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Secretary of State for Trade and Industry

23 December 1985

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The Rt. Hon. Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
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Prime Minister 4

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23/12

Dear Nigel,

1986 BUDGET

At this time of year, my predecessors have made suggestions to the Chancellor of the Exchequer for tax measures in the Budget designed to help promote initiative and a spirit of enterprise among the business community. I should like to do the same this year.

2 The economic context for next year's Budget is again encouraging, with a sixth successive year of economic growth forecast, inflation set to fall below 4 per cent in the course of next year, and a healthy balance of payments surplus on current account again in prospect. Unemployment is still rightly seen as the least satisfactory aspect of the economy, and more recently the acceleration of earnings is causing us concern.

3 In this situation, I believe that, if you have room to reduce taxes, it would be right this year to concentrate mainly on personal taxation. The incentive this will give to hard work and enterprise on the part of individuals will of course be of considerable indirect help to business.

4 The main choice would then be whether to reduce the basic rate of income tax, or to raise the threshold at which tax becomes payable, and the higher rate bands, by more than the rate of inflation. My own firm view is that the benefit from raising the threshold is much greater than from reducing the basic rate, for any given amount of tax revenue foregone. For a married man the impact of a 30 per cent marginal rate of tax comes at only 33 per cent of average earnings. The revenue which would be sacrificed by a 1p cut in the basic rate would enable all tax thresholds to be raised by about 6 per cent, taking approximately 500,000 people out of income tax altogether. This would in my view be just as

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effective a selling point as a cut in the basic rate; and if the higher rate bands were also increased, this would maintain the incentive for higher earners as well.

5 My proposals for changes in taxation directly affecting industry and commerce are set out in detail in the enclosed note by my officials. If there are points in them which your officials would like to clarify, my people are, as in earlier years, available for continuing discussion.

6 The first group of proposals concern the taxation of financial services. Something will have to be done, not later than the ending of single capacity now fixed for October 1986, about the difference between the tax treatment of jobbers and others who buy and sell securities. I believe that we should take the opportunity to remove stamp duty altogether on securities transactions. I recognise that the revenue loss involved, about £460m, is substantial. But London will in the next year or so come into more direct competition than ever before with New York, Tokyo and other international financial markets. It is most important that the London market should not at this strategic moment be burdened with less favourable tax treatment, and hence with higher transactions costs, than our competitors. Already, the volume of trading in some leading British equities is higher in New York in the form of ADR's than in London, and transaction costs are the main reason. My other proposals in the financial services sector would bring modest but useful benefits to the City, without incurring significant revenue costs.

7 The decisions in the last Budget to preserve the 100 per cent Scientific Research Allowance, and to include research and development among the activities eligible under the Business Expansion Scheme, were helpful. But I remain very concerned about the volume of non-defence industrial R and D being undertaken in the UK, which is lower than that of our major competitors. I would not endorse some of the more ambitious ideas which some have put forward, such as the tax credits for incremental R and D available in some other countries. But I should like to revert to two measures which Norman Tebbit proposed last year - to allow tax relief on R and D expenditure undertaken before trading commences; and to widen the definition of scientific research so that it includes development which is not specific to a particular product. Neither change would be expensive; and I believe that between them they would be likely to further both an increased volume of R and D, and more fruitful collaboration between industry and higher education.

8 I favour a substantial increase in the threshold for VAT registration, as soon as this can be achieved consistently with our Community obligations. VAT was clearly identified in the Burdens exercise as one of the main obstacles to the setting up and

expansion of new businesses. I was heartened to learn of M Delors' undertaking to the Prime Minister that the Commission would recommend a higher threshold to the Council. In the meantime, I hope you will be able at least to increase the threshold in line with the movement in the r.p.i, perhaps to £20,500.

9 I understand that you are proposing to review the future of the Business Expansion Scheme in the light of the Peat Marwick Report. I should welcome in early sight of the report, and an opportunity to contribute to your thinking on Peat Marwick's conclusions. In the meantime, our detailed note includes two suggestions for relaxation in the present rules governing eligibility for BES relief. These are within the spirit of the BES objective of stimulating investment in new businesses, particularly in areas like high technology which are of great potential benefit to the economy.

10 I note in passing that the Inland Revenue are reported to be checking whether some of the BES schemes which have been marketed, with the emphasis on asset backing and the prospect of capital appreciation, in fact fall outside the BES rules since they have the character of investment rather than trade. I should not be unduly concerned if it were found that some schemes of this kind fell on the wrong side of the line. Nor would I favour the relaxation, urged by the CBI and others, of the rules restricting BES investments in companies by directors and their families. The deadweight cost would be large and the scope for avoidance considerable.

11 Apart from the Business Expansion Scheme, I have several suggestions to make which would promote enterprise by easing the tax burden on smaller and unincorporated companies. The most important of these is the extension from 30 per cent and 50 per cent to 100 per cent of relief from Capital Transfer Tax for business assets transferred at a cost of some £70m in revenue loss. Even at the reduced 70 per cent and 50 per cent rates, the impact of CTT on small family businesses remains a serious disincentive to expansion and a good deal of time and energy in devoted to avoidance. The other proposals in this group are technical improvements with few revenue implications. But the present situation in which Enterprise Allowance receipts are, in effect, taxed several times over is causing resentment and should be ended.

12 I also receive many proposals for tax concessions for particular industrial sectors. Most of these are at variance with our policy of fiscal neutrality, and have little merit, but I would like to put forward four proposals affecting individual sectors.

13 The first is that the breakpoints for the assessment of car benefit should be aligned with those for the new EC engine emission standards when they come into force.

This will enable BL to compete more effectively with imports, particularly from the major multinationals. I would be happy for this change to be made on a revenue neutral basis.

14 The other three relate to mining. The Inland Revenue consultation document on mines and oil wells allowances, was broadly welcomed by my Department. But there is a good case, in addition to the proposals in the consultation document, for applying the Scientific Research Allowance, which already covers oil exploration, to metals exploration; and for extending the period for which expenditure on making land good after mining has ceased qualifies for relief. I also favour retaining the present tax treatment of second hand costs of mineral rights in the UK.

15 I am copying this letter and enclosure to the Prime Minister and David Young; and to Sir Robert Armstrong.

I would very much like to have a chance to talk to you informally about these before any decisions are taken. I would particularly like to elaborate substantially on Paragraph 4.

Yours,

LEON BRITTAN

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1986 BUDGET

STAMP DUTY ON SECURITIES TRANSACTIONS

1. The City of London is already in vigorous competition with other financial centres in a world market for securities. But transaction costs remain high by international standards. For a purchase and sale of £100,000 worth of securities, they work out at about $2\frac{1}{4}$ per cent (including 1 per cent stamp duty) compared with 1 per cent in New York (no tax) and $1\frac{3}{4}$ per cent in Tokyo ($\frac{1}{2}$ per cent tax). It has been estimated that the halving of stamp duty in the 1984 Budget is leading to a 70 per cent growth in the volume of transactions on the London Stock Exchange. But this is unlikely to bring turnover, as a proportion of total market value, into line with New York and Tokyo levels. In 1983, London turnover was 18 per cent of market value, compared with 43 per cent in Tokyo and 50 per cent in New York. For some leading UK equities, trading volume in the US now exceeds that in London.

2. The ending of 'single capacity' in October 1985 will require, as a minimum, legislation to extend to all market makers the exemption from the 1 per cent rate of stamp duty now enjoyed by jobbers. But this will not change the transaction costs faced by a buyer of shares in London. Removal of the 1 per cent stamp duty costs faced will make the City more competitive internationally and can be expected to lead to a further expansion of trading volume. It will also benefit the better second line UK companies by facilitating a more liquid market in their shares, and so making it easier for them to raise equity finance on favourable terms. Stamp duty is also a tax which discriminates against equity financing, and is thus an obstacle to the Government's objectives of promoting wider share ownership, and the availability of risk capital to companies. For the reasons given in Mr Tebbit's letter of 14 January 1985 to the Chancellor, the abolition of stamp duty on securities transactions need not involve the complete abolition of stamp duty at much greater cost.

STAMP DUTY ON TRUST DEEDS

3. Trust deeds executed in the UK by trustees on behalf of holders of bearer securities in non-sterling currencies issued in the UK are currently subject to stamp duty. To avoid this duty, London houses commonly execute abroad trust deeds for such bondholders. As well as this being an administrative burden to the London houses, it more importantly means a loss of potential invisible earnings to the UK. The duty on such deeds should be abolished.

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UNIT TRUST INSTRUMENT DUTY

4. There are strong grounds for abolishing the duty. This will secure equivalence of treatment between direct investors and those investing through unit trusts. (This principle is accepted for CGT). And it will promote wider share ownership; unit trusts are particularly suitable for smaller investors. Subject to the Secretary of State making the appropriate orders, the Financial Services Bill once enacted will allow authorised unit trusts to invest beyond their current securities restriction. Instrument duty on unit trusts would place these new style trusts at a competitive disadvantage to other financial institutions operating in those extended areas. For instance, Money Market Funds would find it difficult to compete with high interest deposit accounts if $^{1}/_{4}$ per cent of any interest was immediately lost in duty. The Revenue loss would be about £15m.

INTEREST ON CORPORATE BONDS

5. It would both enable UK companies to enjoy a wider range of funding possibilities, and enhance the City's international competitiveness, if London could evolve a short-term corporate bond market with good liquidity. This would attract investors and would offer companies the advantage of greater flexibility in the size and timing of their debt issues. Short-dated bonds may be expected to facilitate the return of companies to the fixed interest market. This development is, however, being impeded by the current requirement to pay interest net of tax. Alternative debt instruments, such as certain bank certificates of deposit and Eurobonds, are allowed to bear interest gross. Domestic corporate bonds of less than five years maturity should also be allowed to bear interest gross.

ALLOWANCE FOR TAX PURPOSES OF R AND D EXPENDITURE BY ENTERPRISE NOT YET TRADING

6. This proposal figured in DTI representations on the 1985 Budget (paragraph 12 of the paper enclosed with the letter of 20th December from the Secretary of State for Trade and Industry to the Chancellor). The objective of the change would be to enable expenditure io be incurred on research and development with the benefit of tax relief from the outset, by an enterprise established for that purpose. The R and D would have to be undertaken with a commercial application in view; but the tax relief would be granted before successful R and D enabled trading to commence, and indeed regardless of whether that point was reached. The enterprise concerned might be either a consortium or a limited partnership. It is recognised that different issues

of tax policy apply to each. It is also accepted that a limit might have to be set to the period for which tax relief could be given without trade commencing.

7. This change, which would bring UK legislation approximately into line with US law as revealed in Snow v. Commissioner (1981) has been advocated to the DTI in contacts with senior industrialists as likely to contribute to an increase in the level of civil industrial R and D in the UK. It would be likely to do so by:-

a) enabling companies to set up joint subsidiaries to conduct high risk R and D which none would be willing to take on its own balance sheet.

b) enabling companies to 'spin out' speculative R and D into separate organisations, in which key employees could have their own equity stake.

c) providing a convenient means of cooperation in R and D between companies and higher education institutions. It is the Government's policy to encourage such cooperation, and the commercial exploitation of R and D done in higher education institutions.

d) providing a vehicle for direct investment by financial institutions in R and D.

DEFINITION OF R AND D

8. The DTI representations on the 1986 Budget drew attention (para 10 of paper referred to above) to the need for a clearer definition of research than the one used for the Scientific Research Allowance and for the tax status of the Research Associations. It would help encourage civil industrial R and D if such a definition clearly covered not only 'pure' research, but the development and testing needed to demonstrate the commercial feasibility of the results of 'research'. The precise formulation would have to reflect the terminology of UK tax statutes. But the corresponding provisions of the US Internal Revenue Code, and paragraph 43 of the 'Frascati' definition of R and D used in OECD, illustrate what we have in mind.

BUSINESS EXPANSION SCHEME

a) Relax Rule Against Overseas Subsidiaries

9. It is accepted that BES relief should be available only for investment in enterprises carrying on activities wholly or mainly in the UK. But to apply this criterion, in the case of a group of companies, to each subsidiary individually, is unduly restrictive. There are cases,

particularly in high technology industry, where it has been found essential to have a US incorporated subsidiary. Such activities are at present effectively prevented from benefitting from the BES. This could be rectified by applying the test of whether the activities are 'wholly or mainly in the UK' to the group as a whole.

b) Accept shares subject to call options as eligible shares for the BES

10. Proprietors of a BES company may wish to accept equity from a BES investor subject to a right on the proprietor's side to buy the investor out once the five year period has elapsed. Such arrangements have been ruled ineligible for BES relief on the grounds that shares subject to such a call option are not beneficially owned by the investor. Provided that there is only a right on the proprietor's side to buy out the investor, and not a right on the investor's side to be bought out, the risk bearing charactor of the investment is not impaired. The existence of a call option should not rule out eligibility for BES relief in such cases.

ENTERPRISE ALLOWANCE SCHEME

11. Payments under the scheme count as taxable trading income of the recipient and are therefore subject to the special commencement rules for assessing new businesses. Consequently, scheme payments will normally be included in profits which form the basis of the first three years of assessment. In extreme cases this means that tax and Class 4 NICs can exceed the grant, while in the rest the tax and NICs can consume a lion's share of the grant. This undermines the effectiveness of the scheme in creating and sustaining new businesses. It is also leading to bad publicity for a scheme otherwise widely acknowledged as successful.

12. It is recognised that a S117ICTA 1970 election can be made to prevent multiple assessment of EAS payments. But an election means that the normal advantage to new businesses of basing the assessments for two or three years on the first year's profits (which are generally low) is lost. It is undesirable that EAS recipients should be prejudiced in this way compared to non-EAS recipients. And, since profits tend to rise sharply in the initial years of trading, a S117 election may not in fact, overall, be beneficial.

13. A solution would be to tax EAS receipts separately from trading profits, under Case VI of Schedule D.

ASSOCIATED COMPANIES - CORPORATION TAX

14. The 1982 Green Paper on Corporation Tax recognised (para 16.18) the anomalies created by the present rules for allocating the small company provisions between associated companies. Undesirable distortions are placed on business organisation as a result of the anomalies. With Corporation Tax continuing for the foreseeable future in substantially its present form, the anomalies should be tackled.

DISINCROPROATION RELIEF

15. In certain circumstances it can be desirable for businesses to disincorporate. They may have become incorporated on poor advice, their circumstances may have changed or legislative changes, including taxation, may mean that incorporation is no longer commercially sound. Whilst reliefs exist in respect of Capital Gains Tax and to allow the carry forward of trading losses when businesses become incorporated, similar reliefs do not exist for businesses disincorporating. There seems to be no good reason for this and appropriate reliefs should be introduced.

1984 SHARE OPTION SCHEME - PARTICIPATION LIMIT

16. It is accepted that there must be a limit on the maximum equity stake that a qualifying individual can have in companies referred to at para 4(1)(b) of Schedule 10 FA84. The present 10 per cent 'material interest' definition is reasonable for large companies, but it makes it difficult for small companies to offer suitably attractive remuneration packages to attract, motivate and retain key employees. A 25 per cent limit, at least for unquoted companies, is proposed.

CAPITAL TRANSFER TAX - 100 PER CENT BUSINESS PROPERTY RELIEF

17. There have been a number of useful measures introduced since 1979 to reduce the burden on business of this tax. However, it still presents difficulties, particularly at the upper end of the small firm sector. There is a disincentive to expand, shares or business assets may have to be sold to pay the tax and much time and money is absorbed in complex tax planning.

18. Two principal options exist for improving the position: 100 per cent Business Property Relief and Hold-Over Relief. The first is recommended as the better alternative. It would completely free businesses from the burden of CTT charges and planning and would not lock families into trades or cause the valuation difficulties of hold-over relief.

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"COMPANY" CARS

19. The Schedule E scale benefits legislation in respect of employer provided cars and car fuel gives a strong incentive to manufacturers to market cars with cylinder capacities at or below the breakpoints of 1300cc and 1800cc. The breakpoints under the new EC vehicle emissions directive will create similar market pressures at 1400cc and 2000cc. It will be relatively easy for the major international vehicle assemblers to offer a range of four engine sizes in this central area of the volume car market. It would be much harder for Austin Rover. Their ability to compete across the range will be much greater if the tax breakpoints are aligned with the emission ones. Failure to do so could mean, in the worst cases, either Austin Rover needing to undertake increased investment of up to £46m or suffer loss of sales leading to an annual cash flow dcterioration of up to £22m - the latter is the more likely outcome, given the constraints on Austin Rover's ability to fund new programmes.

20. Ford's engine production in the UK would also be boosted by aligning the tax breakpoints with the emission ones. This is because Ford's 1300cc and 1800cc engines will be produced abroad whereas 1400cc and 2000cc ones will be produced in the UK.

21. Officials have recently submitted a paper to Inland Revenue setting out the arguments in more detail. The proposal to bring the tax breakppints into line with the emission ones is made on a revenue neutral basis. It is realised that there will be losers amongst those receiving "company" cars. But the long term benefits to the UK car manufacturing industry are believed to outweigh considerably the short term disadvantages.

22. Related to this issue it is noted that Customs and Excise issued a Consultation Document in October regarding the VAT treatment of motoring expenses. The overall package proposed is welcomed as a considerable simplification of the proposals made last year. But since scale charges are proposed for fuel benefits it will be important to ensure that, as argued for Income Tax, the breakpoints are the same as the new emission ones. The Consultation Document does not propose a commencement date for scale charges. The best option would seem to be to introduce the charges with effect from 6 April 1987, coincidental with revision of Income Tax breakpoints.

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MINES AND OIL WELLS ALLOWANCES

APPLICATION OF SCIENTIFIC RESEARCH ALLOWANCE

23. (This point is raised in relation to the present definition of 'scientific research' and without prejudice to the proposal at paragraphs 10 above). At present, the Inland Revenue allow Scientific Research Allowances (SRAs) on oil exploration expenditure, provided it is not in 'mature' areas (and therefore passes the 'extension of knowledge' test at S94(1) CAA 1968). It is understood that on this basis all UK and North Sea Sector oil exploration qualifies for SRAs. But, other than in certain exceptional cases, it has been the Inland Revenue's practice not to give SRAs on UK mineral mining, on the grounds that there is no 'extension of knowledge'.

24. In the case of UK metalliferous expenditure, the distortion, for SRA purposes, between it and oil expenditure is both unsound and undesirable. Whilst in the case of non-metalliferous exploration in the UK there are likely to be grounds for arguing that there is no 'extension of knowledge' this is not the case with metalliferous expenditure. (Metalliferous ones covering barium minerals, flourspar and native metals). Knowledge of metalliferous geology in the UK is by no means comprehensive and there seems no logic in distinguishing metalliferous exploration from oil exploration in this respect.

25. The justification for giving a 100 per cent accelerated depreciation allowance for metalliferous exploration is also strong. Metalliferous mining companies are generally mobile multi-nationals and if reserves are to be found and exploited in the UK it is important that the UK tax regime be competitive with rival countries. Metalliferous exploration is a high cost high risk activity with very long lead times and the tax position is a crucial element in determining whether to explore. Countries such as Australia, Canada and the US treat exploration expenditure in effect as a revenue item; unless the UK also gives 100 per cent accelerated allowances UK metalliferous exploration is bound to be handicapped. This will mean a loss of potential exports, potential tax revenues and potential jobs - jobs in remote upland areas where they are greatly needed.

RESTORATION COSTS

26. The proposal to allow relief for restoration expenditure incurred after the cessation of trading is welcomed. But limiting qualifying expenditure to that incurred within three years of the trade ceasing is unduly restrictive. Environmental pressures against mining and quarrying projects are becoming increasingly strong, and UK

planning authorities set stringent conditions for restoration followed by after-care of worked-out sites. These processes often have to continue for much longer than the proposed three years. The Town and Country Planning (Minerals) Act 1981 itself allows planning authorities to impose after-care conditions for five years from the date of compliance with their restoration stipulations. However, the Town and Country Planning (Minerals) Act formula is open-ended and and it is appreciated that similar provisions in tax law are unlikely to be practicable. Lengthening the proposed three year period to six, though, should not present undue technical and administrative difficulties but would allow a more acceptable proportion of restoration expenditure to be relieved. Such an extension should be made.

SECOND HAND COSTS

27. The Consultation Paper proposes to bring the treatment of second hand costs of mineral deposits in the UK into line with the treatment of such costs outside the UK, by limiting the allowance for second hand costs to initial costs. The desire to simplify the treatment of second hand costs is understood, and it is appreciated that to bring the treatment of such costs outside the UK into line with the present system for second hand costs within the UK would be expensive. Nevertheless, to limit the allowance for second hand costs in the UK to initial costs would be likely to discourage the exploitation of UK mineral resources. Smaller mining entrepreneurs are often prepared to engage in exploration for metals where the risk of failure are high; and when they find a deposit they frequently need to bring in larger partners to develop it. A less favourable tax treatment of second hand costs will make such development less attractive, and so have a dampening effect on exploration activity. The present treatment of second hand costs in the UK should be retained.

Department of Trade and Industry

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