cc: PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State(C)
r. Middleton PS/MST(L)
Mr. Unwin
Mr. Battishill
Mr. Tyler
Mr. Ridley
Mr. Cropper
PS/Inland Revenue

49
107

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PRIME MINISTER

CAPITAL TAX CHANGES IN THE 1981 BUDGET

We have made little progress so far towards our manifesto aim of simplifying capital taxation and making it less oppressive. Indeed except at the bottom of the scale capital transfer tax (CTT) is now heavier in real terms than when it was introduced in 1974 or at the time of the last election. Last year we finally decided, because of the cost and balance of the Budget, to do less than we had earlier intended: next year it may still be difficult, both from a financial and political viewpoint, to make a very large reduction. Hence I think that this year we must start to reduce the burden in real terms if we are to stand much chance of achieving our aims before the next election.

Capital Gains Tax

2. The major concern of our supporters is that capital gains tax is mostly a charge on inflationary gains. We examined this very thoroughly last year and concluded that indexation - however justified in principle - would reduce the yield to about one-sixth while requiring considerable additional staff. Instead we decided on an exempt allowance of £3,000 (which will halve the number of assessments) and removed the double charge to CGT and CTT on lifetime gifts by introducing a CGT rollover; while I am looking again at the charge on inflationary gains, I doubt if we shall find any solution which eluded us last year.

/3.

108

3. Whilst I do not suggest changes in the rate or threshold of the tax I think this year we should extend to settled property last year's removal of the double charge (there is a good deal of pressure for this). It would have a full year cost of £50-70 million (nil in 1981-82) but would be balanced, in both financial and political terms, by tackling some large scale and widespread avoidance practices including the manufacture of wholly artificial capital losses. There is also a CGT counterpart to the proposed Vestey legislation.

Capital Transfer Tax

4. I think that the major attack this year should be on CTT. We cannot get the real burden back to anything approaching what it was when we criticised it so heavily in 1974: to do so would, for example, require increasing the top rate band, at which tax is charged at 75 per cent, from £2 million to £5 million. But we should increase all the bands by a substantial figure: we can leave the final decision until we can see the overall balance of the Budget more clearly, but our minimum aim should be an increase of 20 per cent on all points, costing £90 million in a full year (£40 million in 1981-82) and yielding an eventual staff saving of 30. We might be able to go for a 50 per cent increase all round costing £180 million and £80 million respectively and eventually saving 200 staff. Such an increase would rather more than recoup the ground lost since the Election but still leave the tax much more onerous than it was in 1974. To avoid sliding back in real terms in future, we should extend to CTT last year's provisions for indexing the higher income tax rate bands. The starting rates are far too high - last year we concentrated on increasing the starting threshold. The first rate should, I think, be reduced from 30 per cent to 20 per cent and the second from 35 per cent to 30 per cent at a full year cost of £20 million (£10 million in 1981-82).

109

5. More needs to be done to encourage lifetime giving. I would extend the lower rate of tax on gifts (which at present tails away above £110,000 and runs out at £310,000) all the way up the scale although not at the full half rate, at a cost between £5 million and £10 million, and increase the annual exemption from £2,000 to £3,000 at a cost of £½ million. I would certainly remove the cumulation of gifts over life, substituting 10 years instead, so that the tax no longer runs from the cradle to the grave: this is an essential element in our plan to reduce the financial and administrative burden of the tax, but would have no immediate cost.

6. We should also make a start on dealing with the problems of settled property, but more detailed consultation will be advisable before we finally tackle the technically difficult issue of discretionary trusts.

Presentation of CTT proposals

7. I think that much of this programme can be properly - and best - presented as part of our further enterprise package along with whatever emerges from our studies in FASE. As you know, the impact of capital taxation on businesses, even after business relief, much concerns many of our supporters. By concentrating on the increase in the real burden on businesses in recent years we shall be able to distinguish what we are doing here from the necessarily year by year approach taken for income tax.

Investment income surcharge

8. Apart from following any changes in the bands for the higher rates of income tax, I do not propose any changes to the investment income surcharge.

110

<u>Agricultural Relief</u>

9. I am also enquiring into the progress being made by the farmers and landowners in their discussions on changes in land tenure, as this could provide an occasion for making the tax changes for let agricultural land we had originally planned last year.

<u>Development Land Tax</u>

10. Finally I am conducting a further review of the Development Land Tax, and will minute you if I have proposals to make.

(G.H.)

29 January 1981