CONFIDENTIAL

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PRIME MINISTER

CGT EXEMPTION OF GILTS AND QUALIFYING CORPORATE BONDS

You will remember that when we were considering last month the press notice about disclosure of tax decisions affecting gilts, I mentioned that we might want to amend the Finance Bill to deal with a difficulty with the indexation proposals for capital gains tax as they affect gilts. Peter Rees referred to this possibility during the Committee of the Whole House on the Finance Bill on 8 May. We subsequently included a specific reference to it, as a matter under consideration, in the press notice about disclosure of tax decisions affecting gilts.

2.The difficulty arises because of an asymmetry in the CGT treatment of gilts and corporate bonds that qualify for CGT exemption (qualifying bonds) if they are held for more than 12 months. Investors can choose, if they are showing a loss, to realise it to set against CGT on other gains by selling before the 12 month period is up: while, if they are showing a gain, they can avoid CGT by waiting a year before selling. So the system generates tax losses more often than taxable gains.

3. The extension of CGT indexation to short term losses and gains opens the possibility of much larger scale exploitation of this asymmetry than hitherto by financial institutions, with a corresponding loss of revenue, since it increases the scope for CGT losses. On the basis of information that has become available since the Budget, the Inland Revenue now believe that the full year revenue cost could be at least £60/70m, and maybe as much as £200m. (At the time of the Budget, their best estimate of the cost was only £10m)

4. I have concluded that I must act to close off this loophole which has already attracted some press comment. The best, and simplest, solution is to remove gilts and qualifying corporate bonds from the ambit of CGT altogether. The Bank of England's advice is that this change will have an adverse effect on the gilts market and on market liquidity. (You will recall that they took a similar view before we announced the anti-bondwashing measures in February.) Nevertheless, I believe many will welcome the total abolition of CGT on gilts and qualifying bonds; and that in the longer run it might even improve the liquidity of the gilts market. The step should be seen as a welcome simplification for the taxpayer.

5. There is a legal complication that means that the change cannot be brought into operation until 12 months after the date of announcement. Counsel's opinion is that the specific statement that has always accompanied gilts prospectuses - that CGT exemption only applies if the gilt is held for more than 12 months - carries with it the implication that the gilt will <u>not</u> be exempt from CGT if sold within 12 months. I am advised that this could be regarded as an inducement to purchase stock, and that a change could expose the Government to a claim for loss in respect of all gilts sold on the basis of the existing statement. Because this can be regarded as a <u>specific</u> inducement made at the time of sale, it is not (and could not have been) covered by our press notice on disclosure.

6. We can, however, avoid any significant risks on this score by making the change operative 12 months after the date of announcement. Those who had bought before the announcement will still have their expected 12 months in which to realise losses to set against CGT gains. This should also help to reduce any adverse market reaction of the kind expected by the Bank.

7. I therefore propose to table a further amendment to the Finance Bill (which would otherwise have introduced CGT indexation for gilts and qualifying bonds on 28 February next year), so as to maintain the pre-Budget treatment of CGT on disposals until the 12 months period is up.

8. For market reasons, I want to announce these changes early next week, by means of a Written PQ and Answer on the lines of the attached draft. This would be made available to the market through a Revenue press release, which would also contain the draft Finance Bill Clause, to be introduced at Report.

NL.

N.L.

26 June 1985

DRAFT PARLIAMENTARY QUESTION AND ANSWER

QUESTION

To ask the Chancellor of the Exchequer if he has yet decided whether it is necessary to deal with the problem of losses for capital gains tax purposes referred to by the Chief Secretary in the House on 8 May (Official Report, 8 May, Column 819).

ANSWER

At present, gains on gilt edged securities and qualifying corporate bonds are exempt from capital gains tax if the securities are held for more than twelve months. Following a review of this treatment in the light of the introduction of the accrued income scheme, and as a further measure of simplification, it is now proposed to exempt these securities entirely from capital gains tax.

This exemption will apply to disposals of gilts and qualifying corporate bonds on or after [June] 1986 and to avoid further complication, amendments to the Finance Bill indexation provisions will be proposed so that they have no application to these securities.

As a result, taxpayers will no longer need to keep records or include these securities on their tax returns for capital gains tax purposes. At the same time, it will remove the possibility that the CGT indexation provisions could be used to establish short term capital gains tax losses on these instruments, where counter-balancing gains would not normally arise because holders would delay realising gains until twelve months after purchase.

The Inland Revenue are today issuing a Press Release giving further information about these proposals and of the necessary legislative changes. The changes will be introduced at Report Stage of the Finance Bill.

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10 DOWNING STREET

From the Private Secretary

26 June, 1985.

CGT EXEMPTION OF GILTS AND QUALIFYING CORPORATE BONDS

The Prime Minister and the Chancellor discussed his minute of 26 June this afternoon, and it was agreed that an amendment to the Finance Bill should be introduced along the lines proposed.

(Andrew Turnbull)

Mrs. Rachel Lomax,
HM Treasury.