holder dies prematurely) and an element of investment return. Life assurance also shares with other forms of insurance a number of social and economic characteristics, such as the pooling of resources and the sharing of adversity, although in some modern policies these characteristics are present only in an attenuated form.

2.4 This document is necessarily concerned chiefly with the investment element of life assurance, since that is the element which brings life assurance within the scope of the Taxes Acts. References to life assurance as a savings medium and comparisons with other savings institutions and products are made in this context. The current tax regime, outside Inheritance Tax, does not tax what may be loosely described as the quasi-mutual or mortality benefit inherent in some policy benefits, and that distinction is preserved in this document.

2.5 One-off contracts for life cover are recorded as far back as the sixteenth century. Life assurance in a recognisably modern form was first written in the mid-eighteenth century. The policies were modern in these respects:

- risks were pooled between a large number of lives assured, so that the level of claims in any given year - unpredictable in respect of any particular policy - could be expected to follow a relatively stable pattern, and one predictable from available statistics on the death rates of the time;
- premiums could accordingly be set on a sound actuarial basis, making adequate provision for future claims, and differentiating between customers on the basis of their life expectancy;
- premiums were set on a level basis over the term of the policy, despite the fact that mortality rates, and hence the likely level of claims, increased with advancing age of the policy holders.

2.6 These characteristics introduced a number of key features which remain fundamental to life assurance and to its tax treatment. First, life assurance is a long-term business, in which solvency and profit rest crucially on actuarial judgements about the likely level of income and outgo into the distant future, and about the reserves which need to be set aside out of assets currently in hand to cover future liabilities.

2.7 Secondly, and in consequence, life assurance involves investment by the life office. The reserves set aside by the office must be deposited in an appropriate store of value until such time as they are needed to meet future liabilities. If they can be invested to obtain a positive return, the reserves required, and hence the premiums needed to achieve a given benefit, can be reduced accordingly. The likely investment return on these assets, and the security with which they can be realised in the future, are therefore crucial ingredients in the economics of the business.

2.8 Thirdly, life assurance normally involves an element of saving on behalf of the policy holder. This is obvious enough in the case of policies which guarantee a cash return to the policy holder, sooner or later, in every case. Income from investment of the premiums will also often augment the benefits payable to the beneficiaries under a policy of term assurance, which most policy holders would see as wholly protective in function.

2.9 Policies of life assurance are written as part of a wider long-term business, the principal categories of which are:

- life assurance
- permanent health insurance
- capital redemption.

2.10 Life assurance (by far the largest category) includes industrial assurance business and ordinary life assurance business.

2.11 Industrial assurance business is characterised by frequent regular premiums, which are collected door-to-door. Written by a minority of offices, it forms a declining share of the total market, although the absolute amounts involved remain substantial. Ordinary life business is all the rest of life assurance business, and divides, for tax purposes, into

- annuity business
- pension business
- the rest of ordinary business.

It is with this last segment of ordinary business, and with the analogous industrial business, that this review is primarily concerned.

Types of life policy

2.12 Most taxable life assurance business is written by proprietary companies owned by shareholders; a significant minority is written by mutual offices, all of whose profits go to benefit their with-profits policy holders; and a relatively small amount is written by friendly societies, which also operate on mutual lines.

2.13 The full range of policies now on offer can be split into broad classes by reference to:

- the contingencies on which benefits are paid: including term assurance, which pays only in the event of death within an agreed term; whole of life, which pays on death at any age; and endowment (strictly life or endowment) assurance, which pays on survival for a term of years or on earlier death;

- whether regular premiums are required, or only a single premium at the outset;

- the way in which policy benefits are determined: without-profits policies guarantee a fixed sum assured; with-profits policies guarantee a minimum sum assured with the right to share in the profits of the office by way of additions of "bonus"; and investment-linked policies give a benefit fixed by reference to the value of a specified bundle of assets (or perhaps to the level of a specified index).

2.14 These basic ingredients can be combined and modified in various ways to suit particular market requirements. Important current products include regular premium term assurance (including the decreasing version for mortgage protection); regular premium with-profits endowment and investment-linked policies (including policies designed to match endowment mortgages); and single premium investment-linked policies (usually written in whole-of-life form, but generally cashed in by way of surrender). Policies can be bundled together in various ways to provide a desired overall product; for example income bonds comprise two or more life assurance or annuity policies put together to produce the overall cash effect of an initial single payment by the policy holder earning a regular income followed by the return of capital on maturity or earlier death.

2.15 Life policies are sold either by the office's own sales force (or by other direct means, such as direct mail), or by intermediaries. Commission is paid by offices (with a few exceptions) to intermediaries by reference to the premiums payable and the type of contract, and may also be paid on sales by the office's own sales force. This and the other initial costs of acquiring new business form a substantial share of total life office costs and may, in the case of regular premium business for the longer terms, amount to as much as a full year's premium or even more.

2.16 A brief statistical outline of the UK industry, and its recent development, is set out at Annex A.

A COMPARISON WITH OTHER FINANCIAL PRODUCTS

3.1 It is clear from the outline in Chapter 2 that life policies vary widely. Some are very similar in economic terms to other financial products. Investment bond policies for example may be linked to similar, or identical, underlying assets as are available in unit trust form. The only substantive difference (tax aside) is an element of additional benefit on the policy holder's death which is often small or trivial.

3.2 Other forms of life assurance may compete less directly with other products: regular premium policies, for example, commonly offer a significant element of protection against mortality risk, and with-profits policies provide a degree of protection while still enabling the policy holder to share in the benefits of successful investment.

3.3 The key features of the wider tax regime applicable to investments are that:

- tax is charged annually on income and realised gains, whether or not the net-of-tax return is then withdrawn in cash, or allowed to roll up;

- tax is charged at varying rates (from nil upwards) according to the circumstances of individual investors;

- different rules as respects reliefs, deductions and timing apply to different sorts of investment return, notably as between investment income received and capital gains realised.

There are exceptions to this treatment for particular sorts of savings such as occupational pension schemes and personal pensions, Business Expansion Scheme investments and Personal Equity Plans which have been selected for special tax treatment. It has also been adapted in detail to take account of the individual requirements of particular investment media; for example, in the case of authorised unit trusts and approved investment trusts.

3.4 These vehicles are a useful benchmark in considering the tax regime for life assurance since they are, like life policies, widely used for regular and lump-sum collective investment in a spread portfolio of assets under active professional management. When an investor buys units in an authorised unit trust, an initial charge is levied by the trust's managers and the balance is invested in assets. Income arising from these assets is subject to corporation tax, although a significant proportion is generally in the form of franked investment income (dividends) and does not attract further tax. Distributions of the unit trust investor's share of trust income are made or, in the case of comparable investment in an investment trust company dividends reflecting the investor's share of trust income are declared, year by year carrying the appropriate tax credit. If the investor is liable at the higher income tax rate, further tax is due from him, whether the distribution or dividend is paid out or (as in the case of accumulation units) reinvested in further trust assets; if he is exempt from, or not liable to, income tax the tax credit is paid to him.

3.5 Authorised unit trusts and approved investment trusts are exempt on gains arising from transactions in trust assets. Investors are liable to capital gains tax on any real gains arising on the disposal of their units or shares. Since the full acquisition cost is taken into account for this purpose, the initial charge paid by the investor is effectively deducted from the gain which would otherwise accrue. The (smaller) annual management charges levied by the trust managers are deductible from trust income for tax purposes. The overall effect is to give a tax treatment broadly equivalent to direct personal investment: the franked investment income and tax credit arrangements secure that tax on trust income effectively flows through to unit holders and shareholders; and the exemption of trust gains avoids the two tiers of charge on capital gains which would otherwise arise from the interposition of a separate vehicle to hold the pooled assets.

3.6 The treatment of these vehicles shows that the basic UK tax regime is capable of being adapted to deal effectively with collective investment. There are however important legal and operational differences between life assurance and other products which make it particularly difficult - and sometimes impossible - to apply to life products a tax regime structured along the lines above.

3.7 As a matter of law, policy holders do not invest their premiums in the life office (although they do acquire contractual rights against the office); and the policy benefits are an undivided capital sum, rather than a return of original capital plus an investment return. There is - again as a matter of law - no way of allocating any part of the aggregate assets, income or expenses of the office to any particular policy.

3.8 This means that the legal nature of the life assurance policy cuts across each of the three key features of the wider tax system set out in paragraph 3.3 above.

3.9 In some cases these legal differences are little more than a matter of form. In the case of investment bonds for example the policy holder does not strictly own the units allocated to his policy, receive the investment return generated by the fund assets, or pay administration charges to the office. However, he owns rights - set out precisely in the policy terms - to a cash sum calculated just as if he did own the units, enjoy their income and capital gains, and pay charges to the office according to a set tariff.

3.10 Where policies offer a substantial degree of protection against both mortality and investment risks, the differences are very much more fundamental. In the case of with-profits policies, for example, the benefits of successful investment are passed to policy holders (and shareholders) by means of bonus additions (and appropriations to shareholders). But it is of the essence of the with-profits policy that there is no direct mechanical relationship between the benefits paid to any particular policy holder and the income and gains accruing to the office over the duration of the policy. It may be possible in principle to compute how much of the ultimate benefit reflects a net investment return on the premiums invested, but there is no right way of breaking down that net return into the individual components - income and capital gains - generally recognised by the tax regime. *A fortiori*, there is no realistic way of determining how the total ultimate proceeds built up from year to year over the life of the policy.

3.11 This is the crux of the matter. It is possible eventually to identify the total investment return going to a particular policy holder but not how it is made up, or in which particular years it accrued. It is possible to identify the total income, gains and expenses of the office as they arise, but not how they should be assigned to particular policy holders. The tax regime somehow or other has to bridge that gap if it is to be effective, fair and meet the other objectives to which the paper now turns.

THE OBJECTIVES OF A TAX REGIME FOR LIFE ASSURANCE

4.1 Certain criteria have guided the assessment in this document of the current tax regime for life assurance and of the need for, and basic requirements of, possible alternatives. These criteria might well be thought applicable to any tax system: effectiveness and enforceability; equity and neutrality; certainty and simplicity; adaptability and flexibility; and consistency and compatibility with the wider tax regime and the Government's broader policy aims. Deriving from these criteria, the most significant specific objectives for a tax regime for life assurance can be identified at the outset.

4.2 First (and broadest), an effective system operating on a taxable base commensurate with the investment returns and other profits earned for policy holders and (where relevant) the profits accruing to shareholders; and imposing tax at rates which are appropriate having regard to those applying to individual investment and to corporate trades generally.

4.3 Second, and as far as is relevant, parity of treatment between life offices and other financial institutions, and their respective products.

4.4 Third, a fair distribution of the overall tax burden on the industry between one office and another and one policy holder and another so as not to distort or hamper competition and economic efficiency.

4.5 Fourth, adaptability as far as possible to future changes in the tax system generally and sufficient flexibility to accommodate developments in the industry, innovations in its products and changes to the regulatory system (including any introduced by the European Community).

4.6 Fifth, simplicity and certainty in the regime's effect in so far as the wide range of circumstances to which it has to apply will allow; and economical administration for life offices, their policy holders and the Inland Revenue.

4.7 Sixth, recognition of the obligations of life offices and the rights and expectations of policy holders under the many millions of existing policies, so that any substantial change will have to entail an equitable and workable transition from the existing rules.

4.8 Seventh, consistency with the prudent management of the long term business of life offices and regard for their solvency.

4.9 Finally, regard for the Government's aim of promoting freedom of services within the European Community in the context of the Commission's programme for the completion of the internal market.

4.10 There are obvious links between these objectives. A regime which is not effective in producing an appropriate overall yield from the industry's activities is unlikely to be neutral in its effects on the competitive position of institutions and products or on investment behaviour in general. Conversely, one which is consistently fair in its incidence in particular cases is much more likely to produce a broadly adequate yield overall.

4.11 Inevitably, there are also tensions between them. Parity of treatment for all life policies, between life policies and other financial products and for all prospective purchasers (non-taxpayers as well as higher rate payers) would require a regime tailored much more closely than at present to the individual circumstances of each policy holder. That would be likely to increase complexity and operational costs as well as the problems of transition from the current regime. On the other hand, simplicity and low operational costs might point to a system unresponsive to variations in the individual circumstances of policy holders or to differences between offices or products, and so perhaps less neutral in its impact.

4.12 Any approach to the resolution of one tension introduces another. In so far as life assurance can be seen as one form of saving among others, then its tax treatment ought, so far as practicable, to reflect the liability which would be incurred by the policy holders if they were to be charged directly on the investment return on their premiums. In this way the liability would be brought into line with that payable on direct investment or on investment in a collective form, such as through unit trusts. On the other hand there are features which distinguish life assurance from savings generally: an element of insurance is always present, inseparable from the other elements of life policies. The investment return enures to an undivided fund in which the individual policy holder has an indirect interest only. This points to a system which imposes tax by reference to the circumstances of the life office and takes little or no account of those of individual policy holders.

4.13 As in other areas of tax policy, no one option is likely to meet all the objectives. The purpose of this review is to identify options which resolve conflicting objectives better than the current regime.

THE CURRENT TAX REGIME: DEVELOPMENT

5.1 This chapter does not attempt a complete technical account of the current rules. Nor can it usefully try to reduce the regime to a small set of basic principles. The present tax regime is not tailor-made for the job now in hand. It is the result of a continuous process of adaptation and addition over a period of decades to a basic regime which in essentials goes back to the nineteenth and early twentieth centuries.

5.2 The basic rules underlying the present regime were settled in their current form as long ago as the 1920s. As they then stood:

- policy holders paid no tax directly on their policy benefits. All tax on the investment returns and other profits arising from the business, whether payable ultimately to policy holders or to shareholders (if any), was collected at the level of the life office.

- life offices paid income tax on their life assurance business (at the then standard rate of income tax) on a single tax base generally calculated as ***I minus E***: that is, on their investment income (arising in those days largely from gilts and other fixed-interest securities) less their expenses of management. These expenses included both the day to day costs of running the business and managing its investments, and the commissions and other costs involved in acquiring new business. The legislation provided for the separate taxation of industrial life assurance and for the separation of life assurance from other insurance business.

- in some cases, however, an overriding charge was imposed on proprietary companies by reference to a ***notional Case I*** computation: relief for expenses was restricted so that tax payable on the ***I minus E*** basis was not less than tax on the proprietors' profits. This was to reflect the fact that some business - for example in the industrial branch - showed a high ratio of expenses to investment income, and so generated little or no net investment return, but nevertheless generated trading profits for the office.

5.3 This regime was intended to meet much the same objectives as those set out in Chapter 4: to provide for an appropriate tax yield from the industry, distributed acceptably between offices and policy holders, in a way which was simple and consistent with the wider tax system of the day. It achieved this with fair success.

5.4 The ***I minus E*** approach, by taxing the industry through a single charge at the level of the office, reflected the wider tax system of its time. Income tax was then as a general rule charged at a uniform rate for both individuals and companies and there was no tax on capital gains. Consistently with this, the tax system identified and taxed sources of income, rather than recipients on their total income from all sources. In this context it was sufficient to identify a source of income accruing to life offices - the income arising from their investment portfolios - and tax it as such. This approach escaped the conceptual difficulties discussed in Chapter 3 because it did not try to take account of who ultimately got the benefit of this source of income, so long as the investment returns to policy holders, and the profits for proprietors, were derived from the taxed fund.

5.5 Although from a modern perspective the result looks a little crude, it was not unacceptably so in the circumstances of the time. On the one hand, some policy holders who had incomes below the tax threshold would have paid no tax on income from direct saving and were arguably overtaxed, indirectly, by the charge at the standard income tax rate. On the other hand, full relief for expenses of management could be said to be over-generous by comparison with the wider regime in allowing income tax relief for initial costs broadly analogous to those treated as acquisition costs, and hence not deductible, in other savings contexts. This relief was not given until 1915, when it was introduced to compensate for changes in the tax regime and increases in tax rates, at the beginning of the First World War.

5.6 The charge was possibly generous in recognising only the investment dimension of the business and disregarding other significant sources of profit to shareholders and with-profits policy holders. These sources included the profits from favourable mortality experience, from early surrenders and (for shareholders) from appropriation of loading surplus (in effect, a share of premiums, and not just income from their investment, going to proprietors).

5.7 It seems unlikely that these considerations were of great importance in practice. After all, nominal investment returns and tax rates were relatively low so that the effects of any tax bias on investment returns were relatively slight. Costs, particularly commissions, were also relatively low. Potentially competitive investment products were relatively undeveloped, and not close substitutes for the life policies of the day; nor were they readily available to the broad mass of life office customers.

Developments since the 1920s

5.8 These ingredients - *I minus E*, *notional Case I*, the separation of life assurance from other insurance business, and benefits free of further tax for the policy holder - remain at the heart of the current regime. But the wider tax regime and the market for investment products have changed radically since these rules were first established, and the life assurance regime has been successively modified in response. Important developments have taken place in a number of areas:

- successive changes have been made to the tax treatment of corporate traders, leading ultimately to the current separate corporation tax, charged at its own rates, and with partial imputation allowing advance corporation tax paid by the company to vouch basic rate tax due from the shareholders on their dividends. For life offices, the *I minus E* tax base is now charged to corporation tax. Until recently, life offices paid at a special lower "pegged rate" on the element of investment return due to policy holders rather than shareholders. More recently, the CT rate for companies generally has been reduced below the previous pegged rate and the same rate now applies to the income of life offices as to that of other corporate taxpayers.

- new provisions have been required to cope with tax-exempt pension business, which has formed an increasing proportion of overall ordinary business, both to exclude income and gains accruing to pension policy holders, and to secure tax on pension business profits accruing to shareholders and holders of taxable non-pension with-profits policies.

- realised capital gains are now chargeable to capital gains tax, or to corporation tax in the case of corporate bodies. Life offices are chargeable in basically the same way as other taxpayers on the gains realised on life fund assets. The gains are, however, apportioned between a shareholders' element, chargeable at the full CT rate like other corporate capital gains, and a policy holders' element, chargeable at 30 per cent. Policy benefits in the hands of the policy holder are specifically exempted from CGT.

- the increasing range of progressive income tax made some life assurance products an attractive tax shelter for high income investors. The investment return rolling up in the hands of the life office was taxed at a significantly lower rate than the top marginal income tax rates bearing on direct investment. Investment-oriented life policies were a correspondingly attractive substitute for other forms of investment. In response, changes to the tax regime required life policies to be segregated into qualifying policies (basically regular premium policies with a significant protection element) and non-qualifying policies (single premium and shorter term regular premium products where the investment element predominates). Income tax was then chargeable at the point of maturity, claim or surrender ('exit') on the net investment return from non-qualifying policies, but only at the difference if any between the policy holder's marginal tax rate and the basic rate. (Qualifying policies may also be subject to the same charge in limited circumstances.)

THE CURRENT TAX REGIME: PRACTICE

6.1 This chapter reviews the performance of the current tax regime in the light of statistics for the life assurance industry as a whole and the Revenue's information about particular offices. It looks first at the broad features of the *I minus E* charge and the way these have interacted with developments in the industry. It then outlines some more technical issues which have affected the performance of the current regime, or have been a source of uncertainty or dispute in its application. It considers finally how the current regime affects offices and their policy holders, and the position of life assurance policies in the wider market for financial products.

Developments in the Industry

6.2 The statistical outline at Annex A highlights two major developments which in recent years have affected the performance of the current regime. First, there has been a major shift in the composition of investment returns brought to account by life offices, away from investment income towards investment appreciation. This reflects both a shift in portfolio composition from fixed-interest securities towards equity and property holdings; and also a shift in the composition of the return from any given mixed portfolio (as evidenced for example by the changing relationships between income yields from gilts and equities). Secondly, there has been a change in the impact of expenses in the *I minus E* base both for the industry as a whole and markedly so for some individual companies. This reflects both a long-term change in the relationship between new business and initial expenses (from, for example, changed commission structures) and, more recently, strong real growth in new business, and in the past high rates of inflation.

6.3 Both these factors have tended to reduce the yield of the *I minus E* charge. On the one hand, the change in composition of investment returns affects the timing of the positive components of the tax base. Income, historically the dominant element, is taxable as soon as it arises. Investment appreciation accruing to the office is not taxed until the assets are realised, and the timing of this is largely under the control of the office. Realisations can be, and in practice often are, deferred.

6.4 On the other hand, the negative elements in the tax base - the deductions for commission and other expenses - remain deductible immediately as they arise. Moreover, since relief for expenses was introduced in 1915, the trend has been for the element of immediate expense attributable to new business to increase as a share of the new premium income secured. Strong growth in the nominal value of new business, such as in recent years, thus has a large and immediate impact on *I minus E*.

6.5 The graphs at Annex B show the effect of these factors in recent decades. The proportion of total gross investment returns coming into immediate charge has fallen, while substantial initial costs have remained immediately deductible in full. So the net *I minus E* base has fallen more than proportionately. The graphs may in practice understate this effect since they include pension business (where expenses are often significantly lower than for other ordinary business). Expenses attributable to taxable ordinary business must now account for more than half of gross taxable income.

6.6 This development shows up more starkly at the level of individual companies. Tax-deductible expenses exceed taxable income and gains for many companies, and have in some cases done so for a period of years. Of the sample of major companies reviewed at Annex C, a quarter will have paid, at most, no more tax for 1985 and 1986 than they would have if they were charged solely by reference to their commercial profits and returns to policy holders were disregarded altogether. Of these, some offices pay no tax at all, and others only enough to cover the tax credit on their dividends. These companies are by no means all (as historically they might have been) new companies whose existing business is not yet generating much income, or offices writing industrial business which is intrinsically expensive to service. They account for a substantial share, around 25 per cent, of total UK life funds, and write business which is both profitable and generates substantial net investment returns to policy holders.

6.7 One consequence of this is a tendency for the total tax burden on the the industry to fall very unevenly between offices. This can be shown by ranking offices by reference to the relationship between their tax liabilities and their assets referable to taxable life business. For 1985, about a quarter of the industry's tax bill fell upon offices which accounted for only a tenth of taxable business and about half the industry's tax was paid by companies writing only a third of taxable business. The position for 1986 looks to have been much the same.

Relief for expenses

6.8 This situation raises the question how far immediate relief for all expenses remains appropriate. About two thirds of the total expenses (including pension business expenses), or some £3 billion out of £4½ billion in 1986, goes in initial commissions and other selling expenses. No comparable relief is available for initial costs and commissions in the case of direct investment, or other forms of collective investment: relief may be available for CGT purposes when the investment is ultimately realised, but no relief is available against income from the investment. Still less, unlike the case of life assurance, can the initial costs of new entrants in a collective investment be set against the income accruing to existing participants. Whether this advantage is reflected in lower net of tax costs for policy holders, or in higher marketing costs than other financial institutions can afford, it must tend to distort competition and the size and distribution of the tax burden.

6.9 The effect is hard to measure. But a comparison with the authorised unit trust regime gives a feeling for the scale of it. If the investment income derived from non-pension life business were taxed, expenses relieved, and capital gains exempted, in the same way as authorised unit trust income, expenses and gains, the yield in recent years could have been between two and three times greater than it was. Even if tax were chargeable only at the basic income tax rate rather than the full Corporation Tax rate, the yield for 1985 and 1986 would have been in the order of £1400m and £1500m, as against the industry's total UK tax payments of about £520m for 1985 and an estimated £700-800m for 1986.

6.10 This is only a partial comparison. It disregards, on the one hand, the further tax a unit trust manager would pay on profits, and the higher rate tax and CGT which would be payable directly by some unit holders. On the other hand, it disregards the tax credits which would be payable to unit holders below the tax threshold, and the (relatively small) further yield collected from some life policy holders under the exit charge regime. Nor does it take account of tax reserves held by offices against contingent liabilities which in principle may one day become payable on a substantial scale. It also, of course, disregards behavioural effects - premium inflows, expense levels, and the composition of life office portfolios would all, no doubt, be different if the life assurance tax regime were radically different.

6.11 All that said, however, the relative magnitudes are such as to indicate quite clearly that the current treatment of life office expenses leads to a tax yield substantially lower than the wider tax regime would collect from a similar level of investment handled in other, but not expressly tax-privileged, ways.

Capital gains

6.12 The position of capital gains made by life offices is rather more complex. Life offices can and do defer realisations of capital gain. But so can individuals investing directly or for example in unit trusts. The difference is that individuals can defer realisations only until such time as they withdraw their gains in cash; life offices may be able to defer realisations even beyond the point where the relevant appreciation is paid out as benefit to policy holders. An office with strong cash flow can meet its cash obligations without having to sell investments. Moreover, there may still be sufficient cash left over for new investment to permit substantial changes in portfolio composition (including for example participation in new share issues) without existing holdings having to be sold to finance them. In 1986 for example ordinary branch premiums and investment income exceeded outgo on expenses, commission, tax and payments to policy holders by around £13 billion.

6.13 Life offices like other investors do of course dispose of assets from day to day in the normal course of managing their portfolios. For many offices, however, occasions of charge may arise only from such portfolio switches and not (as they do when CGT is charged at the level of the personal investor) when gain flows out in cash to individuals. Moreover, even when gains are realised, they do not necessarily come into effective charge to tax. Some offices have sufficient relief for expenses available to cover realised capital gains as well as the whole or a large part of their income; others keep their realised gains out of charge by holding their assets at one remove in a unit trust (see paragraph 6.33 below).

6.14 Against this when life office capital gains attributable to policy holders do come into effective charge to tax they are taxable at 30 per cent from the first pound, whereas gains realised directly by personal investors would commonly suffer no CGT liability given the benefit of the initial exempt amount. Even in so far as there is liability, the rate may now be 25 per cent only. To some extent, therefore, the effect of deferral by life offices may be offset by the reliefs available against other sources of capital gain.

6.15 This relatively high rate of tax on life office gains attributable to policy holders has important implications for offices in managing their affairs, which are discussed at paragraph 6.37 below. But it does not necessarily imply substantial immediate flows of tax to the Exchequer: the evidence suggests that in practice the possibilities for deferral outweigh the differences in effective rate compared with other forms of investment.

6.16 It is difficult to quantify these effects as the available statistics do not reveal relevant information about the present situation, and it is impossible to estimate the extent to which gains would have been realised if similar saving flows had passed (contrary to the fact) through other channels. One particular problem is that the current statistics are informative about the investment appreciation brought to account against liabilities, but rather less so about the extent to which current benefits are financed out of appreciation. Available figures do however throw some light on the situation. In the six year period up to December 1986 the value of UK life business assets increased from roughly £50bn to £150bn plus. Net capital appreciation (that is, asset appreciation adjusted to exclude net new investment by policy holders and reinvested income) accounted for about £50bn. Something over half of this appreciation was brought to account to fund benefits, and it is evident that the £45bn or so policy benefits paid in the period must have been financed to a substantial degree by capital appreciation. In the case of with-profits business, this is confirmed by the fact that terminal bonus - the main way in which appreciation is reflected in policy benefits - has come to account for a very significant part of the benefits on maturity, accounting for as much as half or more of the total policy proceeds on longer term policies with some companies.

6.17 Against this background of substantial appreciation both accruing to offices and paid out as benefits, and even allowing for inflation and the tax-exempt status of some assets and classes of business, the chargeable gains realised by life offices look low. Inland Revenue survey data for taxable (non-pension) business suggests that the gains chargeable to tax totalled about £2bn for the most recent two years together, 1985 and 1986, as compared with investment income of about £12bn, underlying appreciation of about £20bn and policy benefits paid of roughly £15bn. This suggests that realised gains were at best keeping broadly in line with gains paid out, at a time of very buoyant and active equity markets, and that few or no gains were realised in respect of the very much larger amounts of appreciation accruing to finance future policy benefits.

6.18 The next step, looking at the actual tax yield from life office gains, is complicated by the facts that gains are taxed as part of a single computation of income **plus** capital gains **less** expenses, and that as a matter of mechanics expenses are set off against gains after unfranked investment income but before franked investment income. So some companies may pay tax on gains, but only because expenses have already sheltered all or a large part of their unfranked income; others pay no tax on gains, but capital gains at the margin still alter their overall tax position by affecting the relief available against franked income. It is therefore difficult to quantify the current tax yield from life office gains considered in isolation.

6.19 One thing can however be said: tax on gains does not redress the overall balance of the *I minus E* base. For the industry as a whole, and for the majority of individual companies, realised gains in charge have in recent years been substantially outweighed by the relief available for initial expenses: hence the conclusion set out in paragraph 6.9 that in relation to its size the industry pays considerably less tax than competing investment institutions such as authorised unit trusts which are wholly exempt from tax on gains.

Future developments

6.20 It could be argued that the impact of all these factors has been particularly marked in recent years. The relationship between *I* and *E* has reflected inflation and strong growth in new business; the importance of the capital gain element in investment returns has been exaggerated by the presence of large unrealised inflationary gains and by buoyant markets. For the future, it may be that real growth in new business, and hence in *E*, will not be sustained at recent levels; continuing low inflation rates will be reflected in the growth in nominal *E*; *I* will build up as recent new business matures; and (following the 1988 Budget proposals) only real post-1982 capital gains will be chargeable, and they are likely to show long-term growth rates much lower than those in the past few years.

6.21 All these considerations have some force. Given the long-term nature of the business, however, they are likely - even if entirely valid - to take a considerable period to work through in full. Moreover, they affect only the quantitative impact of the factors discussed in this Chapter, rather than their character: so long as new business continues to be written, and policy benefits continue to be paid out of an ongoing common fund, this will result in some degree of distortion in the incidence of tax between offices, and between life assurance and other financial institutions and products, and in a significant loss of immediate yield.

Technical difficulties with the I minus E base

6.22 As well as the impact of the factors discussed earlier in this Chapter, the tax regime has suffered from some technical problems and uncertainties.

a) **Pension and annuity business**

6.23 The share of ordinary business income and gains attributable to pension policy holders has to be identified and excluded from the *I minus E* base, since a life office's income and gains referable to pension policies are exempt from tax. This is currently done by reference to the mean funds or mean liabilities of the office in respect of the different classes of ordinary business ("mean" indicating the average of the beginning and end-year figures: "funds" and "liabilities" are alternative measures of the respective weights of each type of business).

6.24 The profits of the office from pension business are, however, taxable as part of the *I minus E* base, since they form part of the return to shareholders or to holders of taxable non-pension with-profits policies. These profits are calculated and added to the *I minus E* base without any deduction for pension business expenses. This avoids the need for these expenses to be separately identified or apportioned. Instead, all ordinary business expenses are deductible as *E* in the *I minus E* base.

6.25 This should produce the right overall result so long as the pension profits for tax purposes are a realistic measure of the true profits before expenses. There are two potential weaknesses in common computational practice which put this in doubt. First, the pension profit computation includes only realised investment gains, while the deduction available for pension liabilities (if not adjusted) reflects investment appreciation brought to account by the office whether realised or not. The amount brought to account may be greater or less than the gains realised. But it has often been significantly greater and it seems likely that this will continue to be the case. Some companies maintain, wrongly in the Revenue view, that they are entitled to the benefit of the disparity between the chargeable and deductible components of the pension profits tax base. In practice this would mean that pension business generating significant commercial profits would show artificially depressed profits, or even losses, for tax purposes.

6.26 The second question arises on the interpretation of the current legislation which allows a deduction for amounts both "allocated to" and "reserved for" pension policy holders. The precise effect of these words is a matter of dispute between the Revenue and the industry. But an extreme interpretation would allow both a deduction for the amount shown as "allocated" to pension policy holders, as an addition to the actuarial reserves disclosed in the office's accounts, and also an unlimited further deduction for amounts shown as surplus in the office's own accounts but nevertheless "reserved" by directors' resolution. The result (on this extreme view which the Revenue does not accept) would be that offices could reduce their taxable pension profits before expenses more or less at will.

6.27 These two issues raise the possibility that pension profits may be significantly undertaxed. Or, going further, that profitable pension business may not only pay no tax but may not even cover its own expenses for tax purposes so that all or a substantial part of the pension business expenses could go to reduce the life assurance tax base. Similar problems (although in absolute terms rather less significant) affect the tax treatment of general annuity business.

b) **Reassurance arrangements**

6.28 Commission may be paid on the reassurance of life assurance risks in much the same way as it is payable in the case of direct assurance, except that it is payable not to an intermediary for introducing the two parties as in the case of direct business but back to the cedant company. Alternatively, reassurance may be written for a net premium with no commission. The difference has no effect on the pre-tax position of the parties, but it is claimed by life offices to have tax consequences. Reassurance commission paid is usually claimed as an expense while commission received is set against other expenses paid. So reassurance on commission-paying terms has in the past been used to shift management expenses from offices which cannot enjoy immediate effective relief for expenses to those that can. This would apply for example where the ***notional Case I*** restriction is operating to restrict the amount of expenses allowed. The reassurance premium rates may then be set so as to pass the benefit of some of the reassurer's extra tax relief back to the cedant.

6.29 So long as the reassurance is written between UK companies, the amounts at stake from such "commission buying", although substantial, are limited by the total unrelieved expenses for the UK industry as a whole, even if the arrangement withstands challenge by the Revenue. But it is also possible to accept inwards reassurance on commission-paying terms from overseas life companies. Where (as will generally be the case) the cedant company is located in a jurisdiction which taxes life assurance on a different basis from the United Kingdom, UK companies may seek to secure substantial extra tax relief for commission paid without the cedant company suffering any, or any proportionate, corresponding extra tax charge. Reassurance on these lines can be arranged so as to generate little addition to the taxable income and gains of the UK reassurer while at the same time minimising the risk passing.

6.30 Reassurance arrangements made by a number of companies are currently being reviewed in the light of existing case law. Even where there are no factors present which might expose the arrangements to challenge, it might be thought anomalous that the choice between effecting reassurance on commission paying terms or otherwise should have important tax consequences when it has no other consequences of substance.

6.31 Reassurance arrangements can also serve to transfer taxable income. For example, a company with unrelieved management expenses can import additional income by accepting investment-rich reassurance business for a net premium, with no commission. The acceleration of effective relief for *E* allows the business to be written on mutually attractive terms.

6.32 As with commissions, the risk of distortion is particularly acute where reassurance is written across the border between the UK and foreign tax regimes. In such cases, a UK office may reduce its taxable income and gains by ceding business outwards to an overseas reassurer, who may face no commensurate increase in tax liability under his domestic regime. Investment income and gains accruing to the reassurer are ultimately received by the UK office in the form of reassurance recoveries, which do not form part of the ***I minus E*** base, and so UK taxable income and gains are reduced absolutely, and not just rearranged.

c) **Capital gains**

6.33 As paragraph 6.13 noted, some offices hold assets at one remove in the hands of an authorised unit trust in which all or most of the units are owned by the office and which is under the management of an associated company (a 'captive' unit trust). So long as the trust qualifies for authorised status - which is possible without selling any, or many, units directly to personal investors - there is no tax on capital gains realised by the trust, and there is no charge on the office in respect of increased unit values until the units are realised by the office. The result is that an office can defer tax on any gains arising from the day to day management of the portfolio held in trust, so long as it can avoid selling units. For an office with adequate cash flow from premiums, that may be possible into the foreseeable future.

d) **Corporate profits and notional Case I**

6.34 The ***notional Case I*** charge is intended as a minimum charge based on the corporate profits of proprietary companies. In many cases it fails to achieve this purpose because:

- when the computation is based on the allocation of surplus to shareholders the unappropriated surplus is left out of account; (this has led to the modification of this traditional approach in some cases, in order to produce an appropriate minimum charge)

- the computation of shareholders' profits may be affected by mismatches similar to those identified in the context of pension business (see paragraph 6.25 above).

6.35 As well as the minimum tax charge, various apportionments between policy holders and shareholders are governed by the ***notional Case I*** computation. These are unsound. Because they are based on the division of surplus, they fail to take account of the investment return inherent in the valuation of liabilities. As a result, capital gains are wrongly attributed to shareholders for tax purposes and, to a lesser extent, dividend income accruing for the benefit of policy holders may be apportioned to shareholders and used to frank a life office's distributions. These distortions are particularly acute where a substantial proportion, or the whole, of the life office's business is investment linked.

6.36 ***Notional Case I*** does not therefore fulfil its current role effectively. A more fundamental question, however, for consideration later in this document, is whether offices should be charged to Corporation Tax on Case I profits, as other traders are, alongside a charge on policy holders' returns in all cases and not instead of it in some cases.

The impact on the industry

6.37 The discussion so far has focussed on the actual flows of tax to the Exchequer and on the technical anomalies, uncertainties and areas for dispute in the current operation of the regime. The uneven distribution of the tax burden, and the technical problems which arise, are a potential source of concern to the industry. Special problems, moreover, stem from the long-term character of the business: offices have to look to potential future liabilities as well as to actual current ones. A life office has to deal fairly with successive generations of policy holders while at the same time securing its own solvency. The problem for the industry can be seen most clearly in the case of investment-linked policies. The policy premiums secure that a given number of units are allocated to the policy, and the policy holder's ultimate benefits are set by reference to the income and investment appreciation accruing to the units over the period of allocation. But in fixing the benefits due to a departing policy holder, a deduction from the full market value of the linked fund is made to provide for future tax liabilities. This provision must be made against the tax on gains accrued to date which may ultimately be payable on realisation of the assets and which would otherwise fall on the office, or on a later generation of policy holders to whom the units were allocated.

6.38 Depending on the precise form of the policy, this provision is made either by a deduction built into the pricing basis for units or by an explicit deduction from the policy benefits. Either way policy holders are effectively suffering tax on account of capital gains, when they might have little or no CGT to pay (thanks to the annual exempt amount) on personal capital gains. The paradoxical result is that linked-life policies may look unattractive on tax grounds to many prospective customers by comparison with other forms of investment, although less tax may actually be reaching the Exchequer in the short and medium term than in the case of investment in the available alternatives. The absence of a neutral tax treatment as respects tax on gains has been possibly the industry's most important single complaint about the broad structure of the existing regime.

6.39 Non-linked policies are in essentially the same position, although no explicit adjustment for contingent tax on gains is apparent to policy holders in this case. Offices commonly bring unrealised investment appreciation to account to fund liabilities and bonus additions. The extent to which this can prudently be done is constrained by the need to provide for future tax on gains; and that in turn is reflected in lower bonuses than would otherwise be the case.

6.40 The 1988 Budget proposal for a rebasing to 1982 of the charge on gains will however have a substantial impact on the reserves needed by offices against tax on gains. In particular, any reserves (express or implied) held against unrealised pre-1982 gains are not now required. To the extent that these reserves were retained out of benefits already paid to past policy holders no longer on the books, there is an unavoidable element of windfall to current policy holders (and to shareholders) which should offset in many cases the need to make provision against any further gains accruing in the short and medium term.

6.41 Other major concerns expressed by the industry and to be addressed by the review relate to:

- the cumbersome character of the policy certification arrangements which provide that contracts have to be vetted in advance to determine whether they are capable of qualifying for exit-charge exemption;

- the anomalous effects mentioned at paragraph 6.35 which flow from the use of the ***notional Case I*** formula to determine *inter alia* the allocation of chargeable gains between shareholders and policy holders; and

- the distortions which can arise from the use of mean fund apportionments of income in determining the quantum of exempt pension income.

THE NEED FOR REFORM

7.1 It is difficult to make general statements about the life assurance sector and its taxation without qualification. If there were an obviously right way of taxing the industry, and of quantifying what the industry as a whole and particular offices ought to be paying, there would be no need for the current review.

7.2 The qualifications appear elsewhere in this document. The performance of the current regime is, however, so far from consistent with the wider tax system that some generalisations at least can be made quite baldly.

7.3 In principle, it is reasonable to expect that the tax arrangements for life assurance would:

- tax income earned for policy holders as it arises, and capital gains, at latest, as they are reflected in benefits paid out;

- allow tax relief for the costs of investment in terms of scope, timing and effective rate, consistently with that allowed for other forms of investment;

- match the increase in yield to the growth in the business, after taking due account of tax rate changes in the wider tax system;

- spread the overall tax burden between offices broadly in proportion to their relative profitability and return on investments; and

- ensure that as far as possible the tax effectively borne by policy holders and that actually reaching the Exchequer are in line.

7.4 A regime which did all this would very largely meet the objectives set out in Chapter 4.

7.5 The picture which emerges in practice is very different:

- the tax paid by the industry on behalf of policy holders and proprietors is low by reference to the level of its assets, income, gains and profits, in relation to that paid by other investment media;

- this is largely because income and realised gains are sheltered by tax reliefs (in particular, but not only, for initial expenses) to a greater extent than elsewhere, and in part because significant amounts of gain stay out of charge altogether in the short and medium term;

- as a result, the increase in tax yield has lagged well behind the growth of the sector;

- this shortfall compared with what might be regarded as the appropriate full tax burden is not spread at all evenly over the industry. Some offices have paid substantial amounts of tax; others, while earning considerable profits and returns for policy holders, have paid little or no tax year after year or have paid tax only in step with distributed profits; and

- policy holders, meanwhile, have effectively suffered significant amounts of tax, often more than they might have borne if investing in other ways, although much, sometimes all, of this has failed to reach the Exchequer.

7.6 Because of the need for their products to be competitive, this last point is as much a problem for life offices as for the Exchequer. Any reduction in policy proceeds to provide for tax may be seen as a disadvantage by potential customers and the intermediaries who advise them, whether or not tax is actually paid by the life offices. This is perhaps the most important single problem for the industry in the current regime. But there are also a number of other technical anomalies and uncertainties which cause significant difficulties.

7.7 Contributing to all this is the failure of the tax arrangements for life assurance to have adapted adequately to changes in the industry's products and underlying investments, in the wider savings market and in the tax system as a whole. At the same time, weaknesses of a more technical nature have emerged which have impaired the performance of the regime both directly and indirectly, by creating opportunities for tax-induced distortions of behaviour.

7.8 Significant changes are therefore now required: the weaknesses cannot be addressed by a handful of technical changes at the margin of the system but only by a major reconstruction of the present tax regime for life assurance.

Options for change

7.9 The objectives set out in Chapter 4 require a tax regime for life assurance which deals effectively both with the corporate profits earned by the office, and with the investment returns earned for policy holders. The charge on returns to policy holders raises special difficulties, as Chapter 3 made clear. There is, in particular, no direct relationship in the case of non-linked policies between the income and capital gains accruing to an office and the amounts reserved for the benefit of, and in due course paid out to, any particular policy holder. There is therefore a choice to be made in specifying a tax base for policy holders whether it should operate by reference to the amounts flowing into the office; the amounts reserved; or the amounts paid out. In the light of these considerations, the three broad options for reform are:

- taxing each policy (so far as it offers a return on investment) by reference to the circumstances of the individual policy holder, as consistently as possible with the tax treatment of other forms of saving. Corporation tax would remain chargeable on an appropriate measure of the office's profits [Option A]

- charging tax at source on the investment return to policy holders (calculated on actuarial lines), possibly with some further charge on policy holders in individual cases. Here, too, a separate charge would be made on corporate profits [Option B]

- an approach broadly along present lines, collecting tax on policy holders through a charge on income and gains received by the office, but modified to tackle the weaknesses and uncertainties of the present regime (again possibly with a policy holder charge in some cases). The same charge might also recover tax on corporate profits, or they might be subject to a separate Case I charge [Option C]

These options need not be mutually exclusive.

7.10 These three broad options are discussed in greater detail in Chapters 8 to 10. Both the second and third options include the possibility of a limited charge on policy holders, broadly analogous to the current chargeable events charge. This is discussed in Chapter 11. The implications of these options for business with an international dimension are discussed at Chapter 12.

7.11 The charge to tax on life assurance commissions receivable and the stamp duty on life assurance policies raise issues outside the main line of discussion in this document; they are discussed in Annex D and Annex E.

THE BROAD OPTIONS FOR REFORM

A. TAXATION OF INVESTMENT RETURNS IN THE HANDS OF THE POLICY HOLDER

8.1 Full consistency of tax treatment between life assurance and other products could probably be achieved only if the investment return on life policies bore the same amount of tax, at the same time, as would be due from the policy holder in question on a similar investment return from direct investment, or from investment through other institutions. In a system of annual taxation at progressive rates, this in turn would require the investment return to be taxed as it arose whether or not it was withdrawn in cash; and the return on each particular policy to be taxed at rates determined by reference to the relevant policy holder's total income and/or taxable capital gains for the year.

8.2 As already indicated in the discussion at Chapter 3 this approach would be likely to run into acute conceptual and operational difficulties. There is - at least in the case of policies which are not investment-linked - no right way of computing the income, expenses and realised capital gains accruing to any particular continuing policy in a given year. It might be possible to develop some rough overall measure of the year-by-year investment return: for example the increase in the surrender value of a policy over the course of the year, less the premiums paid during the year, sets a lower bound (if often an unrealistically low one from a tax standpoint) to the roll-up accruing to a continuing policy. Even then, a tax charge on the undifferentiated accruing investment return would at best only approximate to the income tax on income received, and the capital gains tax on capital gains realised, which might be payable in any particular case from a similar flow of investment in another form.

8.3 However these technical and conceptual problems were tackled, a system of universal annual imputation to policy holders would certainly be complex; impose significant operational and compliance costs on offices, policy holders and the Revenue; and give rise to difficult transitional problems. In short it offers no prospect of an improvement in performance sufficient to outweigh these disadvantages.

8.4 Alternatively tax might be charged only on the surrender, claim or maturity of all policies (and not just those currently subject to an exit charge). This would similarly have to be applied without distinguishing between the income and gains elements in the net proceeds received by the policy holder. The charge would not reflect the differing rates that might otherwise have applied to the underlying income and gains, and the rate would have to be adjusted to take account of the tax free roll-up of income and gains and of the tax deferral. Such a system would be costly to administer and would involve a substantial loss to the Exchequer for many years.

Investment linked business

8.5 Chapter 3 also suggests however that the balance for option A might be more favourable in the case of investment-linked policies. Because of their close competition, it is there that neutrality between life assurance and other investment is most important. And it is there that the current regime is most clearly perceived by potential customers as biased against life assurance.

8.6 The terms of an investment-linked policy make clear what units stand allocated to the policy; exactly what income and gains accruing to the linked assets are to be reflected in the policy benefits; and what deductions are to be made from the policy benefits on account of expenses and death benefits. The overall effect is therefore substantially equivalent to direct investment in an authorised unit trust. Accordingly, the tax regime for linked policies could be modified to provide broad parity with unit trust investment. The income of each linked fund would be taxed as if it were an authorised unit trust, with an appropriate tax credit for the policy holder, who would pay income tax year by year at the appropriate marginal rate on the income attributed to him or her for the year. An exemption analogous to that for authorised unit trusts would be available for gains realised on linked assets: policy holders would be liable to CGT on any realisation of their interest in the policy.

8.7 More detailed points for consideration include the treatment of

- recurrent management charges. The authorised unit trust analogy suggests that these should be deductible for tax purposes from fund income. Charges made by cancelling units already allocated might cause complications;

- mortality charges. There would be a case for separating out these charges for which there would be no deduction from income or gains, the corollary being that any benefits resulting from such charges would not be taxable in the hands of the policy holder. In principle, any unit cancellations to fund the charges should be treated as realisations for CGT purposes.

- switches between funds. An analogous switch between unit trust investments would be treated as a realisation and reinvestment for CGT purposes. Rules would be needed to cater for a switch from a linked fund onto, for example, a "unitised with profits" basis.

8.8 The life office would *mutatis mutandis* be taxed in broadly the same way as the managers of other collective investment vehicles. Charges made by the office (including, for example, the bid/offer spread on new allocations) would be treated as trading receipts of the office. Expenses of the office in acquiring new business and managing existing business would be deductible. All these detailed issues would add some complications to the basic scheme, but it seems unlikely that satisfactory solutions could not be found.

8.9 The advantages of this line of approach would be that

- the effective tax burden on life and other products would be more closely aligned, so answering the current complaints of the industry that the present rules may make their products unattractive for some prospective purchasers;

- the system would reduce tax-induced distortions of behaviour, secure fairer competition between financial products and institutions, and protect the Exchequer against the erosion of tax yield which may flow from tax disparities between life and other products;

- the rules would be more adaptable to future changes in the tax system since an important class of life policies would be subject to the same rules as other forms of saving;

- the system would go with the grain of Government policy for financial services, by offering a more predictable tax treatment for the life policies affected and one more clearly consistent with that for broadly equivalent competitor products; and

- the new approach would be both more effective and more intelligible than the current rules for qualifying policies and chargeable events which would no longer need to be applied to linked policies.

8.10 The disadvantages would be that:

- the change would involve new compliance tasks for offices in accounting for tax on their internal funds, and in passing tax return information to their policy holders year by year; and for those policy holders liable to tax in excess of the credit available (or seeking payment of credit) there would be corresponding tax assessing work for the Revenue.

- it might be argued that it would be objectionable to require tax at the higher rate during the term of a policy, when the policy holder might have no right to withdraw cash from the policy to meet the liability, or be able to do so only on unattractive terms; and

- more significantly, authorised unit trust treatment would secure greater consistency of tax treatment between linked-life policies and other sorts of investment only at the expense of introducing some new inconsistency of treatment between linked-life and other life products. Just as investment bonds are close substitutes for lump sum unit trust investments, some linked policies - for example, the long-term regular premium policies specially designed to partner endowment mortgages - compete closely with conventional with-profits policies.

8.11 Transition. Also for consideration would be the application of a changed treatment to linked policies already in force. It would probably be undesirable to keep two regimes running side-by-side for similar policies for what might be an extended period. A change in tax treatment need not be offensive in principle so long as it applied on a strictly prospective basis only to future income and gains.

8.12 It would however be difficult technically and operationally to effect a clean transition for existing business, on this strictly prospective basis, without at the same time allowing substantial contingent liabilities accrued under the current regime to fall out of charge. Moreover, particular problem cases, such as policies which have already been subject to part surrenders within the current chargeable events regime, would raise special complications. And the objection that some policy holders would have higher rate tax to pay before receiving any policy benefits would have real weight in the case of policies already in force, and might in extreme cases cause genuine and unexpected difficulties. On the other hand, applying unit trust treatment only to new policies might cause problems if it were desired to link both old and new policies to the same internal fund.

Questions for consideration

8.13 Taxing policy holders directly on the investment return on their policies as it builds up has to be ruled out. But it would be feasible to apply to investment-linked policies the current tax treatment of authorised unit trusts. This would however be at the cost of introducing a new discontinuity between the tax treatment of linked-life and traditional life policies. Furthermore, transitional difficulties would be created by a decision either to run the present system for existing policies alongside a unit trust type system for new policies or to adapt the present regime for existing policies to the new one. The question to be answered therefore is whether ways can be found of resolving these problems, or at least mitigating their impact, so that they do not outweigh the real advantages which could be gained from this option.

B. AN ACTUARIAL APPROACH TO THE TAXATION OF CORPORATE PROFITS AND THE INVESTMENT RETURN TO POLICY HOLDERS

9.1 If it is indeed not in general feasible to tax the investment return from life assurance at the level of the individual policy holder, tax on policy holders' returns must continue to be collected, entirely or in large part, through a charge at the level of the life office (the extent depending on the future of the exit charge to be discussed in Chapter 11).

9.2 This chapter looks at the implications of tackling the task by adopting the reverse approach to the current regime. That is to say, it sets out to devise a tax regime specifically for life assurance, resting on the concepts and measures which the industry itself uses in the build-up of obligations to policy holders and the profits of the office, rather than as at present starting with the rules of the wider tax regime and attempting to fit them to life assurance. The aim would be to meet as many of the requirements in Chapter 4 as possible.

9.3 The general approach would entail two separate tax charges, so that:

- the aggregate investment return to the policy holders' fund would be taxed separately, as a substitute for personal tax calculated policy by policy; and

- the life office would be taxed on its profits, calculated on broadly commercial lines, at corporation tax rates and subject to the imputation machinery.

9.4 A major disadvantage of the current tax base is that it does not reliably reflect the build up of policy holders' returns. An alternative starting point would be a life office's own accounts and statutory returns. The life office's assessment of its obligations to policy holders is expressed in its mathematical reserves. These measure that part of the life office's assets to be regarded as committed to meet liabilities to policy holders. These liabilities are calculated on an actuarial basis as (broadly speaking) the difference between the present value of the ultimate benefit to policy holders, less the present value of future premiums. The mathematical reserves are calculated at annual rests, on an actuarial basis not less strong than is specified by Regulation.

9.5 From one year-end to the next, the office has to provide for

- the increase in mathematical reserves (that is, in liabilities) in respect of continuing policies

- the establishment of an initial mathematical reserve in respect of new policies

- the expenses of the business, and

- the cash actually paid out on claims or maturities and surrenders.

The office has to finance this out of

- premiums paid

- investment income, investment appreciation or other profits accruing to the office and earmarked for policy holders

- reserves of past investment appreciation or capital introduced by shareholders, or

- reserves released in respect of policies that become claims, maturities or are surrendered.

9.6 It follows that the income and gains representing the policy holders' return on their premiums in any given year can effectively be measured by

- the closing mathematical reserves (including reserves in respect of profits allocated to policy holders out of that year's surplus)

- less : the opening mathematical reserves

- less : premiums receivable

- plus : claims, maturities and surrenders payable.

9.7 This measure could form the tax base for the purposes of a charge on the policy holders' return (excluding pension policy holders): for convenience hereafter called "Schedule X".

Basis of calculation of Schedule X

9.8 Schedule X could be calculated on either a global or a policy-by-policy basis: each would have advantages and disadvantages. For a single new policy in its first year, the Schedule X base would be equal to the closing mathematical reserve on the policy, less the first year's premium. Depending on the characteristics of the policy and the office's valuation basis, the Schedule X calculation could produce a negative figure because of the incidence of initial expenses. If the Schedule X base were calculated on a global basis, these negative figures would go to depress the tax otherwise due in respect of existing policies showing a positive Schedule X base. This would introduce a degree of tax deferral on account of new business analogous to that arising under the present regime from the immediate sideways relief for initial expenses of management.

9.9 This effect could be avoided if the Schedule X base were calculated individually policy by policy, with negative values available for carry-forward and set-off against positive Schedule X values for the policy in later years. In this way, no tax would be due in respect of any particular policy until the build-up of reserves reflected a positive net investment return on the policy. This approach would however generally give early relief for the full acquisition costs of the policy, which is generous - on the arguments in Chapter 6 - by comparison with the deferred, and possibly limited, relief available for acquisition costs of other investment products. But it would at least eliminate the tax deferral arising under the existing regime from sideways relief.

9.10 In practice, a separate computation for each policy is likely to be unacceptably cumbersome. It might be possible to reduce compliance costs by dividing policies into broad classes by duration in force and type of policy, calculating an aggregate Schedule X base for each class, but allowing no set-off by way of sideways relief for negative Schedule X values between classes.

Discussion

9.11 The advantages of Schedule X would include the following:

- The charge in any year in respect of a particular policy or group of policies would reflect the development of the relationship of the office with its policy holder(s) as it appears in the office's own books. Unlike the current ***I minus E*** basis, the liability would not be affected by:

    - the office's record in attracting new business (and hence new initial *E*);

    - its cash flow position and hence its ability to defer the realisation of chargeable capital gain.

- Because tax liabilities would accordingly reflect more closely actual investment performance, the charge might be thought fairer as between offices and as between policy holders.

- Many of the technical and computational complexities and uncertainties of the current regime would be eliminated or eased. The charge itself would be based on accounting and actuarial processes and results already required for other purposes. It would identify the investment return to policy holders by measuring the growth of the office's liabilities less the net cash inflow on policy holders' account. As an accounting identity this measure ought to match the total net profits, income and gains accruing to policy holders. It would no longer be necessary to compute, and allocate between policy holders and shareholders, each individual component of income, profit, and gain and their respective expenses separately as under the current regime.

- Schedule X would thus automatically collect tax on an appropriate share of pension and annuity profits and miscellaneous income where these go to benefit with-profits policy holders. If these profits were available to support a faster rate of bonus addition than would otherwise be possible, this would be reflected in a faster growth of the office's mathematical reserves, a larger Schedule X base, and more Schedule X tax. No separate calculation would be necessary.

- The possibility of an artificial spillover of pension/annuity management expenses would be removed. The Schedule X base would effectively reflect the expenses actually borne by the ordinary life policy holders. Again, no explicit allocation of expenses would be required.

- If calculated on gross liabilities to policy holders (that is, without deduction for liabilities reassured, and without regard to reassurance liabilities to cedants) the charge ought to avoid the distortions arising from outward reassurance and commission buying arrangements. Similarly, it would not be affected by the use of unit trusts to shelter capital gains arising from portfolio switches.

- It could dovetail with a reformed Case I charge on the lines to be discussed below.

9.12 There would however be significant disadvantages which are in many ways the natural counterparts of the possible advantages, so that:

- because the Schedule X charge would be specially designed for the characteristics of life assurance, it would tend not to be consistent with the wider tax system as it applies to other investments;

- because it would be charged at the level of the life office it would take no account of the personal circumstances of the individual policy holder;

- moreover, because the charge would be based on the measure of undifferentiated investment return it would operate on the investment appreciation recognised by the office and accordingly fail to reflect fully the CGT rules applicable to individual investors (for example a charge on realisation only, the indexation allowance and exemption for some gains);

- similarly, because of the absence of differentiation of the components of the investment

return, it would take no account of income already subjected to foreign tax or of the availability of capital allowances in certain circumstances;

- it might encourage behavioural changes by offices with possible adverse implications for the prudential supervision of the industry; for example in the extent to which investment gains (whether accrued or realised) are brought to account and reflected in mathematical reserves (with implications for the balance between reversionary and terminal bonuses and the need for mismatching reserves). On the other hand, competitive pressures and the interaction with Case I would tend to counterbalance such potential behavioural changes.

Devising adjustments for tax purposes to the investment return in life office revenue accounts to meet these disadvantages would significantly complicate the calculation of the charge.

9.13 The transitional arrangements for a change to the Schedule X basis for policies then in force would entail the establishment of an opening figure for the mathematical reserve. The Schedule X charge could then be calculated in an entirely prospective manner on the basis of premiums receivable, claims payable and additions to the reserve from that point on. Decisions would be needed however on, for example, the treatment of

- unallocated surplus (if any) at the time of the change over

- past realised capital gains, to the extent not recognised in the life revenue account up to the change over

- unrealised capital gains up to the date of the change over,and

- unrelieved management expenses at that date

Rate of charge to Schedule X

9.14 Separate tax bases for the corporate profits of the office and for the investment return accruing to policy holders would enable the tax rate for the latter to be untied from the CT rate. No single rate could be exactly right for all policies and policy holders. Nor would it be possible to compute a rate which would be verifiably right in the aggregate, as it is for example in the very much more straightforward case of the composite rate on deposit account interest. Where the rate should be set would be a matter of judgment in the light of the detailed specification of the Schedule X base; other relevant features of the life assurance package (such as the future role of the exit charge at the higher rate in Chapter 11); tax rates in the wider regime; and trends in inflation and in the mix of life assurance investment returns. In current circumstances the rate might fall somewhere in the range from the basic income tax rate of 25 per cent to around 15 per cent, to reflect the contribution of nominal investment appreciation, as well as interest income, to the Schedule X base. Where the rate might be fixed in this band would depend on whether adjustments to the Schedule X base were made to cater for all, or some, of the factors at paragraph 9.12.

Corporation tax on life office profits

9.15 The taxation of the profits of life offices is conveniently discussed as the second leg of Option B since:

- a Case I charge would be needed to complement Schedule X which would tax only the policy holders' interest in the business;

- Schedule X has been designed to fit with a Case I charge on life office profits;

- life office profits are necessarily based on an actuarial assessment of the state of the office's affairs, and so rest on the same actuarial concepts and measures discussed in the Schedule X context.

9.16 The question of a Case I charge arises, however, whatever approach is adopted to tax on policy holders' returns. The basis of charge discussed below is valid whether or not it is accompanied by Schedule X. And the issues and problems identified at paragraph 9.20 below, plus others which the Case I/Schedule X pairing is designed to avoid, will still need to be addressed however policy holders' returns are taxed.

9.17 A Case I charge would be designed to impose corporation tax on the office's Case I profits from operating the life assurance business, including any profits from pension and general annuity business. The Case I and Schedule X charges would have to dovetail so that:

- as a protection to offices and their policy holders there would be no double taxation of life assurance. The Case I tax base should therefore exclude any income, profit or gain appropriated to policy holders and taxable as such (and also exclude the tax itself);

- as a protection to the Exchequer, nothing would fall out of tax altogether. The Case I base should include any taxable profits, income or gains not falling within the policy holders' base, or the tax on it.

9.18 These objectives might be met by taking as the starting point the surplus for the year shown in the statutory return. The tax charge would thus be based on the premiums, investment income and investment gains shown in the life revenue account, less claims and surrenders, increases in mathematical reserves (including allocated bonuses) and expenses. Adjustments would be needed:

- to certain figures on ordinary Case I principles;

- to tax profits not included as receipts in the revenue account and;

- to allow as a deduction the Schedule X tax for the year.

The Case I profit produced by this calculation would in a simple case be broadly equivalent to the surplus allocated to shareholders in the life office's accounts plus the unallocated surplus shown in the statutory return.

9.19 All the items which would be positive in the calculations of the Schedule X base, and also the Schedule X tax chargeable on that base, would appear as deductions in the calculation of the Case I base. Similarly, the items which would be negative in the calculation of Schedule X would be positive for Case I purposes. Thus the two bases taken together should avoid double taxation, but achieve full single taxation. Added together the two new bases would bring into charge investment income, "recognised" gains, and other profits less expenses, thus broadly duplicating the current charge on *I minus E* and capital gains.

9.20 The following issues would have to be addressed:

- The need to bring into charge miscellaneous profits (e.g. underwriting commissions) taken to investment reserve or similar accounts; and the need to analyse the transfers from investment reserve to life revenue account.

- The possible distortion for non-linked business caused by the difference between investment appreciation recognised by the office in its accounts and the basis for charging capital gains.

The Case I deduction for liabilities ought to reflect a consistent approach to the investment appreciation which funds those liabilities. For linked business the liabilities of the office already reflect the full appreciation to date of the linked assets (less a deduction for any actual or contingent tax liability of the office on the potential gain) so that a consistent approach should be easier to sustain.

- The treatment of any unallocated surplus carried forward in the life revenue account. Because by definition it is not needed to secure liabilities it would not seem logical automatically to deduct it from the office's taxable profits. Taxing it under Case I would be to treat it in the same way as undistributed profit of other corporate traders. If and when allocated, say to with-profits policy holders, the surplus would increase liabilities and thereby be included as a Case I deduction for the year of allocation. An allocated surplus would be allocated to policy holders by way of bonus (and therefore deductible under Case I as an office liability) or to shareholders (and thus properly taxable Case I).

- A deduction would be permitted both for the actual expenses (including the initial cost of acquiring new business) and for the full addition to actuarial reserves (including the element of expense loading in respect of new policies). Using a zillmerised valuation basis (see glossary) might help offset this effect. The zillmerised basis would however have the opposite effect on the Schedule X base for new business.

Questions for consideration

9.21 It is theoretically possible to specify separate tax bases for life assurance corporate profits and for the investment return to policy holders. Those bases would rest on actuarial concepts which are mutually consistent as well as consistent with the way life offices conduct their business and measure their state of affairs. A straightforward implementation of this approach, by sticking closely to the figures in life office accounts and statutory returns, would however fail to meet some of the requirements at Chapter 4, particularly those seeking parity of treatment with other financial institutions and their customers. This raises the questions

- whether the required neutrality could be achieved in arriving at the overall tax rate on policy holder returns; or

- whether instead the tax base for policy holders could be adjusted to produce a more equitable incidence of tax without introducing intolerable complexity.

9.22 If one or other of these approaches seemed feasible, further questions would then arise for example whether

- a tax charge based on actuarial measures would have undesirable behavioural implications, and if so whether and how they might be controlled or mitigated; and

- the transition to a new charge could be achieved in a way fair to all parties and manageable in legislative and operational terms.

9.23 The final question would then be whether on balance the approach in this chapter offers sufficient advantage over the alternative of a programme of reform to the existing regime to justify its introduction. The possibility of applying these special rules to non-linked policies only (as discussed in Chapter 8) should of course be borne in mind.

C. REFORM OF THE PRESENT SYSTEM

10.1 The alternative to a radical new tax regime involving the introduction of Schedule X would be to follow the existing regime by taxing policy holders' investment returns at the level of the office, through a charge based on ***I minus E***.

10.2 Tax on shareholders might also be collected as at present through the ***I minus E*** base; or alternatively a separate charge on corporate profits, calculated on Case I lines, might be introduced to run alongside the ***I minus E*** base. This option and the future of the current ***notional Case I*** provisions are discussed at paragraph 10.39 below.

"I minus E"

10.3 Discussion of the present system has indicated two central issues to be tackled here if the objectives at Chapter 4 are to be met:

- first: the corrections needed to remove the various weaknesses and uncertainties in the current regime, to enable the base to reflect more accurately the full measure of ***I minus E***;

- secondly: the further adjustments to the ***I minus E*** base, and perhaps to the tax rates to be applied which would be needed to achieve a more level playing field as between life assurance and other products and institutions, and a tax yield consistent with the size of the sector.

Technical reforms

10.4 Some of the measures discussed below do no more than codify existing practice; clarify points of obscurity in the current law; or reflect the Revenue's interpretation of current law where it is in dispute. The fact that such matters are discussed as candidates for legislative action is entirely without prejudice to the Revenue's position under the current law. There would be advantage for the future in setting out explicitly what rules are to apply, even if that were to do no more than confirm a Revenue position which might well be sustained in litigation under current law.

Scope of "I minus E"

10.5 Measures to ensure that the scope of the ***I minus E*** charge corresponds to the actual extent of the taxable life assurance business would be an essential component of any reform package. This would rule out, for example, artificially increased expenses or misallocations of income and gains arising from the current apportionment formulae. The present approach, which starts from the undivided income, gains and expenses of the whole long-term business, follows the fact that (as a rule) long-term assets, and the return on them, are not legally hypothecated to particular lines of business. This is reflected in the way some offices conduct their business; other offices, however, in practice operate on the footing that particular assets are referable to particular areas of business. In the extreme, if for example solvency were in question, all assets would be available in support of any liabilities.

10.6 It has been suggested that, notwithstanding the absence of strict legal hypothecation, offices should be given the opportunity to identify the assets, income, gains and expenses attributable to particular types of business and the appropriate tax treatment would then be applied to each business separately. Ancillary provisions would be needed to deal, for example, with transfers of assets from one line of business to another: a transfer from the taxable life business to the tax-exempt pension business would count as a disposal and a transfer the other way would establish a base cost at the value on the date of transfer (rather than the original acquisition cost or 1982 value) for the purposes of any charge on subsequent disposal.

10.7 This approach would remove some of the anomalies arising out of the current rules, and would align the tax regime with the way offices actually conduct their affairs. That might both simplify and improve the system from the industry's viewpoint. In considering asset disposals, for example, gains on a particular asset would, on this approach, either be fully taxable, or fully exempt (if allocated to pension business) rather than, as at present, a mixture of the two for tax purposes. It is for consideration in this review whether this approach could be developed into a workable regime, and whether it could, or need, be made to apply to all offices.

Pension and annuity business

10.8 Even if this change were made, it would still be necessary to arrive for tax purposes at a measure of pension and annuity profits reasonably in line with the underlying commercial facts. That would involve, first of all, eliminating timing differences between the recognition of investment appreciation for tax purposes and the corresponding tax deductions for liabilities, bonuses and claims which reflect such appreciation.

10.9 The amounts deductible on account of pension and annuity obligations would also have to be restricted to a level consistent with the office's liabilities, thus precluding any increase by way of further reservations for tax purposes only.

Components of the "I minus E" base

10.10 Given an initial ground-clearing along these lines, the remaining technical issues in the taxation of life business proper can be considered by reference to the components of the *I minus E* base.

(i) Income

10.11 Following the introduction of the accrued income scheme, the current treatment of life office income has become relatively straightforward. Two remaining difficulties would however need resolving. Chapter 6 mentioned the effect on the *I minus E* base of reassurance ceded to overseas reassurers. It is a central feature of the current regime that investment returns ultimately paid out to UK taxpayers are derived from the "taxed fund" of offices taxable in the United Kingdom. That is not the case to the extent that investment returns arise in the hands of overseas reassurers and are received by UK offices in the form of reassurance recoveries, which are not recognised in the *I minus E* base. The most practicable remedy might be to gross up income and gains chargeable on the UK office in proportion to the relationship between the office's gross liabilities on direct assurance business and the corresponding net liabilities after reassurance.

10.12 On the second difficulty, the current legislation provides for certain miscellaneous sources of income ("fines, fees or profits from reversions") to be included in the *I minus E* base by reducing the expenses otherwise allowable. Some significant additional sources of income (such as underwriting commissions and fees from stock lending to securities dealers) are, however, not included in the *I minus E* base. These may be taxable on normal Case I principles in some circumstances, but it might be preferable to amend the legislation to include them in the tax base in all circumstances.

(ii) Capital gains

10.13 Chapter 6 noted that life offices can effectively realise and reinvest their assets without giving rise to a charge on any capital gains, by holding their portfolio at one remove in a captive unit trust. So long as the trust satisfies the normal rules for an authorised unit trust it is exempt from tax on realisations of gain within the trust. Moreover, so long as the office can avoid net disinvestment from the trust - which it may well be able to do indefinitely - it too will pay no tax on gains.

10.14 The current transparent treatment of authorised unit trusts is of course designed to allow small investors to obtain the benefits of an adequately spread portfolio and professional investment management without being exposed to two tiers of charge to tax on gains. These considerations are not relevant to a life office. Offices are themselves professional investment managers, and in the case of a captive trust within their own group of companies, effectively retain the management of the portfolio. Offices can achieve an adequately spread portfolio by investing directly without recourse to captive unit trusts; and no double charge to tax on gains would generally arise.

10.15 The peculiar problems within the *I minus E* regime for both offices and the Exchequer caused by the taxation of the capital gains of life offices are considered at paragraph 10.29 below. But it is desirable as a starting point to ensure consistency of treatment for all life office assets and to prevent some offices enjoying an extra degree of tax deferral by interposing a collective investment vehicle between themselves and their assets in a way not available to all assets of all offices. This could be achieved by amending the tax base so as to look through unit trust holdings of life offices and impute to the office a rateable share of the capital gains accruing to the trust. Unit trust holdings associated with linked policies would not of course be affected by such a change if they were charged directly on policy holders as discussed in Chapter 8.

(iii) Expenses

10.16 Whatever the merits of the current immediate relief for the costs of acquiring direct assurance business (as discussed in Chapter 6) it is inappropriate to give similar treatment to reassurance commissions which are in substance little more than book entries. This points to a change in the tax base so as to disregard all reassurance commissions paid or received. It would then be immaterial for tax purposes whether reassurance was written on commission-paying terms or not.

10.17 Similar issues arise in relation to commissions on direct life assurance business. Under certain practices commissions may be received by a proposer; for example, where an agent arranges cover for himself and receives "own commission". Or the commissions may be passed back, in whole or part, by an intermediary; for example, by obtaining for the proposer a higher sum assured, or unit allocation, than would otherwise be available for the same gross premium. The implications of these practices are discussed in more detail at Annex D.

Revised tax base

10.18 Action on the issues set out above would go some way toward meeting the objectives in Chapter 4. But it would still leave two fundamental problems. One of these is that, so far as most policy holders are concerned, the tax rates imposed by the present charge compare unfavourably with the rates, allowances and exemptions available to them as direct investors, certainly in terms of the tax reserved by life offices, if not necessarily that actually paid.

10.19 On the other hand, in contrast to direct investment elsewhere, the timing of the charge on the life office would still be deferred and the base reduced absolutely to the extent that

- immediate relief remained available for acquisition costs; and
- realisation of the capital gains of life offices could still be deferred beyond the point at which corresponding policy benefits were paid out.

10.20 Since these two considerations pull in opposite directions, neither ought properly to be considered in isolation. The aim of any reform should be to produce a broadly balanced package although it may have to rest more on judgement than on precise calculation. In striking the balance, it would be necessary to take account of all the components of the package; for example,

whether a separate regime applied to linked policies and the impact of any additional charge at the level of the policy holder on the lines to be discussed at Chapter 11 below.

Relief for expenses

10.21 As already observed (in paragraph 6.8) the tax regimes for other forms of investment, whether collective or direct, do not permit the initial costs of acquiring an investment to be set against the income arising from it. Still less is any excess of acquisition costs over the early years' income available for relief against the income of other investors in the case of collective investment other than life assurance. Some initial costs may however be deductible for capital gains tax purposes when the investment is eventually realised.

10.22 Because of the nature of life assurance, in particular the impossibility (investment-linked business excepted) of allocating specific amounts of income and gains to individual policies, absolute parity with the tax treatment of direct investment, or of other collective investment media, cannot be achieved. There are however several ways in which the present tax regime could be modified to achieve closer parity with that applying to other forms of investment.

10.23 One option would be to allow no relief for life assurance initial costs. This would be straightforward, minimise compliance costs, and leave little scope for tax-induced distortions of behaviour. It would be more consistent than the current rules with the treatment of other forms of personal investment given that relief for initial costs against tax on personal gains is deferred even where it is available. But denying relief altogether would be harsher than the wider tax regime in some circumstances, and that would be a factor in considering the overall balance of any reform. A variant of this approach would be to allow relief against the income and gains of the taxed fund for only a percentage of initial costs, so as to reduce, but not eliminate altogether, the extent of the relief.

10.24 Another possible approach would be to spread relief for acquisition costs over a prescribed period determined by average policy duration. This approach would preserve the overall quantum of relief, but would have the broad effect of reducing or eliminating the current mismatch between the initial costs of new business and the investment yield generated by that business. Calculation of the length of period appropriate in any particular case would however be extremely difficult, particularly where the life office wrote a number of types of business with widely differing characteristics.

10.25 Deferral of relief for initial costs for a similar period would achieve a degree of parity with other forms of investment. The timing would be more consistent with the way in which relief is given for various costs in the case of other forms of investment. The degree of consistency would however depend on the sophistication and thus complication of the calculation of the period of deferral, and on the extent of its application (for example to regular premium policies only or across the board). A much greater degree of consistency could be achieved by giving relief for the costs associated with any particular policy only in the year of maturity, claim, surrender or lapse. There would however be technical problems and operational costs in allocating expenses to individual policies and in maintaining the necessary records.

10.26 A rather different approach would be to allow relief for initial costs only against the life offices' realised gains. This approach would avoid the complications and compliance costs of the options discussed in the previous paragraphs and would be superficially consistent with the tax treatment of the initial costs of other forms of investment. It would however still allow relief for the expenses of new business against capital gains referable to old business. It might also have behavioural implications for the composition of investment portfolios and the rate of asset turnover.

10.27 The options set out in the preceding paragraphs raise a number of questions. The first is whether the identification of acquisition costs which has already to be made for regulatory purposes could be adopted for tax purposes without an unacceptable risk of distortion of the reported results either for tax or regulatory purposes, or whether it would be more appropriate to establish a free-standing measure of initial costs for tax purposes. Secondly, consideration would also need to be given to possible changes in the current balance between initial and renewal commissions. Accurate identification of the expenses refeable to different types of business (eg pension business and long term business other than life assurance) would be necessary not only for the options discussed here but also in order to correct the misallocation of pension business expenses referred to in paragraph 6.27 above.

10.28 The choice between the options discussed here may depend partly on decisions to be taken on other aspects of the reform and may in turn affect those decisions. The overall judgement to be made, after taking into account the interaction with other possible changes, is whether the more complex options offer a sufficient advantage over the simpler options (no relief, or relief for only a proportion of initial costs) to justify their technical, compliance cost and behavioural implications.

Capital gains

10.29 So far as capital gains are concerned, action on unit trusts along the lines discussed in paragraph 10.15 would curtail the present scope for deferment of charge to some degree, and limiting relief for initial expenses would mean that more of the gains which were realised would come into charge. Even without recourse to unit trusts, however, life offices would in many cases still be able to defer realisation of capital gains. In these circumstances, a relatively high rate of tax on life office gains compared with effective CGT rates applying to personal sector gains would be needed to raise an Exchequer yield commensurate with that on other investments. That in turn would mean that offices would still have to reserve (expressly or implicitly) against future tax on gains at a relatively high rate; and that accordingly many policy holders might still perceive a tax burden on life policies out of line with that of competing investments.

10.30 Following the 1988 Budget, offices will have to provide for tax on real capital gains only and they will in most cases be among the major beneficiaries of the proposal to re-base the charge to 1982. This ought to allow existing reserves to be released. Particularly if investment-linked policies were to be given separate treatment (as discussed in Chapter 8) a charge on life office gains broadly along current lines might be acceptable for the balance of policies.

10.31 If not, however, a number of other approaches could be considered. One would be to tax life office capital gains in step with the investment appreciation brought to account in life office revenue accounts, thus putting the charge on a basis consistent with the way offices themselves deal with appreciation. This would obtain for the Exchequer a more dependable, and probably in most years a significantly larger, tax base for life office gains, and this in turn might justify a lower tax rate than at present. For life offices, it would offer the prospect of keeping up to date with their tax on gains without the need to provide against contingent liabilities which are inevitably uncertain in timing and amount. Moreover, a lower rate of tax would also offer the prospect of a more attractive tax treatment than at present from the customer's viewpoint, and one more consistent with that for other products.

10.32 This approach would, however, raise in the case of non-linked policies a number of the difficulties discussed at paragraph 9.12 in the context of Schedule X: how far could the figure for "investment appreciation brought to account" as it appears in life office accounts be married up with particular tranches of gain on particular assets and their respective tax allowances and exemptions? It would also be subject to the same concern about the behavioural implications of a charge tied to "recognition" of gain, and hence to actuarial policies rather than actual transactions.

10.33 Another possible course might be to move all the way to an accruals basis of charge on life office gains, so that they would be taxable each year by reference to the year's growth in the market value of life fund assets whether realised or not. A recognition basis of charge gives this

result in the case of linked business in any event. An accruals basis is not a practical proposition for taxpayers generally, partly because of the compliance burden of regular revaluation of unrealised assets, and partly because taxpayers may have no funds available to pay tax if their assets remain unrealised. It may be more feasible in the case of life assurance, however. Annual valuation of assets at market value is required for regulatory purposes and life offices have funds available from premiums, investment income and liquid investments to cover any tax due on unrealised gains. Since the starting point would be the appreciation of every asset, it would on the face of it seem straightforward enough to separate out tax-exempt assets and allow the appropriate indexation allowances.

10.34 The consequence however would be a significant acceleration in the timing of the charge on gains compared with that applying elsewhere, although offset by a correspondingly immediate recognition for tax purposes of unrealised capital losses. The balance might appropriately be reflected in a further abatement of the tax rate.

10.35 Under all these approaches, whether offices were taxed by reference to realisation, recognition, or accrual, all policy holders would effectively bear some tax on any real capital gains earned for them, and the same effective rate of charge would fall on all holders of comparable policies irrespective of their personal tax circumstances (except for the limited differentiation introduced by the chargeable events regime). Some unavoidable inconsistency would therefore remain with the effective incidence of CGT at the personal level, particularly following the 1988 Budget proposal which envisages taxing gains at income tax rates as if they formed the marginal slice of income.

10.36 A quite different approach to the taxation of life office capital gains has been suggested in the past as an attempt to resolve this problem. They would be exempt at the level of the office, so far as they are allocable to policy holders, on the argument that this would be the right result for the majority of policy holders who could manage their disposals so as to keep their own chargeable gains below the annual exempt amount. Tax from the minority whose personal tax circumstances make a charge on gains appropriate would be recovered by way of an exit charge at the level of the policy holder. It is clear that the current exit charge would be inadequate for this task, both because it has no application at all to the majority of life policies and the greater part of the accruing capital gain; and partly because where it does apply, it is a rather poor approximation to the CGT charge on personal gains.

10.37 The design of a more effective exit charge raises in a somewhat less acute form the conceptual and operational problems discussed at paragraphs 8.2 and 8.3 in the context of a charge entirely at policy holder level. These are, first, how to identify a part of the total ultimate proceeds which approximates to the contribution from real capital gains; next, how to tax that as part of the policy holder's total tax bill; and finally, how to achieve a sufficient coverage of policies with a substantial investment content without unacceptable resource costs for all concerned.

10.38 None of these approaches to the taxation of life assurance capital gains is without disadvantages. Any one of them might raise, over time, a broadly appropriate Exchequer yield. Whether there is a case for moving from the current realisation basis of charge would depend on the perceived balance of advantage for industry and for the Revenue, and between on the one hand complexity and operational costs, and on the other the benefit of a closer relationship between the effective incidence of tax on gains as between policy holders and other investors.

***Notional Case I* and corporate profits**

10.39 The second half of this chapter looks at how the tax on shareholders might be collected.

10.40 ***I minus E*** does not distinguish in any fundamental way between the part of the business which belongs to the shareholders, and the part which belongs to policy holders. Tax is sometimes charged on the ***notional Case I*** basis by reference, in theory, to shareholders' profits. There are also provisions which use ***notional Case I*** figures to apportion certain elements of ***I minus E*** between shareholders and policy holders: but these are imperfect (for example, in misallocating gains attributable to linked-policy holders) and do not tackle all the problems that currently arise from the combined tax base for both shareholders and policy holders.

10.41 How could the current regime be adapted to provide a better fit with the wider Corporation and personal tax regimes? Three broad approaches might be considered. The first two could be applied in combination.

(i) Case I as an alternative basis of charge

10.42 If the weaknesses of the current ***I minus E*** base were to be corrected along the lines of the other measures discussed above, a charge on ***notional Case I*** lines might apply significantly less often than has been the case in recent years, and ***notional Case I*** would return to its original role of taxing profits from classes of business yielding no net return to policy holders. That function has been overtaken to some extent by the advance corporation tax rules: a profitable proprietary office cannot, in any event, reduce its tax payments below a certain point without correspondingly reducing dividend distributions to shareholders. An alternative Case I charge might however fulfil a useful role where offices, perhaps part of a wider corporate group, make no, or no substantial, distributions; and, more generally, where significant amounts of surplus are unappropriated. If it were retained, the treatment of unallocated surplus would thus be for consideration. If unallocated surplus were charged, this would raise the question whether in future mutual offices should be subject to a Case I charge on their unallocated surplus. The case for ***notional Case I*** would have to be considered in the light of the other changes discussed in this chapter.

(ii) Reformed apportionment arrangements

10.43 As at present, tax on both shareholders and policy holders would be collected through a single corporation tax charge on ***I minus E*** but with the overall tax base divided into separate shareholders' and policy holders' parts for particular limited purposes. There is scope for improving the apportionment arrangements where they already apply, and for extending them so that, for example, aspects of the Corporation Tax machinery relevant only to the shareholders' interest would not apply to the policy holders' part of the tax base. Points for attention would include changes designed to:

- improve the allocation of gains, particularly gains on linked assets, for the purposes of any differential tax rate on policy holders' and shareholders' gains;
- prevent loss relief or group relief in respect of losses on shareholders' account in other insurance activities or in other group companies being set against the policy holders' share of the tax base;
- prevent the policy holders' share of franked investment income being available to frank distributions to shareholders.

The major technical problem would be to find an appropriate formula on which to base these apportionments and restrictions. This is considered in more detail in the third approach below.

(iii) Parallel charges on I minus E and on corporate profits

10.44 The third approach would be to introduce a parallel charge on corporate profits, alongside ***I minus E***. Two problems would need to be resolved:

- what should be the measure of the shareholders' profit chargeable to corporation tax; and

- how the share of *I minus E* referable to policy holders should be identified so as to fit with this measure of profit, without either overlap or gaps.

10.45 A logical approach to a Case I profit calculable from life office accounts would be (as in Chapter 9 above) the office's actuarial surplus for the year, less allocation of surplus to policy holders plus any other sources of corporate profit not included in surplus. Questions for consideration include:

- what adjustments should be made if unallocated surplus charged to Corporation Tax were subsequently used to fund allocations to policy holders?

- should mutual offices continue to pay no tax on unallocated surplus?

10.46 The more difficult issue then is how the *I minus E* base attributable to policy holders ought to be adjusted to reflect the fact that part of the total income and gains of the office will - in the case of proprietary offices - contribute to profit, and would therefore be charged under Case I. In the case of linked business the income, gains and expenses are readily identifiable, as explained in paragraph 8.6. However, in the case of non-linked business the only information readily available relates to the division of surplus and there is no entirely satisfactory way of working back from this to an imputed division of income and gains.

10.47 One reasonably simple formula for non-linked business would be to calculate the policy holders' proportion of income, gains and expenses by excluding from the total the part represented by the fraction

$$\frac{A}{(A+B)}$$

where

A = surplus not allocated to policy holders,

and B = increase in non-linked liabilities (including bonuses) plus claims and surrenders less premiums.

10.48 A possible alternative would be to calculate the investment return implicit in the actuary's valuation assumptions (which would be allocated to policy holders) and allocate the excess of the actual return over the assumed return in the same proportion as the allocation of surplus.

10.49 If the policy holders' share of *I minus E* could be established along these lines, further questions would include:

- what would be the character of the charge on policy holders? Would it still be Corporation Tax? Or a wholly new charge? If the latter, what would be the basis of assessment, and the dates for payment?

- what would be the implications for existing double taxation treaty provisions?

10.50 A Minimum Tax Charge. One final possibility might be an alternative charge in substitution for *I minus E*, not specifically to tax corporate profits but to put a limit on the scope for tax deferral, and so obtain a minimum level of yield from both proprietary and mutual offices. Whether such a charge would serve any useful purpose would depend on how far other changes along the lines in this chapter were introduced to deal more fundamentally with the scope for tax deferral in the current regime.

Questions for consideration

10.51 This chapter started by considering a range of relatively technical changes for inclusion in a package of reform to the current regime. The first question raised is whether it would be feasible to move from the current rules for apportionment of ordinary business to the designation of the actual assets, income and gains attributable to particular lines of business. If not, more modest technical improvements to the current rules would have to be considered. Effective action on the remaining technical issues would be essential: the question in each case is how exactly this should be implemented.

10.52 However, technical changes of this nature would not by themselves be sufficient and the question then arises what more fundamental changes would be needed to the structure of the *I minus E* charge. Three aspects need to be considered in conjunction

- how the tax base should be widened so that the treatment of initial commissions and other initial costs would be consistent with their treatment in the case of other sorts of investment;

- how capital gains arising in the hands of life offices, and effectively paid out to policy holders, might be taxed so as to address the weaknesses in the present regime both for the Exchequer and for offices and their policy holders; and

- what tax rates would then be appropriate.

10.53 The further questions are then whether a separate Case I charge should be levied on life office profits; if so how it should be specified (and in the light of that, whether it should apply to mutual as well as proprietary offices); and what consequential amendment would then be appropriate to the *I minus E* charge on policy holders. Failing complete separation on these lines there would be a case for detailed amendment to ensure a better fit between the life assurance rules and the wider corporation tax machinery.

10.54 The overall judgment to be made is whether a programme of reform to the current regime along these lines would be preferable to a fresh start on fundamentally different lines as discussed in the previous chapter. Detailed amendment to the current rules is likely to be complex and demanding in legislative terms, with the risk that new difficulties might emerge over time to take the place of the present anomalies and obscurities. The outcome would inevitably produce results rather different, in terms of the effective incidence of tax in particular cases, from those of the wider tax regime for financial products generally.

10.55 On the other hand, there would be advantage in working within the existing basic structure. It would allow known defects in the current regime to be tackled in ways which were broadly predictable in effect; and it would minimise the transitional upheaval, and the risk of unforeseen side effects, which would arise from more radical change.

THE TAX TREATMENT OF POLICY HOLDERS

11.1 This Chapter considers the future of the current exit charge on policy holders on the assumption that the primary charge on income and gains accruing for policy holders will, as at present, be collected from life offices. A rather different approach, whereby capital gains accruing for policy holders would be taxable only at the level of the policy holder, is outlined briefly at paragraph 10.36 and not discussed further here.

The future of the charge

11.2 The current rules were designed to inhibit the use of investment-oriented life policies as a tax shelter by higher rate taxpayers. The Budget proposal to reduce the higher rates of income tax to a single band at 40 per cent somewhat reduces the attractions of such a shelter for taxpayers with the highest incomes; but the proposal to tax personal capital gains at the rates applicable to a marginal slice of income introduces a new incentive for some taxpayers to seek shelter for capital gains.

11.3 If investment-linked policies were treated separately on the lines discussed at Chapter 8, and so taken out of the scope of the current exit charge, that would remove many, but not all, of the policies currently within its scope. That does not necessarily mean that the exit charge would become less important: if it were removed, investment-oriented, but not investment-linked, policies might become sufficiently attractive as a tax-sheltered investment to distort competition and erode the tax yield from investment. On balance, therefore,it seems likely that an exit charge provision will continue to be required: but this is a matter for final decision in the light of the overall package emerging from the review.

The qualification rules

11.4 The present exit charge rules distinguish between qualifying and non-qualifying policies. Qualifying policies have to satisfy a number of conditions. These require for example a minimum term, regular premiums of broadly even amount, and a minimum sum assured on death; and they restrict the options for variations and conversion which can be offered. A payment arising from a qualifying policy is not normally chargeable although it may be if, for example, the policy is surrendered early.

11.5 All non-qualifying policies are within the scope of the exit charge. Very broadly, payments on death, maturity, surrender or assignment amount to a chargeable event to the extent that the payment (or the surrender value immediately before death) exceeds the premiums paid. Payments in the case of part surrender are chargeable to the extent that they exceed 5 per cent a year of premiums paid. This ration can be carried forward to the extent unused in any year. Part surrender proceeds within the 5 per cent ration are included in the final computation on subsequent complete surrender, maturity etc. Although "chargeable", the events are very commonly not in fact charged. Since tax is due only at the excess of the policy holder's marginal tax rate over the basic income tax rate and is subject to a top slicing relief, the liability is in most cases nil. But the "event" has to be identified and in many cases reported by the life office, and the potential charge reviewed by the Revenue.

11.6 When they were first introduced, the rules for qualifying status were designed in part to identify policies eligible for the life assurance premium relief (LAPR). Since this relief is no longer available in respect of new policies, it is appropriate to reconsider

- whether a qualifying/non-qualifying distinction continues to serve any useful purpose (apart from regulating LAPR entitlement for pre-abolition policies);
- if it does, whether the demarcation line needs to be moved, and whether the rules can be simplified or improved, in the light of the other reforms discussed in this document; and, in particular,
- whether the present requirement for prior certification of policies needs to be maintained.

11.7 On the first point, there are arguments both ways. To the extent that the chargeable events rules are designed to do no more than remove a tax shelter for some policy holders, there seems no reason in principle why any class of policies should be outside the scope of the rules. It may be that, under some sorts of policy, chargeable events giving rise to positive liability on the policy holder might never, or very rarely, occur. But that should arguably be established case by case on the basis of the policy terms and the circumstances of the policy holder, rather than achieved by a blanket exclusion.

11.8 It would, on the other hand, be wrong to overstate the case for an exit charge on chargeable events lines on grounds of neutrality. The present charge is (unavoidably) somewhat rough and ready, and the same is likely to be true of any workable replacement for it. This - and the associated compliance and operational costs - may be justifiable in the case of policies most directly in competition with other savings products, and where any significant tax shelter for the life policy form of saving is likely to mean substantial loss of yield and distortion of behaviour.

11.9 It is debatable however whether these arguments apply with such force to the more traditional, regular premium policies where (linked policies aside) competition between life assurance and other forms of saving is less direct, and demand is likely to be less affected by subtle disparities of tax treatment. Given an effective charge at the level of the office, a further tier of charge on exit would yield no further tax in most cases but would still involve significant compliance and operational costs for all concerned. There are, therefore, attractions in keeping a significant proportion of benefits outside the scope of the charge altogether.

11.10 The operational advantages of such an exclusion would have to be weighed against the operational costs of identifying the benefits eligible for exclusion.

A new approach to qualification

11.11 The current qualifying policy rules are complex and troublesome for offices and the Revenue. This largely reflects the original dual role of qualifying status. For the purpose of tax relief on premiums, it was necessary to establish at the outset that a policy was eligible for tax relief, and that it contained no options which might subsequently render it ineligible. Given the natural desire of offices to offer the most attractive and flexible policy terms compatible with eligibility for tax relief, complex and difficult tests were unavoidable. Experience showed that prior certification of policy terms by the Revenue was essential for effective enforcement.

11.12 The present qualifying policy tests will have to be retained for the diminishing number of policies still eligible for LAPR. For the future, however, if it were decided to define a class of payments which are exempt from the exit charge, there should be scope for radical simplification of the current tests, and the associated administrative machinery. In particular, it should be possible to shift the focus of the rules from the characteristics of the policy to the characteristics of payments under the policy. It would not be necessary from the Revenue's standpoint to establish at the outset that a given policy was incapable of generating a payment appropriately subject to the exit charge. It would be sufficient to establish, as and when a payment was actually made, whether the circumstances were then such as to exclude the payment from the scope of the exit charge. Much of the complexity of the current rules might then be dispensed with, together with the requirement for prior Revenue certification of policy terms. The aim would be to establish simple tests to be applied by life offices (subject to Revenue audit) to establish whether any given payment need be reported to the policy holder and the Revenue as potentially liable to the exit charge. At the simplest, the tests might be reduced to four: that

- the payment was made in cash after a specified minimum policy duration;

- the payment reflected the full value of the benefits due to the policy holder and exhausted all rights to further payment;

- regular level premiums had been paid throughout the life of the policy or for some minimum shorter duration;

- the policy had provided for a substantial minimum sum assured in relation to the premiums payable.

The exit charge

11.13 The current chargeable events regime is outlined at paragraph 11.4 above. In the most straightforward case, where the full policy value is withdrawn on a single occasion, the rules are reasonably simple. But they are unavoidably somewhat crude, for two main reasons.

11.14 First the charge has to recover, in arrear, the benefit of a tax-sheltered build up of investment return over a period of years. It is possible in principle to imagine a procedure for spreading back the ultimate policy benefit over the life of the policy, and taxing a part of it by reference to the policy holder's circumstances in each of those years. But it seems clear that any practical implementation of such an approach would be exceptionally complex, at best imperfect at recapturing the true economic benefit of the shelter to the policy holder, and unacceptably burdensome operationally. In many cases, information about the taxpayer's situation over an extended period of years would be unavailable at the time of exit.

11.15 Secondly, the charge has to deal in a reasonably simple way with an undivided cash benefit which reflects a mixture of return of the premiums paid, rolled-up income, and accrued capital gain. The precise degree of tax shelter enjoyed by a taxpayer varies, in theory, according to both the mix of assets underlying the policy and the taxpayer's personal income and capital gains tax position. But, linked policies aside, there is no ready way of even quantifying these factors, let alone designing an exit charge which is sensitive to them.

11.16 The current chargeable events regime tackles these difficulties by treating the policy return (net of premiums paid) as taxable income of the year of receipt, but only for higher rate tax purposes, with the benefit of top-slicing relief. The chargeable return is treated as received net of basic rate tax but is not (as in logic it should be) grossed up for basic rate tax before the charge is calculated. And there is no attempt to claw back the benefit of internal compounding, when the investment return has been subject only to life office tax rates rather than the policy holder's own marginal rates during the life of the policy.

11.17 In theory, the charge could (and occasionally perhaps does) operate more harshly than the equivalent tax burden on comparable direct investment. In practice, it generally errs the other way: a well-advised policy holder can enjoy a degree of tax-shelter during the term of his policy without paying any, or any substantial, tax charge on exit. Typically, the policy holder might plan to pay premiums during years of high earnings (and hence exposure to the higher personal income tax rate) and take the policy benefits at a time of reduced income, say after retirement, when top-slicing would eliminate or greatly reduce any charge.

11.18 Revenue statistics confirm this picture: the latest survey (for 1983-84) showed that only about £10m was collected in respect of some 60,000 chargeable events. This low yield does not of course go to prove that the charge, or a future equivalent, is redundant. The charge is designed as a deterrent to control what might otherwise be a substantial behavioural effect, not just as a direct revenue-raiser.

11.19 It is for consideration whether a future exit charge could improve on this broad structure. Switching linked-life products to the regime described in Chapter 8 above would remove a substantial majority of policies currently within the scope of the chargeable events regime, including possibly those most attractive to the sophisticated investor who would want to exploit the theoretical weaknesses of the current charge. It may be that a charge on the same lines as at present (not fully effective, but at the simple end of the spectrum of possibilities) will remain preferable to anything more complex, or more Draconian, for the balance of unlinked policies remaining within the regime.

11.20 Part surrenders The position is more complex when the policy holder does not withdraw the full policy value. The problem in such part surrender cases is in determining what part of the surrender proceeds is to be treated as a notional return of premiums paid (not taxable) and what part is to be treated as taxable investment return. The present rule is that the initial slice of part surrender proceeds - up to 5 per cent a year of the premiums paid - is treated as a non-taxable return of premium. Any excess over 5 per cent, however large, is taxed as income. Where a large part of the policy value is taken by way of part surrender, the amount charged on this basis can exceed the total investment return over the lifetime of the policy: but this can only be established when the balance of the policy value is subsequently withdrawn. In this event the difference - or "corresponding deficiency" - is treated as reducing the taxpayer's income liable to higher rate tax (if any) in the year of final exit. In practice, this rarely happens. Policy holders exposed to liability on part surrenders are generally careful to keep their withdrawals within the 5 per cent ration. Indeed, a substantial number of single premium policies are marketed exactly on the basis that they offer a 'tax free income' up to this level.

11.21 The results of the present rules are paradoxical. What is functionally an income return (and is promoted by offices as such) is treated in effect as a return of capital, and the ultimate lump sum return as taxable income. But where a policy holder makes a large part surrender, which must in substance include a substantial return of premiums, it is treated as almost all income although possibly offset by a corresponding deficiency later on.

11.22 No regime for part surrenders is likely to produce fully satisfactory results, given the flexibility of modern life policies and the range of possible circumstances. But in the light of experience with the current 5 per cent threshold, and the market's response to it, one possible alternative would be to turn the current approach around. Small surrenders (which would be an income return in any other context) would be subject to an exit charge: a maximum annual surrender for this purpose would be defined as a proportion of premiums paid. Any excess over this limit, including any unused portion from past years, would count as a non-taxable return of premiums, until such point as all premiums had been treated as returned. Any choice of limit would be arbitrary to a degree: 10 per cent would have the merit of simplicity.

11.23 Such an approach would, of course, introduce a new compliance and operational burden at the point of part surrender in the case of small surrenders below the current 5 per cent ration. But this might not be very significant in practice, to the extent that the change removed any tax-based motive for making small part surrenders.

Questions for consideration

11.24 The main questions for consideration arising from this chapter are

- whether an exit charge is needed at all; and if so

- whether all investment returns should be potentially chargeable or (as at present) only those derived from a defined sub-group of policies.

11.25 If the conclusion were that the charge had to be retained, but need not be extended to all

policy benefits, the questions would then be whether there was scope for simplifying the current qualifying policy rules; and if so, what new tests should be applied.

11.26 Following from that, the final question would be how exactly the charge should be calculated, and in particular whether there was scope for improving the current treatment of part surrenders.

INTERNATIONAL ASPECTS

12.1 The document has so far concentrated on business between UK policy holders and UK offices. Life assurance is however a substantial business in many countries and all developed tax systems have to address the problems that arise in taxing it. This chapter considers whether the overseas solutions have anything to offer for a revised UK regime.

12.2 The approach to taxing life assurance adopted in other countries within the European Community is more immediately relevant. The movement towards Community-wide freedom of financial services could lead to a significant increase in cross-border business, both directly between UK policy holders and non-resident offices (rather than through a UK branch) and in the reverse direction between UK offices and non-resident policy holders. The implications of this need to be considered. The existing tax provisions specifically designed for cross-border business also need to be reviewed.

International comparisons

12.3 It can often be useful to examine how issues are tackled in other countries. However, care has to be taken when drawing comparisons, particularly in an area so intrinsically complex as the taxation of life assurance. It is difficult from a distance to gain a complete appreciation of the way in which a foreign country's system really works. The tax provisions are, moreover, only part of a wider economic, social and legal context which may be very different from that in the United Kingdom. In particular the types of life assurance available, and the savings market generally, may be affected by widely differing approaches to consumer protection and the regulation of financial markets.

12.4 The picture overseas is complex. In a few cases the rules, reflecting the past influence of the UK regime on Commonwealth and ex-Commonwealth tax systems, are broadly along UK lines (albeit with important differences in detail). More generally, the tax charge on life offices is on their commercial profits. Since these are normally arrived at after deducting liabilities to policy holders there is no explicit charge on the investment return to policy holders and/or life funds. In practice, however, withholding tax arrangements for investment income, and premium taxes, may often obtain a significant yield from policy holders. There is commonly also a charge on the proceeds of at least some policies. In addition, non-tax regulatory provisions governing such matters as product design, premium rating, and the permissible mix of life fund assets may constrain the use of life assurance as a tax-efficient investment medium.

12.5 The tax provisions for life assurance in a number of overseas countries have been reviewed in the course of preparation of this document. This has given helpful guidance both in identifying possible options which merited detailed consideration and in eliminating those which did not seem to offer a way forward. Some general conclusions are that:

- developed tax systems generally have had to make special provision for life assurance;

- the approaches vary, but none seems capable of straightforward replication in the UK context; and

- judging by the various amendments and extensions in the past, and those under consideration for the future, the authorities overseas have often not been entirely satisfied with their own systems.

Some more detailed conclusions can also be drawn which are relevant to this review. A number of countries have provisions restricting the tax effect of high initial expenses; investment returns to policy holders, at least in the case of shorter-term and/or investment-oriented policies, are

generally subject to taxation; and, more specifically, the Canadian regime includes a treatment of investment-linked policies which reflects very much the same thinking as the unit trust treatment discussed in Chapter 8.

European Community Issues

12.6 The aim of Community-wide freedom of financial services raises special technical difficulties for the taxation of life assurance. This paper has argued that it would be difficult, if indeed it were feasible, to tax the investment content of life policies promptly and accurately in the hands of the policy holder. The alternative of taxing investment returns at the level of the office presents obvious problems where the office is located in another EC country and has no taxable presence in the United Kingdom. But if the overall burden of tax on policies sold by foreign offices to UK customers were significantly lighter than that on policies of UK offices, there would be serious consequences for the competitive position not just of UK life offices but of other UK institutions selling competing financial products and for direct investment by UK investors. Similarly, UK offices selling policies to foreign policy holders in the exercise of rights of freedom of services might be at a competitive disadvantage compared with other EC offices if the total tax burden in their case - including both UK tax and that of the policy holder's country of residence - were heavier than applied to an office of the policy holder's home country, or of some third EC country. Similar issues would no doubt arise for other EC countries.

12.7 It is not possible at this stage to forecast how these issues may be resolved in the wider EC context, or what implications, if any, they may ultimately have for the detail of the UK domestic regime for life assurance. However it would not be appropriate to hold up the necessary reform of the UK system for what may be an extended period while these issues are resolved. What is possible is to consider in a general way the implications for the the broad options discussed in this document.

12.8 The proposal in Chapter 8 would in theory be an attractive approach to the taxation of life assurance under EC-wide freedom of services. If the investment return to policy holders were taxable always and only in their hands irrespective of the residence of the issuing office, problems in taxing the office itself would not arise. In practice, however, the Chapter notes some formidable technical and operational problems in taxing the investment return in the hands of policy holders as it accrues, and these would be greatly exacerbated if the roll-up in question were to arise in the hands of a non-UK office, from which the necessary information was also required.

12.9 The only practicable approach would be to collect all UK tax in respect of the accumulated investment return from the policy holder once for all when policy benefits were paid. Such a charge currently applies to foreign life policies held by UK taxpayers, for lack of a more suitable safeguard against what would otherwise be a major loophole in the UK regime. But the extension of such an approach to all policies of UK policy holders would have a number of disadvantages. It would have potentially serious implications for the Exchequer yield into the long term; it might result in a serious distortion of competition between life assurance and other products; and it is unlikely to be attractive to the UK industry.

Impact of freedom of services on the three main options

12.10 The option of unit trust treatment for investment-linked policies discussed in Chapter 8 would apply, if approved, only to UK policies (including those of UK branches of foreign offices), just as the current arrangements for unit trusts themselves, including the tax credits attaching to trust distributions, can be applied to UK unit trusts only. The treatment of investment-linked policies offered by foreign insurers would need to be considered in due course in the light of the development of Community policy for cross-border life assurance and the form of contracts available from foreign insurers (in some Community countries investment-linked policies are not presently marketed).

12.11 The approach in Chapter 9 - Schedule X and a new Case I charge - could apply only to offices within the UK tax jurisdiction. As such, it would be broadly on all fours with the current regime as to compatibility with freedom of services in life assurance.

12.12 The programme of reform to the current regime set out in Chapter 10 would reinforce the long-standing position of the UK regime that the investment return to life assurance policy holders is a proper object of direct taxation. It would leave the present regime essentially unchanged in its broad structure, and so avoid change which might be short-lived because of subsequent Community developments.

Special provisions for international business

12.13 A number of foreign offices do business through UK subsidiaries, and UK offices likewise operate through foreign subsidiaries. Such cross-border ownership raises no special issues for the present exercise or in the context of freedom of services. However, a minority of UK offices continue to write business abroad through foreign branches and agencies and similarly some foreign offices write business through UK branches. These situations require special provision.

UK branch business of foreign offices

12.14 A small but significant proportion of UK life business is written by UK branches of non-resident, particularly Canadian and Australian, companies. This business should in principle be taxed so far as possible consistently with the business of UK offices.

12.15 Where the relevant double taxation treaty permits, or where there is no such treaty, current legislation provides a formula for calculating the investment income and annuity (including pensions) business profits of the UK branch as a proportion of the results of the worldwide business. Where the relevant double taxation treaty requires it, the UK branch business is taxed by reference to the income of the investment portfolio held for the purposes of the UK branch business. In either case, a deduction is allowed for the management expenses attributable to the UK branch business, and capital gains arising on the disposal of investments held by the UK branch are taxable.

12.16 Of the options discussed in this paper, it should, on the face of it, be straightforward to treat the investment-linked business of UK branches along the lines applicable to unit trusts since - as in the case of similar business of UK offices - the linking mechanism will itself identify the assets, income and gains to which it should apply. Similarly, a Schedule X approach to the taxation of policy holder returns should present no special problems, since the reserves required in respect of UK business are already required to be calculated in accordance with UK regulatory requirements, and the premiums received and benefits paid under UK branch policies should be readily identifiable. A Case I charge on UK branch profits should also present no special difficulty.

12.17 If the option adopted were a programme of reform to *I minus E*, the measures discussed in Chapter 10 would apply to UK branch business as to business of UK offices, in some cases with appropriate modification. For example, any action to bring into charge income other than investment income would apply only to an appropriate fraction of the office's worldwide income of the relevant character.

12.18 The current tax provisions specific to UK branches may be capable of improvement. Where the branch income is determined by apportionment of worldwide income, the result can be distorted by differing investment performance, and differing valuation bases, between the United Kingdom and the other countries in which the office does business. It might be possible to stipulate a more consistent basis for apportionment. A more attractive approach, however, and one consistent with that suggested for UK offices at paragraph 10.6, would be to require overseas offices to designate sufficient assets of appropriate character as referable to their UK business for tax

purposes, and to tax the actual income (as well as the capital gains) arising from them. It would also be for consideration whether any part of head office expenses should continue to be allowable, and if so whether a more consistent basis for identifying them could be found.

Overseas business of UK companies

12.19 Many UK companies now conduct their overseas operations through locally resident subsidiary companies. A handful however do business abroad through local branches and agencies. Although no figures are available, it seems unlikely that much business is currently done with non-residents directly from the United Kingdom. It is possible however that UK offices exercising rights of freedom of establishment or freedom of services may in future wish either to start new foreign branch businesses, or to offer policies to non-resident customers directly from the United Kingdom on a significant scale. The problem, broadly, is to secure so far as possible that the UK tax regime does not put UK offices at a disadvantage in competing for the business of residents of other EC countries, without providing any artificial tax incentives for UK offices by comparison with other EC offices; with other UK financial institutions seeking to do business with non-residents; or with direct investment by residents of other EC countries in the United Kingdom.

12.20 The general approach of the UK regime for corporate profits requires the profits of a UK office from foreign business to be taxed in the United Kingdom subject in the case of an overseas branch or agency to the appropriate relief for double taxation. The current tax regime of life assurance provides broadly that taxation of non-resident policy holders' investment returns, so far as they are from foreign-source income and gains, should be a matter for the tax authorities of the policy holder's country of residence. The question of UK-source income and gains enuring to the benefit of non-resident policy holders is more difficult. General considerations of UK tax jurisdiction, and the case for equivalence with other forms of investment, suggest that some UK charge may be justified, given that some charge would generally be made (subject to the relevant double taxation treaty benefits) in the case of UK investment by non-resident individuals taking a form other than life assurance. Such an approach should broadly satisfy the objectives mentioned in paragraph 12.19 above.

12.21 Relief for foreign source income and gains (and for income from UK Government securities which are free of tax to residents abroad - 'FOTRA') is currently given through the 'Foreign Life Fund' (FLF) relief. The relief is complex and in practice may be only indirectly related to an office's actual foreign branch business. It is applied by allocating foreign source (and FOTRA) income and gains primarily to foreign branch or agency business (although this may not in fact reflect the true allocation of assets to foreign business) subject to limits derived from the apportionment of total income and gains.

12.22 The detail of the current rules and the possibilities for reform are not discussed in depth here. In the context of a reform of the current *I minus E* basis, some broad questions which need to be addressed, however, include

- whether the current FLF relief should be replaced by new legislation which sets out expressly, and in a carefully-targetted way, a relief designed for foreign business;

- if so, how the scope of the relief should be defined; whether, for example, it should extend to foreign business not transacted through a foreign branch;

- how, in the context of a reformed *I minus E* base, assets, income, gains and expenses allocable to foreign business should be identified; and what relief, if any, should be due to any UK source income and gains falling in this category;

- what would then be the implications for the current rules about remittances, reinvestment and so on;

- what would be the proper treatment of reassurance accepted by a foreign branch;

- what measures would be needed to exclude UK policy holders from the benefit of the relief.

12.23 The crucial question here is likely to be whether it is possible to identify a specific tranche of assets which fully and realistically reflects the assets underlying the foreign business.

12.24 Foreign business should be relatively straightforward to handle under the other options discussed in this paper: in the case of Schedule X, because the premiums received, benefits paid, and reserves held in respect of foreign business should all be readily identifiable; and in the case of a unit trust treatment of investment-linked policies, because the linking machinery would allow the identification of assets, income and capital gains referable to non-resident policy holders.

CONCLUSION

13.1 Life assurance is available on a range of policies with widely varying characteristics sold to policy holders with widely varying personal needs by offices in widely varying commercial circumstances. No relatively brief account of the current tax regime for life assurance can apply therefore with equal force to all offices, policies, and policy holders. Nor can a brief summary of the options for reform deal exhaustively with all the packages which might be put together from the components discussed in this document. It may therefore be helpful to respondents to offer a framework within which the major strategic questions might be answered; and to identify some of the central issues in the current regime as being in any event in need of clarification and amendment.

13.2 The current regime does not perform well. First, and crucially, it does not produce a tax yield commensurate with the profits earned by offices and the income and gains earned for, and paid out to, policy holders. This shortfall in yield does not reflect any specific decision to provide special tax privileges for life assurance and it does not serve any policy objective which would justify such privileges. Secondly, the total tax burden for the industry falls very unevenly between offices, corresponding neither to their own taxable capacity nor to that of their policy holders. Thirdly, the regime is uncertain and anomalous in a number of technical respects. This has led to difficulties in applying the current law and to disputes between offices and the Revenue. Worse still, it is encouraging distortions of behaviour, shading into artificial tax-saving arrangements with no commercial substance. Fourthly, it is unsatisfactory for life offices and for a significant proportion of their policy holders, notably in its treatment of capital gains accruing for policy holders, but also in more technical respects. In sum, the current regime does not work well for any of those interested in it: neither for the Exchequer or the Inland Revenue; nor for life offices, competing financial institutions, or the personal investors who are their prospective customers.

13.3 Against this background the document has proposed three broad options for reform.

13.4 The first option would be to make life assurance subject to the normal tax rules which apply to financial institutions generally and their customers. There are, however, compelling reasons why this has to be ruled out for the generality of life assurance business. It may however be feasible for investment-linked business. The first major question for decision therefore is whether or not this business should be removed from the special life assurance tax regime and taxed instead in the same way as other collective forms of investment.

13.5 However this question is decided, changes will clearly be needed for non-linked business. The second option would require a radical shift from the current regime to one based on actuarial concepts and measures. The advantages would flow from a tax regime precision-made for the way the industry actually operates. Against that, a specific regime for life assurance would not, by virtue of that very fact, fit very closely with the wider tax system. And the more radical the change, the more daunting the transitional problems. The second major question for decision therefore is whether a radical switch to an actuarial basis of charge offers a better way forward than the alternative approach of reform to the current regime. If it does, then the next series of questions to be answered would be those raised in Chapter 9.

13.6 If, however, the answer is that the third broad option is to be preferred so that the current ***I minus E*** basis is retained, the present rules will have to be clarified and amended as they apply, for example, to pension business profits, the treatment of reassurance, and the use of captive unit trusts. But these steps would not, by themselves, be sufficient. The tax treatment of the initial costs of new business would have to be put onto a basis more consistent with that of analogous costs for other investments. It would also be desirable to bring the charge on life office capital gains more closely into line with what might be expected in the context of those other investments. The third major question for decision is how, within a reformed ***I minus E***, these proposals for broadening the taxable base could best be combined with appropriate tax rates to produce a fair and effective outcome.

13.7 A further issue in the context of ***I minus E***, and the fourth major question for decision, is whether the current undivided tax base should be split into a separate Case I charge on shareholders and a policy holder charge on an adjusted ***I minus E*** base; or, failing that, what changes would be required short of complete separation to produce a more sensible interaction between the life assurance regime and the wider corporation tax code.

13.8 The fifth substantial question is whether, assuming the decisions on the earlier questions have enabled an effective charge at the level of the office to be introduced, a further charge is required on appropriate occasions at the level of the policy holder and, if so, when and how it should operate.

13.9 All these topics also impinge on non-resident offices conducting UK life business through a UK branch as well as on UK companies conducting their overseas operations through foreign branches and agencies. They may therefore interact with the current 'Foreign Life Fund' relief for UK offices doing branch business abroad. A number of free-standing issues arise in each case. More immediately relevant perhaps is the possible impact on this review of the movement by the EC towards Community-wide freedom of financial services, including life assurance. These international dimensions make up the sixth, if rather more specialised, area for consideration.

13.10 Within each of these broad strategic issues a large number of technical matters will need to be resolved.

13.11 There are two further matters to be considered which are discussed in the annexes to the document. The problems arising from commissions which are effectively paid, directly or indirectly, to policy holders need to be tackled whatever the broad option for reform eventually chosen. Symmetry of tax treatment is desirable where this can be achieved but, as observed in Annex D, the solutions to these problems may be affected by the future tax treatment of life office expenses.

13.12 The stamp duty charged on life assurance policies is described in Annex E. The choice between outright abolition of the duty, changes in the way it is charged and on what, or its retention in its present form will depend partly on the overall balance of the reform of life office taxation, and in particular its likely yield, incidence and treatment of initial costs.

13.13 In all, significant and perhaps even fundamental changes to the present system will be needed if the taxation of life assurance is more fully to achieve the objectives set out in Chapter 4. Retention of the present regime, as it stands or with changes only at the margin, is unlikely to be sufficient.

ANNEX A

THE INDUSTRY TODAY

1. There are currently about 280 life offices authorised by the Department of Trade and Industry, and there are 50 or so friendly societies writing taxable life or endowment business. The total assets dedicated to long-term business exceeded £150bn (at end 1986 market values), of which about two-thirds is attributable to life assurance within the scope of this review. Most offices are organised as proprietary companies owned by shareholders but a significant minority are organised on mutual lines, where all profits benefit with-profits policyholders.

2. In all, about 90 million policies are in force. Over 70 per cent of households have life assurance policies. Total long-term business cash flows in 1986 for UK offices and their overseas subsidiaries included as income:

premiums: £21bn of which new single premiums accounted for £3.5bn and new regular premiums £2.1bn

investment income: £9.6bn

and as outgo:

claims on death: £1.3bn

surrenders: (including pension refunds) £6.7bn

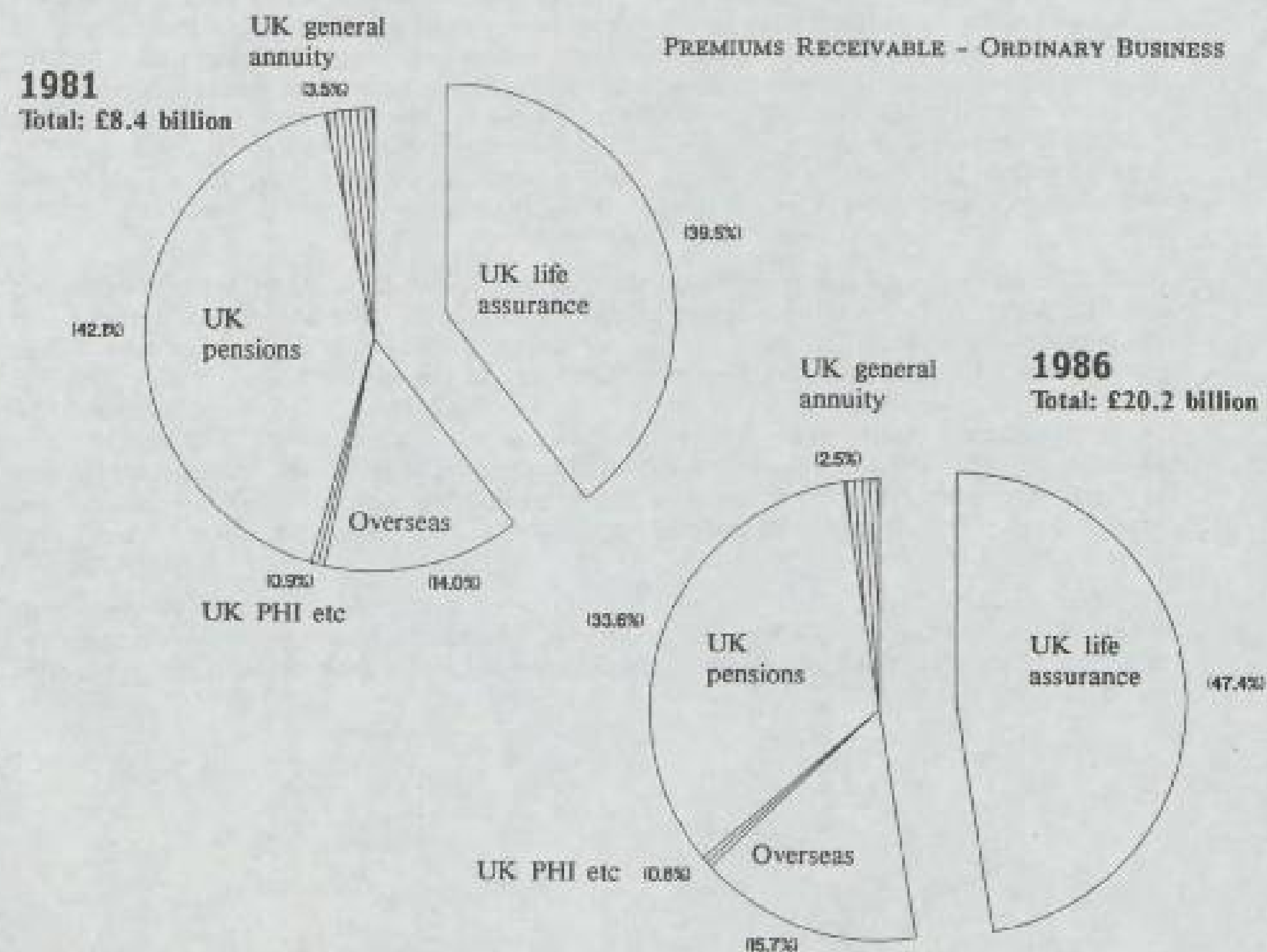
payments on maturity: £2.9bn

annuities: £1.3bn

costs of acquiring new business (including commission): £3bn

other expenses of management: (including commission): £1.6bn.

3. The split of ordinary business premiums between classes of business for two recent years is shown in more detail in the chart below:



4. Complete figures for tax payable in respect of 1986 business are not readily available: as with other large corporate businesses, life office tax liabilities commonly take a considerable time to settle. Industry statistics show, however, tax provisions of nearly £900m in 1986 in life office revenue accounts.

5. A relatively small amount of further tax is collected directly from policyholders in a minority of cases.

6. Annex B contains a series of graphs presenting data for the UK industry over a run of recent years. As the commentary at Annex C explains they are subject to some unavoidable uncertainties and qualifications: in particular that

- available figures do not permit a precise split of ordinary branch business between (in particular) taxable life assurance and other business; and
- tax figures shown in the graphs reflect the amounts provided in life office accounts, as distinct from tax actually paid to the Exchequer (although cross-checks with Inland Revenue data suggest that the amounts provided do not materially understate the tax actually suffered).

7. Despite these reservations, a number of important conclusions can be drawn from the published data. First, and most obviously, the UK life assurance business as a whole has grown very substantially in recent decades. Almost all components of income and outgo reflect this trend more or less strongly. The conspicuous exception has been industrial branch business where premium income, and other components of income and outgo, are relatively unchanged in real terms from the levels of the 1960s.

8. This overall growth has been accompanied by some important shifts in the pattern of business. First, there has been a substantial increase - at least up to 1986 - in the proportion of new business written on linked single premium terms. This is reflected in the composition of premium income and the number of new linked policies (Graphs 2 - 4), and also in the composition of the payments out to policy holders where payments on surrender, and to a lesser extent on maturity, have outstripped the growth of payments on death claims (Graph 1). Taken together, these developments suggest a substantial shift away from protection and long-term saving towards more liquid and possibly short-term investment. Second, the composition of the investment returns of life offices has changed markedly. While investment income was once the predominant if not the exclusive component of investment return, capital growth has become increasingly important to the point where it actually outstripped investment income in 1986 (see Graph 5). Third, there has been a corresponding growth in the value of life business expenses (particularly selling costs) as a proportion of investment income, to the point where it is not exceptional for the income of individual companies to be largely or completely absorbed by management expenses and commission.

9. Both the change in product mix, and the changing mix of returns on offices' assets have affected the composition of the investment return brought to account in life office revenue accounts. At the beginning of the period shown in the revenue account (Graphs 5, 7 and 8), investment income made up the vast majority of total investment returns. In the case of linked business, the full appreciation in market value of linked assets (as well as the income derived from them) must be brought to account year by year, whether the appreciation is realised or not. The large increase in linked business, and the buoyant markets of the years up to end-1986, therefore contributed to a large increase in the share of investment returns attributable to capital gain rather than income. Market developments since the end of 1986 are likely, of course, to have affected more recent experience.

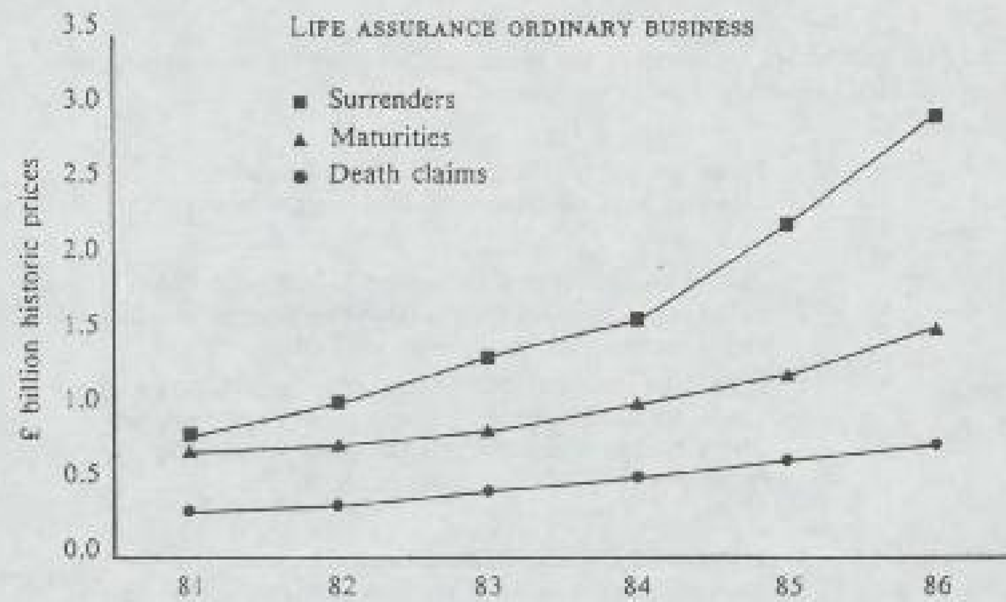
10. Over the same period, there has been a similar shift in the composition of the investment return on unlinked business. Offices have transferred substantial amounts of investment appreciation from reserves in recent years. Unless bonus rates fall significantly below recent levels, this seems likely to persist.

LIFE BUSINESS GRAPHS (BASED ON ABI/LOA STATISTICS)

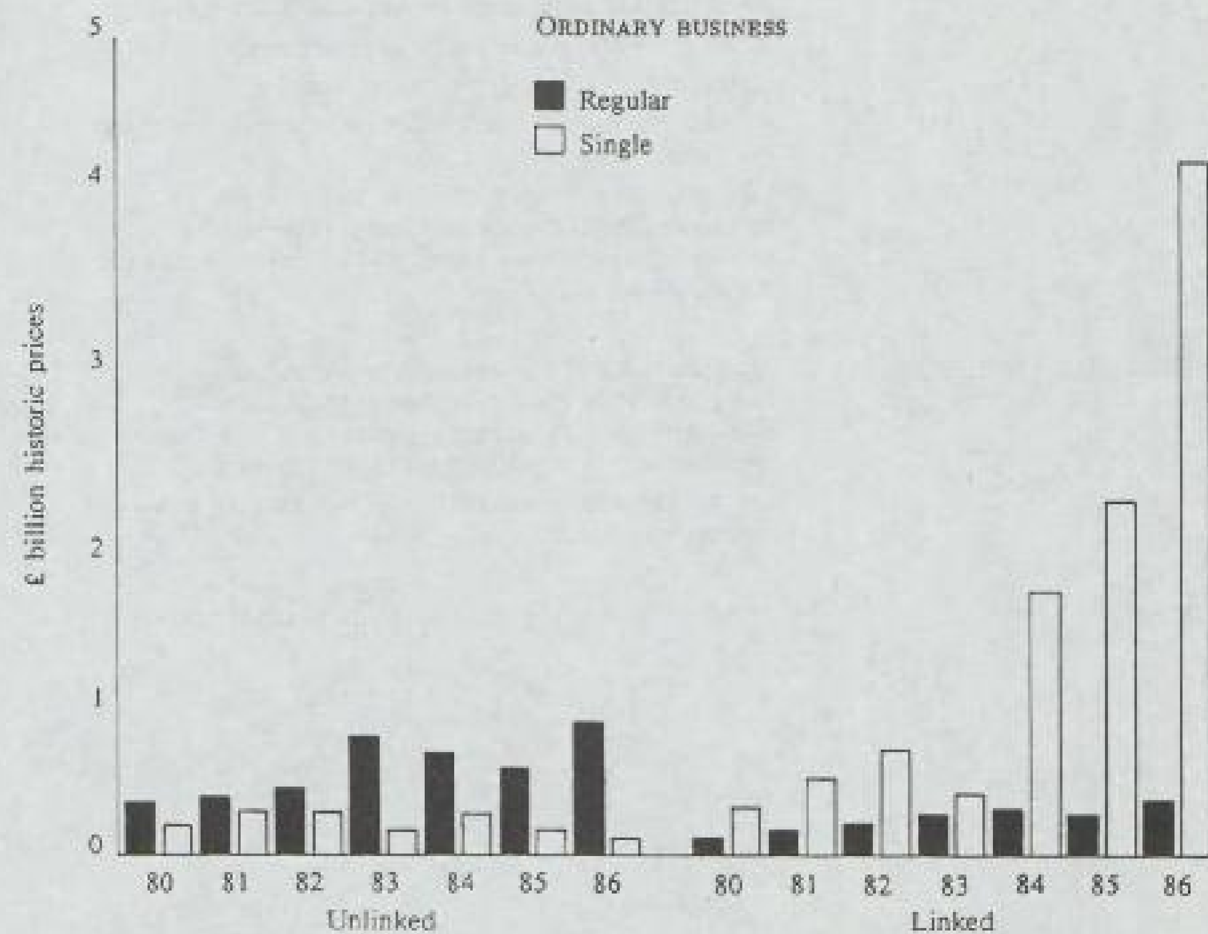
Most of the terms used in the graphs are explained in the glossary. The following brief notes give further explanation of particular conventions used in the graphs.

Commissions:	These are accounted for separately from other expenses for Department of Trade return purposes.
Gains etc:	This is a portmanteau term used in ABI statistical publications to cover incomings other than premiums and investment income. It includes realised investment gains, revaluation of assets, transfers from special and general reserves for policy holders and other miscellaneous income recognised in the life revenue account.
Life Assurance:	In graphs 1,2,3 and 4 this means non-pension/non-annuity life business; that is 'life' insurance as it is most widely understood (and as defined at the end of Chapter 2.11).
Other income, gains etc:	This is a sub-set of the category "gains etc" referred to above. The detailed life revenue account submitted to the Department of Trade divides income other than premiums and investment income into 3 categories: - Recognised appreciation on unlinked assets; - Recognised appreciation on linked assets; - Other incomings, which often include transfers from investment reserves. "Other income, gains etc" is the last of these categories, embracing all incomings other than premiums, investment income and explicitly recognised appreciation.
Recognised investment returns	Premiums and investment income are generally recognised in revenue accounts upon an accruals basis, but other incomings - particularly investment appreciation - are not necessarily so recognised; see the foregoing notes on "gains etc" and on "other income, gains etc".
Tax provided:	Taxation provisions appearing in the revenue accounts.

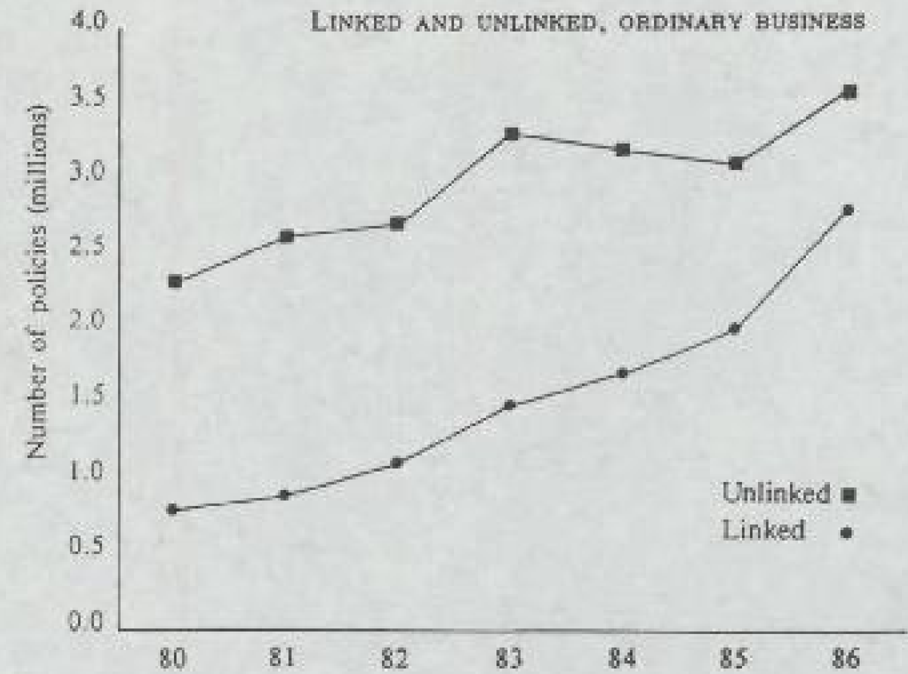
1 : Payments to UK life policy holders



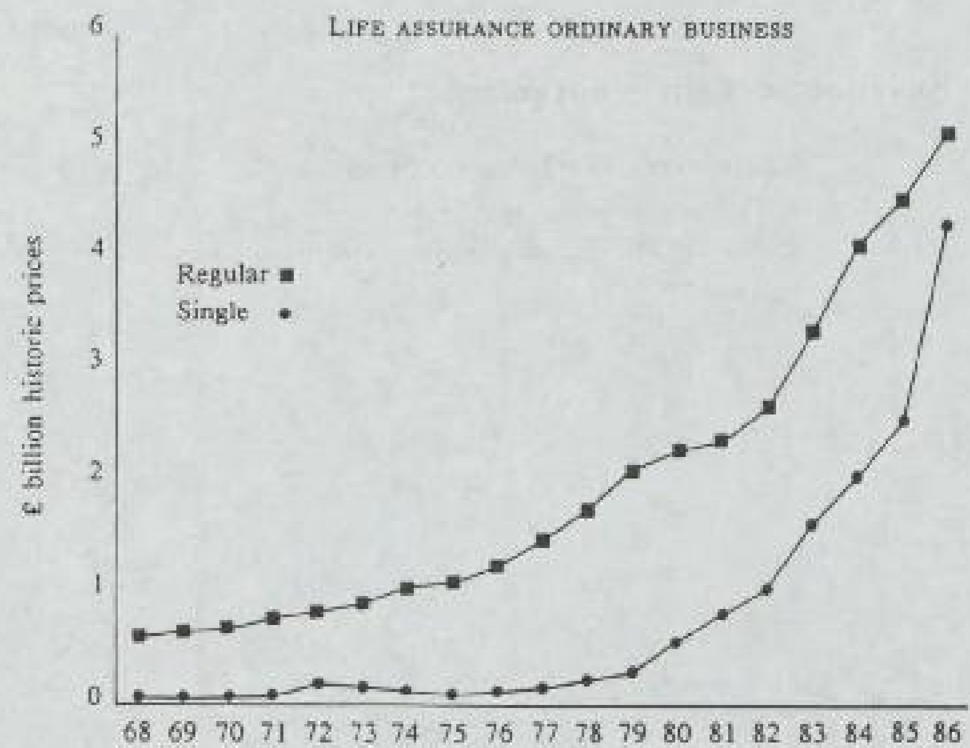
2 : New UK life assurance premiums



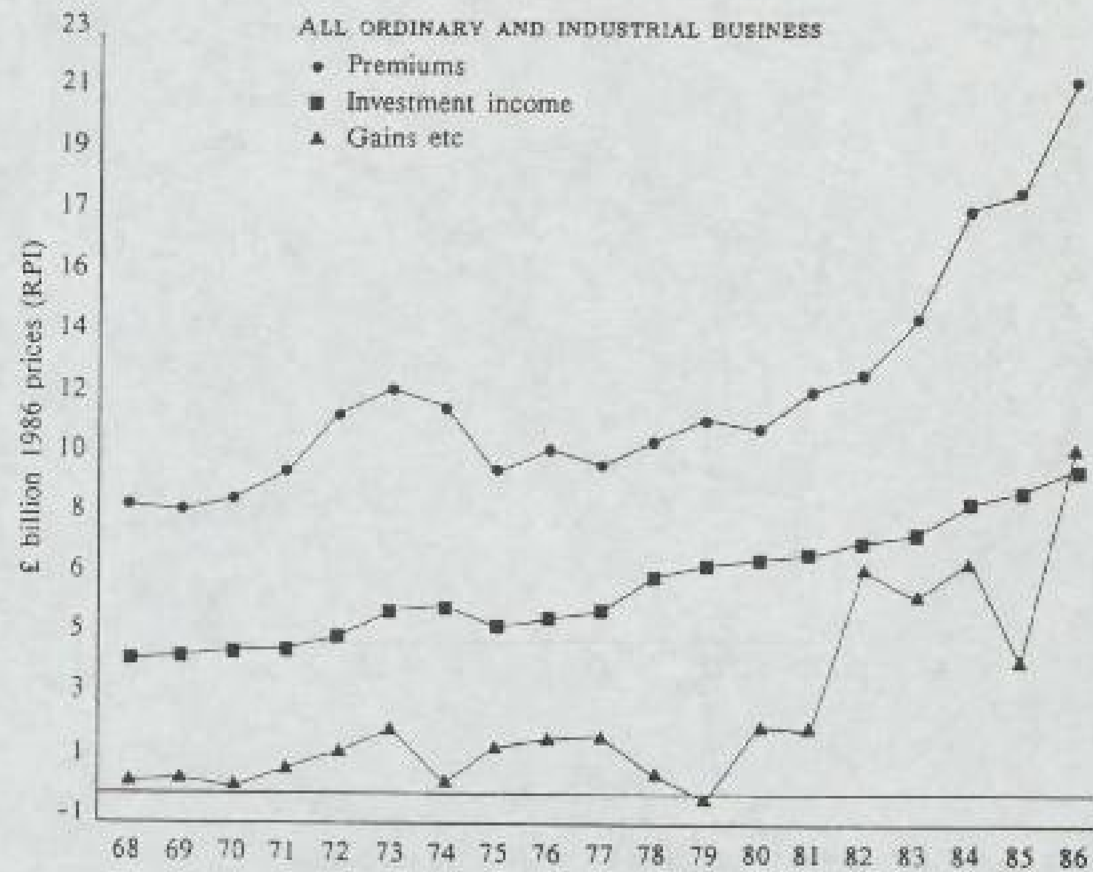
3 : New UK life assurance policies



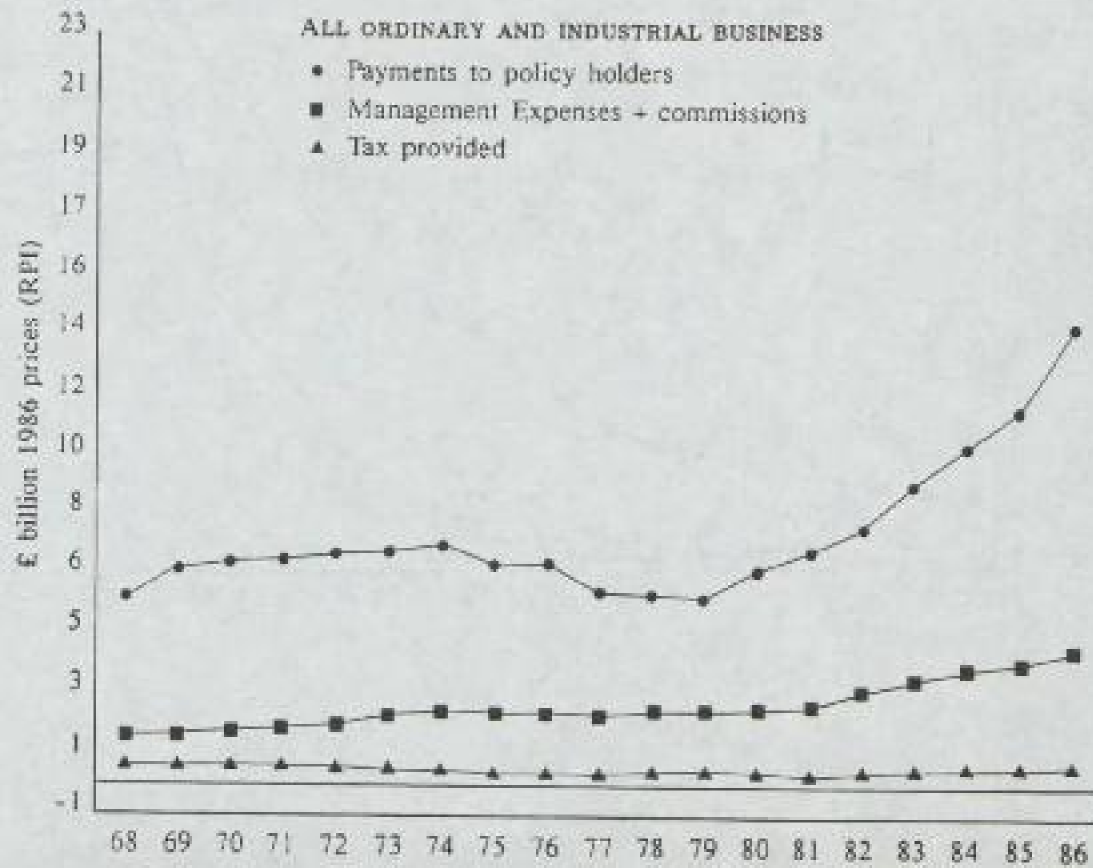
4 : Premiums receivable - life assurance



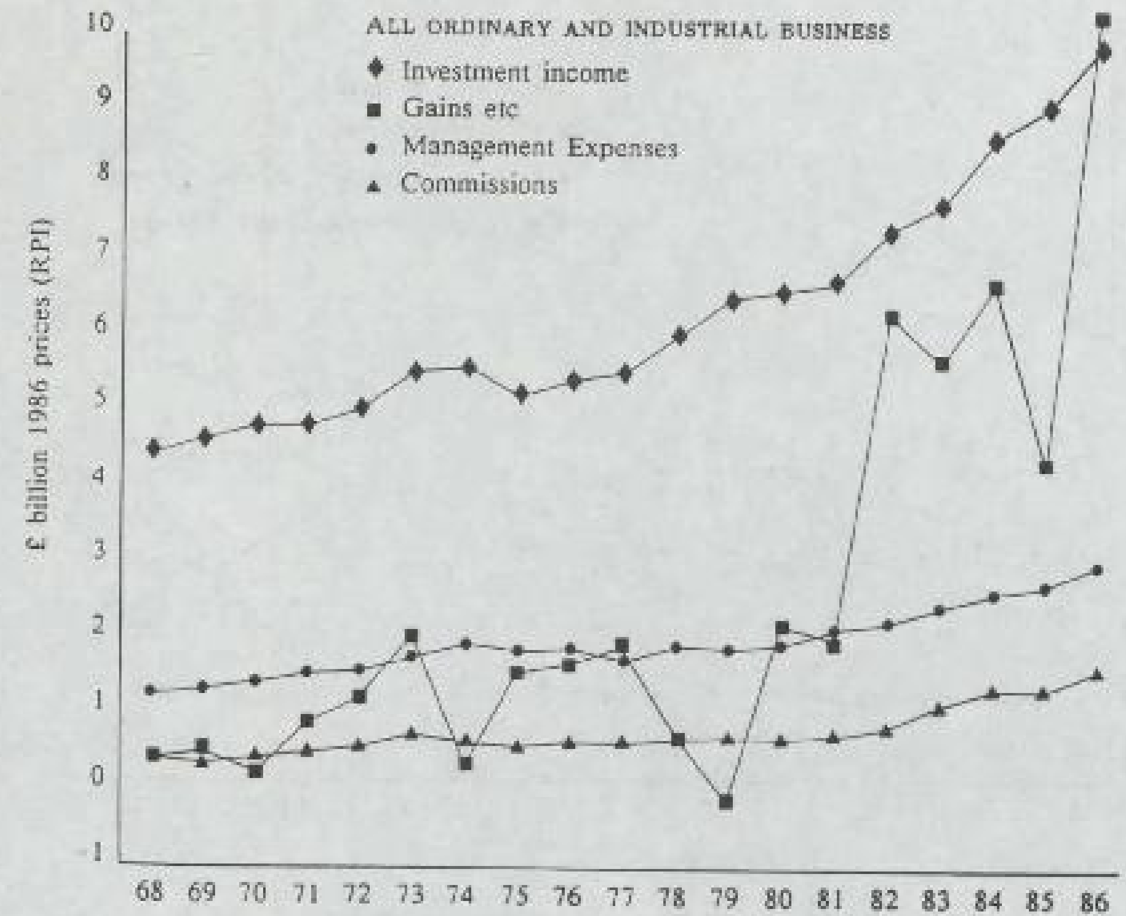
5 : Revenue account - incomings



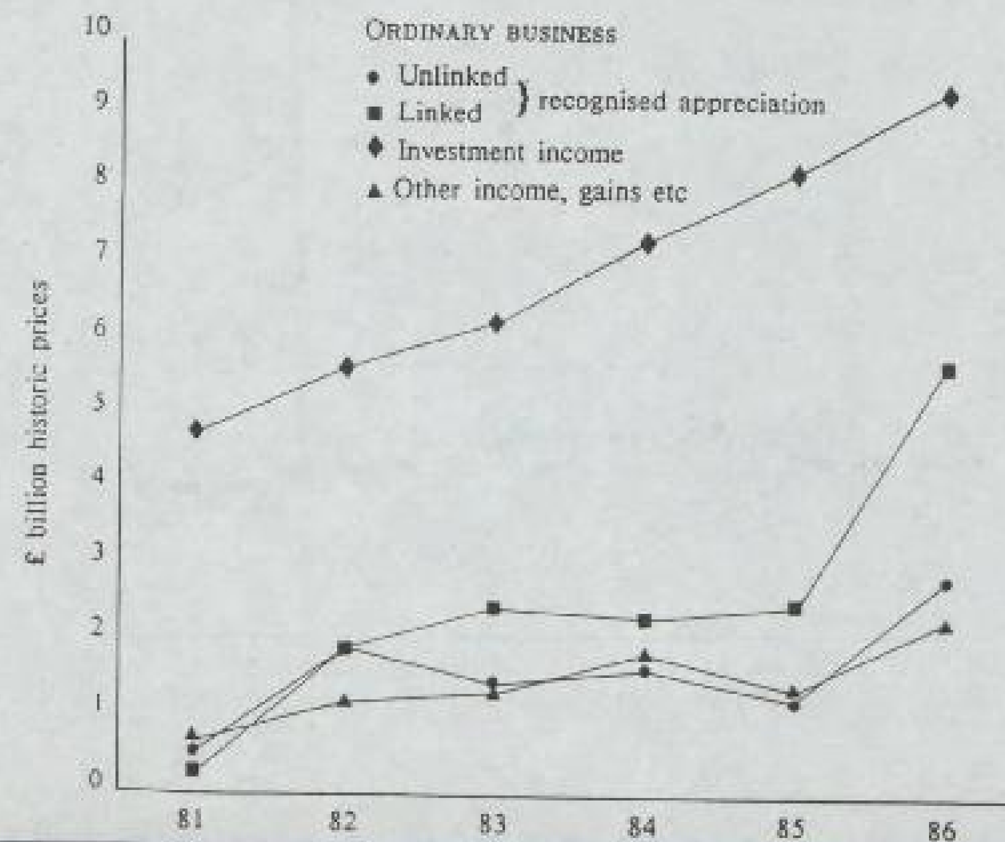
6 : Revenue account - outgoings



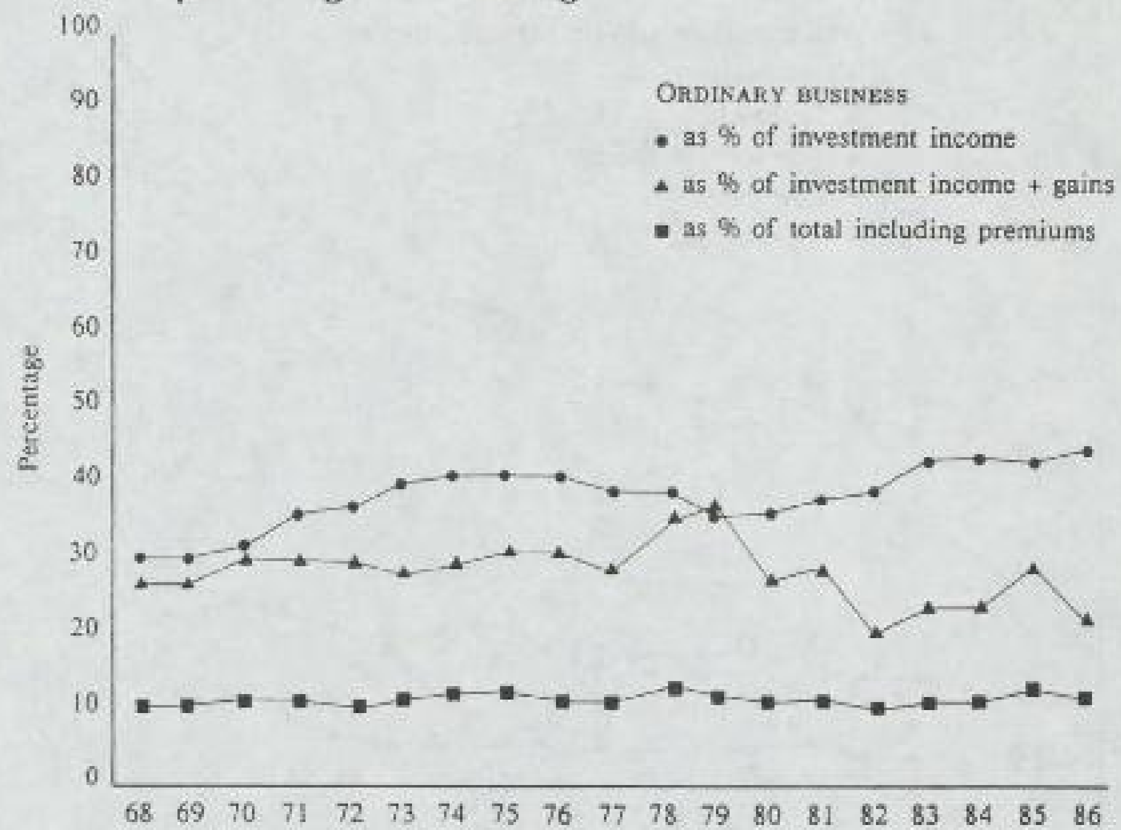
7 : Recognised investment returns, management expenses and commissions



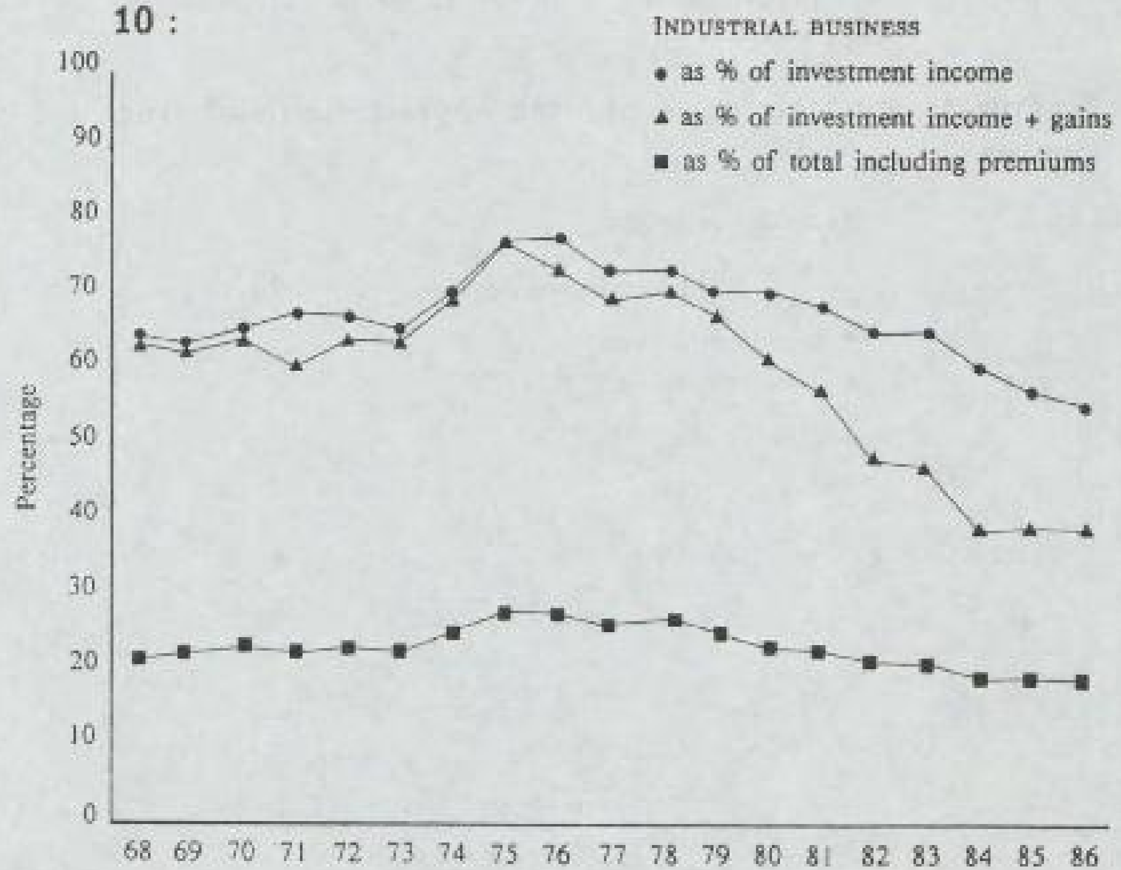
8 : Investment income, recognised appreciation and other income



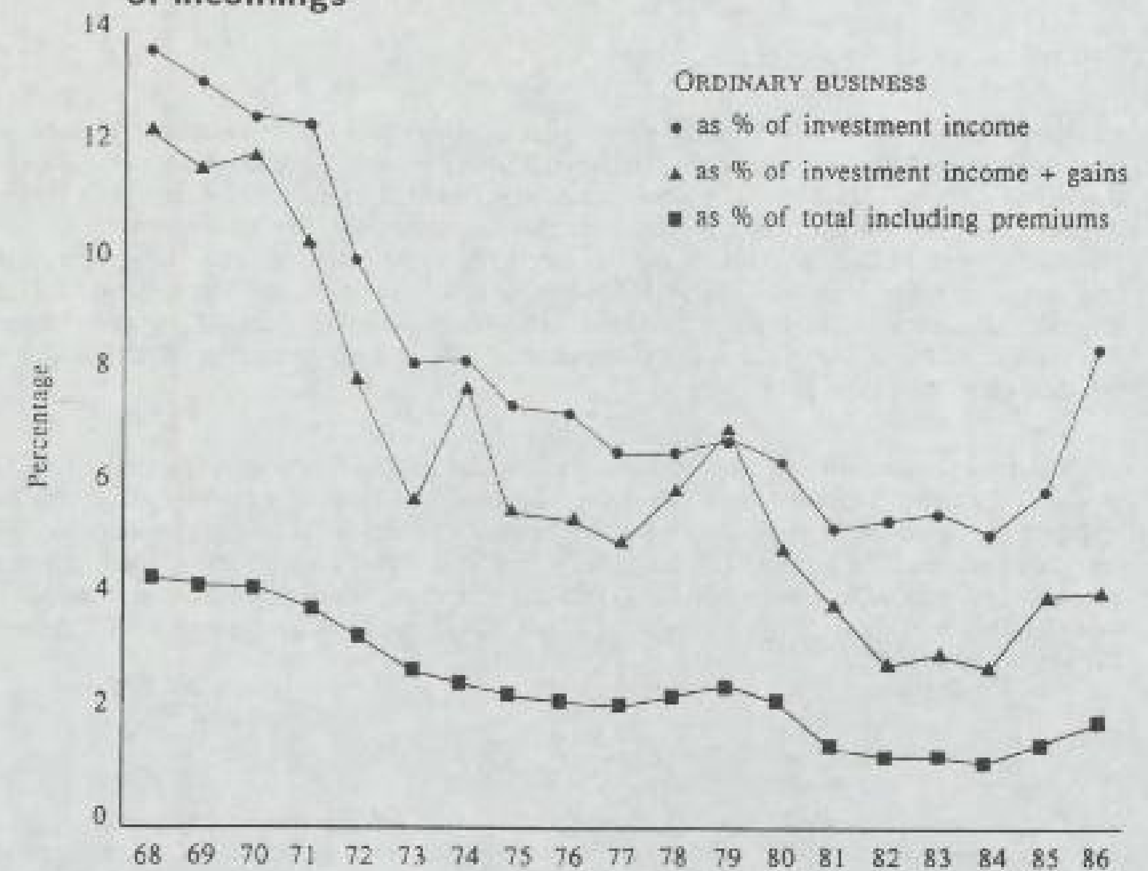
9 : Management expenses and commissions as a percentage of incomings



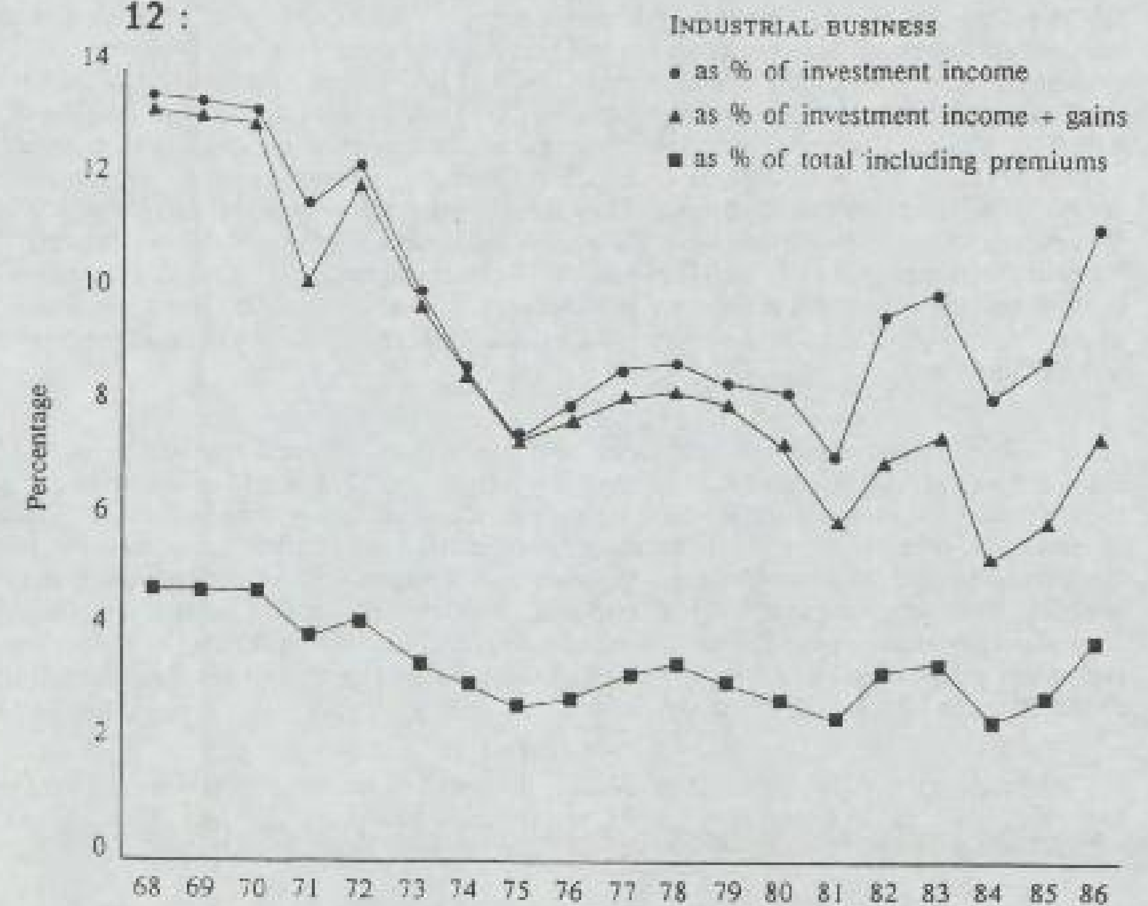
10 :



11 : Tax provided in revenue accounts as a percentage of incomings



12 :



COMMENTARY ON THE STATISTICS

Sources

1.1 Reference has been made in the preparation of this consultative document to a number of sources ranging from the Business Monitors published by the Government Statistical Service to individual company tax files. The graphic material included in Annexes A and B is based upon statistics published or otherwise provided by the Association of British Insurers. The ABI (and previously the Life Offices' Association) has for many years collected data on various aspects of long-term insurance business. The Association provides statistics to the Department of Trade and to other Departments, and itself publishes selected annual statistics. These give substantially complete coverage of the life assurance business of UK companies and their subsidiaries and of UK branches of foreign companies.

1.2 The revenue account and new business statistics underlying the graphs reproduced in Annexes A and B are derived directly from ABI/LOA statistics. The basis of collection of certain data has changed from time to time, so that it has not proved practicable to go back earlier than 1981 for certain purposes. The revenue account graphs run from 1968, but in view of certain changes of coverage in the LOA figures, results for earlier years, and particularly for years prior to 1971, need to be treated with caution. The revenue account data have been converted to 1986 prices using the retail prices index.

Problems

2.1 The quantification of the UK tax actually suffered by the life offices, and the presence within ordinary branch life business of tax-exempt pension business, pose particular problems for the present exercise.

2.2 The quantification of UK tax is a problem because life offices tend to bear tax primarily in the form of unrelieved tax credits on franked investment income (UK company dividends) rather than in the form of mainstream Corporation Tax, and statistics for corporation tax paid therefore significantly understate the actual tax borne by the life offices. The statistics published by the ABI/LOA include figures for tax (including tax on franked investment income) charged in the revenue accounts of life offices (see Graphs 6, 11 and 12). These figures do not directly reflect tax due and payable to the Exchequer. They may incorporate overseas tax, but may not include, for example, any tax on capital gains charged to investment reserves. Exercises mounted by the Revenue in recent years suggest, however, that these distortions have tended to balance one another, so that overall figures for tax provided in life revenue accounts give a reasonable guide to the amounts of UK tax actually suffered by the life offices in the form of unrelieved tax credits and Corporation Tax.

2.3 The income and gains referable to pension business (as distinct from the corporate profits derived from running pension business) are exempt from tax. Thus,in any representation of taxable ordinary life business revenues, it would be appropriate to exclude investment returns, management expenses etc referable to pension business. (No such problem arises in relation to industrial business.) The apportionments necessary for the tax computations of individual companies are generally made on a *pro rata* basis by reference to liabilities to policy holders, but there are no equivalent global statistics for ordinary business in general. The only relevant global figures for the weight of pension business are in the ABI/LOA records of premiums receivable and since 1981 in the statistics for payments to policy holders.

2.4 While premiums give some indication of the relative weight of pension and non-pension incomings they are a poor guide to the relationships between outgoings. Thus, for example, expenses, and particularly commissions, are much lower for group pension business than for individual business and ordinary business generally. And the mix of ordinary business has changed over time. Ideally, all the ordinary branch graphs should be presented net of pension business; if that were done Graph 11 (tax provided as a percentage of incomings) would show tracks roughly one half higher. But for the reasons given it has not proved possible to do this with sufficient accuracy.

2.5 Graphs 11 and 12 need to be treated with caution also because the tax system itself has changed during the period covered. The imputation system was introduced only in 1973, and nominal tax rates declined between 1968 and 1986. The components determining the effective rates suffered by individual companies are complex, but for one important sample of companies the effective overall average rate of tax suffered on net income and gains fell during the period from 37.4% to 33%. All things being equal, therefore, some decline in the proportion of incomings absorbed by tax was to be expected.

Departmental Statistics

3.1 The Revenue has conducted a series of in-house exercises since 1980 designed to gauge the effectiveness of the current tax regime for life offices, and has drawn on the experience of the Inspectors of Taxes working the cases as an important source. Attention has been directed in the main towards medium and larger companies appearing to bear no tax at all or bearing tax only upon ***notional Case I*** profits.

3.2 In one exercise covering the accounting periods from 1980 to 1984 the tax records of 56 companies were examined, representing about a fifth of all long-term business funds. Over the years in question, half of these companies bore little or no tax, and two-thirds did not pay any significant amounts of tax on income and gains referable to policy holders (as distinct from corporate profits). Surplus management expenses for these companies at the end of 1984 totalled £m470. Comparison of the overall results for these companies with global statistics for the industry suggested that the companies in question were probably not exceptional.

3.3 For 1985 and 1986 accounting periods the Department has mounted a more comprehensive exercise and collated information on 89 companies, representing over 90% of relevant assets. Whilst the 1986 details are incomplete (since tax computations tend to be filed much later than Companies Act accounts and Department of Trade returns) the exercise does seem to confirm the picture conveyed by earlier projects.

3.4 The companies in the sample have been examined both against the current tax regime and against the main options for change outlined in this document. The current regime is intended in theory to yield tax both on corporate profits and (still more importantly) on income and gains accruing for policy holders. One very basic measure of the effectiveness of the regime is the number of companies which are paying no more tax than they would pay if policy holders were simply ignored and the companies were assessed only on a conventional profits basis (which is somewhat different from the ***notional Case I*** basis, which does not necessarily tax unappropriated profits). The exercise suggests that a quarter of the companies in the sample (representing the same proportion of funds) fall into this category, which itself embraces a spectrum ranging from companies suffering no tax at all to companies whose tax bill only marginally exceeds the ***notional Case I*** threshold.

3.5 Of particular concern is the unevenness of the impact of the current regime on individual offices. One measure of this is referred to in paragraph 6.7. In another exercise the current tax base of each of the 89 companies in the sample was compared with its market share and also with an approximation of its Schedule X base plus its reformed Case I base (see Chapter 9: these bases reflect the investment return to policy holders and the commercial profits of the office). The general conclusion is that individual company tax bases correlate very poorly both with company size and with investment returns.

3.6 The allowance of relief for selling costs against investment income represents the most important structural difference between the tax regime for life assurance and that which holds for competing investment media. This feature is arguably the single most important factor underlying both the industry's relatively low level of tax payments by comparison with competing investment media and the unevenness of the impact of tax on life offices. It is not uncommon for investment income to be largely or completely covered by management expenses and commission and not particularly unusual for selling costs alone to exceed investment income. A high level of expenses has always been a feature of industrial business, because of the high cost of door-to-door collection of premiums: for this reason, industrial business has for many years been taxed separately from ordinary business. Recent figures however show that high selling costs have pushed the expenses of some offices' ordinary business to even higher levels. This can be illustrated from the Department of Trade returns made by the 89 companies mentioned above (10 of which write both ordinary and industrial business). Their 1986 returns showed:-

	Ordinary	Industrial
	(89 cases)	(10 cases)
Overall costs over 50% of income	38 cases	6 cases
Overall costs over 100% of income	16 cases	0 cases
Selling costs over 50% of income	22 cases	0 cases
Selling costs over 100% of income	8 cases	0 cases

ANNEX D

INSURANCE COMMISSION - OWN COMMISSION AND COMMISSION REINVESTED

Introduction

1.1 Paragraph 10.17 mentions some issues which arise where

(i) a proposer is entitled to commission in respect of his own policies; and

(ii) where commission is foregone by an intermediary for the proposer's benefit, so increasing the amounts effectively invested for the policy holder.

The first topic is the subject of an existing Inland Revenue Statement of Practice which might appropriately be considered for revision during the course of the current review. The second topic has been an increasing source of technical problems and uncertainty for intermediaries, which might usefully be clarified.

Own Commission

2.1 The present practice is set out in Statement of Practice 3/79 which reads as follows:

"1. The Inland Revenue practice at present is to regard an individual or corporate taxpayer who is entitled, as agent of an insurance company, to commissions on premiums on policies effected on his own account as not liable to tax on them as income in his hands, except that where the premiums are allowable deductions in computing profits or gains for tax purposes or are otherwise allowable under the Taxes Acts, only the net premiums (after deducting the commissions) are allowable.

2. The Board of Inland Revenue have considered this practice in the light of the provisions for the premium relief by deduction scheme commencing on 6 April 1979. The position will then be that the amount of relief will depend on the amount of money which passes between the individual and the life office at the time the premium is paid. Thus, if the premium is £100 and commission is £10 and only the net amount of £90 is paid, relief will only be available on £90. If however, the gross amount of £100 is paid, the income of the individual is diminished by £100, and relief would be based on £100 even though £10 comes back by way of commission later on. In such circumstances, the commission would be assessable to tax."

2.2 The practice was devised to cope with problems arising out of the allowance of life assurance premium relief at source (LAPR). It does not deal satisfactorily with the full range of possible circumstances. Now that LAPR is no longer available in respect of new policies, the treatment of "own commission" can be reconsidered without reference to the constraints imposed by the LAPR system.

2.3 "Own business" by a person acting in the dual capacity of intermediary and proposer (referred to for simplicity as the "proposer") can take three forms:

(i) The proposer pays a discounted premium and receives no commission.

(ii) The proposer is entitled to commission, pays the gross premium and receives the commission back as a separate payment.

(iii) The proposer is entitled to commission, but sets it off against the gross premium payable, paying over only the net amount to the life office.

2.4 In the first case no tax-relievable commission is paid by the office. None is received by the proposer or (therefore) taxed in his hands. The tax system is symmetrical. Similarly in the second case commission is paid by the office which obtains relief. Commission is received by the proposer and is taxed (Case I or Case VI of Schedule D) in his hands. In the third case, however, commission may appear as a relievable expense in the hands of the office but is not currently regarded as a taxable receipt of the proposer, on the footing that it is not "received" by him. It is anomalous that such bookkeeping details should have important tax consequences; and equally anomalous that offices should obtain relief for expenses "paid" which may never, for tax purposes, reach any recipient.

2.5 In normal usage, "commission" implies a payment to a third party for the introduction of business. It is arguable that in this sense "own commission" is not commission at all; and that in all cases, offices should be treated as receiving a net premium, with no "commission" either taxed on the proposer, or relieved in the hands of the office. That is clearly the economic substance of the matter: all three cases are effectively equivalent in terms of the net amount paid and received.

2.6 In practice, however, there may be operational problems for offices in identifying and applying a special treatment to "own commission" cases, and subsequent complications if, for example, the chargeable events charge, or a successor charge, comes into question. A more conservative approach might be to leave the treatment of discounted premiums unchanged, but to clarify the position so that "own commission" comes consistently into charge in the hands of the intermediary, whether netted off or paid separately.

Reinvested Commission

3.1 There are now a number of products being marketed by intermediaries on the basis that they forego some of their commission and reinvest this in some way on their client's behalf. The products take various forms but typical are those in which foregone commission is used to achieve a higher unit allocation in unit-linked assurance policies and those in which it is invested in a building society account in the client's name. In some cases the arrangements are controlled entirely by the intermediary but in others the life office is either the instigator or an active party.

3.2 In many cases it is difficult to determine the precise terms of the arrangement, particularly where the marketing literature does not make it clear that the additional benefits being offered to the client result from foregone commission. In such cases the client will find it difficult to discover just what he is getting and what, if anything, he should declare on his tax return.

3.3 These practices raise a number of problems. For example, to what extent is the life office entitled to a deduction for commission paid? Is the intermediary assessable on the full or the reduced commission? If the former, is he entitled to a deduction in respect of the sum reinvested for his client? Is the client assessable on the amount of the commission reinvested on his behalf? If the commission is reinvested in a life policy, what is the premium to be taken into account in any subsequent chargeable events computation?

3.4 It seems anomalous in principle that offices (and indirectly the policy holder) should obtain tax relief for "expenses" which actually find their way back, in one way or another, to the proposer. The fact that either the office or the policy holder may not be fully informed about the dealings between the two parties involved is a considerable complication.

3.5 The nature of the problems, and the shape of their possible solutions, may be affected by, and will need to be considered in the context of, possible wider changes in the tax treatment of life office expenses.

STAMP DUTY

1. Life assurance policies are liable to stamp duty on issue at a rate of 50 pence for each £1,000 or part of £1,000 of the sum assured - ie effectively 0.05 per cent. There is a similar duty of effectively 0.5 per cent of the annuity value of superannuation annuities and purchased life annuities. These duties currently yield about £60 million a year.

2. Three questions arise here:

a. should stamp duty be charged at all on life assurance policies?

b. if stamp duty is retained on what basis should it be charged?

c. are special arrangements needed for reassurance of foreign policies?

Stamp duty on policies of life assurance

3. Policies of life assurance have been liable to stamp duty on essentially the same terms since 1870. The case for the duty, like other stamp duties, is essentially a practical one. It collects significant amounts of revenue; is straightforward to calculate; and is relatively cheap for offices and the Revenue in compliance and collection cost terms. (In many cases, it is accounted for periodically under composition agreements, rather than policy by policy.) Against these advantages, the question is whether the duty has unacceptable behavioural consequences in terms of demand for life assurance products and competition between life assurance and other financial products.

4. One possible criticism of the duty is that it imposes a second tier of charge on savings flows handled by life offices: duty is payable on the policy, and also generally payable when the office invests in underlying assets, whereas only a single tier of charge exists in the case of direct investment or (following the 1988 Budget proposal to abolish unit trust instrument duty) of collective investment through unit trusts. In practice, however, the picture is complicated by the fact that the charge is based on the sum assured. This has its roots in the nature of stamp duty as a once-for-all levy on a document which has to be quantifiable from the terms of the document at the outset of the contract.

5. The effect of the charge is that the duty payable for a given sum assured is the same whether the contract is, say, for term assurance; for whole of life without profits (at a significantly higher premium and with a higher investment content); or for with-profits endowment assurance (at a higher premium again and a correspondingly higher investment content). Where the policy provides for no determinate sum assured, the duty cannot be applied and none is chargeable. In practice this is likely to arise in the case of policies - like unit-linked investment bonds with no guaranteed minimum return - which are most completely orientated to investment, and so most closely competitive with non-life-assurance products. Conversely, the duty is highest in relation to premiums in the case of pure protection policies, where costs generally are relatively high, demand is likely to be relatively inelastic, and the question of substitution by other products does not arise.

6. It is arguable, therefore, that the effective incidence of the duty, although it may at first sight seem rather capricious, is in practice quite well adapted to the wider situation as it exists following the 1988 Budget proposals. Nevertheless, the first question for consideration is whether, in the light of the shape and overall balance of the wider reform of life assurance taxation, the duty should be abolished on some or all categories of life policy. If the duty were to be retained in some form the questions for further examination, still in the context of the wider reforms, would be

- whether any change to the basis of charge, for example to one more closely related to the level of premiums, would be appropriate;

- the impact of any changes in the tax treatment of expenses on the effective yield of the duty;

- the effect on premium levels of changes in the structure of the duty and any behavioural or economic consequences, with particular reference to policies having a substantial protection content;

- the possibilities for further reducing compliance and administrative costs for life offices and the Inland Revenue.

Reassurance of foreign policies

7. There is a narrower and more technical issue in the area of cross-border business which arises when one company reassures the risks of another.

8. There is a relief from stamp duty on the reassurance of a risk to which a stamped policy relates. So in practice duty is not paid when a company reassures policies granted by other UK offices.

9. Duty is payable when UK companies reassure risks assured by foreign companies. The yield is currently about £1 million a year. The argument for not extending relief to these policies has been that someone insuring with a UK company direct (and hence paying duty) should not be worse off than someone who takes out a policy with a foreign company which passes on the risk to the United Kingdom.

10. However, the duty on reassurance of foreign risks arguably puts UK companies at a competitive disadvantage compared with foreign reassurers who do not pay duty when bidding for foreign business (some other countries exempt all reassurance business.) The sums at stake are significant for mortality risks where the premium may be very small in relation to the cover being reassured.

11. The question therefore is whether relief should be extended to the reassurance of foreign business, at a cost of some £1 million a year, in order to allow UK companies to compete more effectively. If this change were made, a demarcation line to allow relief without putting at risk the yield from duty on UK policy holders would need to be considered.

GLOSSARY

Accruals (basis)	An accounting convention under which incomings and outgoings are recognised as they arise (or accrue), rather than as they are received or paid.
Actuarial	Following the principles which govern the practice of actuaries.
Actuary	A person qualified to apply the mathematical doctrines of probability and compound interest to the statistics on which life and pension business, etc, are based.
Agent (insurance)	A person who introduces life assurance business for which he receives payment by commission.
Allocations	Appropriations of surplus, generally to policyholders, by way of bonus additions etc.
Annuity	Generally a contract whereby, in return for a capital sum, regular payments are made by the life office for the rest of the life of the annuitant.(Some contracts provide for payments for a predetermined period).
Appreciation	Growth in asset value, especially where not attributable merely to the accumulation of income.
Appropriations	Withdrawal or earmarking of surplus. Life offices are permitted to appropriate as profit (for the benefit of shareholders or policyholders) only ascertained surplus (see surplus).

Bonus	Share of surplus allocated to holders of with-profits policies. Annual or reversionary bonuses are allocated as at the company's year end, whilst terminal bonuses are added at the company's discretion to policies maturing or otherwise terminating during the company's year.
Broker	A professional adviser who assists a client to arrange his insurances, and who may receive commission on new business written.
Capital Allowances	Tax allowances for depreciation of capital assets such as plant.
Capital Redemption	Business whereby in return for one or more premiums a sum or series of sums is to become payable to the insured in the future, without reference to the death or survival of any life assured.
Captive	A company or unit trust effectively under the control of a company or group.
Cedant	Ceding company.
Cede	An insurer seeking reinsurance cover is said to "cede" that business which is covered by the reinsurance contract.
Ceding Company	The insurance company which covers part of its risk by buying reinsurance.
Chargeable event	An event giving rise to an "exit" charge. Maturity, surrender, assignment, part surrender or death can all be chargeable events.
Claim	Invocation of indemnity on or after occurrence of event insured against, such as death or maturity.
Commission	1 The remuneration paid to an agent or broker for the introduction of business, usually in the form of a percentage of the premium. 2 An allowance made by the reinsurer for part or all of a ceding company's acquisition and other costs. It may also include a profit factor.
Decreasing Term Assurance	A form of term assurance under which the sum assured decreases during the term of the policy eg in step with the repayment of a mortgage debt.
Endowment Assurance	Policy (strictly "life or endowment") under which the benefit is payable on a predetermined date or at death if this occurs first. Can be with or without profits.
Endowment Mortgage	A mortgage, usually on a home, under which interest only is payable to the lender, with the intention that the capital debt should be repaid out of the proceeds of an endowment policy which is held by the lender as further security.
Exit charge	A tax charge made when certain policy benefits are realised in whole or in part. Currently, exit charges are levied only where policy holders are liable at the higher rate, and are charged at difference between the higher rate and the basic rate.
Franked Investment income	Dividend income carrying a tax credit (see Imputation system).

Fund	1 An accounting concept expressing the balance of a life company's 'liabilities' (including unappropriated surplus). The fund must be matched with appropriate assets (see margin of solvency). 2 (Sometimes) the assets representing the fund.
General annuity business	Annuity business other than "Pension business".
General Insurance	Indemnity insurance, as distinct from long term (including life) insurance.
Hypothecation	The establishment, by statute or contract, of a legal charge over a particular asset or group of assets as security for the performance of an obligation assumed under a contract or class of contracts.
Imputation system	The current corporation tax system under which corporation tax paid by a company is creditable against the tax liability of shareholders on distributions by the company.
Industrial Assurance	Life assurance run on "home service" lines; that is, for which premiums are collected at the door at short regular intervals.
Intermediary	An agent or broker through whom a contract is arranged.
Investment	Deployment of premium income pending settlement of claims.
Investment bond	Generally a linked, single premium whole of life or endowment policy providing minimal guaranteed death benefits, and capable of surrender without penalty.
Investment-linked Assurance	Long term business with an investment content whose return is linked to the performance of a specified investment, group of investments, or index.
Investment reserve	Broadly represents the value of a company's assets over and above its recognised liabilities to policyholders, shareholders and others. It may appear explicitly in the office's accounts, or implicitly where assets are given a book value below market value.
Life Assurance	Insurance business whose benefits are contingent upon the duration of a human life (or lives).
Life Assured	The person on whose death or survival the benefit under a life assurance policy becomes payable.
Life/long term business Revenue Account	The income and expenditure account expressing a life company's life/long term business operations.
Long term Business	Life assurance business (including annuity and pension business), capital redemption business and permanent health business. (contrast with General Insurance)
Margin of Solvency	Under the Insurance Companies Acts the total assets of an insurance company must exceed its liabilities by a defined amount, known as the margin of solvency.
Mathematical reserves	The actuarially calculated assessment of a company's obligations to policyholders, consisting essentially of the difference between the present value of anticipated benefits to policyholders and the present value of future premiums.

Maturity	The end of the term of an endowment assurance policy.
Mortality cover/charges	The pure protection element in life assurance may be funded by appropriation by the life office of all or part of the premiums or, in the case of investment-linked business, by cancellation of part of the policy value.
Mortgage protection	Policy designed to provide decreasing term assurance cover sufficient to pay off the anticipated outstanding balance of a repayment mortgage.
Mutual Company	A company the only members of which are the holders of policies entitling them to share in the profits of the company.
New business strain	Regular premium contracts often impose initial strain on companies insofar as they may require the establishment of reserves greater than the company's net receipts (ie after paying commission and other front-end expenses).
Ordinary (branch) business ("OB")	All long term, including life, business other than Industrial branch business.
Pension Business	Tax-exempt annuity, death in service and other business, contracted either with insured occupational pension schemes, or on an individual "personal pension" basis.
Permanent Health Insurance (PHI)	Insurance (often arranged by employers for employees), providing a fixed amount or proportion of salary for individuals prevented from working by sickness, accident, etc.
Person Assured/Policy Holder	The person effecting the policy. The policy holder or person assured is not necessarily the same person as the life assured, or the beneficiary.
Policy	The document which contains written evidence of the contract between the insurer and the insured. If the full terms of the contract are located in more than one document, all relevant documents taken together constitute the policy.
Portfolio	1 A block of business. 2 A block of investments associated with a block of business.
Premium	Sum paid to the insurer as consideration for the assumption of contractual obligations by the insurer.
Premium rating	The pricing of contracts, by adding to the basic mortality cost "loadings" to cover expenses, profit, and any additional benefits.
Proprietary Company	A company owned by shareholders.
Qualifying policy	A policy certified by the Inland Revenue as qualifying under the rules laid down, and therefore exempt from the exit charge if not surrendered prematurely. (Any other policy is a non-qualifying policy). Qualification criteria generally require a term of not less than ten years, regular premiums and a minimum sum assured in relation to the premiums paid.

Reassurance (inward/outward)
The reinsurance of life assurance liabilities. The reassurer, who accepts reassurance business does "inward" business. The cedant who buys reassurance cover does "outward" business.

Recognised (gains/appreciation)
Incomings are 'recognised' when credit is taken for them; and more particularly, when taken into the life revenue account as distinct from investment reserves. Recognised gains etc are not necessarily 'realised' gains. Assets may have appreciated in value without being sold.

Reinsurance
The insurance of insurance or reinsurance liabilities, by which an underwriter lays off a proportion of the risk or protects his own account against the effects of very large losses.

Reinsurer
An insurer who accepts insurance from another insurer or reinsurer.

Reserve
An amount built up in the early years of a group of policies when the level of premiums is greater than required to meet claims, expenses etc. It is used to pay claims in the later years when the premiums are less than required.

Reversionary Bonus
A guaranteed addition to the sum assured payable in the same circumstances as the sum assured. Regular additions are usually made to policies which have been effected as "with profits" contracts, and the additions arise from "surplus" funds not required by companies to cover their liabilities.

Roll-up
Combined undistributed income and gains.

Solvency
See Margin of Solvency

Sum Assured
The cash benefit guaranteed by a life assurance policy.

Surplus
The actuarial surplus of a life company is that part of the fund over and above the sum of its liabilities. Holders of "with-profits" policies are entitled to a share in the surplus, usually by way of a reversionary bonus added periodically to and payable with the sum assured.

Surrender Value
Cash value of a whole life or endowment assurance policy when discontinued. Surrender values can be small in the early years of a policy. This is because expenses are highest at the beginning of the term of a policy and in the first few years there has been little time for interest to accrue.

Temporary Assurance
See Term Assurance.

Term Assurance
A type of assurance under which benefit is payable only on death of the life assured before a predetermined date.

Terminal bonus
Bonus, added to accrued policy value on maturity, etc at office discretion.

Top-slicing
A relieving provision associated with the "exit charge". It recognises that the sums to be charged may represent the accumulation of years of investment yield, which would have been taxed at lower marginal rates had it been assessable year by year.

Unit-linked Assurance	See Investment-linked Assurance.
Unit-trust	A type of collective investment medium. 'Authorised' Unit Trusts are treated as investment companies exempt from tax on capital gains.
Valuation basis	The particular set of assumptions and conventions upon which the actuary bases his valuation of a liability.
With profits	Assurances providing for a minimum sum assured plus "bonus" additions. (See "reversionary bonus").
Without profits	Assurances providing only a fixed sum assured.
Whole of Life Assurance	Assurance under which benefit is payable on death whenever it occurs; can be with or without profits.
Zillmerisation	A modification of the net premium reserve method of valuing a long term policy: it increases the part of future premiums for which credit is taken so as to allow for initial expenses.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

2 June 1988

Andy Bearpark Esq
10 Downing Street
LONDON SW1

Prime Minister 2

Excellent debate

Dear Andy,

CHANCELLOR'S PAMPHLET ON TAX REFORM

The Chancellor has mentioned to the Prime Minister that he is publishing a pamphlet on tax reform. It is to be published on Monday (6 June), and I enclose a copy of the typescript which was sent to the printers. I shall send you a copy of the printed pamphlet as soon as we get one.

Yours sincerely,

Andrew Hudson

A P HUDSON

713/002

TAX REFORM - THE GOVERNMENT'S RECORD

Around the world, governments of all persuasions are moving tax reform up the political agenda. Everywhere it is politically difficult, yet everywhere governments persevere.

For us in the UK, it is part of the second wave of the 'eighties revolution.

First, we had to dispel the notion that the way to economic success lies through a sort of fiscal levitation. That was the abiding post-war delusion - that governments could spend and borrow their way to prosperity, and fine-tune the performance of the economy through something known pretentiously as demand management.

It may be hard to remember, but it used to be an Establishment nostrum that you need a budget deficit to get economic growth. That was the belief which lay behind the notorious letter by 364 economists in March 1981. We have given the lie to that, decisively. There can no longer be any argument about it.

Everyone - or almost everyone - now accepts that the proper role of macro-economic policy is to keep downward pressure on inflation and to maintain a stable framework in which the private sector can expand.

Our second task has been to shift attention to the enterprise culture. Our commitment to it has been there from the start but, perhaps not surprisingly, has taken a bit longer to receive the attention it deserves.

Building the enterprise culture takes many forms.

- We had to give management back to the managers, so we stopped the Government from setting pay and prices through the elaborate and self-defeating machinery of incomes policies.

- We had to give the unions back to their members, so we wrote into law a series of basic rights.

- We had to leave businesses and their workers to accept more of the consequences of their own actions, so we increasingly took the Government out of the industrial bail-out business.

- We had to get the Government off the backs of the entrepreneurs, so we abolished whole batteries of controls.

- And we had to make it possible for ordinary people to enjoy the benefits of ownership, and all that goes with it, so we gave council tenants the right to buy, and promoted the spread of share ownership.

All this, too, is now accepted as the success it has manifestly been.

Tax reform is a crucial part of the same story.

For obvious reasons, Budgets are presented each year as strings of measures, each explained in its own terms. The tax changes are invariably analysed in terms of who gains what and who loses what, while the economic section of the Budget speech is reported separately.

I make no complaint about this: indeed, I have little doubt that it is inevitable. But it has the unfortunate effect

that tax reform and economic performance are seen as wholly unconnected.

Yet my main objective in reforming taxes has been to improve the performance of the economy; and that is the overriding test by which the reforms stand to be judged.

In a nutshell, our objectives have been:

- to leave people more of their own money, so that they can choose for themselves what to do with it

- in particular, and so far as is practicable, to reduce marginal tax rates, so that an extra pound of earnings or profits is really worth having

- to see that, as a general rule, people's choices are distorted as little as reasonably possible through the tax system

- but to be prepared, when it is sensible, to promote tax reliefs which will help to make the economy work better.

There have been other important objectives too - simplicity, for example, and the fair deal for married women which I announced in this year's Budget. But I want to concentrate here on the main economic case for tax reform: what we have done, why we have done it, and what the results have been.

Lower tax rates

The key objective is to reduce marginal tax rates. That is what makes the extra pound worth earning, without recourse to tax dodges; and that, in the long run, is what matters for incentives. The economics are simple: if you reward enterprise, you get more of it.

Of course, what really matters is not whether Chancellors can take a bit off this or that tax rate in any one Budget - though that is certainly not to be sneezed at. It is whether, through a series of Budgets, a climate can be created in which people feel they are living in a country where tax rates are reasonably low and likely to come down further - a country where individuals and businesses are working less for the Government, and more for themselves and their families and the causes they want to support.

The salient features of our record can be simply stated:

- The basic rate of income tax down from 33 per cent to 25 per cent, and set to fall further, to 20 per cent, in due course. The top rate on earnings halved, from 83 per cent to 40 per cent.

- The main rate of corporation tax down from 52 per cent to 35 per cent. The small companies' rate down from 42 per cent to 25 per cent.

- The stamp duty on shares, which inhibited transactions, cut from 2 per cent to ½ per cent.

- The burden of capital taxation progressively lightened, with fourteen rates of tax on inheritance, running up to 75%, reduced to a single flat rate of 40%.

- And five major taxes abolished altogether: the investment income surcharge, capital duty, the national insurance surcharge, development land tax, and the tax on lifetime gifts.

Lower tax breaks

The high tax rates we inherited when we first took office in 1979 were often not paid. The well-heeled and

well-advised took great pains to avoid liability through the use of tax shelters. But with lower tax rates, there is both less need for tax shelters and less to be had out of them.

Reducing or eliminating them is never popular with those who benefit from the tax breaks; and reform plans in other countries have foundered on this rock more than once. But the principle is clear: as someone once said, if you want the Government off your back, you have to get your hand out of its pocket.

So long as we persevere, there is a virtuous circle to be had. Reducing or eliminating tax breaks provides increased revenue which can be used to help bring down tax rates. Lower tax rates of themselves reduce the value of tax breaks. So it is then a little easier to reduce the tax breaks that remain. This in turn releases more money to reduce tax rates. And so it goes on.

So just as high tax rates tend to bring with them high tax breaks, lower tax rates go hand in hand with lower tax breaks.

In general, the objective should always be to charge lower rates on a broader tax base. That is the best way to improve incentives without an unacceptable revenue cost, to reduce distortions - a point I shall come back to - and to simplify the system.

Here too the key features of our record can be simply stated.

- The big reductions in company taxes were made possible by abolishing stock relief and phasing out the special first year allowances for capital investment.

- Income tax reductions have been facilitated in part by broadening the VAT base; by more than doubling

the taxation of company cars; by ending tax relief for new life assurance policies, for foreign earnings and emoluments, for non-charitable covenants, and for new home improvement loans; by tightening the rules for taxing the UK earnings of non-resident entertainers and sportsmen; and by ending or limiting a number of other reliefs.

- I have also tightened a number of the more arcane-sounding rules in the tax system, for example those affecting partnerships, dual resident companies, controlled foreign companies and offshore funds.

- And I have limited the surpluses which can be built up in pension funds free of tax.

More neutrality

In part, to repeat, this trimming of allowances and reliefs is a matter of helping to find the revenue needed to pay for reductions in marginal rates. But it is also intended to make the tax system more neutral. That is, to reduce the extent to which the tax system biases people's choices, by making it worth their while to spend or save in some ways rather than others, purely for tax reasons.

The tax system we inherited in 1979 was not only badly biased, but biased in ways that could not but stultify the progress of the economy. It was biased against employment, biased against savings, biased against share ownership and biased against sensible business investment decisions.

Employment

There were three main biases against employment.

First and most obviously, there was the national insurance surcharge - Labour's tax on jobs. At a time of rising

unemployment, it was hard to imagine a less appropriate policy than to be levying an extra tax on extra jobs, wholly unrelated to the need to finance national insurance benefits. We reduced it in 1982, reduced it again in 1983, and got rid of it entirely in 1984.

Second, there was a bias against jobs inherent in the corporation tax system. That provided unnecessarily generous allowances - tax subsidies in effect - for investment in capital equipment even where more labour-intensive methods of production might be instrinsically more economic. I dealt with that when I reformed the capital allowances in 1984.

Third - and this is not strictly a tax matter - there was the problem of national insurance contributions, which we were obliged to raise in the early 1980s, particularly for employees, to finance the increase in expenditure on national insurance benefits. I announced a major reform of the structure of the contribution system in 1985, to make it much cheaper to employ people on relatively low earnings, and to allow them to keep more of what they earned.

I believe that, taken together, these measures have contributed significantly to the large falls in unemployment we have seen in the last two years.

Savings

The main bias against savings was, quite simply, that the income from savings was subject to a special additional tax, the investment income surcharge. With its origins in a distant past, when earned income was considered precarious and savings income certain, it had long ceased to have any real justification. It was particularly inappropriate, to say the least, at a time when our predecessors' policies had produced both high inflation

and low or negative real interest rates. People had to save more and more to protect the real value of their savings. Yet they were simultaneously denied a real return and subjected to penal tax rates on their nominal receipts.

Geoffrey Howe reduced the investment income surcharge in his first Budget. I got rid of it altogether in mine.

The surcharge did not apply to capital appreciation, which was taxed on a quite different basis from ordinary savings income. And, for higher rate taxpayers, the marginal rate of capital gains tax was much lower than the marginal rates of income tax - even after the investment income surcharge had been abolished. This, too, discriminated against ordinary income-yielding savings.

Any higher rate taxpayer who could choose had an incentive to convert income into capital gains, and to invest savings for speculative gain rather than steady income. I cannot believe that this was healthy.

In 1985, I eliminated the tax advantages of converting savings income into capital appreciation through the device known as bond washing. That measure wiped out a whole avoidance industry at a stroke. And, though there was some nervousness at the time, it did so with no damage whatever to the gilt-edged market.

In this year's Budget, I have gone a good deal further, and made the marginal rates of capital gains tax the same as the marginal rates of income tax. And that puts paid to another distortion. In general, you no longer face a higher marginal tax rate if you work for a company than if you speculate in its shares.

These changes can only help to promote more sensible savings and investment decisions. They will encourage people to judge between alternative uses of funds according to the return they offer, rather than their tax advantages.

In 1982 Geoffrey Howe introduced an important measure of indexation into the taxation of capital gains. In this year's Budget I completed the process, so as to eliminate finally the taxation of inflationary or paper capital gains, which was both an injustice and an economic own goal.

It was an injustice because the paper gains were simply a reflection of the hyper-inflation of the 'seventies. They represented no real appreciation whatever to people who held land or shares. So to tax them was to eat into the real value of the original investment.

It was an own goal because people with paper gains would simply sit on their assets to avoid paying an unjust and penal tax.

Eliminating the tax on paper gains ends that needless distortion. People who have been sitting on pre-1982 assets are now able to sell them without incurring a penal tax bill, and so turn them to more productive use.

Share-ownership

The biases against share-ownership affected the willingness both of companies to sell shares and of ordinary people to buy them.

Companies were inhibited because the tax system made it much cheaper to borrow than to raise equity finance. That was essentially a function of the difference between the rate of corporation tax and the basic rate of income tax. Since we first took office this gap has been eliminated altogether for small companies and virtually halved for large companies.

Companies also had to pay a discriminatory impost called capital duty when they raised equity. I abolished that in this year's Budget.

And anyone buying shares had to pay a 2% stamp duty. I halved that to 1% in 1984 and halved it again to ½% in 1986. Despite that, the revenue from stamp duty on stocks and shares has actually increased.

At the same time, ordinary people found it less attractive in tax terms to buy shares directly than to save through the life assurance and pension funds. Institutional saving attracted tax relief which was not available for direct equity investment.

To some extent, we have levelled down. I ended relief for premiums on new life assurance policies in 1984.

To some extent, we have levelled up. I introduced tax relief for Personal Equity Plans in the Budget of 1986. I have consolidated the reliefs available for equity investment in smaller companies through Geoffrey Howe's innovatory Business Expansion Scheme, which I shall come back to. And we have developed tax incentives to foster the spread of employee share schemes.

I do not pretend that these measures have brought about anything like parity of treatment. But I do believe that they have complemented our hugely successful privatisation programme in helping to treble the number of share owners in this country.

Business investment

The bias against sensible business investment decisions arose because the old capital allowances produced an incentive to undertake projects with no economic return whatever, simply to save tax. The unwritten rule was "never mind the quality, feel the tax relief".

So we saw higher rate taxpayers going into things like container leasing, simply to generate paper losses which

they could set against other income, and so reduce their tax bills. Geoffrey Howe closed that particular loophole in 1980.

More generally, we saw the tax system feed a culture in which businesses were given every incentive to buy more and more plant and machinery, whatever its purpose, but not, for example, to spend money on improving the design of their products, or on research or on training their employees. This was a classic way to misallocate resources. I abolished this discriminatory tax subsidy in 1984.

The old capital allowances also made it more attractive for some companies to lease assets than to own them, again purely for tax reasons. The 1984 reforms put an end to that too. And so far from knocking leasing on the head, the reforms helped to unleash such a flood of profitable activity - on a genuine and non-tax-induced basis - that the leasing companies have just had their best year on record.

Promoting flexible markets

These are all examples of changes which have reduced the distortions between different sorts of economic activity. Some call this greater neutrality. Some call it levelling the playing field. It is in fact part of our wider policy, to get the Government off people's backs and out of the market place: leave them their own money and let them choose what to do with it, without too much nudging from the tax man.

But as long ago as 1984, when I introduced my first radical reforming Budget, I made it clear that I had no intention of removing all the distortions in the tax system. The purist tax reformer - the level playing field fanatic - will be disappointed by this. There are those who would have a Chancellor drive his steamroller up and down the pitch,

until he has levelled out every hummock and filled in every hole. But I do not believe that this extreme should be our aim. While the general presumption should invariably be in favour of fiscal neutrality, in practice there will always be a place for some carefully considered tax incentives.

The main economic reason is this. The Government's objective is to improve the performance of the economy. In general, that is best served by levelling out tax reliefs and trusting to the free play of the markets. But in some cases, the markets in this country have suffered from long years of ossification. To take the two most striking examples, the labour market was allowed to become notoriously rigid, and the market for private renting verges on the non-existent. If some modest tax relief can help to complement our other policies to get these markets working better, that is a prize worth taking.

In short, well-directed tax relief can help to promote developments which can make the economy more flexible, adaptive and dynamic.

That is why, for example, I extended the Business Expansion Scheme to private renting in this year's Budget. The lack of privately rented accomodation in this country is still a crying disgrace, which plainly inhibits the mobility of labour. Nicholas Ridley is tackling it through housing legislation. I judged it worth complementing that by offering a new tax incentive for a limited period of five years.

That is also why I introduced tax relief for profit related pay in 1987: again, a desirable carrot to get more flexibility into the labour market. Interestingly, the biggest response so far has been among small firms, confirming that these are in many ways the spearhead of the enterprise culture.

Limiting the value of reliefs

But while some tax reliefs can play a worthwhile role, the general presumption against them means that, as time passes, every relief must be reviewed with a citical eye. Is this one still needed for the purpose for which it was devised? Is that one now being used more as a tax planning device than for its original purpose? Is the other one showing diminishing economic returns in relation to the amount of revenue foregone?

Perhaps I could illustrate the process by reference to the Business Expansion Scheme.

When we came into office, small business was in the doldrums; and it was still difficult, if not impossible, for small and medium sized companies to raise venture capital. So Geoffrey Howe introduced the Business Start-up Scheme, which developed into the Business Expansion Scheme. That has provided tax incentives which have helped substantially to promote new businesses, to the great benefit of the economy.

I subjected the Scheme to a searching review by independent consultants from Peat Marwick, before deciding to make it permanent in the Budget of 1986.

Meanwhile, the spread of the enterprise culture, fostered by this and other policies, has brought forth a dramatic growth in the venture capital industry, from almost nowhere when we took office to over £1,000 million of investment a year. Thus much of the original purpose of the Business Expansion Scheme has now been fulfilled. I therefore took steps in the 1988 Budget to place a limit on the amount any one company can raise through the Scheme each year, so as to concentrate BES money in future on the smaller companies, where the need still exists.

And in extending the Scheme to private renting, I have explicitly limited the relief to five years.

Moreover, it is an important feature of our tax reform that the value of all the allowances and reliefs in the system falls as tax rates fall. If we had retained Labour's tax rates, mortgage relief, for example, could now be worth about £3,000 a year to a top rate taxpayer - assuming the present £30,000 limit and present interest rates. Instead, on the same assumptions, it will be worth a maximum of about £1,200 this year.

Results

I have stressed that the objective of tax reform is to help bring about a more efficient economy, with more freedom of choice. And the proof of the pudding is in the eating.

- We have created the conditions in which individuals and businesses can flourish and prosper.
- As companies have become ever more profitable, they have come to pay increasing amounts of tax, even though their tax rates are lower.
- As individuals have become ever more prosperous, they too have come to pay more tax on their higher earnings, even though their tax rates are lower.

It is the economist's dream: to reduce tax rates to improve incentives, yet to do it without unacceptable sacrifices of revenue.

Over the past decade, we have cut tax rates markedly. Yet so far taxes and national insurance contributions still amount to a higher proportion of national income than when we first took office.

At the beginning, we could afford to reduce income tax rates only by raising VAT, because we simply had to get the borrowing requirement down. We also had to accept increases in national insurance contributions to finance increases in spending on benefits for the pensioners and the unemployed. And our oil revenues were still rising. So it is not difficult to see why taxes and national insurance contributions rose as a proportion of our national income, even though we cut income tax rates substantially.

But over the past five years, I have been able to make large reductions in the rates of direct taxation without having to impose very much in the way of offsetting increases in indirect tax rates. There has been no increase at all in the rates of national insurance contributions - though there have been reductions for the lower paid, financed by abolishing the ceiling on employers' contributions. And oil revenues have been falling substantially - from almost 3 per cent of national income five years ago to less than 1 per cent now, and from about 7½ per cent of total tax and national insurance revenues five years ago to about 2 per cent now. Yet despite all this, total taxes and national insurance contributions amount to only about 1 per cent less of our national income than they did when I became Chancellor in 1983.

The moral is simple. Tax reform has helped to give us a better performing economy. And a better performing economy has given us higher revenue for any given tax rates.

So we have put paid to another post-war nostrum: that you need high tax rates to finance the welfare state. I trust this year's Budget will mark the final break with this myth.

But although the size of the tax and national insurance burden has not changed much, and indeed is still clearly too high, the result of the reforms I have described is that the burden is now much better distributed.

I would single out three changes in particular, all of which have promoted both efficiency and equity.

First, the tax on companies has been shifted decisively from employment to profits. As a proportion of total taxes and national insurance contributions, revenue from the national insurance surcharge and employers' national insurance contributions is down about 4½ percentage points, compared with the position when we took office; while revenue from corporation tax is up a little more than that.

Second, the tax on individuals has been shifted decisively from income to spending. Again as a proportion of total taxes and national insurance contributions, the revenue from income tax is down about 8½ percentage points; the revenue from VAT is up about 7 percentage points.

Interestingly, the share of VAT continues to rise, even though there has been no change in the rate since 1979 and no significant change in the coverage since 1984. That is partly because we have taken measures to ensure that the tax is properly collected; partly because people have chosen, quite naturally, to spend their rising incomes on higher consumption; and partly because spending on the items to which VAT applies tends, on the whole, to be more buoyant than spending on the items which are zero rated.

Third, income tax has been shifted from the great mass of the population to the better off. In Labour's last year, with their nine higher rates of tax, plus the investment income surcharge, the top 5 per cent of taxpayers bore 24 per cent of the total income tax burden. In 1988-89, in spite of the reductions in the Budget, the top 5 per cent are expected to shoulder 28 per cent of the total burden.

And despite the fact that the total income tax burden has been substantially reduced, to the great benefit of ordinary

taxpayers, it looks likely that the single higher rate in 1988-89 will yield at least as much revenue, as a proportion of total taxes and national insurance contributions, as the nine higher rates and investment income surcharge did in 1978-79.

So we have put paid to yet another part of the conventional wisdom: the idea that a progressive income tax system requires a steeply rising schedule of marginal rates.

Moreover, the share of revenues from stamp duties and from capital taxes paid by individuals - in great part by the better off - has risen by a full percentage point.

In short, we are now raising the money to finance public expenditure in a way which imposes much less of a drag on work and effort and enterprise. And that will continue to pay dividends in the years ahead.

The low tax society

That is the economic benefit of low tax rates; but there is a wider benefit too. Because a low tax system is an <u>acceptable</u> tax system.

For almost fifty years, from the outbreak of the Second World War, Britain was a high tax country. Top rates were seldom below 60 per cent, usually very much higher. Left to their own devices, such penal rates of tax would have crippled the economy completely.

Did anybody seriously think, when the decades of high taxation reached their pinnacle of absurdity between 1976 and 1978, that any investor would really pay at the top rate of tax, 98p in the pound, the rate that applied during those dismal years? No, the economy had to develop its own survival mechanisms, with avoidance techniques, fiddles and downright illegal evasion. That could only

bring the system into disrepute.

We have now brought the top rate down to 40p in the pound, which most people will regard as reasonable. So for the first time in our adult lives, Britain is a low tax country. People will take time to adjust, but it is fair to expect that the tax system will gradually recover the legitimacy of which it was deprived during a period when it was hijacked by the social engineers. And that will be a momentous change.

I believe, too, that in the final decade of this century, the acceptability of the tax system will be further enhanced by the far-reaching reform I announced in this year's Budget to provide independent taxation of husband and wife from 1990. For the greater part of two centuries, ever since the time of the Younger Pitt, a married woman's income has been treated as if it were her husband's. That cannot possibly have engendered respect for the tax system in recent years. Scrapping this outdated rule will be a major milestone, and a very welcome one.

Indeed, we may well come to look back on the 1988 Budget not only as the one which finally marked the end of high tax rates in the UK - a historic turning point if ever there was one - but also as the Budget which marked the end, at long last, of the second-class status of married women.

Conclusion

I said at the outset that the main test by which our tax reforms stand to be judged was their success in helping to improve the performance of the economy. I have offered my own account of the progress to date, and I believe it speaks for itself.

There is still a good way to go. But all the evidence is that we are going down the right road.

Not the least of this evidence is that other countries are doing the same. Reducing income tax rates, in particular, has become part of the new international consensus of the 1980s. The Americans are doing it, and so are the Canadians. The Japanese are doing it, and so are the New Zealanders. Many other countries have also made reductions, or intend to do so. And most leading countries have reformed their corporate taxes along the lines I did in 1984, reducing the rates and reducing the distortions introduced by special investment allowances.

Pretty well everywhere you go, tax reform is now seen as an essential (though difficult) instrument for improving economic performance. And it has played a critically important part in Britain's economic renaissance.

But this is only the beginning. Economic policies take years - often generations - to have their full effects.

And tax reform, like other reforms we have introduced, is in the end about changing the very culture of this country. There can be no doubt that this is happening, and will continue for years to come.

APPENDIX

TAX REFORM - THE GOVERNMENT'S RECORD

This Appendix sets out the main tax reforms which the Government has made since 1979. The dates refer to the Budget in which a measure was announced, and not necessarily to when it was introduced.

REFORMS TAX BY TAX

Income Tax

- Basic rate reduced in stages from 33p in the pound to 25p in the pound.
- New objective of 20p in the pound set in 1988 Budget.
- Personal allowances up by over 25 per cent in real terms.
- Top rate of tax reduced from 83 per cent to 40 per cent. All other higher rates - there were nine in 1978-79 - abolished.
- Starting point for higher rate tax up over 15 per cent in real terms.
- Investment income surcharge of 15 per cent abolished in 1984.

Capital Gains Tax

- Indexation introduced in 1982, and extended in 1985; in 1988, all gains rebased to 1982, so no taxation of 'paper' gains.
- Rates aligned with income tax in 1988.

Inheritance Tax/Capital Transfer Tax

- Tax abolished on lifetime gifts made more than seven years before death in 1986.

- Threshold more than doubled in real terms.
- Fourteen rates of tax on death in 1979, now replaced by single rate of 40 per cent.
- Business and agricultural reliefs improved.

Corporation Tax

- Major restructuring in 1984:
  - rate reduced in stages from 52 per cent to 35 per cent;
  - first year capital allowances phased out;
  - stock relief withdrawn.
- Small companies rate reduced from 42 per cent to 25 per cent, same as basic rate of income tax.
- Companies also benefit from rebasing of capital gains to 1982, and indexation of gains since then; as for individuals, capital gains taxed at same rate as income.

Value-Added Tax

- Dual rate of VAT replaced by single 15 per cent rate in 1979.
- Base broadened, to include hot take-away food and building alterations in 1984, and advertising in newspapers and periodicals in 1985.
- Options introduced in 1987 for small businesses to move to cash accounting to ease cash-flow problems, and (starting in 1988) to annual accounting to ease compliance burden.

Stamp Duties

- Rate on shares halved to 1 per cent in 1984, and again to ½ per cent in 1986.
- Maximum rate on land, houses and other buildings halved to 1 per cent in 1984, and threshold raised.

- Capital duty and unit trust instrument duty abolished in 1988.
- Several minor duties abolished in 1985.

Development Land Tax

- Abolished in 1985.

National Insurance Surcharge

- National insurance surcharge abolished in 1984.

THEMES AND OBJECTIVES

Promoting enterprise and participation

- Business Expansion Scheme introduced (Business Start-up Scheme 1981, enlarged into BES 1983). Subsequently revised to improve targeting, particularly limitation to £500,000 raised per company per year in 1988.

- New all-employee share scheme introduced in 1980; successive improvements to that and 1978 profit-sharing legislation.

- Employee share option scheme introduced in 1984.

- Personal Equity Plans introduced in 1986.

- New tax relief for Profit-Related Pay in 1987.

- Tax relief extended to new personal pensions in 1987.

Reducing Tax Reliefs and Tax Breaks

- Life assurance premium relief abolished for new policies in 1984; tax relief for pre-1984 policies reduced in line with basic rate of income tax.

- Tax on company cars increased by 150 per cent in real terms.

- Commercial woodlands taken out of income and corporation tax in 1988, ending notorious abuse.

- Mortgage interest relief withdrawn from home improvement loans in 1988.

- New covenants, other than to charity, taken out of tax system in 1988.

- New rules introduced in 1986 to limit surpluses which can be built up in pension funds free of tax.

- Introduced limit on size of tax-free lump sums, and on tax relief on fast-accrual pensions, in 1987.

Taxation of Married Couples

- Independent taxation of husband and wife from April 1990 (legislation in 1988 Finance Bill), following two Green Papers.

- Tax penalties on marriage abolished in 1988 Budget.

Helping Charities

Improvements in tax regime for charities and charitable giving in successive Budgets, including:

- reduction in minimum period of charitable covenants from 7 to 4 years in 1980;

- gifts to charity exempted from stamp duty in 1982 and CTT/inheritance tax in 1983;

- employers given tax relief on salary costs of employees seconded to charities in 1983;

- new Payroll Giving Scheme, to enable individuals to give regularly to Charity with tax relief in 1986;

- abolition of limit on higher rate relief for covenanted donations by individuals in 1986;

- tax relief for company donations in 1986;

- extension of VAT concessions for charities, especially for the disabled in 1986.

Improving Tax Administration

- Computerised Pay-As-You-Earn, to be followed by taxation of the self-employed.
- Simplified administration in a number of ways e.g. giving mortgage interest relief at source (MIRAS), extending composite rate to the banks, and taking maintenance payments and non-charitable covenants largely out of tax.
- Set up Keith Committee to investigate enforcement powers of the Revenue departments; gradually implementing recommendations.
- Planning for the 1990s: legislated for "pay and file" system for corporation tax, to be implemented when new computer system is operational.

Countering Tax Avoidance

- Tax charged on profits of investment in certain offshore funds in 1984.
- Tax charged on certain controlled foreign companies in 1984.
- Tax advantages in bond washing (conversion of income into capital) eliminated in 1985.
- Restriction on use of losses by dual resident companies in 1987.
- Unapproved share schemes: simplified and retargeted tax provisions affecting acquisition of shares by employees in 1988.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 April 1988

MORTGAGE TAX RELIEF

You asked me about the Times report of the Prime Minister's press briefing on her return from Turkey.

I enclose a copy of the relevant part of the transcript. As you will see, the Prime Minister did not say she would like to see the ceiling raised; the Times comments on this point were their own interpretation.

PAUL GRAY

Jonathan Taylor, Esq.,
H. M. Treasury

Mr Addison

You will need this especially pages 4-14 inclusive

11/4

TRANSCRIPT BY ALEX STACEY FOR COI TECHNICAL RADIO SERVICES OF:

AN ON THE RECORD PRESS BRIEFING BY THE PRIME MINISTER

MRS MARGARET THATCHER ON THE VC10 ON HER RETURN FROM TURKEY

ON FRIDAY 8 APRIL 1988

==

(THE SOUND QUALITY IS TERRIBLE BECAUSE OF THE NOISE OF THE VC10)

PRIME MINISTER:

....

QUESTION:

So what is a realistic target?

PRIME MINISTER:

Probably the only realistic target is round about nought.

QUESTION:

Really? Is that realistic?

PRIME MINISTER:

Yes. Well Germany has just got about,got it round about there.

QUESTION:

....

PRIME MINISTER:

Germany has had it zero. Unless you think in practice if any increase in wages or salaries that you take is matched in a technological age proportionately by increase in output, you need a bit more than that because your increase in output also has to go towards extra population and so on but it is possible to do. It should not be too difficult to do in a technological age but what I was just saying was that with 3.3, I think we are just slightly

above the average of OACD.

QUESTION:

Prime Minister, will lower interest rates help or hinder the move towards zero?

PRIME MINISTER:

Well the way you gentlemen talk about the rate of inflation, there is the retail price index; that is not technically the rate of inflation as you know because you cannot say the rate of inflation is actually the move up or down of mortgages for example. Our retail price index is one of the few that has mortgage rates in. That affects it quite a lot but will it help the RPI? If the mortgage rate goes down as I understand it may because it did not go down with the last half percent then it helps the RPI. Do not forget equallly we have got bigger increases this year, firstly because of electricity and gas prices because those have been down for a long time. Gas has actually gone down and they are now having to come up because of investment of one kind or another.

QUESTION:

But are you worried that lower interest rates will encourage the economy to overheat?

PRIME MINISTER:

Well do not forget, your exchange rate is going up which tightens your money supply therefore it does put you in a position to lower your interest rate a little bit without having any affect on your money supply because the rising exchange rate tightens it and then that does enable you actually to take it down - the interest rate - by a little bit without it having a neutral effect.

QUESTION:

You are obviously worried about the level of the Bearsted (phon) curve expansion. Now that is likely to be encouraged by lower interest rates.

PRIME MINISTER:

It is counterbalanced. You have got the higher exchange rate which is adverse on some, advantageous to others. But that higher exchange rate tightens your money supply but it does open up the possibility of reducing your exchange rate by a little bit.

QUESTION:

But a higer exchange rate obviously means that foreign goods are s... into shops and lower interest rates mean that people can afford to buy them more.

PRIME MINISTER:

Yes indeed. But the exchange rate is something that you are not wholly in a position to determine because a lot of it depends on what people think of other countries and what other countries are doing.

QUESTION:

But how seriously should we take these reports of a disagreement between No 10 and No 11 ....?

PRIME MINISTER:

Now you should not, Bruce, you should not. You should know better than to aks me that.

QUESTION:

Prime Minister, you mentioned mortgages just now. One of the surprises in the budget was that there was no restriction on

mortgage tax relief. Have you set your face against that for traditional political reasons or do you think there will come a stage in your economic policies...?

PRIME MINISTER:

You have your tongue in both cheeks when you ask me that question. Is that an angelic look on your face? Devils have angels as well. No, you know full well that I feel very strongly that mortgage relief is one of the few which I am absolutely determined to retain and I really do not think very much of people who having got their own houses, got their foot on the first rung of the ladder with mortgage relief themselves attempt to stop other people from climbing up by the same route.

QUESTION:

In that case, would you like to see the ceiling grades raised sometime?

PRIME MINISTER:

I am not going to go into that. It has been raised once during our time but what you have to watch also is the price of houses as well. But of course in London, £30,000 is very small and there are many many young people who just have not been able to buy with that amount of relief.

QUESTION:

In your visit to Turkey you said you were hoping to boost British trade and it was a bridge building visit - that sort of thing; have you come away pleased with what you have got out of it?

PRIME MINISTER:

Well we do not quite know what we get out of it. Obviously

we discussed quite a large number of contracts but in the end you have to win contracts on merit. But I mean also you do really beat the drum that really our industry is in quite good shape now, very good shape and I think we will find that we will win quite a number of contracts yet purely on merit which is a mixture of price, design, value for money in one way or another. It is not always the cheapest; it is the best value for money.

QUESTION:

In any particular field Prime Minister?

PRIME MINISTER:

The ironic thing is that they admire our bridge building design - a chap called Dr Brown as you know who did the Severn - and of course he did the second Bosphorous. Dr Brown did the second Bosphorous bridge? Dr Brown is one of the best bridge builders in the world. At the moment he is not the one whose design ....But in fact, yes, we did not get the second Bosphorous bridge but they had to come to us for design and the steel. We did not get the second Bosphorous bridge. .... in the end and they had to come to us for the design of the bridge and the steel.

QUESTION:

There was apparently some feeling that you might be able to do magic with Turkey's inflation rate. Did you give Mr Ozal any particular advice?

PRIME MINISTER:

No, they have got to deal with that. As I indicated at the Press Conference, they are at a completely different stage of their cycle but he is bringing it down and is attempting to bring it down.

QUESTION:

And how should he do it given that he needs growth?

PRIME MINISTER:

There is only two ways ... by not having too big a budget deficit and by having your money supply not too hard ahead of your production. It takes a time to get to those. As we know, it is not always easy to bring your public spending down as fast as you would wish. The view we took was if we could not do that, we would cover our expenditure honestly by taxation. He has got quite a high public sector deficit but he is bringing it down as fast as he can.

QUESTION:

But ... protection for investment outside in Turkey and of the protection of intellectual property rights; what particularly did you have in mind?

PRIME MINISTER:

Well first we have not got an investment protection agreement with them. One is being negotiated. Now it is no good talking about joint ventures and more investment in a country unless people who put their money there are safe from it being appropriated by nationalisation. Now he has already completed - as he tells me - some agreements with some other countries and certainly there is one that is being negotiated with us but I must see that it is very soon completed.

On intellectual property rights, that is tape ... patents and copyright, some countries do not fully observe them and we just have to look at Turkey and see that they do observe them because I remember going to South Korea - some of you were with me with me

when we went to South Korea - they did not observe, for example, all our patents on drugs. Once you put all your knowledge into a patent for the world to see, you are telling them just exactly the design of the various things and how to make them and if they do not observe them then obviously it undermines your willingness to go on pouring in research and development and we just have to have a look at the intellectual property rights which are not satisfactory with Turkey.

QUESTION:

.. Turkey... Britain and the rest of Europe. I mean it is evident from driving around this afternoon how far they have got to go. I mean cheek by jowl by a modern factory ... some awful areas. Do you think they can get up to scratch to join the Common Market in the foreseeable future?

PRIME MINISTER:

They will tell you that if you look at their standard of living not by converting it into a dollar which depends upon vagaries of the exchange rate but you looked at it on purchasing power parity, which is what the money will buy in Turkey - what a salary will buy in Turkey compared with what a salary will buy in another country - that their standard of living is higher than the ordinary method of converting into dollars and they are concentrating as fast as they can on getting it up. And that of course does make it easier over the years for considering them for Europe. Portugal is not a very high standard of living as you know.

QUESTION:

.... population growth in the country and did you feel that

they were actually making the effort to bring the rate .... down?

PRIME MINISTER:

They say again that it is starting to come down particularly in some of the south eastern areas. They say that gradually it is starting to come down and the reason it comes down in most countries is by greater education of the people and of course by far greater survival rate among their families and the realisation of parents that they have large families and the possibility of launching them on a reasonable standard of living is not necessarily very high.

QUESTION:

Can I come onto Cyprus? Now if partition in Ireland had been accompanied by a movement of population we might think this was a very desirable state of affairs. There is obviously rough justice in the present .... but they do work. Isn't it almost ludicrous to want Cyprus reunited; we do not want Ireland reunited?

PRIME MINISTER:

It was your initial premise Bruse, that partition in Ireland had been accompanied by a very considerable movement in population; it was not.

QUESTION:

I know.

PRIME MINISTER:

But it was not and never has in Ireland. There have been various attempts to do it.

QUESTION:

But that is perhaps why partition may work in Cyprus in a way

....

PRIME MINISTER:

After World War II, as you know, there were substantial movements between Greece and Turkey, the Turks in Greece were made to move out to Turkey and the Greeks in Turkey were made to move out to Greece so it is over a million each way. I think Cyprus is very complex, there is a better atmosphere between Greece and Turkey which helps. I have ... Mr Vassiliou would like a settlement but when you said that, as I indicated at the press conference, it is when you get down to the detailed negotiating against a background of mutual suspicion. You have got to go also with the negotiations, have a look at them as a whole and see what you are prepared to comprimise on and what is the alternative to having a unity state because a divided state would not be easy and when you have partition you still tend to get minority problems in each section so you then have to have a look at what drives you to depart from ... the alternative. You have to ... politics is often a question of alternatives. But I think the sooner they get down to it the better.

QUESTION:

It must give you great satisfaction to say as you said this morning, "We are good, we are worth knowing."

PRIME MINISTER:

We are. I said that to some Japanese ... We are.

QUESTION:

When did you decide to come out in such frank terms?

PRIME MINISTER:

I would think about certainly a year before the election because I thought we have got all of the economics pretty nearly right. There are perhaps still some restrictive practices and more to be done on ensuring we have competition, we have got the paper out now. But we have got the tax about right and now we have re-established the incentive because we were getting out of kilton (phon) with other nations on their top tax. Ours was much higher than theirs.

One of my goals has been is supposing we get inflation down, sound financial policy, tax incentives, a lot of red tape gone, competition working well, that people have been so constrained for 20 years that they have lost the habit and the desire of enterprise, well I will be there; it would have been a great worry. But the fact is they have not and that was evident somewhere between a year to 18 months before the election that new businesses were building and all of a sudden some of the older ones were expanding, they were doing new products, they knew the importance of design, management of returns. They were really managing again and all of a sudden it became evident that the kind of enterprise that built us in the first place is still there. I think it was evident at the last election.

QUESTION:

We are on take-off again.

QUESTION:

At the other end of the scale, Prime Minister, are you confident that the new Social Security changes, that you got the

balance right in every sector? There seems to be alot of disquiet in the Tory party about penalising those who have some small amount of savings while perhaps ... £6000 ... are now going to lose out on housing benefit?

PRIME MINISTER:

If you have a system which concentrates on helping those in need and bringing up people to a basic income, you are going to have difficulties wherever you draw the line and that is what some of the critics will not admit. There is no alternative to concentrating the help on those most in need. Now if I had said to you in the election in 1979 that we would be defining ... help with housing and rates and you would still get need if you had up to £6000 in the bank, you would have thought that quite generous wouldn't you? And that is a measure of how we have come on actually helping those in need out of the greater amount of money we have had.

You see, why they are going on individual cases is because they cannot argue on the broad main case. Now if you are never going to do any Social Security reform because some people are going to be worse off, you would never have had the Labour party producing fair rents. Dick Crossman did not then say "We cannot do this because some people will pay a higher rent", he said "We have to do it, we cannot go on as we are".

On the big broad things there is far more being spent by the working people of this country on social services and I reckon we are all working between 16 unless they are in full-time education ... than ever before. What they cannot argue with is the colossal

improvement in the health service. You do not go from spending 8 billion on the health service and spending nearly 23 billion this year - 8 billion to 23 over eight years - without it being a colossal improvement. You do not go from 16 billion on the Social Security to 46½ billion in eight years without it being a colossal improvement. You do not have an extra 1.1 billion on health from last year to this, an extra 2 billion on Social Security without every single penny piece of that going to either those who are either sick or in need. But you simply could not go on with the highly complex thing under which people on Social Security, if they needed something extra for laundry; they got a laundry allowance, something extra for diet; they got a diet allowance, they got an extra heating allowance. You simply could not go on calculating it individually so you took them all; we did not give them back to the Exchequor or anything like that, you took them all and evened them out so of course those who got colossal high individual allowances are less well off. On the whole there are a tremendous number of people who have gained.

QUESTION:

Having achieved all this, what is your own dearest personal ambition for the next stage of the Thatcherite revolution?

PRIME MINISTER:

Well we still have to extend owenership further and enable people to build their own security for retirement which is going on very well; 70% of people who retire now have not only their basic pension but a second pension as well - 70%. Half of the people who retire now also own their own homes so you are moving into a totally

different kind of background for people who are retiring now.

I think there are still some more restrictive practices to go. The battle is still to realise that it is not the Government that provides more for Social Services; it is the earnings of people and if you take too much out of people's pockets of their own earnings and leave them less and less over which to decide how to spend, you will in fact throw sand into the wealth creating engine. And that you must not do.

The objective is to get people earning more and more, creating more and more wealth so they raise their own standard of living but because they are creating more and more wealth, by taking the same or a lower level of taxation, you still have more than enough for the Social Services and things you want to do.

QUESTION:

This bears on the image as ... presumably.

PRIME MINISTER:

Yes it does. It bears upon your whole attitude. You see the attitude which some people still adopt. If they say "I can get as much from Social Security by not working as I can working". My reply to them is "You are not entitled to live off your neighbour if you can earn that same amount yourself".

Social Security is for people who genuinely cannot find a job or are sick or who cannot earn. The money does not come from Government; it comes from your neigbour and if you can earn the same amount as you get on Social Security yourself, then the fact is that it is your bounden duty so to do because George Bernard Shaw "Freedom incurs responsibility". And you are primarily responsible

for your own earnings and your family and it is only when you are actually unable to do that because of illness or genuinely being unable to get a job that you are entitled to call upon your neighbour to keep you. But you see the phrase "Am I my brother's keeper?"; it is not "Is my neighbour my keeper?". Can you see the difference?

(END OF TRANSCRIPT)

NNNN

Vice Prem

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

17 March 1988

NATIONAL SAVINGS: REDUCTION IN INTEREST RATES

Thank you for your letter of earlier today, which the Prime Minister has seen and noted.

Paul Gray

P.D.P. Barnes, Esq.,
H.M. Treasury.

53/2/LPD/3759/032

CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG

Paul Gray Esq
10 Downing Street
LONDON
SW1

17 March 1988

Dear Paul,

NATIONAL SAVINGS : REDUCTION IN INTEREST RATES

This is to let you know that we have decided to make the following reductions in National Savings interest rates which will be announced at 5.30pm today:-

(a) Investment Account - reduced by 1.5% a year to 8.5% from 31 March. It is usual to give 2 weeks' notice of changes in Investment Account rates.

(b) Income and Deposit Bonds - reduced by 1.5% a year to 9.0% a year from 1 May. The prospectus for each requires us to give 6 weeks' notice of changes in interest rates.

(c) Premium Bonds - the rate of interest used to calculate the prize fund is to be reduced from 7.0% a year to 6.5% a year from 1 July. This will not result in fewer prizes.

These changes bring the rates offered to personal savers by National Savings into line with those offered by banks and building societies. These decisions were made in advance of today's reduction in base rates, but are not affected by that reduction.

Yours sincerely,

Peter Barnes

P D P BARNES
Private Secretary

3745/1

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG

NBPM
PRCG
24/2

Paul Gray Esq
10 Downing Street
LONDON
SW1

24 February 1988

Dear Paul

NATIONAL SAVINGS: GENERAL EXTENSION RATE

This is to let you know that we have decided to reduce the General Extension Rate, which is paid to holders of matured savings certificates, from 6.51% to 5.76% from 1 March.

This is the fourth in a series of reductions in this rate since April 1987. The aim is to help improve the quality of funding by encouraging holders of these certificates to transfer into the current issue certificate, which offers a guaranteed tax free return of 7% if held to maturity (5 years).

The Department for National Savings will be announcing this at noon on 25 February.

Yours sincerely,

Peter Barnes

P D P BARNES
Private Secretary

PAM40

SECRET AND PERSONAL

PRIME MINISTER

EUROPEAN COURT OF JUSTICE: VALUE ADDED TAX ON SPECTACLES AND OTHER GOODS SUPPLIED WITH MEDICAL CARE

I understand that, tiresomely, on Tuesday (23 February) the European Court is to publish its judgment in the infraction proceedings taken against us by the EC Commission over our VAT exemption for spectacles and certain other goods supplied with medical care.

The Commission's case is that the relevant provision of the EC Sixth Directive on VAT (which was adopted in 1977 and lays down a harmonised system of exemptions from the tax) permits exemption only for the services of doctors and other medical professions; it does not extend to goods supplied in connection with their services. Our VAT reliefs for many goods supplied in connection with medical care, for example, drugs and medicines on prescription and artificial limbs, are in fact protected under other provisions of the Directive; the Commission's proceedings will in practice affect only spectacles, contact lenses and privately purchased hearing aids.

On the basis of the Advocate General's opinion, which the Court normally follows, the Court's judgment is likely to go against us. We shall therefore be obliged to apply VAT at a positive rate to spectacles and the other goods concerned. This should not mean that the price of spectacles would increase by anything like the full 15% of the standard rate of VAT. Opticians are at present not zero-rated but exempt from VAT, and thus already suffer sticking tax on their purchases. This means that prices should rise only by the amount of VAT on the retail margin.

As you may recall, we fought the infraction proceedings through to the European Court not because we expected to win but to allow a breathing space for the breaking of the opticians' monopoly to bring down prices. This has duly occurred; but unfortunately the imposition of the tax now, with an annual yield of some £25 million, would come at a particularly awkward time, given the sensitivity over the NHS in general and eye-testing in particular.

I propose that, as an immediate response, the Economic Secretary should answer an arranged PQ, along the lines that "the UK has a Treaty obligation to implement rulings from the European Court. The Government will abide by the Court's decision but we need to study the judgment in detail before we can make any firm decisions about how to proceed. Any amendment to United Kingdom law imposing taxation will have to be proposed to, and approved by, the House of Commons".

However, in practice, given the controversy this matter is likely to cause, it seems to me that the sooner we get it over the better. I would not, of course, want to take any decision in time for the Budget, but would bring forward the necessary clause in time for the Committee Stage of the Finance Bill.

Moira Wallace

pp N.L.

19 ~~December~~ February 1988

(Approved by the Chancellor and signed in his absence.)

RJ8.60 PERSONAL AND CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Good - worth fighting through. [handwritten]

23 September 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Prime Minister 2
You won! (And a number of people in Whitehall have cause to thank you even if they never know it.)
DRN 23/9. [handwritten]

Dear David

TAX TREATMENT OF THIRD PARTY ENTERTAINMENT AND GIFTS
LATE NIGHT TAXIS FOR EMPLOYEES

Thank you for your letters of 15 September recording the Prime Minister's views on Third Party Entertainment and Gifts and Late Night Taxis, which we have taken on board.

The proposed £100 limit on the exception for gifts will be regularly reviewed along with other minor monetary limits in tax legislation or extra statutory concessions. The Chancellor would not propose to commit the Government to automatic annual upratings- which (he would hope) would be trivial in amount. But he entirely agrees that the intention should be to ensure that the £100 limit maintains its real value over time.

The extra statutory concession on late night taxis will operate where the number of journeys is no more than 60 in a tax year, and if Civil Servants face liability by exceeding this number they will be fully compensated.

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 22 September 1987

Tax Arrangements for Expatriates

You may like to see the letter attached sent to me by Sir David Wolfson.

(DAVID NORGROVE)

Jeremy Heywood, Esq.,
HM Treasury.

DSS

SIR DAVID WOLFSON

Thank you for your note about the tax arrangements for expatriates. What you say seems to me to make a good deal of sense, and I have taken the liberty of sending a copy of your letter to the Treasury.

David Norgrove
22 September 1987

Sept.17,1987

Dear David,

The Expatriate rules are, I presume, designed to discourage people from moving their residence abroad in order to avoid UK Tax. If return is made too easy, many people who do not require to be in UK full-time would "emigrate" and enjoy the benefits of lower tax rates while continuing to be in UK as much as they wanted.

Therefore I propose that, for a period of say 4 years, the expatriate would continue to operate under present rules. BUT, AFTER SUCH A PERIOD, THE RULES COULD BE RELAXED TO ENCOURAGE EXPATRIATES TO SPEND MORE TIME OVER HERE. An additional 60, or even 30 days per year, after 4 years, would not encourage more people to emigrate. But it could generate a considerable sum of Foreign Income into the UK, since many expatriates spend as much time over here as they are allowed, and spend money each day they are here!

One could even restrict the additional days to people over retirement age, and make it a concession which only applied from year to year. That way no-one would emigrate because of an enlarged allowance in the future which might be withdrawn before they could take advantage of it!

But each year it operated we would derive income, hotel charges, food bills, and shopping requirements which might otherwise have gone to Marbella, Palm Beach or Cannes.

Why not try to get the best of both worlds?

No reply needed, this is merely to put on record the object of the exercise as I see it.

Yours etc.

David

David Wolfson

5/16

SCBG

Treasury Chambers, Parliament Street, SWIP 3AG

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

cc Sir David Wolfson. and pa.
We shall see.

30 July 1987

DRN
31/7.

Dear David,

TAX ARRANGEMENTS FOR EXPATRIATES

You wrote to Tony Kuczys on 8 July asking about the current rules on residence in the UK for tax purposes - in particular with regard to expatriate visitors - and for comments on a suggestion by Sir David Wolfson that the presence test could be extended for expatriates who had been abroad for sufficient years to have established residence firmly outside the UK.

In order to simplify the explanation of the existing rules I will assume that the expatriate is working full time in a business profession or employment carried on wholly abroad. In these circumstances a visitor, expatriate or otherwise, will not be treated as resident or ordinarily resident in the UK unless

(i) he stays here for six months or more in a tax year - when he will always be regarded as resident here for that year;

or (ii) his visits for four consecutive tax years have averaged three months or more per year - when he will be regarded as becoming resident and ordinarily resident;

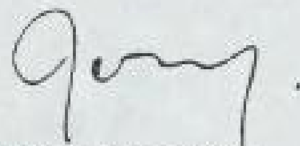
or (iii) on the occasion of his first visit to the UK, he proposes to make visits for four consecutive tax years which will average three months or more per year - when he will be regarded as becoming resident and ordinarily resident from the outset.

The extent of a visitor's liability to UK tax varies with his residence status: a resident in the UK is liable to tax on his worldwide income and gains; an individual who is not resident but ordinarily resident is liable on his worldwide gains but only on income arising in the UK; whereas an individual who is not resident and not ordinarily resident is not liable on capital gains and is liable on income arising in the UK. There are some exceptions to these rules which depend upon domicile or upon special issue terms of certain British Government securities.

The current "regular visitor" rules do permit an average three months' presence per tax year over a four year period and provided the six months per tax year is not exceeded, this does give considerable flexibility to the visitor to the UK - whether he be an expatriate or not.

As it happpens, the residence rules for tax purposes are being looked at in some detail at present and Sir David's comments will certainly be borne in mind in that review.

Yours ever,



JEREMY HEYWOOD
Private Secretary

Sir D Wolfson

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 September 1987

TAX ARRANGEMENTS FOR EXPATRIATES

You wrote to David Norgrove on 30 July with a note about the existing rules in response to a request from Sir David Wolfson here.

Sir David Wolfson had a word about his proposals with the Prime Minister last week, and she has noted that you are reviewing residents' rules at present. One particular point Sir David raised, which I should be grateful if you would also bear in mind, was a proposal that retired people living abroad might be given more flexibility, and allowed to spend more time in the UK.

Once again, his argument is that this would help increase expenditure in the UK, without adversely affecting tax revenues.

MARK ADDISON

Jeremy Heywood, Esq.,
H.M. Treasury.

PERSONAL AND CONFIDENTIAL

File DG
(Not to be copied to BG)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 September 1987

Dear Jeremy,

LATE NIGHT TAXIS FOR EMPLOYEES

The Prime Minister has seen the Financial Secretary's minute of 7 September about the limit of forty occasions proposed for the provision of transport home for an employee to be regarded as exempt from tax.

The Prime Minister remains very doubtful about the wisdom of making the announcement proposed, partly on grounds of principle and partly because she regrets the way in which the tax system is being elaborated. (She has in mind also of course the proposed announcement about the tax treatment of third party entertainment and gifts.)

The Prime Minister is nevertheless willing to go along with the proposal on late night taxis for employees provided first, that the limit of forty journeys is increased to sixty journeys, and secondly, that those civil servants affected (whether for example in Private Offices or those involved in taking legislation through the House, e.g. the Finance Bill) are properly compensated, with the compensation grossed up according to the marginal tax rate faced by each individual.

Yours sincerely,

David Norgrove.

David Norgrove

Jeremy Haywood, Esq.,
Financial Secretary's Office,
H. M. Treasury.

GA

PERSONAL AND CONFIDENTIAL

PERSONAL AND CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 September 1987

Dear Alex,

TAX TREATMENT OF THIRD PARTY ENTERTAINMENT AND GIFTS

The Prime Minister has seen your letter to me of 11 September about the proposed £100 limit on exemption for third party gifts.

The Prime Minister continues to have great doubts about this proposal. She is, however, prepared to go along with it on the understanding that the size of the limit is reviewed and increased each year. It should not be allowed to fall in real terms.

Yours,

David.

David Norgrove

Alex Allan, Esq.,
H. M. Treasury.

PERSONAL AND CONFIDENTIAL

MR 1/72

PERSONAL AND CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

11 September 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

TAX TREATMENT OF THIRD PARTY ENTERTAINMENT AND GIFTS

Your letter of 8 September recorded the Prime Minister's invitation to the Chancellor to reconsider the £100 limit on the proposed exemption for third party gifts to ensure that it will be adequate.

The proposal is that gifts - but not, of course, gifts of cash - of up to £100 in any tax year from any third party source should be exempt from tax.

The Chancellor has looked carefully at this again. The purpose of the £100 limit is to ensure that tax should remain payable on really quite valuable gifts given to someone because he or she is an employee, while excluding from tax the overwhelming majority of more modest goodwill gifts, so that very few people will need to be bothered about tax on third party gifts at all.

We are not proposing any overall limit when someone receives a number of gifts, each within the £100 limit, from different sources. But we are relying on the monetary limit on the value of gifts from each source to help ensure that we are only exempting genuine "goodwill" gifts and not gifts which are an indirect form of remuneration.

The Chancellor feels that, in these circumstances, a limit of £100 strikes the right balance.

I understand that the Prime Minister also asked about the position of the Royal Family. The advice we have from the Inland Revenue is that they are not, as such, holders of an "office" for income tax purposes. It follows that, as a general rule, there is no risk of their incurring a tax charge

on gifts they receive. This applies even where a member of the Royal Family holds an office (for example as Patron or President of some charitable or artistic body) which is essential honorary or unpaid. But the normal rules would, of course, apply in the case of a member of the Royal Family who holds a paid employment or office of profit, and who receives a gift in that capacity.

Yours,
Alex

A C S ALLAN
Principal Private Secretary

10 DOWNING STREET

Prime Minister

It may well not alter your view, but I think you should see the Financial Secretary's minute, which was by mistake not attached to mine. Both are now below.

Does it change your view at all?

DW 10/9.

No – if this kind of thing goes ahead we must have a special allowance for officials like mine. For normal late working plus exceptionally late working – an extra £1,000 a year or so

PRIME MINISTER

LATE NIGHT TAXIS FOR EMPLOYEES

The Financial Secretary argues that a limit of forty journeys per year is about right as the number to be regarded as exempt from tax.

This is not a welcome development for people in private offices, including your own. But, reluctantly, I believe that the Inland Revenue are right to want to set a limit of this kind, given the approach they are following.

Large numbers of people work unsocial hours and this seems to be spreading, not just in the entertainment industry but also in the City and elsewhere. If an employer wants an employee to work late it should be his job to look after that employee both in the matter of extra payments and, if he wishes, to make the person's journey home quicker and easier. The help for the journey home is as much part of the employee's remuneration as overtime payments or payments for working unsocial hours. It is also an important principle that travel between home and work is not allowable for tax.

Against this background, the Inland Revenue are drawing what seems to me a reasonable distinction between late night travel which is regular and frequent and more occasional journeys.

There will however, as the Revenue recognise, be a number of people who will have to pay tax even though they receive no financial benefit from the use of private transport, because for example they own season tickets.

So, agree:

(i) a limit of forty journeys?;

(ii) to ask the Revenue to investigate the possibility of exempting also those people who already have arrangements for their journeys home?

(I would like to suggest also exempting those who would otherwise travel by bicycle! But that would scarcely be taken seriously.)

David Norgrove

9 September 1987

For my private office £40 is ludicrously small (and for others - especially those who have prolonged legislation going through the House this year). There is no public transport at certain hours of the night. It is quite wrong under those circumstances to tax the money unavoidably spent on getting home.

SRWAZZ

CONFIDENTIAL

SUBJECT cc MASTER

FILE

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 8 September 1987

Dear Alex,

TAX TREATMENT OF THIRD PARTY ENTERTAINMENT AND GIFTS

The Prime Minister and the Chancellor this afternoon had a word about the draft press releases, attached to your letter to me of 2 September, which discussed the tax treatment of third party entertainment and gifts.

After discussion, the Prime Minister agreed that the press release on third party entertainment was acceptable, but invited the Chancellor to reconsider whether the proposed limit of £100, below which the Inland Revenue would ignore the tax charge, was adequate.

Yours,

David.

D R NORGROVE

A. C. S. Allan, Esq.
H. M. Treasury

CONFIDENTIAL

4372/29

PERSONAL and CONFIDENTIAL

Bro please.

FROM: FINANCIAL SECRETARY
DATE: 7 September 1987

PRIME MINISTER

LATE NIGHT TAXIS FOR EMPLOYEES

Your Private Secretary's letter of 1 September asks us to review the limit of 40 occasions we propose if the provision of transport home for an employee is to be regarded as exempt from tax.

The Chancellor and I have given further thought to whether an upper limit for the number of journeys which can be taken in a year is necessary. We have concluded that it is. The main reasons are set out below:-

1. Under the concession as it presently stands, both employers and employees will be free from the need to make a return of the benefit to the Revenue. However, if we do not stipulate an upper limit for "infrequent" it will be a matter for each employer's judgment how many journeys he can provide for an employee before he need regard them as taxable, and feel under an obligation to return them to the Revenue. This will vary, but some will include all these journeys in their returns even where these have been relatively few. Similarly employees themselves would wonder whether or not to include the journeys on their tax returns. Again interpretations will vary, and some will choose to include them.

2. Another result would be that the application of the concession would be inconsistent as between taxpayers, depending upon the view taken by their employers. This would be a very difficult position to defend and I do not think it would be a practical way to operate the concession.

3. Undoubtedly, employers will want to know what the official interpretation of "infrequent" is. If we do not offer a number at the outset we will soon come under pressure to provide one.

4. We also need an upper limit to make sure the concession is confined to the people to whom it is meant to apply. These are people who habitually work normal office hours but are occasionally required to work late and the idea is to spare them a tax penalty in addition to the other inconvenience this can cause. An upper limit is a practical way of identifying these cases. Without it there would be little to prevent employers who were so minded from exploiting it to provide free transport for the much larger number of workers who habitually work late - eg in the catering and entertainment industries - for whom the concession is not designed. This would substantially increase the cost.

5. In addition, if the relief were to be available to employees on a wide basis it would not be proper to give it by way of an extra statutory concession. If there were no limit to the concession and it became widely used, it would then become much more clearly a matter for legislation.

6. There is one final point. Travel between home and work is not allowable for tax. This applies equally to people working unsociable hours. What we propose here is a limited exemption in exceptional circumstances eg. where late working is unexpected.

As you say, the reasons for providing an employee with private transport home may be similar on the first and forty-first occasions, but this is an inevitable characteristic of any numerical borderline and forty journeys is already a fairly generous interpretation of the kind of case at which we are aiming.

NL

NORMAN LAMONT

ECON POL

TAX + SAVINGS

PT 4

MR 1/52

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

2 September 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

TAX TREATMENT OF THIRD PARTY ENTERTAINMENT AND GIFTS

The Chancellor has asked me to let you know about two press releases that the Inland Revenue are proposing to issue about the tax treatment of entertainment and gifts which employees receive from someone other than their employer (a third party). I attach copies of the draft press releases which are, I think, self-explanatory.

Yours
Alex

A C S ALLAN
Principal Private Secretary

DRAFT

INLAND REVENUE
Press Release

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

[3x] September 1987

ENTERTAINMENT PROVIDED FOR EMPLOYEES BY THIRD PARTIES

The Financial Secretary to the Treasury, the Rt.Hon. Norman Lamont MP has announced that the Government intend to introduce an exemption from income tax for entertainment employees receive from third parties. The exemption will take effect from 6 April 1987. The necessary legislation will be included in the 1988 Finance Bill.

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1. The exemption will apply to entertainment an employee receives by reason of his employment from someone other than his employer. It will not, however, apply where the entertainment is directly or indirectly procured by the employer for his employees or where it is provided under any kind of reciprocal arrangement with the employer. The tax treatment of entertainment provided by the employer for his employees remains unchanged. Nor will the exemption apply to entertainment provided as a reward or inducement for or in recognition of some specific service or services done or to be done in the course of the employee's duties.

2. Ministers have authorised the Inland Revenue not to pursue liabilities in respect of entertainment received from third parties for years up to and including 1986/87 which are unsettled at the date of this announcement. Liabilities which have been settled will not be re-opened.

3. The Finance Act 1976 provides special rules for charging tax on benefits and expenses received by directors and "higher paid" employees and office-holders (people whose earnings including expenses and benefits are at the rate of £8,500 a year or more). These rules apply to all expenses and benefits received by a director, higher paid employee or office holder by reason of his employment and not just those provided by his employer. Any benefit such a person receives from entertainment provided by reason of the employment is thus chargeable to income tax. The exemption will apply only to entertainment provided by a genuine third party. It will not

include entertainment provided (or procured) by the employer for his employees (subject to the present concessionary exemption for expenditure on a Christmas party or similar function costing up to £30-35 a head), for which the same problems do not arise. Nor will it apply where the entertainment is, in effect remuneration for services provided as part of the employee's normal duties.

4. In some circumstances the employee may be able to claim a deduction against the charge for expenses "incurred wholly, exclusively and necessarily in the performance of the duties" of the employment. This will generally be the case where hospitality is provided at what is essentially a working occasion and the Inland Revenue has long accepted that in practice no tax liability will arise on the typical working lunch, dinner or reception.

5. Many businesses however provide entertainment for business contacts and clients as a means of generating goodwill. Such entertainment provides the recipient with a benefit chargeable to tax, for which he is unlikely to be able to claim a tax deduction. However this charge raises numerous practical difficulties for the recipient, his employer, the provider and the Revenue, and the Government have concluded that the present rules cannot be effectively and satisfactorily enforced. Accordingly they propose to exempt such entertainment provided for employees from tax with effect from 6 April 1987.

DRAFT

INLAND REVENUE
Press Release

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

[3x] September 1987

GIFTS FOR EMPLOYEES PROVIDED BY THIRD PARTIES

The Inland Revenue, with Treasury Ministers approval propose to introduce an extra-statutory concession exempting from income tax gifts employees receive from third parties costing not more than £100 in any tax year. The concession will apply to gifts received on or after 6 April 1987.

---

1. The concession will cover gifts which an employee receives by reason of his employment from someone other than his employer. It will apply to gifts costing £100 or less from any one source in a tax year. A gift made to a member of the employee's family or household will count towards the annual £100 limit.

2. The concession will not however apply where the gift is directly or indirectly provided or procured by the employer for his employees or provided under any kind of reciprocal arrangement with the employer. Nor will it apply where the gift is provided as a reward or inducement for or in recognition of some specific service or services done or to be done in the course of the employee's duties. It will not apply to cash or other monetary gifts eg tips, whether or not given in recognition of some specific service.

3. For years up to and including 1987/88 where the tax liability is unsettled at the date of this announcement ~~the~~ Ministers have authorised the Inland Revenue to collect tax only where the cost of the gift exceeded £100 or more than £100 of gifts were received from the same source in one tax year. Liabilities which have been settled will not be re-opened.

4. The main features of the concession - in particular the definition of a gift from a third party will be in line with proposals for entertainment for employees provided by third parties which the ~~Finance~~ Financial Secretary, the Rt. Hon. Norman Lamont MP has announced will be included in the 1988 Finance Bill.

5. The gift of an asset to an employee, as such, (or the sale of an asset at less than market value) is taxable under the Schedule E rules as part of the remuneration of the job. Liability is generally based on the realisable (market) value of the asset; but for directors and "higher paid" employees and office holders (people whose earnings, including expenses and benefits, is at the rate of £8,500 a year or more) the charge is on the cost to the employer if that exceeds realisable value.

6. The tax charge extends to any gift which comes to the employee by virtue of his employment and not just gifts received from the employer. Many gifts are made by businesses to "third party" business contacts to generate goodwill. Such gifts provide the recipient with a benefit chargeable to tax. However, the Inland Revenue have been authorised to ignore the charge where the cost of a gift or gifts received by the employee from one source is £100 or less in a tax year.

7. The concession will only apply to gifts from a genuine third party. It will not apply to gifts provided (or procured) by the employer for his employees. Nor will it apply to gifts which are in effect remuneration for services provided as part of the employees normal duties - for example, various kinds of "incentive awards".

8. Extra statutory tax concessions are relaxations which give the taxpayer a reduction in tax liability to which he is not entitled under the strict letter of the law. Most concessions are made to deal with what are, on the whole, minor or transitory anomalies under the legislation and to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter. In a particular case there may be special circumstances which will require to be taken into account in considering the application of a concession. A concession will not be given in any case where an attempt is made to use it for tax avoidance.

psl/7A

PERSONAL AND CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG
01-270 3000

Prime Minister 2
To be aware.
DCW
3/9.

PRIME MINISTER

TAX TREATMENT OF BENEFITS IN KIND

My Private Secretary's letter today enclosed a copy of draft Inland Revenue press releases on the proposed tax treatment of "third party" entertainment and gifts (ie those provided by someone other than the recipient's employer). I thought it might be helpful if I set out some background to these proposals.

We have a difficult line to tread on benefits in kind. On the one hand, it is clearly wrong in principle that some employees should be able to avoid tax simply by receiving part of their remunerations in the form of perks, rather than cash. On the other hand, excessive zeal in pursuing this principle can lead to a souring of relations between the Revenue and the taxpaying public in pursuit of a tax that cannot be enforced with any reasonable degree of consistency.

Recent legal advice obtained by the Inland Revenue has revealed that many more "benefits" are liable to tax than had previously been thought, certainly by the taxpaying public. The Revenue do seem to have been taking a somewhat purist attitude, but the legal position seems unassailable. "Third party" benefits provide perhaps the most notable example: few people imagine that accepting entertainment in the course of their job potentially leaves them with a tax bill; indeed, few would think this was justified. And the administration of this tax charge would be completely impossible.

PERSONAL AND CONFIDENTIAL

Norman Lamont and I have examined this at length with senior Inland Revenue officials. I am satisfied that the only practical route is to exempt these benefits entirely. Employees would of course continue to be liable to tax on benefits provided by their own employers.

I am proposing that this exemption should be enacted in next year's Finance Bill, and made retrospective to April 1987. But the Revenue press release makes it clear that there would be no question of pursuing unsettled tax liabilities for previous years.

There is a similar problem with the legal taxability of third party gifts. While there are some instances of very substantial gifts to employees, which it is reasonable to tax, it would be a nonsense to levy tax on, for example, the receipt of a desk diary. We are therefore proposing that gifts (other than cash) totalling up to £100 from any individual source / should be made exempt from tax. This seems most appropriately done by an extra-statutory concession.

L in a tax year

There are several other issues on benefits in kind which have cropped up as a result of the Revenue's more careful interpretation of existing law and which are still under discussion. These include:

(i) some problems over the benefits which employees receive from their priority applications for shares in privatisation issues. This raises some difficulties over the BP sale, and I am pursuing these urgently;

(ii) the proposal which you have already seen on late night taxis; we will be letting you have a further note on whether we should set a specific limit on the frequency;

(iii) a host of other "automotive" benefits, of which the most contentious is perhaps the provision of car parking

spaces, where I think we will want to announce a substantial exemption.

These problems inevitably raise the question of the earnings threshold below which employees are not liable to tax on benefits in kind, which has not been raised since we first took office, when it stood at £8,500. I shall be considering this in the context of the Budget, and will bring forward proposals in due course. Meanwhile, I should be happy to discuss this tedious but sensitive complex of issues with you when we next meet.

NIGEL LAWSON

2 September 1987

CF pps file X6

cc Sir D Wolfson

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 September 1987

TAX ARRANGEMENTS FOR EXPATRIATES

You wrote to David Norgrove on 30 July with a note about the existing rules in response to a request from Sir David Wolfson here.

Sir David Wolfson had a word about his proposals with the Prime Minister last week, and she has noted that you are reviewing residents' rules at present. One particular point Sir David raised, which I should be grateful if you would also bear in mind, was a proposal that retired people living abroad might be given more flexibility, and allowed to spend more time in the UK.

Once again, his argument is that this would help increase expenditure in the UK, without adversely affecting tax revenues.

MARK ADDISON

Jeremy Heywood, Esq.,
H.M. Treasury.

PERSONAL AND CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 September 1987

Dear Nigel,

The Prime Minister has seen your letter of 28 August to Nigel Wicks about the proposed Press Release on taxation of the benefit an employee receives if his employer sends him home by private transport.

The Prime Minister has noted the intention that benefit would not be taxable if the occasions on which private transport were provided were neither regular nor frequent, and that late working would normally be regarded as frequent if it occurred on more than 40 occasions in a tax year. The Prime Minister is most doubtful about setting a limit in this way and has asked that it should be reviewed. She has commented that the reasons which require an employee to be given private transport for the journey home will be just as much present on the 41st, 42nd and later days as on the first 40 days.

Yours sincerely,

David Norgrove.

D. R. Norgrove

Nigel Williams Esq.,
H. M. Treasury.

PERSONAL AND CONFIDENTIAL

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PERSONAL and CONFIDENTIAL

Prime Minister 2

The limitation to 40 journeys per year will not be welcome in Private Offices (inc No 10!) but at least it is better than none which is the limit at present.

ADJ 28/8

Treasury Chambers, Parliament Street, SWIP 3AG

Nigel Wicks Esq CBE
Principal Private Secretary
to the Prime Minister
10 Downing Street
LONDON
SW1A 2AA

28 August 1987

The limitation is ridiculous.

Dear Mr. Wicks,

I am writing to let you know about a new extra-statutory concession the Financial Secretary has agreed the Inland Revenue should announce. I attach a copy of the Press Release which it is intended should be issued on 2 September.

The concession will provide that where an employee is occasionally required to work late and either public transport has ceased or it would not be reasonable to expect the employee to use it, he will not be charged income tax on the benefit he receives if his employer sends him home by private transport.

It is intended to cover the situation in which an employee who normally works regular hours which enable him to travel to and from work by public transport is occasionally, perhaps unexpectedly, required to work so late that public transport has either stopped for the night or could not reasonably be used. The employer then provides private transport home for him. The employee will generally be liable to tax on the cost of private transport provided in these circumstances. But the employee gains nothing from this. Quite apart from the inconvenience of being kept late at work, he will generally have a ticket for the journey home which he cannot use, so he does not save on travelling costs. Nor does he get any financial benefit from the ride home. An extra tax penalty on the cost of the journey home seems unduly harsh when the employee has in effect no alternative means of getting home.

Occasional late working is becoming more of a feature of life these days and this means that even quite junior members of staff can sometimes be kept late. The Revenue have received representations and enquiries from a few private sector firms about the tax treatment of the cost of transport they provide for their staff. Treasury Ministers agree that clear guidance on this is necessary.

The proposed concession will apply where an employee is occasionally required to work until 9pm or later provided those occasions are neither regular nor frequent and by the time the employee can go home public transport has either ceased or it would not be reasonable to expect the employee to use it.

The concession will not, however, apply where transport home is provided on a regular basis. Travel between home and work is private expenditure which is not in law deductible for tax. Where late working is a predictable and regular feature of the job the need to make special arrrangements to get to and from work can be properly taken into account and the problems that arise when late working happens unexpectedly need not occur.

Yours sincerely,

Nigel Williams

NIGEL WILLIAMS
(Assistant Private Secretary)

INLAND REVENUE

Press Release

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

[3x] 1987

INCOME TAX : LATE NIGHT JOURNEYS BY EMPLOYEES FROM WORK TO HOME

With the approval of Treasury Ministers, the Inland Revenue have today announced a new extra-statutory concession. It provides that where an employee is occasionally required to work late, and either public transport has ceased or it would not be reasonable to expect the employee to use it, he will not be charged income tax on the benefit he receives if his employer sends him home by private transport, for example, a taxi or hired car.

Notes for Editors

1. The full text of the new concession is given below.

2. It is intended to cover the situation in which an employee who normally works regular hours which enable him to travel to and from work by public transport is occasionally, perhaps unexpectedly, required to work so late that public transport has either ceased, or could not reasonably be used, and his employer therefore provides private transport home for him. The cost of private transport in these circumstances would often form part of the employee's income for tax. The concession provides that, in the special and limited circumstances to which it applies, the cost of private transport home paid for by the employer is not to be treated as part of the employee's income.

3. No change is proposed in the present statutory treatment when these special circumstances do not apply. In particular, when an employer provides work-to-home transport for an employee more than "occasionally", or when reasonable public transport services are available, the full cost of all work-to-home journeys will continue to be liable to tax on the present basis.

4. The concession takes effect from 6 April 1987. Where the concession applies, employers will no longer need to include the cost of late night transport provided for employees in their pay for PAYE purposes (where cash is reimbursed) or in the employer's return of employees' expenses and benefits (on form P11D). Similarly employees will be able to exclude such payments from

th-ʻr tax returns. In deciding what action to take regarding re. vant payments made to employees since 6 April 1987 employers will need to consider, in relation to each employee, whether taking the tax year as a whole payments to that employee are likely to come within the terms of the concession.

5. Extra statutory tax concessions are relaxations which give the taxpayer a reduction in tax liability to which he is not entitled under the strict letter of the law. Most concessions are made to deal with what are, on the whole, minor or transitory anomalies under the legislation and to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter. In a particular case there may be special circumstances which will require to be taken into account in considering the application of a concession. A concession will not be given in any case where an attempt is made to use it for tax avoidance.

6. The new concession will be included in the Inland Revenue booklet on concessions (IR1) when it is next reprinted.

TEXT OF THE CONCESSION

Employees' late night journeys from work to home

Where an employer pays for an employee's journey between work and home, the cost to the employer is generally treated under present law as a benefit to the employee forming part of his taxable income from the employment; and no off-setting deduction would normally be allowable under the Schedule E expenses rules.

Where however -

a. an employee is occasionally required to work late but those occasions are neither regular nor frequent; and

b. by the time the employee can go home, either public transport between the employee's place of work and home has ceased or it would not be reasonable in the circumstances for the employer to expect the employee to use it

the employee will not be charged income tax on the cost of a taxi, hired car, or similar private transport which the employer provides solely to take him home after work on such occasions.

For the purposes of the concession

- a requirement to work late means working until 9pm or later

- late working would normally be regarded as frequent if it occurs on more than 40 occasions in a tax year.

- regular means a discernible or predictable pattern, for example if late night transport is provided every other Friday.

Circumstances in which, although public transport has not ceased, it would not be reasonable for the employer to expect the employee to use it to get home include circumstances where, because of the low level of availability/reliability of services at that time of night, a journey using public transport would be likely to take much longer than a normal journey between work and home.

MR BEARPARK

Depending of course on the Prime Minister's comments on my note, you may like tomorrow to send the Treasury a letter along the lines of the draft attached.

MGA

Mark Addison

26 August 1987

pa now

PRIME MINISTER

David Wolfson mentioned to you yesterday his ideas about tax arrangements for expatriates. You might like to see the note which the Treasury provided in response to a request from David Norgrove.

The Treasury note says that visitors not wishing to be treated as residents for tax purposes can spend up to six months here in any one year, though they must not exceed three months per year on average over a four year period. The Treasury are, as they say, looking at these rules at present and have agreed to bear David Wolfson's comments in mind. I think all that needs to be done is to put the particular point about exemptions for retired people to them at this stage.

Mark Addison

Mark Addison

26 August 1987

MJ2BHC

From: R B Willis
Date: 1© August 1987

POLICY DIVISION

cc Mr Beighton
Mr Houghton
Mr Weeden
Mr M P Wright

MR FAWCETT (o/r)

MR DAVENPORT

MR DEARMAN

MR S C JONES

MR MASON

RESIDENCE: CONSULTATIVE DOCUMENT

I attach the results of my work on who might be affected by the changes discussed in the consultative document. I am grateful to Mr Dearman, Mr Jones, Mr Wright and other colleagues for pointing me towards information and for explaining the effects of the existing rules, although they share no blame for any remaining misunderstandings.

2. There is information about flows of people coming to and leaving the UK which may provide colour and background for the consultative document. But hard information (on the numbers of gains and losses) and the size of their gain or loss, will require special exercises. I recommend two highly selective samples.

3. Mr Taylor Thompson suggested in his minute of 30 July (not to all) a meeting to take stock of the consultative document and to commission further work. I assume that will be the occasion on which to decide any statistical samples, and would be happy to attend the meeting to deal with questions about my paper.

4. May I suggest that any detailed comments and questions on the paper are copied to Mr Mason, with whom I shall be leaving the background papers (including the helpful comments from Special Offices) while on leave (14-31 August).

R B WILLIS

No 5/CR

RESIDENCE CONSULTATIVE PAPER

WHO WOULD BE AFFECTED?

Summary

Changes to the tax rules for residence and domicile, or to the remittance basis, might affect many different individuals in different categories - people coming to this country to visit or work or live, people born and living here of overseas origins, and people leaving the UK temporarily or permanently. We do not have information on the tax position of these groups. It would be expensive to collect it, because special sampling exercises would be needed in Districts. Options for carrying out such samples are considered, but the only two I recommend are a selective survey of cases which have been subject to Claims Branch rulings on domicile, and a selective sample of foreign firms' PAYE schemes.

what about

Overview

2. There were about 1½ million people living in the UK in 1984 who are not UK nationals [1]. Of these there are:

a. about ½ million Irish citizens.

b. about ½ million Commonwealth citizens.

c. about ½ million other nationalities.

3. There were another 1½ million people born outside the UK but living here as British nationals [2].

4. In total 3 million people (including children, dependent relatives, students) have some potential to claim they are not domiciled in the UK

5. There is little net emigration but there are substantial flows of people into and out of the UK.

6. In 1985 over 170,000 people left the UK. Of these nearly 70,000 were people who were born outside the UK.

7. Also in 1985, 230,000 people came to the UK. Of these over 90,000 were born in the UK.

8. These flows suggest stocks at any one time of very roughly a million non-British resident in the UK and ½ million UK nationals resident overseas.

INLAND REVENUE STATISTICS

9. The Revenue has no need to collect centrally information on overseas visitors or UK citizens working abroad which would justify the considerable costs of doing so.

10. There are a few estimates available from management statistics and previous special exercises. The main figures are:

a. about 65,000 foreign employees in UK in 1980-81 claiming FED [NB probably now more] [3].

b. about 65,000 seafarers of whom about 49,000 in 1983/84 had work relief for 365 days abroad [NB probably less now with contraction in shipping] [4].

c. some 3,000 requests a year to Claims Branch for rulings on domicile in cases which are not straightforward, of which about 1 in 10 are foreign employees and 1 in 5 long-term residents;

d. about 20,000 new requests a year to Claims Branch for rulings on residence of which most (about 4 in 5) are people leaving the UK or returning afterwards, and most of the remainder are people coming to work in the UK.

10. Note that (c) and (d) are unrepresentative samples because straightforward cases are dealt with in Districts without reference or record.

OTHER DEPARTMENTS' STATISTICS

11. No government department collects statistics which are intended to give a direct handle on the numbers and incomes of migrants. Several departments have useful statistics which they collect for other purposes.

12. The OPCS carry out an international passenger survey which yields figures for the nationality and country of residence of people coming to or leaving the UK. For our purposes it provides a measure of where immigrants to the UK come from (Tables 1 and 2 attached) and how long they stay in the UK (Table 3). Information about people entering the UK who were born here provides a measure of how long they have been away (Table 4).

13. The DHSS collect management statistics of people registering or re-registering for National Insurance purposes (Table 5). These will be less than the number of immigrants but more than the number of people with a net liability to UK tax.

14. <u>The Home Office</u> publishes each year immigration control statistics. The latest figures for 1986 (Cm.166, June 1987) confirm the large flows of people into and out of the UK. Of particular interest are the figures for work permits and residence permits (Tables 6 and 7). At first sight the total of about 11,000 in 1986 looks low; and Home Office statisticians confirm informally that there are immigrants working without permits. On the other hand the figure is consistent with our broad estimates of foreign employees of foreign firms (para 10(a) above) - people who might on the whole be expected to register.

THE MAIN GROUPS AFFECTED

15. We do not have much quantitative information. We do have qualitative information and examples of the main groups of people who might be affected by changes. We can divide them into 3 clusters of a total of 13 categories.

A. <u>People coming to the UK</u>:

1. visitors
2. foreign employees of UK firms
3. foreign employees of foreign firms
4. foreign people living here long-term
5. new immigrants*

B. <u>People leaving the UK</u>:

6. people working abroad long-term
7. people leaving the UK for other reasons (eg to avoid CGT)
8. emigrants.

---

* Different departments use different definitions of immigrant and emigrant. I use the words in their dictionary sense - ie an immigrant is someone who comes as a permanent resident and an emigrant someone who leaves this country to settle in another.

C. <u>Miscellaneous</u>

9. visiting expatriates/emigrants
10. returning expatriates/emigrants
11. commuters and cross-border workers
12. investors in Government securities.
13. trustees and beneficiaries of non-resident trusts.

16. I have already circulated notes on these groups, with examples of the more objectionable kinds of cases which crop up. The examples are anonymous so that they could be used in discussion with Ministers or - with a bit more camouflage - a public document. In the following paragraphs I try to put some numbers on the group.

A. <u>People coming to the UK</u>

17. Over 5 million <u>visitors</u> in 1986 were given leave to enter the UK for less than 12 months. Finding those who might have available accommodation, or be caught by changes in residence rules, is impracticable.

18. Our best direct handle on <u>foreign people of one kind or another</u> who are here on a longer term basis (groups 2-4) is the number of forms 11K. Districts requisitioned 90,000 in 1987. This puts an upper bound on the number of people

known to be in these categories. Of course many of the forms will not be used: they will be scrapped by Districts, or by agents who like to keep a stock. On the other hand there will also be people in these categories who ought to be on our books but are not. Allowing for this, and for the anecdotal but consistent stories of increasing activity by foreign firms since 1980, I suggest we work on the assumption that some 60-90,000 foreign taxpayers are employed in the UK. If we take the OPCS figures for emigration as typical of employees (ie we assume size of family is not a determinant) then about a third of the people - say 30,000 - UK are in the for 5+ years.

19. Our only extra handle on long-term stayers (group 4) are the management statistics of Claims Branch domicile rulings. If we assume 600 such cases a year and a life of 10 years we get a population of 6,000. Adding to that an allowance for people who never come to our attention a round figure would be 10,000 long-term residents of foreign origin with substantial wealth.

20. For new immigrants we can take the Home Office figure of 47,000 acceptances for settlement in 1986 as a lower limit. (NB this counts wives and children and other dependants as separate immigrants.)

B. People leaving the UK

21. Even less is known about people leaving the UK. Our controls are over immigration.

22. Claims Branch statistics do not help us greatly because Districts deal with straightforward cases. So we are forced to rely on the OPCS figures for people coming back to the UK (Table 4). These suggest there are something like 100,000 British people leaving the UK each year and about the same number entering. As more than half of the entrants who were

born in the UK have been away for less than 5 years I think we have a high churn rate of people working overseas. Hence my <u>very</u> rough estimate of ½ a million UK nationals overseas - say about 250,000 taxpayers (counting husband and wife as one). This could easily be wrong by a factor 2 or more.

C. <u>Miscellaneous</u>

23. The only groups on which I would comment are the visiting or returning expatriates/emigrants. The OPCS figures (Table 4) confirm the impression that there is a sizeable body of people who return to the UK for visits/residence after long periods away: 20,000 in 1985 after 10 years or more.

YIELD

24. It will always be difficult to estimate the unremitted income where at present we have no locus to insist on information. But some impressions are:

a. many of the 60,000+ foreign employees in the UK (groups 3 and 4) will have overseas investment income and/or income from other employments. Some of this will be taxed overseas and protected by DTAs. But perhaps [£10] million tax might accrue to the UK. And in [many] cases by voluntary compliance.

b. foreigners living here long-term (group 4) are a mixture of people who will probably arrange their affairs in other ways to avoid UK tax (eg the very rich), or who would still need an enforcement effort to identify and collect UK tax (eg the "ghosts" who keep out of the Revenue's net by claiming to live on capital remitted from abroad). But assuming we will at least gain better rights to information about worldwide income and gains a first estimate is £10-100 million;

c. people leaving the UK to avoid CGT (group 7): it is difficult to estimate how many leave for this purpose rather than deciding to leave and then subsequently disposing of assets. It is also hard to estimate how changes (eg a fiscal connection) would in practice change behaviour. And enforcement would be an obvious difficulty. But SO and Claims Branch cases suggest we might hope to gain up to £[10-50] million.

HOW WOULD WE GET BETTER ESTIMATES OF NUMBERS AND YIELD?

25. The only way we could get reliable estimates would be to:

a. examine a large sample of District records (PAYE and Schedule D) in order to identify the numbers of taxpayers entering or leaving the UK net; and

b. follow that up with a survey of a sample of those taxpayers to ask about their unremitted income and gains.

26. This would not be practicable and cost-effective. A large sample would be needed to hit a reasonable number of people in the categories that matter. We have no ready-made identifier because 11Ks are issued manually under COP; D registers will generally just show a manual return; and establishments files are rarely kept (and kept up to date) in Districts. If the sample was drawn randomly from PAYE records we would need to look at about 200,000 cases to hit about 600 foreign employees. I cannot guess how many of those employees would respond to our enquiries about unremitted income. They would however have little if any motivation to answer our questions truthfully.

27. We <u>might</u> undertake less ambitious exercises to look at some of the more sensitive groups.

28. First, foreign employees. Many will be employed by foreign banks, airlines, and multinationals. We could look at their PAYE schemes to get a measure of how many employees are non-domiciled and how many admit to remitting overseas income. (An exercise in connection with FED gives us a list of LP districts and schemes for some 50 companies). I think this would be worthwhile because it would allow us to see the marginal rates of the people involved and hence how much they stand to lose if unremitted income is brought into the computation, and gain if the Chancellor reduces UK rates. Appendix A suggests how this exercise could be carried out - at a cost of some hundreds of man-hours.

29. Second, capital gains tax. Special Offices and Claims Branch have provided references to 50 or so cases which could be examined to see which would and would not be brought within liability by various "fiscal connections". The question is whether or not it is worth doing so when this is an area where behaviour is likely to change with any change in the tax regime? On balance I do not think it would be worth trying to identify and quantify the gains and losses when the players will react to a new set of rules.

30. Third, long-term foreign residents. This is the heterogeneous group which will generate most opposition; and where much of our evidence is anecdotal or based on cases which cannot be called representative. So I think we would find it worthwhile to look at a sample of cases from the Claims Branch Domicile register. Appendix B suggests basic information to collect. And, on the basis that each case takes ½-1 hour to examine, suggests a sample of 300: 1 in 20 cases from the past year and 1 in 40 from each of the 2 preceding years.

31. Fourth, people leaving the UK to reside permanently overseas - especially those who retire to another country. The idea of a fiscal connection which applies some years after departure would be the main issue for these people. But we know little about their circumstances. We could find out more by asking Districts to extract P85s. However I doubt the value of such an exercise because the majority of P85s will relate to people working abroad; and we would still not get information about their subsequent gains.

REFERENCES

1. Official Report, 4 February 1986, WA col 104

2. Labour Force Survey, OPCS Monitor, LFS 85/1,

3. District Memo 93/1982 and Stats 49/5

4. Notes on Clauses, FA84 (p.371)

TABLE 1

IMMIGRANTS BY COUNTRY OF LAST RESIDENCE (1985)

	(thousands)
EC	53
USA	23
Commonwealth	79
Other	77
TOTAL	232

TABLE 2

IMMIGRANTS BY SEX AND CITIZENSHIP (1985)

	Total	Male
British	110	50
Old Commonwealth	19	7
New Commonwealth	28	12
Foreign	75	30
TOTAL	232	99

Source: OPCS Population Trends

Notes: 1. Statistics are based on sample survey of passengers arriving in and leaving the UK. They are not considered reliable by all Government statisticians.

Contact: S M Richardson, OPCS Migration Analysis Unit
01-242 0262 x 2182

TABLE 3

LENGTH OF STAY IN UK: LEAVING MIGRANTS BORN OUTSIDE UK (1985)

(Thousands)

CITIZENSHIP	LENGTH OF TIME IN UK		
	10+ years	5-9 years	1-4 years
British	7	3	2
Old Commonwealth	1	1	8
New Commonwealth	1	4	7
Foreign	3	4	28
TOTAL	12	12	46

TABLE 4

LENGTH OF ABSENCE: MIGRANTS ENTERING WHO WERE BORN IN UK (1985)

(Thousands)

CITIZENSHIP	LENGTH OF TIME OUT OF UK		
	10+ years	5-9 years	1-4 years
British	20	16	52
Old Commonwealth	0.6	0.9	0.1
New Commonwealth	0.2	-	0.2
Foreign	1	0.6	0.7
TOTAL	21.7	17.2	52.8

Source: OPCS Series MN No 12.

Notes: Confidential until 1985 figures published.

Contact: As above.

TABLE 5

IMMIGRANTS (RE-)REGISTERING WITH DHSS IN 1985-86

COUNTRY	TOTAL	MALE
Other European	42,667	22,224
Old Commonwealth	2,194	943
New Commonwealth	17,117	6,961
Pakistan	3,205	1,902
Other Countries	16,771	8,766
Not Known	7,810	6,426
TOTAL	109,897	57,515

Source: DHSS Newcastle Central Office

Notes:

1. information based on DHSS National Insurance records. These do not pick up many immigrants who have no need to register.

2. the registration with DHSS cannot be taken as evidence of work.

3. DHSS have provided tables with more detailed breakdowns by country of origin.

Contact: Mrs E Cowley
Longbenton
x 7239

TABLE 6

WORK PERMITS ISSUED IN 1986 FOR EMPLOYMENT OF 12 MONTHS OR MORE (excludes EC)

Old Commonwealth	500
New Commonwealth	750
Foreign	4,710
TOTAL	5,960

TABLE 7

RESIDENCE PERMITS ISSUED TO EC NATIONALS IN 1986

Workers	5,020
Self-employed	200

Source: CM.166 (Control of Immigration: Statistics)

Notes: 1. figures exclude Irish nationals who do not have to obtain residence permits.

2. not all migrants require permits; and some EC migrants who should probably do not.

Contact: Pauline Penneck
Lunar House
GTN: 2822 - 2301

APPENDIX A

SAMPLE OF FOREIGN EMPLOYEES

Sample size

1. If we concentrate on the PAYE schemes of foreign companies, as I think we should, we are accepting a sample which is not necessarily representative. How big it needs to be to be representative of those people is impossible to predict without some assumptions.

I suggest we assume there is:

a. a majority of legitimate and straightforward people working in the UK on relatively short terms of duty (say up to 5 years);

b. a sizeable fraction - perhaps a quarter - who are here for longer periods;

c. a wide spread of incomes: from about average earnings to some very high salaries;

2. (c) is the crucial factor. In order to capture the distribution of incomes we need a sample big enough to pick up the tail of high earners. Subject to any suggestions from Mr Dearman I suggest we aim for 500 employees. The sample could be extracted sequentially from each scheme up to a ration of, say, 10 employees.

3. The bigger the sample the better our chances of gaining some indication of other factors - eg the distribution of employees by nationality. However I doubt if 500 will be a big enough sample for reliable estimates. We should not have a model by income <u>and</u> nationality <u>and</u> length of stay. Is this acceptable?

Information

4. Table 1 lists the essential information I think we need for each employee and further information it would be helpful to have if it is readily available (eg from the 11K.)

5. Note this does not include information about expected date of departure from the UK; or about the nature of overseas income or UK investments. Although it would be helpful to have this it
would often require a more narrative report and examination of correspondence.

Extracting the Information

6. We have first to identify suitable PAYE schemes. Claims Branch have provided lists from previous exercises on FED (copies attached - Annex A) of banks and overseas airlines. These are a good starting point. However we would be in a stronger position to answer potential criticism of change if we also had information about people in manufacturing (eg Nissan, Sony), new technology (eg IBM, McDonnell Douglas, DEC) and the newer areas of the city (eg Nakumura).

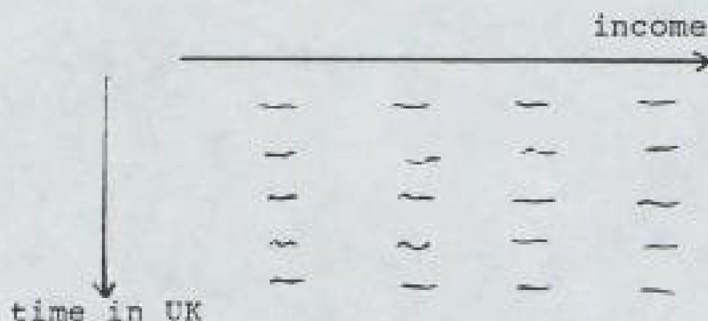
7. Second there is a choice between looking at taxpayers in whatever District deals with their company or concentrating on a few Districts. I recommend the latter. Table 2 suggests a few LP districts which should (give a cross-section of companies. By concentrating on those we minimise the work required to extract the information, although the work will bear more heavily on individual Districts.

8. Third, do we ask Districts to extract the information or provide someone to do so from their files? I raise the possibility of putting in separate people because they would be additional to the District's resources, could be briefed centrally on the information we are looking for, and could be given extra remits - eg to look for examples of people resident here for many years and examine in greater depth their connection with the UK. Against this approach are the difficulties of finding people who could be used in LP Districts, and the possible objections from staff in Districts.

I have no strong views either way. But if we ask Districts to extract the information we may be asked to pay for overtime (perhaps 100-200 hours) to do the work. Does P5 or SD or M4 have any budget for this?

Analysis

9. I suggest we use the information primarily to model the distribution of foreign employees by income and length of stay. If we can show a table on the following lines.



We can show how many foreign employees gain, and by how much, from reductions in UK rates. We can also show roughly the boundary between those who would and would not be caught by a fiscal connection based on years of residence.

Summary

10. The points for decision now are

i. do we go ahead with the survey?

ii. with the questions in Table 1?

iii. with the Districts in Table 2?

iv. for the schemes in Annex A?

v. with Districts extracting the information?

TABLE 1

Information to be extracted from PAYE scheme for foreign employees - defined as employees not domiciled in UK.

PART I

1. District:

2. Employer:

3. District Reference:

PART II

0.	taxpayer's reference	
1.	domiciled in UK:	Yes/No
2.	ordinarily resident in UK:	Yes/No
3.	earnings from UK employment	£
4.	overseas earnings received in UK	£
5.	overseas earnings paid	£
6.	claim for FED	Yes/No
7.	income from UK trade etc	£
8.	investment income	£
9.	income from abroad	£
10.	capital gains	£

Part III (if available)

1. national
   a. British
   b. Irish
   c. other (please specify)

2. year of arrival in UK.

3. If married whether wife is
   a. domiciled Yes/No
   b. ordinarily resident Yes/No

PART IV - COMMENTS

ANNEX C

GROUP: 1 VISITORS (EXCLUDING FOREIGN EMPLOYEES AND EXPATRIATES)

PRESENT POSITION:

Become resident on any visit

i) when have available accommodation,

ii) of 183 days or more.

Become resident and ordinarily resident if

i) resident in 4 consecutive years,
ii) average visit in 4 consecutive years is 3 months or more.

Assume not domiciled in UK.

POSSIBLE CHANGES:

Abolition of "available accommodation" test would relieve some visitors.

Weighted average could have both winners and losers depending on what calculation we adopt and the pattern of visits. However, "losers" will not face real loss if no UK income and gains.

DISCUSSION:

Unlikely to be much affected in practice, but some hard cases at the margins are likely to add to pressure for generous rules on averaging/accumulating visits.

Some will argue against removing the available accommodation test because they want to be resident here in order to escape residence in their home country e.g. for Danes the UK provides a convenient tax haven.

INITIAL ASSESSMENT: BROADLY NEUTRAL AND SOME WINNERS

GROUP : 2 FOREIGN EMPLOYEES OF UK FIRMS

PRESENT POSITION:

As for (3) above but with less likelihood of the complication of second employment.

POSSIBLE CHANGES:

As for (3) above.

DISCUSSION:

With mobility of labour within EC will be difficult to identify those affected.

INITIAL ASSESSMENT: LOSERS

EXAMPLES ATTACHED

Examples: Group 2

1. Mr A was a US citizen who came to the UK in 1980 to work for a UK company. He declared his UK income (which was inescapable because it was taxed under PAYE). But on investigation he was found to have in effect dual contracts of employment with another $100,000 a year paid in the USA.

GROUP: FOREIGN EMPLOYEES OF FOREIGN FIRMS IN UK

PRESENT POSITION:

About [60,000] people. Many employed by banks and airlines.

Unlikely to be domiciled in UK. Are likely to be R and in most (but not all?) cases OR.

May have second employment abroad which escapes tax.

POSSIBLE CHANGES:

Main changes are from FC/abolition of remittance basis.

With FC main effect is to bring overseas investment income and gains into UK net. And to close door on second employment.

With abolition of remittance basis would have bigger numbers affected - in particular foreign emoluments of those not OR.

DISCUSSION:

One of the areas where UK's rules are generous by comparison with other countries. Change would give UK better information about and rights over foreign income. But net effect turns on DTAs so we need to know countries of origin of employees (presumably USA, Japan, EC and old commonwealth predominate?)

Bound to generate complaints from city bodies/multi-nationals.

INITIAL ASSESSMENT: LOSERS

EXAMPLES ATTACHED

EXAMPLES: GROUP 3

1. Mr A is an American who comes to work in London for the UK branch of an American bank. He is resident and ordinarily resident but non-domiciled. He has a second contract of employment in a tax haven, the income from which is taxed neither in the UK nor the USA.

2. Mr B in Japanese. He works for a Japanese company in the UK and in Japan. His UK income is taxed here. Japan taxes his income in Japan <u>and</u> his UK income, but with double taxation relief for the latter.

GROUP: 4 FOREIGN PEOPLE LIVING HERE LONG-TERM

PRESENT POSITION:

Will be R; and OR; but not domiciled.

POSSIBLE CHANGES:

Will lose remittance basis.

FC likely to bring some (many?) emigrations.

DISCUSSION:

These are the wealthy individuals who might point to their contribution to the UK economy in other ways: spending on goods; services and property; employment; investment; support of arts and institutions. The group is heterogeneous, covering people genuinely living off (overseas) capital; "ghosts"; businessmen who operate through foreign companies; users of trusts in tax havens; etc; etc.

INITIAL ASSESSMENT: LOSERS AND A POWERFUL LOBBY.

EXAMPLES ATTACHED

GROUP: 6 NEW IMMIGRANTS

PRESENT POSITION:

Become R and OR from date of arrival: Domicile less clear cut.

Practical position depends on whether

a. employed/or business here, in which case in UK net; or

b. living on overseas investments/gains, in which case an remittance basis.

POSSIBLE CHANGES:

FC/abolition of remittance basis would bring overseas gains and investment income into the tax net - but note FC might delay.

Residence rules irrelevant for genuine immigrants.

DISCUSSION:

Difficult to define an objective test which distinguishes immigrants from long-stay visitors (turns on intentions). But immigrants unlikely to command support for anything but full UK liability.

INITIAL ASSESSMENT: LOSERS.

GROUP: 6 BRITISH PERSONS WORKING ABROAD LONG-TERM

PRESENT POSITION:

Will usually cease to be R and OR from departure until return. Will be domiciled.

POSSIBLE CHANGES:

FC would extend to 3 years following departure and bring gains in that period within UK tax.

DISCUSSION:

Bound to generate complaints about asymmetry between emigrants and immigrants (see 9 below), especially from those who argue they do not know whether or not they have "severed their connection".

Special consideration needed for merchant seamen and airline staff.

INITIAL ASSESSMENT: LOSERS

GROUP: 7 ONE-YEAR ABSENCES TO AVOID CGT

PRESENT POSITION:

As for emigrants.

POSSIBLE CHANGES:

As for emigrants.

DISCUSSION:

A subset of people who make substantial gains while overseas which escape UK tax.

INITIAL ASSESSMENT: SOME LOSERS WHO DESERVE NO SYMPATHY. SOME LOSERS WHO ARE LESS CLEAR-CUT

EXAMPLES ATTACHED

GROUP: 8 EMIGRANTS

PRESENT POSITION:

As for people working abroad except intention to leave UK permanently may establish domicile of choice.

POSSIBLE CHANGES:

As for people working abroad: note new rules would make intentions irrelevant.

DISCUSSION:

INITIAL ASSESSMENT: LOSERS.

GROUP : 9 VISITING EXPATRIATES

PRESENT POSITION:

Assuming has become non-resident and not ordinarily resident rules are as for other visitors (see 1 above).

However are likely to be domiciled in UK so consequences of becoming resident are more substantial: liability for foreign investment income, gains and (if OR) emoluments.

POSSIBLE CHANGES:

Most are likely to be relieved or unaffected by abolition of available accommodation test and by averaging. Indeed averaging might allow occasional longer visits. But have to bear in mind possibly of hard cases if weighted average makes some resident who at present keep below the 3 month limit.

Introduction of FC (or abolition of remittance basis) would not affect genuine expatriates.

DISCUSSION:

A sensitive group with Ministers and the public. Argument is likely to be that we should encourage expatriates to return for holidays and to invest in UK.

We need to get some idea of the numbers in this group and the patterns of their visits.

INITIAL ASSESSMENT: BROADLY NEUTRAL AND LIKELY TO BE MORE WINNERS THAN LOSERS BUT SOME HARD CASES WILL TEST AVERAGING RULES ON RESIDENCE TO THE LIMIT.

GROUP: 10 RETURNING EXPATRIATES

PRESENT POSITION:

Likely to have UK domicile and to become R and OR on return.

However also have returning emigrants who may claim to have established a non-UK domicile.

POSSIBLE CHANGES:

No significant change for expatriates generally unless FC delays start of charge.

For those who claim non-UK domicile effects would be as for immigrants generally.

DISCUSSION:

INITIAL ASSESSMENT: NEUTRAL; POSSIBLY SOME WINNERS.

GROUP: 11 COMMUTERS AND CROSS-BORDER WORKERS

PRESENT POSITION:

May be: a. living in UK but working abroad, and thereby able to establish not R and not OR;

b. working in UK but living abroad, in which case are likely to be ND and hence liable only on UK income.

(b) includes about [2,000] who live in Irish Republic but work in Northern Ireland.

POSSIBLE CHANGES:

Those in (a) may not be affected, although depends on length of time spent in UK and the averaging rules.

Those in (b) likely to become FC and hence lose protection of ND status. (Would pressumably need to make special provision to deal with cross-border workers.)

DISCUSSION:

Much will turn on treatment of day of leaving UK and day of returning to UK.

INITIAL ASSESSMENT: LOSERS WILL MAINLY BE THOSE LIVING IN UK AND WORKING ABROAD.

DRAFT

RESIDENTS AND NON RESIDENTS: THE SCOPE OF UK TAXATION FOR INDIVIDUALS

INTRODUCTION

1. This consultative document reviews the way in which an individual's tax liability on his income and capital gains depends on the closeness of his connection with the United Kingdom, and examines some possible changes to the present rules.

Part I contains a description of the present system in the UK and sets out some criteria against which it, and any changes, should be judged.

Part II indicates some of the main criticisms which are made of the present system, and evaluates its effects in the light of the above criteria.

Part III sets out a number of areas in which the present system might be changed, suggests a possible approach to overcome the deficiencies of the present rules and considers the implications of this approach for a number of broad categories of individuals who might be affected.

2. This document is concerned only with income tax and capital gains tax. It does not examine the

rules which affect liability to inheritance tax or any other taxes.

3. Further, it does not consider the position of companies, partnerships and other bodies. The rules which are relevant for them are different from those which apply for individuals. A new test of company residence for tax purposes, based on incorporation in this country, is proposed in the current Finance Bill.

4. The proposals which are outlined in Part III will be relevant to the residence status of individual trustees and of the beneficiaries of the trusts for which they act. But the document does not discuss the tax treatment of trusts more generally. That is being considered in the context of the review of settlements announced by the Financial Secretary to the Treasury in the debates on this year's Finance Bill (Hansard, Standing Committee A, 23 June 1988 cols 623/4).

5. In this document, "United Kingdom" or "UK" means England and Wales, Scotland and Northern Ireland. It does not include the Channel Islands or the Isle of Man.

6. Comments on the suggested approach contained in Part III in this document should be sent by   to the Board of Inland Revenue, Room   Somerset House, London WC2R 1LB.

PART I

I. THE EXISTING UK SYSTEM

1.1 The scope of the liability to tax of an individual under the present system in the UK depends, in most cases, on three factors - residence, ordinary residence and domicile. The meaning of these terms has remained largely unchanged over the years. It may be helpful at the outset to give a brief description of what they mean.

Residence and Ordinary Residence

1.2 Although there is no definition in the Taxes Act of the terms resident and ordinarily resident, some guidance as to their meaning has been given in decisions of the Courts. These show that both expressions are used in an everyday sense and do not have any special or technical meaning. The Courts have also stressed that residence is very much a question of fact; they have been loath to interfere with decisions of the bodies of appeal Commissioners on the facts, even if they themselves might have come to a different conclusion.

1.3 If a person is to be regarded as resident in the United Kingdom for a particular year of assessment he must normally be physically present in the country for at least part of that year. He will always be regarded as resident if he is here for 183 days or more in the year. Where a person is resident, under their respective domestic laws, in

two countries, then the relevant double taxation agreement will usually determine in which country the individual is to be regarded as resident for the purposes of the agreement.

1.4 If, however, a person is present here for periods amounting to less than 183 days in a year, a large number of factors may be relevant in determining whether or not he is resident. These may include

- whether he has accommodation in the UK available for his use, in which event, a day's presence may suffice to make him resident,
- whether he intends to make regular visits exceeding on average 90 days a year for 4 years,
- whether he is in this country or is abroad for a temporary purpose,
- whether he is working full time, either as an employee or by carrying on a trade or profession,
- whether any duties of an office or employment performed here are incidental to those performed abroad, and
- whether he has set up a permanent home abroad.

1.5 The term "ordinarily resident" is broadly equivalent to "habitually resident"; if an individual is resident in the United Kingdom year

after year he is ordinarily resident here. Thus, an individual may be resident but not ordinarily resident in the United Kingdom for a given year - if, for example, he normally lives outside the United Kingdom but makes visits here in that year for 183 days or more. It is also possible for an individual to be ordinarily resident but not resident for a given year - although a recent decision by the High Court has restricted the circumstances in which this is likely to apply.

1.6 The statutory position is that an individual is resident and/or ordinarily resident for a complete tax year; there is no provision for dividing the year. However for certain categories - eg a person coming to take up permanent residence in this country, or conversely leaving this country to take up permanent residence abroad, a long standing extra statutory concession does enable the UK liability to be related only to the period of residence here during the year.

1.7 Domicile is a concept of common law. It is distinct from nationality or residence. An individual may be resident in more than one country, but, in the United Kingdom, the law ensures that every person has a domicile, and only one domicile, at any given time. A person acquires a domicile of origin at birth: this is normally the domicile of his father and therefore not necessarily the country where he himself was born - or even where his father was born. This domicile of origin is retained until a different domicile is acquired.

1.8 A person with the necessary legal capacity may acquire a new domicile - a domicile of choice - at any time. To do so, he must normally sever his ties

with the country of his existing domicile and settle in another country with the clear intention of making his permanent home there. If he severs his links with his domicile of choice, his domicile of origin will revive unless and until he has acquired a new domicile of choice. The Courts have put a heavy burden of proof on anyone who claims that an individual has changed his domicile - particularly if it was his domicile of origin.

1.9 In addition to these three concepts, nationality may also be relevant, primarily in determining relief from UK tax. For example, a person who is not resident in the UK may be entitled to personal allowances if he is a Commonwealth citizen or citizen of the Republic of Ireland. This derives from the fact that before 1948 a British subject was anyone owing allegiance to the Crown, wherever in the Empire they lived; those who later became citizens of independent Commonwealth countries nevertheless retained the status of British subject under the British Nationality Act of 1948, just as did the citizens of the UK and colonies. This link was however broken by the British Nationality Act of 1981, which introduced various categories of British nationality which were restricted to those who had been citizens of the UK and colonies.

II. THE SCOPE OF LIABILITY

2.1 The basic principle of the scope of UK taxation can be discerned in the first Income Tax Acts of 1799 and 1800. These distinguished only between residents and non-residents. Everyone was taxed on income arising in the UK, but residents were also taxed on their income from abroad to the

extent that it was received in this country (ie the remittance basis).

2.2 This distinction still applies. An individual is taxed on the whole of the world wide income arising to him only if he is resident, ordinarily resident and domiciled in the United Kingdom. At the other end of the spectrum, someone who is neither resident nor ordinarily resident here and is not domiciled in the United Kingdom is liable, broadly, only on income arising in the UK.

2.3 In between these two extremes there is a host of liabilities, reliefs, exemptions and exceptions, including the use of the remittance basis, which depend on various combinations of residence, ordinary residence and domicile. Nationality may be relevant in some cases and the position may also be affected by the residence status of the employer.

2.4 The test for liability to capital gains tax - which was introduced in 1965 - is whether an individual is resident or ordinarily resident. Someone who is not resident and not ordinarily resident is not liable to tax on capital gains - except from UK assets used by him for a trade which is carried on here through a branch or agency.

2.5 The present system is shown in tabular form in Annex A. A short account of the historical development of the existing rules is provided at Annex B.

2.6 There are now around 200 references to residence and ordinary residence in the Taxes Acts and about 30 to domicile, excluding those relating only to corporation tax or inheritance tax. A list

of the more important of them is in Annex C. The number and diversity of these references demonstrates how substantial would be any undertaking to make changes in the system of which they form a part.

III RELEVANT CRITERIA

3.1 In considering whether any changes should be made to the present system, it is desirable to set out some yardsticks against which the present system and any proposals for change, can be measured.

3.2 In the broad context of residence, so far as practicable a tax system should, inter alia, satisfy the following criteria:-

i. fairness and equity

it should in principle bear less heavily on those whose connection with the UK is limited, than on those with permanent and substantial connections with this country; and people in similar circumstances should be liable to a similar extent.

ii. neutrality

it should not needlessly discourage people from coming to live and invest in this country or encourage people already living here to invest abroad or to leave; any incentives provided by the tax system for particular groups of taxpayers or in relation to certain types of income, should be intentional and specifically targetted.

iii. simplicity and certainty

the rules for determining liability should be as clear as possible and based on objective tests. The taxpayer should be able to ascertain his position reasonably quickly and easily and should not have to incur undue expenditure in complying with the law. Similarly, the rules ought to be readily applicable by the tax authority with the minimum of administrative cost.

iv. enforceability

whatever rules are laid down should be capable of being reasonably enforced.

3.3 In practice, it is unlikely that all these criteria can be satisfied - at least to the same degree - but they are all relevant in judging the existing rules and any proposals for changing them.

PART II

IV CRITICISMS OF THE EXISTING SYSTEM

4.1 In recent years, there has been increasing criticism of the difficulties which a taxpayer may have of knowing under the present system exactly what his status is and therefore of determining his liability to UK tax. The main criticisms have centred on the following areas.

i. Lack of statutory guidance

4.2 There is a lack of statutory guidance on the meaning of the terms which determine liability to UK tax. Statute law dating from 1799 and Court decisions mostly from the period 1880 - 1940 are generally regarded as of diminishing value in dealing with a very different world in which there is increasing international mobility of labour and capital and communications between countries are both easy and almost instantaneous. It has been suggested that the Inland Revenue booklet on the subject (IR 20) has, in effect, come to fill the gaps in the law, although it is, of course, not intended to be anything more than a general guide to the way in which the law is interpreted and applied: nor indeed could it be anything other than that under the law.

ii. Complexity

4.3 Over the years, the UK system has become increasingly complicated. With three main determining factors - residence, ordinary residence, and domicile - it is possible to have eight different combinations, each giving rise to a

different set of liabilities and title to relief. If an individual's nationality and his employer's residence status are also taken into account there are even more combinations (see Annex A). This contrasts with the residence rules which apply in other major countries.

iii. Uneven impact

4.4 The present rules bear harshly in some instances and generously in others. The existence of accommodation available for someone's use may make him resident for a year even if he is in the United Kingdom for only one day. This extreme result gives rise to frequent disputes about the meaning of "available". The rule is criticised because it does not take account of the possibility that many visitors to the United Kingdom consider that buying a house or flat meets their requirements better than the alternatives.

4.5 When an individual arrives in or leaves the UK, then that day is not counted in calculating the time he has spent here in that particular year. This practice is more generous than the law requires particularly for people making a lot of short visits. At the extreme, it is possible for an individual to be in the United Kingdom on every day of the year and not be treated as resident so long as he is absent for a few hours on at least half of them. Similarly, an individual could be in the United Kingdom for almost three-quarters of every year for four consecutive years and not be treated as resident here for tax purposes. Not only is the present practice complicated to understand and apply therefore, but the result may often appear arbitrary.

4.6 Where it is necessary to go beyond the counting of the days in order to determine residence, an individual's mode and habits of life over several years may be relevant; much may then depend on his stated intentions. This introduces an element of subjectivity into the determination of his status. It may be necessary for example, to examine a person's activities for a period of years both before and after the year in question. Such an enquiry means that decisions must be provisional and liabilities may remain unsettled for a number of years. The practice in this area can be contrasted with what a judge has recently called the "normal approach of a taxing statute" which he said is to "make the amount of tax assessable by reference to objective criteria".

iv. Unsuitability of domicile

4.7 It is said that domicile is unsuitable for defining the scope of liability to an annual tax, since it often requires a consideration of a person's life history and long term intentions. It might be considered appropriate for a tax such as inheritance tax which is charged on the assets a person has acquired over the whole of his life. But even for this purpose the law recognises that, after a long period of years of continuous residence, an individual's connection with this country has become sufficiently close to justify complete worldwide taxation even if he has not become domiciled here.

4.8 Domicile can also be capricious in its effects. An individual's domicile of origin is determined by reference to that of his parents. A person may be domiciled in a country which he has never visited because only one domicile is possible

at any one time and a domicile of origin is difficult to shed. Thus, an individual may not be domiciled in this country even if he was born in the United Kingdom, has lived in this country all his life and holds a British passport. But he will be taxed differently from his neighbour who is in all respects the same except that he has a UK domicile.

4.9 The relevance of domicile runs wider than tax; it also affects matters such as marriage and divorce. As the law stands, any changes in the general law of domicile, such as that brought about by the Domicile and Matrimonial Proceedings Acts 1973, automatically affect taxation. The Law Commission and the Scottish Law Commission has recently reviewed the law of domicile and suggested some changes. They concluded that their recommendations were unlikely to have a significant impact on taxation. But that if justified anxieties did arise, the continued use of domicile for taxation purposes should be reconsidered.

vi. Opportunity for exploitation

4.10 Under a long standing practice for income tax purposes, and more recently for capital gains tax purposes, an individual who goes abroad for full time service under a contract of employment may be treated as not resident and not ordinarily resident from the day after his departure until the day before his return. This practice applies so long as all the duties are performed abroad (apart from merely incidental duties), the period abroad extends over a complete tax year and visits to the United Kingdom during that period do not amount to six months or more in any one year or an average of three months or more a year.

4.11 This practice has had the unfortunate result of employments being created abroad with a view to realising gains free of United Kingdom capital gains tax shortly after departure. The individual may then return to the UK a year later, and remain here for the rest of his life.

4.12 Another significant gap in the present rules concerns the individual carrying on a trade or profession who is able to control both the timing of his income receipts - for example, the proceeds from the disposal of a copyright for a lump sum - and his residence for tax purposes. If he spends a full tax year outside the United Kingdom, such proceeds can fall outside the UK tax net, and quite possibly that of other countries as well. This process can be repeated at judiciously chosen intervals to secure that the maximum amount of income is not subject to tax.

v. Defects of the remittance basis

4.13 As indicated earlier, some individuals are liable to UK tax on various bases falling between tax on world wide income and gains, and tax on income and gains from a UK source only. Probably the most significant of these is the remittance basis - under which the liability to tax is based on the "sums received in the United Kingdom".

4.14 At present, it is primarily those who are not domiciled in this country who pay tax on the remittance basis. As can be seen from the table in Annex A, it is also available to certain categories of UK domiciled individuals who are not ordinarily resident in this country. In practice, this basis suffers from three major drawbacks.

4.15 First, the broad definition of remittance in the Taxes Act and the wide interpretation which has been given to it by the Courts make it extremely difficult for a taxpayer to calculate his own liability; effectively, it requires an analysis each year of almost every financial transaction undertaken.

4.16 It may, for example, be necessary to follow income as it arises through a number of different bank accounts to its final destination. The compliance burden on the taxpayer can be substantial. An Inspector of Taxes faces equal difficulty when examining tax returns if he has reason to suspect that the full amount remitted has not been disclosed.

4.17 Second, it encourages the setting up of arrangements overseas - which may be more or less artificial - in order to secure effective exemption on income which is in reality related to a UK employment, and which would otherwise be taxed in full.

4.18 Third, it is easy for the well advised to arrange to bring back money from overseas to meet their expenditure in the United Kingdom without it being regarded under the present law as a "remittance". These arrangements include:

- opening separate accounts for capital and income and remitting only from the capital account; and

- closing an account or selling an income producing asset in one year, and remitting accumulated income in the next

when there is no longer a source of income that can be charged to tax.

V. EVALUATION OF THE PRESENT SYSTEM

5.1 When set against the criteria outlined in section II above, the present system is open to a number of criticisms. These include the lack of:

- equity. On the one hand, the availability of the remittance basis for individuals who are not domiciled in this country means that for a particular group of long term residents in this country, tax on overseas income and gains is effectively a voluntary tax. On the other hand, the available accommodation rule can be seen to operate unjustly. As a result, there are people with the closest possible connections with the UK who pay tax on only their UK income and others with very little connection who are liable on all sources.

- neutrality. The remittance basis also operates to bias the non-UK domiciled long term resident towards overseas as against domestic investment. An imbalance also results from the ability to avoid a charge to capital gains tax on assets that have accrued in value over a long period while a taxpayer was resident, by their realisation shortly after departure from the United Kingdom for a relatively short term assignment abroad. A similar result can be achieved with certain income receipts.

- simplicity and certainty. The law on residence consists of a complex set of rules attempting to codify ancient case law and sketchy statutes. It can be difficult for a taxpayer to know his status for a particular year and it may take several years before a definitive ruling can be given. A detailed examination of a person's life style and financial affairs may be necessary in which intentions and motives may be relevant.

- enforceability. The remittance basis in its present form is extremely difficult to apply in practice. In terms of enforcing liabilities, however, recent amendments to the Rules of the Supreme Court have made it easier for writs and bankruptcy petitions to be served on those living outside the United Kingdom.

5.2 In considering the weight of these criticisms, comparison can usefully be made with systems operating in other countries. Some of the main provisions are given in Annex D, but in general, most OECD countries have only one factor, residence or "fiscal domicile". The factors which determine residence vary greatly and include available accommodation, duration of stay, place of family, and centre of economic interests. Some countries have specific reliefs for particular classes of taxpayer, for example for foreign executives working in the country, but only the Republic of Ireland and Japan adopt the remittance basis for these cases.

PART III

VI. POSSIBLE AREAS FOR CHANGE

6.1 The first section of this part of the document considers a number of areas in which the present rules might be changed, and suggests some possible alternative approaches which might be adopted.

6.2 The preceding analysis suggests that there are two main areas for consideration:

- the scope for rationalising the present tests of residence, ordinary residence and domicile; and the possibility of replacing them by some other, more objective, tests and

- whether there is a need for an intermediate basis of liability. By this is meant an unrestricted charge on all UK source income, but only a limited charge on income from abroad. Such a basis could apply to those who are resident in this country for a number of years but who have strong ties with another country. If there is a need for such a basis, then it is for consideration what precise form it should take.

Citizenship as a factor in determining liability to UK tax

6.3 At present, the nationality of an individual plays only a small part in the UK tax system. The following paragraphs consider the implications of using it more widely. The rules for determining residence would then, for example, apply only to foreigners living in this country.

6.4 The only major country in the world which uses citizenship as the main test of liability is the United States. A US citizen is liable to tax on his worldwide income and gains wherever he may be: the only concession to US citizens living abroad is that they are exempt (at present) on $70,000 of non-US earned income.

6.5 At first sight, citizenship seems a suitable test to determine the extent of an individual's tax liability. Perhaps more than any other, it reflects the degree of association which an individual has with a country. It is, arguably, a concept which is more easily understood than domicile, as well as providing a greater degree of certainty in its application to individual cases. In general terms, a British citizen is, by definition, an individual who has a permanent right of abode in the United Kingdom (in this case the definition of the United Kingdom includes the Channel Islands and Isle of Man) normally through birth, parentage or naturalisation. There are other classes of British nationals (eg British Dependent Territory citizens and British Overseas citizens) who do not have the unrestricted right of entry into the UK.

6.6 The most obvious consequence of adopting this approach is that tax liability would no longer be determined by the place where a British citizen lived; there would be no incentive to live abroad solely for tax reasons.

6.7 There are however a number of other factors to be taken into account in considering whether this concept should be accorded greater prominence in the UK tax system. First, nationality is much more of a political concept than domicile or residence.

British citizenship can for example, apply to individuals who have never set foot in this country or who were born here but have spent the whole of their lives abroad. Second, the nationality rules have been drawn up without regard to any taxation consequences. If the possession of British citizenship meant higher taxation there might be a move by some to renounce their citizenship and it might deter others from applying for naturalisation even though they were residentially qualified to do so.

6.8 Third, if the concept of nationality were to be accorded greater prominence, the question would arise as to the definition which would apply. At present, where nationality is used for tax purposes it generally refers to Commonwealth citizens (which includes British citizens) or citizens of the Republic of Ireland. It could be argued however that there is no relevant distinction for the purpose of levying UK tax between foreign and Commonwealth (other than British) citizens. On this view, the appropriate test to apply might be whether or not the individual was a British citizen, but even if this approach were adopted it might be necessary to have special provisions to cater for some classes of citizens.

6.9. Finally, the adoption of citizenship as the main test of liability would raise a number of practical issues. It would be necessary, for example, to compile and maintain a comprehensive record of all British citizens living abroad. This would be a considerable task, requiring access to the records of other government departments eg the Passport Office, the Home Office Immigration Department, the DHSS and Customs and Excise.

Moreover, the difficulty of collecting tax liabilities, particularly where there may be no assets in the UK, and the cost of establishing a network of offices throughout the world to assist both in the completion of returns and to carry out audits and any necessary investigations should not be under-estimated.

6.10 It is perhaps relevant in this context that although the US has used a nationality basis for the last 75 years, Congress has expressed concern about the non-completion of returns by US citizens living abroad. A recent study by the General Accounting Office found that about 60% of Americans abroad were not filing US tax returns. In the light of this, the Internal Revenue Service is taking a number of special measures to increase compliance.

6.11 It is apparent from even this short summary, that the use of nationality as the basis for imposing liability on world wide income would require the most careful and detailed consideration of the far-reaching issues, of both a practical and political nature, which it would raise. Although some of the administrative difficulties would be less significant if the test were used to determine a limited measure of liability, as against a charge on world income, the underlying problem of the nature of nationality as a fiscal test would remain.

Rationalising the present residence rules

6.12 If citizenship is not adopted as the main criterion, the residence rules become all the more important.

6.13 In order to deal with the criticisms and difficulties of the present system of determining residence, it would clearly be desirable to move to a system which is based more on objective and easily determined facts. This could be achieved by determining residence for tax purposes solely on the length of time an individual is in the UK. And to remove what has become an inequitable feature of the present system, the rule relating to available accommodation could be abolished; someone who is in the country only for one day in the year would not then be treated as resident simply because he had a house or flat here. The present practice of not counting days of arrival and departure might also be changed.

6.14 A possible approach to meet these objectives could incorporate the following features:

i. an individual who was present in the UK for 30 days or less in the year would not be resident for tax purposes in the UK in that year. The "available accommodation" test would be scrapped.

ii. the first test of residence would remain as now - an individual would be regarded as resident if he was present in the United Kingdom on 183 days in any tax year.

iii. the second test of residence would apply to an individual who is present for between 30 and 183 days in a year. There are a variety of possible approaches involving looking back over the number of days of presence in the country in previous years which could be adopted. It is important however that any

rule which is chosen should apply equitably not only to emigrants and immigrants, but also to regular, or irregular, visitors here. The US introduced rules in 1984 under which an individual who is present in the United States for at least 31 days in a year may, depending on the number of days of presence in the 2 previous years, be regarded as resident in that year. This is calculated by adding to the number of days he is actually present in that year one third of the number of days he was present in the previous year and one sixth of the number of days he was present in the year before that. The fractions used and the years brought into the calculation could be varied to suit particular purposes. Taking these fractions as illustrative however, an individual would be able to be present in the country for up to about 120 days each year without becoming resident (ie 120 + (1/3 of 120) + (1/6 of 120) = 180).

iv. presence for any part of a day would generally count as presence for the whole day subject to the exclusion of some special categories like transit passengers. It might be necessary to amend the appropriate double taxation agreement to deal with cross-border workers e.g. those commuting to work in Northern Ireland from the Republic of Ireland and vice versa.

Basis of liability

6.15 The next area for consideration is whether there is scope for radical simplification of the present system by imposing tax liability on

either worldwide income or UK source income, and doing away with the remittance basis and all the other intermediate bases. If it is considered that there is a need for an intermediate basis, it is, of course, necessary to go on to consider who should be entitled to it and what form it should take.

i. Need for an intermediate basis

6.16 As we have seen, at one end of the spectrum there is the individual who has his permanent home here and has no ties with any other country. It would be generally accepted that such a person should be liable on the whole of his income and capital gains for the year, wherever they arise. At the other end, there would also be general acceptance for the proposition that the individual who has no connection with the United Kingdom and whose permanent home is in another country should be liable to UK tax only on any income which arises or is earned here.

6.17 These are however very general propositions and a wide variety of circumstances can arise in between these two extremes for which the tax system should provide an equitable and acceptable regime. This poses the classic tax dilemma of equity against simplicity. Although there is considerable scope for rationalisation of the present rules, there may be a need both in terms of equity and on economic grounds to provide some intermediate basis of taxation for certain groups of taxpayers. On this view, simplification ought not to be achieved at the expense of other objectives.

6.18 Although most other OECD countries distinguish only between residents and non-residents, some have

special provisions for foreign executives or other groups. There are good reasons why this should be so: those who have a part to play for a relatively short period in the economic or cultural life of a country should not be deterred from so doing by the tax burden; and, more generally, their position can be distinguished from that of long term residents.

6.19 This suggests that any intermediate basis of taxation should not be permanent for the individual concerned. In those countries which do have such a basis, five years is the longest period this type of relief lasts. It is for consideration therefore whether an acceptable intermediate basis could be introduced which applied only for a number of years, after which the individual would become liable to tax on his worldwide income in the same way as any other long term resident.

6.20 An approach on these lines would adversely affect those who have been resident in this country for a long time, but who are not domiciled here. They are, under the present rules, subject to tax on their income which arises here and on any income which they remit here from overseas.

6.21 Most of those in this category will have enjoyed the benefits of living in this country for many years, if not for their whole life - and many play a full part in its economic, social and cultural life. It does not seem unreasonable that they should be expected to meet their fair share of tax on similar terms to other people who spend all or most of their lives in the UK, and that their liability should not continue to be affected by their origins or background, including in some cases the domicile of their parents.

6.22 The impact of any change in the tax rules for this group will, in many cases, depend not only on the burden of tax which they are asked to bear in this country, but on the amount they would bear overseas. In some cases it will mean little more than a change in the tax take between the UK Exchequer and that of another country. The reduction of the top rates of income tax this year is, of course, an important factor in this context.

ii. Entitlement to the intermediate basis

6.23 At present, it is primarily those who are not domiciled in this country who can enjoy a basis of taxation less than that of their worldwide income and gains. For reasons which have already been outlined, this is, in its present form, an unsatisfactory criterion for this purpose, since it enables a very favourable basis of taxation to be enjoyed by groups of taxpayers for whom taxation on their worldwide income might be regarded as appropriate and equitable.

6.24 The main problem in dealing with domicile under the present regime is displacing it when it loses validity because of the duration and continuity of a person's connection with this country. The test turns in part upon an individual's intentions and it is difficult to prove that he has for example lost a domicile of foreign origin even where he may have lived in this country for most of his life and intends to go on doing so for some years.

6.25 There are two possible approaches which might be adopted:

(i) to retain the concept of domicile but to introduce a rule that, purely for tax purposes, a person who had been resident in this country for a number of years should be regarded as sufficiently "fiscally connected" with the UK to be liable to tax here on his world wide income and gains. The number of years taken for this purpose would need to be long enough to establish that a person had done more than make a temporary home in this country; and it would be necessary to prevent the test from being easily avoided by a relatively short break in residence. Taking account of these factors, a possible test might be that a person who was not domiciled in this country but who was resident in a year and had been resident in say 7 out of the previous 14 years had established the necessary fiscal connection with this country. Until this point was reached, the person who was not domiciled in the United Kingdom would be liable to tax on the intermediate basis.

This approach would remove the main weakness of using domicile in the present system and has the advantage of continuing with a concept which is probably familiar to tax practitioners.

(ii) to drop the concept of domicile altogether, and replace it by a concept of "fiscal connection" based purely on years of residence. Any individual who

was resident in the UK in a year and had not been resident for 7 out of the previous 14 years would then be liable to tax on the intermediate basis.

This approach would provide much greater certainty and objectivity than any rule relying on domicile, but it might seem less appropriate for those coming, or returning, to the UK for permanent residence. For example, where a person whose home is in the UK but who has spent many years working abroad, retired to live in this country, it might be difficult to justify their receiving a preferential tax basis for a period of 7 years as compared with other retired people who had spent all their working lives in this country. To meet this point an additional rule would be necessary - possibly on the lines that the individual should not have been previously resident in the UK at any time for a continuous period of say 10 or 15 years. Not only would this be a somewhat arbitrary test however, it would presumably require information which could relate to the distant past and which might not therefore be readily available.

iii. The form of the intermediate basis

6.26 The present intermediate basis consists of two, quite separate, parts. First, it brings into UK liability any income and gains which arise in this country. There seems no need to change this rule. However, consideration may need to be given to making it more effective by bringing within it income which is closely related to a UK employment but which has been split off into an overseas employment in order to secure the benefit of the present remittance basis.

A new "receipts basis"

6.27 The second strand - and the more unsatisfactory at present - is the taxation of income and gains from overseas on a "remittance basis". The main defects of this basis have already been outlined (see paragraphs 4.13 to 4.18), and particular reference has been made to the exploitation of the source rule and of remittances of capital. Clearly, any new basis of intermediate liability must counter arrangements of this kind.

6.28 A possible approach would be to extend the concept of remittance basis so that, in effect, all benefits enjoyed in the UK from foreign income and gains were regarded as a remittance from overseas, and as therefore within the UK tax charge.

6.29 Under an approach on the lines, UK tax would be levied not only on all financial remittances, but also on the proceeds of certain valuable chattels eg. jewellery, paintings and antiques which were brought into this country and disposed of while the owner was resident here. In addition, the value of

benefits, for example in the form of an interest free loan or the rent free use of a property, which was provided for out of overseas assets would be brought into the UK tax charge.

6.30 In determining the amount chargeable to UK tax under this basis, account would need to be taken of any tax which was otherwise payable, for example capital gains tax on the disposal of an asset, and appropriate relief would need to be given for any overseas tax paid, Overall, the amount brought into charge could be subject to a limit of worldwide income and gains for a particular year.

6.31 A strengthening of the remittance basis in this way would remove many of the unsatisfactory features of the present basis, while continuing to provide a more favourable basis of taxation for those who are resident in this country for a relatively short period.

6.32 On the other hand, it would introduce a new element of complexity and impose substantial compliance burdens for those to whom it applied. In order to prevent avoidance, the definition of a benefit would need to be very widely drawn, one consequence of which could be to attribute income tax liability to what were genuinely remittances of capital.

A "world income" approach

6.33 An alternative approach would be to charge a percentage of an individual's world wide income to UK tax, while taking into account the proportion of income and gains which arises in this country.

6.34 This could take the form, for example, of determining the UK liability by the greater of

- the tax on any income and gains arising in the UK, and

- a percentage of the tax liability on the individual's world wide income and gains. This percentage could be graduated to phase in with the length of period after which the individual would become liable to UK tax on his total income. This would ensure that there was no sudden jump in liability when the person became liable to tax on all his income in the same way as all other long term residents.

6.35 Clearly, there is a considerable amount of flexibility over the figures which might be chosen for this purpose and the impact in any particular case would vary according to the ratio which overseas income bore to the individual's world income. In general, however, it would provide a basis of taxation which was certain and relatively simple, and which reflected the closeness of an individual's connection with this country in terms of the duration of his residence here.

Measures to avoid exploitation by short absences abroad

6.36 As indicated in paragraphs 4.10-4.12, there are gaps in the present rules which enable, for example, capital gains which have accrued over many years to be realised free of tax during a relatively short period of absence abroad.

6.37 A number of countries deal with this particular problem by imposing a capital gains tax charge on any unrealised gains up to the date of emigration. A measure on these lines is included in the package of reforms to the rules governing the residence and migration of companies in this year's Finance Bill. It is however accompanied by appropriate measures to ensure that notice is given to the Revenue of an intention to emigrate and that the tax is paid; sanctions can be taken against others eg a controlling company in the United Kingdom or a director of the migrating company, if the company fails to meet its liabilities. It would clearly be more difficult to ensure a similar level of compliance in the case of individuals. Additional provisions would be necessary, in any event, to deal with those who exploit the present rules of assessment by choosing appropriate years to be non-resident for tax purposes.

6.38 A more comprehensive way of dealing with this problem which would apply for both income and capital gains, would be to provide that an individual who went abroad for, say, up to 3 years, and on his return was regarded as "fiscally connected" with this country, would be liable to tax

- on any gains made during the period of non-residence, except in respect of any overseas assets which were acquired and disposed of in that period, and

- on any income receipts received during the period of non-residence which related to activities carried out in the UK in an earlier year of residence. This could be done, for

example, by adopting some form of apportionment basis of income received during the year of non-residence, or by introducing a simple averaging provision which would lead to a subsequent adjustment to the profits liable to UK tax in the years immediately prior and subsequent to the year of non-residence.

VII A POSSIBLE APPROACH

7.1 The previous section examined the main features of the present residence regime and considered various possibilities for change. This section brings together a number of these possibilities in the light of the criteria which were set out in the early part of the document and the difficulties to which the present system gives rise. In the final part, consideration is given to the way in this approach would affect certain categories of taxpayer.

7.2 This approach could contain the following main elements:

i. Residence

- an individual who was present in the United Kingdom for 183 days or more in any year would be resident for tax purposes in the United Kingdom in that year;

- an individual who was present in the United Kingdom for 30 days or less in any year would not be resident for tax purposes in the United Kingdom in that year;

- when an individual was present here between 30 and 183 days in any year, his residence position would be determined by including not only the days spent here during the year in question but also one-third and one-sixth of the days spent in the UK in the preceding year and the year before that, respectively;

- presence for any part of a day would count as presence for the whole day subject to an exclusion for certain special categories like transit passengers.

- it would be for consideration whether the present concessionary treatment for years of arrival and departure could be given statutory backing.

Some simple examples of the effect of rules on these lines are given at Annex E.

ii. Basis of liability

There could be a three tier basis of liability on the following lines:

(a) Liability on world-wide income and gains would apply to all residents of the United Kingdom who have been resident in this country for at least 7 out of the previous 14 years. The term "fiscally connected" with the UK might be adopted to describe this category.

(b) Liability on UK income only would apply to individuals who are not resident under the rules considered above.

(c) Liability to an intermediate basis of taxation would apply to residents of the United Kingdom who have not been resident here for at least 7 out of the previous 14 years. If it were considered that the concept of domicile should not be retained in this limited context there would be an additional qualification to ensure that this basis applied only to those who had not previously been resident in this country for a continuous period of say 10 or 15 years. It must be recognised however that evidence on this question might not always be readily available.

iii. Form of intermediate basis of taxation

7.3 Broadly, as outlined earlier, the intermediate basis of taxation could take the form either of a more effective and wide-ranging remittance basis or the more radical, but possibly simpler approach of imposing tax on a percentage of world wide income and gains, or tax on UK income and gains if that were greater.

7.4 In principle, it is arguable, on equitable grounds, that the UK liability of those living in this country for a relatively short period should take account of the extent to which their style of living is financed out of resources abroad. It is unlikely however that any strengthening of the remittance basis to secure this result could be achieved without imposing substantial additional complexities and compliance costs on those to whom it applied. It is perhaps significant that there are very few countries which adopt this particular basis of taxation.

7.5 On balance therefore, the better approach might be to replace the remittance basis by a charge on world income and gains which was graduated according to the length of an individual's stay in this country. This would introduce a new element into the UK system, but it would reduce the relatively high compliance costs which are currently incurred in order to analyse in detail the origins of sums which are remitted to this country. Examples of this alternative approach are given in Appendix F.

iv. Measures to prevent exploitation

7.6 The concept of "fiscal connection" could also be used more widely for tax purposes to prevent exploitation of the rules by short absences abroad. In particular, it could be used to apply any special measures which were regarded as necessary to prevent the avoidance of income tax and capital gains tax by going overseas for a relatively short period, although sufficiently long to be regarded as not resident in this country.

v. Transitional provisions

7.7 Some form of transitional provision would be necessary for those individuals who are already resident in this country and who would face the possibility of becoming liable to tax on their world wide income and gains for the first time under these proposals.

7.8 There are a number of possible approaches to determining when the clock should start running for the purposes of the proposed "fiscal connection" test. One possibility would be to start the clock

7 years before the introduction of the legislation. The effect of this would be that a non-UK domiciled individual who had been resident in all of the 7 preceding years would become liable immediately to UK tax on all his world wide income and gains. If however he had been resident here for fewer than 7 years or, if during those 7 years there had been a break in his period of residence, the change in the basis of his liability would not come until a later date.

7.9 Another possibility would be for the clock to start in the year in which the legislation was introduced. This would provide a minimum period of 7 years on a favourable basis of taxation irrespective of the number of years which an individual had already been resident here.

7.10 A compromise approach and one which would give a reasonable transitional period for all those affected, might be to allow a 2 year period of adjustment. In other words, if the legislation were introduced in the Finance Act 1989, the 7 year test would be applied to the years from 1983/84.

VIII. IMPLICATIONS OF THIS APPROACH

8.1 The approach set out in the previous section would have a number of advantages over the present system

- the residence rules would be simple and objective; a new concept of "fiscal connection" would largely remove the elements of subjectivity and uncertainty in the present system;

- by applying the same tax treatment to those who spend all or most of their lives in the UK, the equity of the system as a whole would be enhanced;

- the remittance basis would be replaced by a simpler and more certain relief which could be graduated according to the length of an individual's stay in this country;

- the opportunity to manipulate the present rules to secure tax advantages would be significantly reduced.

8.2 It might be helpful to consider how some broad categories of individuals might be affected by an approach on these lines.

i. As we have seen, under the present system those who have lived in the United Kingdom for much of their lives and who happen by birth or background not to be domiciled here are liable to tax on any income or gains arising here and on any remittances here from their overseas income and gains. Under the approach considered above, these people could be liable to tax on their world-wide income and gains.

ii. Similarly, a foreign executive who comes to the United Kingdom for the purposes of a short to medium term employment, say 5 to 7 years, is under the present system liable to tax here on any income or gains arising here and on any remittances here of his overseas income and gains. Under the approach considered above, he would be entitled to the new intermediate

basis which could bring into his UK liability depending on the scale of the charge not only the tax on his UK income and gains but also an increasing proportion of the tax on his overseas income and gains. This might lead in some cases, to an increased liability as compared with the present remittance basis but nonetheless would be less than that of other residents.

iii. For the regular visitor to the United Kingdom from abroad, the present law can be at its most questionable and complex. If for example the visitor is regarded as having accommodation available for his use here, he will be regarded as resident here in any year in which he spends at least a day here. Under the approach considered above, this person will be resident in the United Kingdom for tax purposes only if he is here for 183 days or more in any one tax year or more than an average of 120 (approx) days each year for 3 successive years. This might be particularly important for emigrants from this country who wish to spend some time each year with their family and friends here.

iv. Under the present rules, the UK expatriate employee who has been working abroad for a few years can find that his exact status depends on a variety of factors, including whether he retains accommodation in the United Kingdom and the extent and nature of any duties which he performs here. For him, like the short stay visitor, the present system can be complex and uncertain. Residence rules of a

more objective kind would be a considerable improvement.

v. A person living, say, in the Channel Islands and commuting regularly to the United Kingdom for a few days at a time, spending in all a substantial period here both on business and domestic affairs may not be resident here under the present practice of not counting days of arrival and departure here. Changing this practice would secure a more equitable result.

CONCLUSION

1. This document has attempted to identify some of the unsatisfactory features of the present residence rules. A review of an area of the tax system where the rules are of long-standing and have not previously been codified in statutory form clearly raises issues which need careful consideration and discussion.

2. The document does not attempt to deal with all the detailed circumstances on which the residence rules now impinge. The starting point for any wide-ranging review of this kind is to consider the framework of the system. Indeed it is a criticism of the present arrangements that to a large extent they represent a piece-meal series of changes to meet changing conditions, without adequate consideration being given to the basic structure of the system into which they had to be fitted.

3. The possible approach to residence considered in this document would represent a move in the direction of greater simplicity, certainty and

neutrality, and would result in liabilities more closely related to an individual's degree of connection with this country. But it is obviously important that those who are likely to be affected should have an opportunity to present their views before any firm proposals are brought forward.

SCOPE OF LIABILITY TO UK TAX UNDER PRESENT RULES

UK STATUS FOR THE FISCAL YEAR		EMOLUMENTS FOR DUTIES OF EMPLOYMENT PERFORMED WHOLLY OR PARTLY IN THE UK		DUTIES OF EMPLOYMENT PERFORMED WHOLLY OUTSIDE THE UK	INVESTMENT INCOME		CAPITAL GAINS		UK GOVERNMENT SECURITIES SECTION 47 ICTA 1988 (S99 ICTA 1970 ISSUES)
		IN THE UK	OUTSIDE THE UK		UK SOURCE	FOREIGN SOURCE	UK SOURCE	FOREIGN SOURCE	
1	R/OR/D	L	L+	L+	L	L	L	L	L
2	R/OR/ND	L	L+	L+*°	L	L (R)°	L	L(R)	L
3	R/NOR/D	L	L(R)	L (R)	L	L ci°	L	L	NL
4	R/NOR/ND	L	L(R)	L (R)	L	L (R)°	L	L(R)	NL
5	NR/OR/D	L	NL	NL	L	NL	L	L	L
6	NR/OR/ND	L	NL	NL	L	NL	L	L(R)	L
7	NR/NOR/D	L	NL	NL	L	NL :	NL	NL	NL
8	NR/NOR/ND	L	NL	NL	L	NL :	NL	NL	NL

R Resident
NR Not resident
OR Ordinarily resident
NOR Not ordinarily resident
D Domiciled
ND Not domiciled
L Liable on arising basis
L(R) Liable on remittance basis
NL Not liable

* If employer is NR, L (R) but no relief as in +

\+ Less 100% deduction under S193(1) ICTA 1988 (formerly Schedule 7 Finance Act 1977) from emoluments for a qualifying absence from the UK lasting 365 days or more.

ci Unless Commonwealth or Irish citizens who are L(R) (Section 65 (4) ICTA 1988 - formerly S122 (2) ICTA 1970)

° The arising basic applies to income from the Republic of Ireland (Section 68 (1) ICTA 1988 - formerly Schedule 12 paragraph 2

: L if gains on assets of branch etc of UK trade or connected with North Sea Oil and gas (S12 CGTA 1979 and S38 (11) FA 1973

This chart shows the general position: but it should not be overlooked that a bilateral Double Taxation Convention may affect some of the entries.

ANNEX A

ANNEX B

HISTORICAL DEVELOPMENT

This Annex traces the development over nearly two centuries of the income tax and, more recently, capital gains tax law of the provisions described in this document.

1799 In an Act (39 George III c.13) Income Tax was imposed for the first time. Section 2 charged tax on "all Income arising from Property in Great Britain belonging to any of his Majesty's subjects, although not resident in Great Britain, and upon all Income of every person residing in Great Britain". Section 8 provided that people who were in Great Britain "for some temporary Purpose only and not with a View or Intent of establishing his or her Residence therein" should not be chargeable as residents. Section 10 provided that a subject who had been ordinarily resident who had gone overseas for occasional residence abroad should still be chargeable as a resident.

A further Act of the same year (39 George III c. 22) divided income into various categories (cases) with special rules for each. The seventeenth case provided for income from foreign possessions to be charged on the "full Amount of the actual Annual Net Income received in Great Britain". The eighteenth case, income from foreign securities, was to be charged on "the Annual Income of such Securities".

1800 Section 19 of an Act (39 and 40 George III c.49) amended Section 8 of the original Act to treat as resident people who, despite being in Great Britain for a temporary purpose, had "continually resided in Great Britain for the Space of six Calendar Months". Section 23 allowed a person whose ordinary residence was not in Great Britain and who was treated as resident by virtue of Section 19 to elect to pay only on that part of his income accruing to the date of his departure.

1803 For the first time the familiar schedules appeared. Schedules A, B and E concerned only property in Great Britain and did not contain any limitation by reference to the residence of the taxpayer. (Schedule E then only covered offices and employments paid out of the public revenue of Great Britain).

Schedule C charged to tax public revenue dividends but Section 71 exempted a non-resident who was not a British subject.

Schedule D charged residents on the profits of all property, whether in Great Britain or elsewhere, and non-residents, whether British subjects or not, on property in Great Britain and profits of trades, professions, employments or vocations exercised in Great Britain.

The cases of Schedule D appeared for the first time. The fourth case charged interest arising from "Securities in Ireland, or in the British Plantations in America, or in any other of his Majesty's Dominions out of Great Britain, and foreign Securities". The duty was charged on the whole amount received in Great Britain in the year.

The fifth case charged duty in respect of "Possessions in Ireland, or in the British Plantations in America, or in any other of his Majesty's Dominions out of Great Britain, and foreign possessions. The charge was computed "at not less than the full Amount of the actual Sums annually received in Great Britain, either for Remittances from thence payable in Great Britain, or from Property imported from thence into Great Britain or from Money or Value received in Great Britain, and arising from Property of any Person or Persons, which shall not have been imported into Great Britain".

Section 10 of the 1799 Act (and Section 19 of the 1800 Act) reappeared as Section 85 of the 1803 Act (43 George III c. 122) while Section 8 of the 1799 Act reappeared as Section 86. Section 87, a new provision, contained a special rule to the effect that anyone departing from Great Britain and returning before the 5th April was charged on the whole income of the year. The "split year" rule enacted in Section 23 of the 1800 Act appears to have disappeared.

Thus as early as 1803 the framework was established which is still clearly with us today.

1806-1913 Apart from a number of provisions amending the charge imposed by Schedule C and the conditions for exemption from Schedule C for non-residents and foreigners, no substantial change was made in this areas for more than a century. In 1853 Ireland was integrated into the tax system which until then had applied only to Great Britain. As a result, Irish

source income previously chargeable under Cases 4 and 5 of Schedule D on the remittance basis was brought on to the arising basis.

1914 For the first time, income from foreign stocks, shares, securities and rents was taxed on the full amount arising but with exceptions. Persons not domiciled in any part of the United Kingdom and British subjects not ordinarily resident remained entitled to claim the remittance basis on this type of income. This was the first occasion on which domicile became relevant for tax.

1915 Exemption from taxation on interest from certain Government securities was afforded to people not ordinarily resident in the United Kingdom

1918 The rule in Section 87 of the 1803 Act, concerning people returning to the UK before the 5th April, although featuring in the 1842 Income Tax Act when income tax was reintroduced, had disappeared from the statute book by the time of the consolidation of 1918.

1940 The remittance basis was further cut down. For persons resident, ordinarily resident or domiciled in the United Kingdom it applied now only to trades, professions or vocations carried on abroad, pensions from abroad and employments carried out wholly abroad (which were then still within Schedule D, UK source employments having been moved to Schedule E in 1922).

1956 Following recommendations of the Royal Commission on the Taxation of Profits and Income, foreign employments were moved to Schedule E. The remittance basis however continued to apply to earnings for duties performed outside the UK, whatever the status of the taxpayer, and, if he was not domiciled and his employer was not resident, to earnings for duties within the UK as well.

In determining whether a person was resident, the availability of accommodation in the UK was statutorily ignored if he had gone abroad to work full-time in a trade, profession, vocation or employment.

1965 Capital Gains Tax, like the short terms gains tax in Case VII of Schedule D which was introduced in 1962, had a charging provision which required a taxpayer to be either resident <u>or</u> ordinarily resident, but did not charge non-residents on UK source gains except in a very limited area. It

maintained the remittance basis for gains from foreign assets for non-domiciled taxpayers.

1974 The scope of the remittance basis was reduced again. Trades, professions, pensions and all UK employments came on to the arising basis subject to a range of percentage deductions; foreign duties remained on it only for non-domiciled employees of non-resident employers and for taxpayers who were resident but not ordinarily resident.

1984 The percentage deductions introduced in 1974 (except for that on foreign pensions) were, subject to transitional arrangements, abolished.

1988 The provisions relating to residence in Sections 8 and 10 of the 1799 Act and Section 19 of the 1800 Act still appear in the law today. They are now to be found in a modernised but essentially unchanged form in Sections 334 and 336 of the Income and Corporation Taxes Act 1988. Section 335 of the 1988 Act is the provision dating from 1956 concerning available accommodation. The only provision in the Capital Gains Tax Act 1979 on this subject is Section 18(3) which is the equivalent of Section 336.

ANNEX C

This annex lists and describes the more important of the numerous provisions in the Taxes Acts in which a reference is made to one or more of the connecting factors described in the consultative document. It also lists the more important of the provisions governing the remittance basis. The references in the first column are to the Income and Corporation Taxes Act 1988 unless otherwise stated. Where relevant, pre-consolidation references are shown in brackets; references here are to the Income and Corporation Taxes Act 1970 except when stated.

1. Provisions in the Taxes Acts where a taxpayer's residence is a factor in charging him or giving him relief.

	Provision		Description
a.	S18(1)(a)	(S108.1(a))	Schedule D Charge - Resident taxed on profits or gains wherever arising; non-residents taxed on profits or gains from UK trade and property only.
b.	S19(1).1	(S181(1).1)	Schedule E Charge - non-resident taxed on emoluments from UK duties only.
c.	S19(1).4	(S181(1).4)	Schedule E Exemption - non-resident not taxed on foreign government pensions.
d.	S48	(S100)	Schedule C Exemption - non-resident not taxed on overseas public revenue dividends payable in UK.
e.	S103(3)a S104(3)	(S143(3)(a)) (S144(1)(b))	Post-cessation receipts - non-resident not taxed on income arising outside UK.
f.	S122	(S29 FA70)	Mineral royalties - non-resident does not get relief (CGT treatment for 50% of royalties).
g.	S123(4)	(S159(4))	Foreign dividends - Exemption for non-resident on foreign dividends paid through UK paying agent.
h.	S232	(S98 FA 72)	Non-resident who qualifies for Section 278 relief entitled to tax credit on UK dividends.

ANNEX C

2. Provisions in the Taxes Acts where ordinary residence is a factor.

a.	S19(1).1	(S181(1).1	(i) All emoluments charged on arising basis if resident and ordinarily resident.
			(ii) Emoluments for non-UK duties charged on remittance basis if resident and not ordinarily resident.
b.	S2 CGTA 79		Charge to CGT arises if either resident or ordinarily resident.
c.	S47	(S99)	Interest on certain gilt-edged securities exempt if not ordinarily resident.
d.	S65(4)	(S122(2))	remittance basis for foreign income if resident but not ordinarily resident and Commonwealth or Irish citizen.
e.	S135 & S138	(S186) (S79 FA 72)	Stock option and incentive gains charged as income only if resident and ordinarily resident at the time of grant/acquisition.
f.	S193(1) & Sch 12	(Para 1 Sch 7 FA 77)	100% deduction for absences abroad only if resident and ordinarily resident.
	S193(3) - (7) S194	(S32 FA 77, S34 FA 86)	Relief for certain travel expenses only if resident and ordinarily resident.
g.	S219 & S220	(S53 & Sch 9 FA 82)	CGT treatment for shareholder where a company purchases its own shares from him only available if resident and ordinarily resident.
h.	S291(1)	(Para 4(1) Sch 5 FA 83)	Relief for Business Expansion Scheme investments: must be resident or ordinarily resident at time of share issue.

3. Provisions in the Taxes Act where domicile is a factor

a.	S22(1) F(No 2)	A1931	Certain gilt-edged securities free of all taxes if held by not ordinarily resident and non-domiciled individual.
b.	S65(4)	(S122(2))	Remittance basis for foreign income if non-domiciled.
c.	S 192(1)(2)	(S181(1).1 Para 4 Sch 2 FA 74)	Remittance basis for emoluments of employment if all duties outside the UK, employer non-resident and taxpayer non-domiciled.
	S192(3)	(Para 6 Sch 2 FA 74)	Deductions for certain payments abroad if employer non-resident and taxpayer non-domiciled.
d.	S195	(S37 FA 86)	Relief for travel expenses etc if non-domiciled.
e.	S14 CGTA 79		Remittance basis for foreign gains if non-domiciled.
	S29(4) CGTA 79		No relief for losses on foreign assets if non-domiciled.
f.	S15(2) CGTA 79		No liability on gains made by non-resident companies in which non-domiciled taxpayer a shareholder.
g.	S80(1) FA 81		No liability on gains of non-resident trustees if settlor non-domiciled at time of settlement and during the year of assessment when gain arose.
	S80(6) FA 81		No liability on gains of non-resident trustees if beneficiary not domiciled in year of assessment when capital payments made.

4. Provisions in the Taxes Act in which nationality is relevant.

a.	S65(4)	(S122(2))	Remittance basis for foreign income if resident but not ordinarily resident and Commonwealth or Irish citizen.
b.	S232 S278(2)	S98 FA 72 S27(2)	Tax credit on UK dividends and personal allowances due if non-resident and Commonwealth or Irish citizen.
c.	S334	S49	Temporary absences abroad are ignored if Commonwealth or Irish citizen who was previously ordinarily resident.
d.	S730(5)	(S470(3))	Transfer of income from securities if non-domiciled or resident, not ordinarily resident and Commonwealth or Irish citizen.
e.	Para 4(5) Sch 4	(Para 1(5) Sch 9 FA 84)	Foreign deep discount securities if non-domiciled or if resident, nor ordinarily resident and Commonwealth or Irish citizen.

INTERNATIONAL COMPARISONS

This annex describes very briefly, and in general terms, the provisions of a number of OECD countries concerning residence, and treatment of resident and non-resident individuals, for tax purposes. The table below covers three aspects:

i. definition of residence, domicile etc;

ii. incidence of tax on income and gains of resident and non-resident individuals;

iii. tax provisions coming into effect at the time of emigration.

The table is based on the most recent information available at the time of writing: in practice in most cases this reflects the position in 1987.

The most striking feature of the definitions of residence in the countries covered in the wide variety of tests applied, ranging from objective tests (eg citizenship or time spent in the country) to much less precise tests of intention or degree (eg centre of economic interests). Most of the countries listed have a combination of time-tests and more subjective criteria, but the tests in Denmark and USA are purely of the objective type, while the test in Belgium appears to be largely subjective. Available accommodation, in the sense in which it is a factor currently taken into account in the UK, appears not in itself to be a determining factor in any of the countries covered in this annex.

As for the scope of taxation of resident and non-resident individuals, by far the most common approach is to tax residents on world income (and world capital gains to the extent that gains are taxed at all), and to tax non-residents only on income and gains arising in the country concerned.

ANNEX O

RESIDENCE AND SCOPE OF TAXATION

COUNTRY	DEFINITION OF RESIDENCE	SCOPE OF TAXATION: RESIDENTS	SCOPE OF TAXATION: NON-RESIDENTS	SPECIAL EMIGRATION PROVISIONS
Australia	Definition is primarily of fact and degree. Place of residence is the place where an individual has a settled place of abode or lives permanently for a considerable time. Presence in Australia for 6 months in the income year makes an individual resident there, unless he can show that his usual place of abode is outside Australia, and he does not intend to take up residence there.	Liable on world income and capital gains.	Chargeable only on Australian income and capital gains.	Deemed disposal of non-Australian assets when residence ceases.
Belgium	A resident is defined as an individual who has established his home ("domicile") or has his centre of economic interests in Belgium. Varying factors indicating a certain permanence and continuity may be taken into account by the tax authorities to establish residence.	Liable on world income and world capital gains (but only business gains and certain gains on shares and land are taxable)	Liable on Belgian-source income and gains from Belgian real estate.	
Canada	An individual sojourning in Canada for 183 days during a year is resident for the whole year. People "ordinarily resident" are also deemed to be resident. Factors determining residence include: regularity of visits to Canada; retention of place of abode in Canada; whether spouse and children are in Canada; whether living accommodation is bought or leased in a new (overseas) location.	Liable on world income and world capital gains.	Chargeable on most Canadian-source "passive" income (eg interest, dividends, rents), on income from employments, professions or businesses carried on in Canada, and on Canadian capital gains.	Accrued capital gains on non-Canadian assets taxed when residence ceases.
Denmark	An individual who has his "ordinary residence" in Denmark, or sojourns there for at least 6 months, or has lived in Denmark for four years immediately prior to the tax year (unless taxed in another country) is resident for tax purposes.	Liable on world income and world capital gains.	Liable on Danish income and on gains derived from disposals of real property and businesses or business assets in Denmark.	Deemed disposal of shares if 25% or more of company owned when residence ceases.
France	An individual who has substantial connections with France is regarded as resident. One or more of the following criteria may establish residence: - normal place of abode (ie where family lives) in France; or - main professional activity in France; or	Liable on world income and capital gains	Liable on income and gains derived from France. May be liable to tax based on notional rent of French property etc.	

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RESIDENCE AND SCOPE OF TAXATION

- presence in France for 6 months of the year or, if less than 6 months, at least longer than his stay in any other country; or
- centre of economic interests in France

COUNTRY	DEFINITION OF RESIDENCE	SCOPE OF TAXATION: RESIDENTS	SCOPE OF TAXATION: NON-RESIDENTS	SPECIAL EMIGRATION PROVISIONS
Germany (FRG)	An individual is resident in FRG if he occupies a residence there not merely on a temporary basis, or if his customary place of abode is there.	Chargeable on world income and world capital gains (but only short term and business gains are taxable).	Chargeable on German-source income and gains arising in FRG.	Residents who emigrate to lower-tax countries continue to be taxed on certain German-source income and gains as if resident. Deemed disposal on emigration of 25%+ holdings in companies and assumed winding-up of trade etc.
Greece	An individual's "ordinary residence" is the place where he is mainly or permanently established.	Chargeable on world income and world capital gains (business gains only).	Chargeable on Greek-source income and business gains.	-
Japan	An individual who has his "domicile" or has a residence for a year or more in Japan is deemed to be resident. An individual who has no intention of residing permanently in Japan and has had residence or domicile for 5 years or less is designated a "non-permanent resident". "Domicile" means "centre of living", and factors determining it include location of primary residence, presence of family members and location of employment.	<u>Residents</u> Chargeable on world income and world capital gains. <u>Non-permanent residents</u> Chargeable on Japanese-source income and gains, and foreign income and gains remitted to Japan.	Chargeable on Japanese-source income and gains.	-
New Zealand	An individual is resident if he spends a continuous period of 365 days in New Zealand, ignoring short breaks. But he is deemed to be not resident if he shows that his permanent place of abode is outside New Zealand.	Chargeable on world income (no tax on gains).	Chargeable on New Zealand-source income.	-
Spain	An individual who stays in Spain for more than 183 days in a year is "customarily resident" there. Temporary absences are ignored.	Chargeable on world income and gains	Chargeable on income and gains arising in Spain and on income paid to them by persons or entities resident in Spain.	-

ANNEX [illegible]

RESIDENCE AND SCOPE OF TAXATION

COUNTRY	DEFINITION OF RESIDENCE	SCOPE OF TAXATION RESIDENTS	SCOPE OF TAXATION NON-RESIDENTS	SPECIAL EMIGRATION PROVISIONS
USA	The main criterion determining tax status for US nationals is US citizenship. For non-nationals, a resident is someone who has official permission to reside permanently in the USA, or meets the requirements of the "substantial presence" test (an individual has a substantial presence if he is present on at least 31 days in the calendar year, and the sum of the number of days he was present during the current calendar year, together with a prescribed fraction of the days present in the two preceding years equals or exceeds 183 days).	Chargeable on world income and capital gains.	a. Non-resident citizens are chargeable on world wide income and gains with substantial reliefs for foreign earned income. b. Non-resident aliens are chargeable on US income and gains from interests (including indirect interests) in real estate and gains connected with a trade or business.	A citizen who renounces citizenship for tax reasons is liable to tax on all US source income & gains for up to 10 years.

ANNEX E: EXAMPLES OF PROPOSED RESIDENCE RULES

Suppose an individual spends the following days in the United Kingdom after an absence of two years:

	A	B	C
Year 1	60	130	340
Year 2	5	130	25
Year 3	150	130	50
Year 4	130	130	100

Using a three year test, with fractions 2/3 and 1/3, the result is:

A	Year 1	60 + (2/3 x 0) + (1/3 x 0) = 60 therefore NR
	Year 2	Not present 31 days therefore NR
	Year 3	150 + (2/3 x 5) + (1/3 x 60) = 173 therefore NR
	Year 4	130 + (2/3 x 150) + (1/3 x 5) = 232 therefore R
B	Year 1	130 + (2/3 x 0) + (1/3 x 0) = 130 therefore NR
	Year 2	130 + (2/3 x 130) + (1/3 x 0) = 216 therefore R
	Year 3	130 + (2/3 x 130) + (1/3 x 130) = 260 therefore R
	Year 4	130 + (2/3 x 130) + (1/3 x 130) = 260 therefore R
C	Year 1	Present 183 days therefore R
	Year 2	Not present 31 days therefore NR
	Year 3	50 + (2/3 x 25) + (1/3 x 340) = 180 therefore NR
	Year 4	100 + (2/3 x 50) + (1/3 x 25) = 142 therefore NR

R = Resident
NR = Not Resident

Outline of a proposed intermediate basis of taxation

BASIC RULES

(1) the liability to tax on UK income and gains is calculated in the normal way.

(2) the liability to tax on world income and gains is calculated, taking account of any overseas tax paid.

(3) the amount of tax in (2) is reduced by a percentage appropriate to the length of the individual's years of residence in this country.

(4) the UK liability to tax will be the greater of the tax under (1) and (3).

EXAMPLE I

Assumptions

Number of years' residence in the UK in previous 14 years	Percentage applied to tax on world income
0	5
1	15
2	25
3	40
4	55
5	70
6	85
7	100%

1. An individual who has never previously been resident in the UK comes to this country and remain here for 8 years.

2. His income remains the same throughout and is, in each year, as follows

UK source income	£55,000
Overseas income	£30,000 (overseas tax of £6,000)

3. He has no chargeable gains, and is entitled to personal allowances of £5,000. (A basic rate band of £20,000 is assumed, and tax rates of 25% and 40% are also assumed throughout).

Liability

1. On the basis of these assumptions the tax position is as follow:

Tax on UK income is £17,000

Tax on world wide income (after allowing for overseas tax paid) is £23,000.

2. The liability in each year would be as follows:

I	II	III	IV	V	VI	VII	VIII
Year	No. Of Years Resident In Past Fourteen	UK Source Liability (£B)	World Source Liability (£A)	Relevant %	World Liability x Relevant % (£)	Actual Liability (Greater Of Columns III & VI) (£)	Relief Against Tax On Overseas Profits (£)
1	0	17,000	23,000	5	1,150	17,000	6,000
2	1	17,000	23,000	15	3,450	17,000	6,000
3	2	17,000	23,000	25	5,750	17,000	6,000
4	3	17,000	23,000	40	9,200	17,000	6,000
5	4	17,000	23,000	55	12,650	17,000	6,000
6	5	17,000	23,000	70	16,100	17,000	6,000
7	6	17,000	23,000	85	19,550	19,550	3,450
8	7	17,000	23,000	100	23,000	23,000	Nil
Totals		136,000	184,000			144,550	39,450

EXAMPLE 2

The assumptions are the same as in the previous example except that the individual's income each year is:

UK source income £15,000

Overseas income £70,000 (overseas tax of £15,000)

Liability

1. On the basis of the assumptions, the tax position is as follows:

Tax on UK income is £2,500

Tax on world wide income (after allowing for overseas tax paid) is £14,000.

2. The liability in each year would be as follows:

I	II	III	IV	V	VI	VII	VIII
Year	No. Of Years Resident In Past Fourteen	UK Source Liability (£B)	World Source Liability (£A)	Relevant %	World Liability x Relevant % (£)	Actual Liability (Greater Of Columns III & VI) (£)	Relief Against Tax On Overseas Profits (£)
1	0	2,500	14,000	5	700	2,500	11,500
2	1	2,500	14,000	15	2,100	2,500	11,500
3	2	2,500	14,000	25	3,500	3,500	10,500
4	3	2,500	14,000	40	5,600	5,600	8,400
5	4	2,500	14,000	55	7,700	7,700	6,300
6	5	2,500	14,000	70	9,800	9,800	4,200
7	6	2,500	14,000	85	11,900	11,900	2,100
8	7	2,500	14,000	100	14,000	14,000	Nil
Totals		20,000	112,000			57,500	54,500

4375/16

Treasury Chambers, Parliament Street, SWIP 3AG

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

30 July 1987

Dear David,

TAX ARRANGEMENTS FOR EXPATRIATES

You wrote to Tony Kuczys on 8 July asking about the current rules on residence in the UK for tax purposes - in particular with regard to expatriate visitors - and for comments on a suggestion by Sir David Wolfson that the presence test could be extended for expatriates who had been abroad for sufficient years to have established residence firmly outside the UK.

In order to simplify the explanation of the existing rules I will assume that the expatriate is working full time in a business profession or employment carried on wholly abroad. In these circumstances a visitor, expatriate or otherwise, will not be treated as resident or ordinarily resident in the UK unless

(i) he stays here for six months or more in a tax year - when he will always be regarded as resident here for that year;

or (ii) his visits for four consecutive tax years have averaged three months or more per year - when he will be regarded as becoming resident and ordinarily resident;

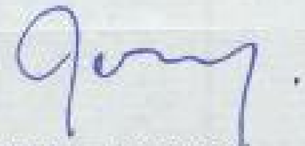
or (iii) on the occasion of his first visit to the UK, he proposes to make visits for four consecutive tax years which will average three months or more per year - when he will be regarded as becoming resident and ordinarily resident from the outset.

The extent of a visitor's liability to UK tax varies with his residence status: a resident in the UK is liable to tax on his worldwide income and gains; an individual who is not resident but ordinarily resident is liable on his worldwide gains but only on income arising in the UK; whereas an individual who is not resident and not ordinarily resident is not liable on capital gains and is liable on income arising in the UK. There are some exceptions to these rules which depend upon domicile or upon special issue terms of certain British Government securities.

The current "regular visitor" rules do permit an average three months' presence per tax year over a four year period and provided the six months per tax year is not exceeded, this does give considerable flexibility to the visitor to the UK - whether he be an expatriate or not.

As it happpens, the residence rules for tax purposes are being looked at in some detail at present and Sir David's comments will certainly be borne in mind in that review.

Yours ever,



JEREMY HEYWOOD
Private Secretary

ECON POL: Tax and Savings Pt2

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 6 July 1987

Dear Tony,

TAX ARRANGEMENTS FOR EXPATRIATES

Sir David Wolfson has mentioned to me a suggestion for changing the tax treatment of expatriates. He believes that at present the basic rule is that an expatriate may spend up to ninety days a year in this country before becoming liable for UK tax. He has suggested that there might be a case for increasing that period once an expatriate had been abroad for enough years to establish that his residence was firmly outside the UK. He argues that an increase in these circumstances might encourage higher expenditure in the UK rather than overseas, without jeopardising tax revenues.

I should be grateful to know what the rules are, and for your comments on this suggestion.

Yours,

David.

David Norgrove

A. W. Kuczys, Esq.,
H. M. Treasury.

PART THREE ends:-

FST to DRN 18/3/87

"Green Paper on the Reform of Personal Taxation".

PART FOUR begins:-

DRN to HMT 6/7/87.

"Tax Arrangements for Expatriates"

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