



Treasury Chambers, Parliament Street, SW1P 3AG

TO ALL MEMBERS OF THE HOUSE OF COMMONS

*Dear Colleague*

I am writing to you to explain some events in relation to personal tax reliefs and allowances which by coincidence are all happening at about the same time. I am doing this in order to help you in replying to your constituents if they find events confusing and write to you. There are really four separate things happening coincidentally.

First, the PAYE code numbers for 1983-84 include an adjustment to recover the excess of mortgage interest relief given during 1982-83. The allowances for mortgage interest relief included in PAYE codes for 1982-83 were calculated on the basis of the building society interest rates in force at the time. But during the course of the year these interest rates fell twice. Corresponding adjustments were not made in the PAYE codes. This means that the original estimates of relief in PAYE codes were too high, and insufficient tax has been deducted during 1982-83. The adjustment to 1983-84 codes is necessary to recover the excess relief given in 1982-83. Nonetheless the reduction in interest payments still leaves everybody better off.

Second, from April this year the new system of giving mortgage interest tax relief at source starts. The change is entirely an administrative one. Until now, borrowers have been getting their tax relief for mortgage interest either through PAYE or their tax assessments. From April, most borrowers will get their tax relief instead by making lower mortgage payments to their lender. At the same time, they will find their tax payments going up because the relief is no longer given through PAYE or tax assessments. The net effect will be to leave borrowers in broadly the same position as before; and I emphasise that there is no change in the entitlement to mortgage interest relief for taxpayers. Indeed, one benefit of the new system of giving relief is that for most borrowers the kind of adjustment to collect excess relief mentioned above will not be necessary in future years, because the relief will be given in the calculation of the mortgage payments and not through PAYE.

Third, under the new scheme, some mortgage lenders will propose to borrowers with repayment mortgages a switch from their present repayment basis - constant gross payments - to a constant net repayment basis. The constant net repayment basis costs a little more in the earlier years but a little less in total over the life of the mortgage. Borrowers do not have to accept the proposal and may choose to make lower payments.

I have had some notes prepared on these three topics which I hope will help you to answer most of the questions raised by your ... constituents. I enclose some copies which you may find helpful at surgeries or with correspondence. If you would like more copies the Vote Office have a supply.

Fourth, the Chancellor announced in his Budget that personal allowances will be increased by 14 per cent. This will result in a reduction of taxation for your constituents, from May 1983.

All of these factors may produce some fairly major changes in your constituent's PAYE codings over the next two or three months. Equally they must be seen alongside the fact that their mortgage payments declined three times - on the two occasions of the two falls in interest rates in August and November last year, and in April when the switch to giving tax relief at source is made.

Overall everyone should be better off as a result of all these changes, (although some more than others depending on whether they switch to the constant net repayment basis). I append a diagram in pictorial form showing the precise sequence of events from the first interest rate fall for which no general coding adjustment was made until the benefit of the Budget changes comes through in May. The figures given are illustrative only and are for a taxpayer with around average gross earnings of £750 per month on the basic rate of tax with a mortgage of £16,000 (the average new mortgage at the beginning of 1982-83). For mortgages greater or lesser the figures will vary accordingly.

Sometimes taxpayers will wish to raise more particular questions about their own circumstances. In that case, I am sure that either the taxpayer's own tax office or his lender (depending on the nature of the question) will be happy to try and clear the points up. And of course do write to me in cases of difficulty.

Yours sincerely  
Nicholas Ridley

NICHOLAS RIDLEY

A. MORTGAGE INTEREST AND TAX RELIEF : THE NEW ARRANGEMENTS

From April 1983 most borrowers will be getting their tax relief on their mortgages in a new and simpler way. Instead of getting that relief in their PAYE codings or tax assessments, as they do at present, most borrowers will get tax relief at the basic rate by making lower mortgage payments to their lender. The borrower's payments will go down because tax relief at the basic rate of 30 per cent will be taken off the interest part of the mortgage payment. But because the borrower will no longer be given an allowance for the interest in PAYE codings or assessments, the amount of tax he/she pays will go up. The change is administrative. It does not affect the tax relief rules or the amount of the relief, only the way in which it is given. Borrowers entitled to relief will still get all the relief which is due on their interest payments.

Why is the change being made?

The main reasons are to make the system simpler and more efficient. Frequent changes in interest rates have made it difficult to give the correct relief through PAYE, and taxpayers often overpay or underpay tax. With the new system, the right amount of relief can be given at once, even if interest or tax rates change, without involving the tax office. This is better for the borrower and has the added benefit of enabling administrative savings in the Inland Revenue - about 1,000 staff by April 1984 - from which taxpayers generally should also benefit.

Is everyone affected by the change?

Although most borrowers will be affected, some will be outside the scheme. For example, some borrowers whose loans are above the tax relief limit will find that their relief will still be given by their tax office. This is because their lender has exercised its option to keep loans above the tax relief limit outside the scheme. And although the major lenders are within the scheme, some lenders - mainly those bodies for whom mortgages form a small part of their

business, and private lenders - will remain outside. -- Borrowers with those lenders will, of course, continue to get their tax relief through their PAYE codings or assessments as they do now.

Will borrowers still get the higher rate tax relief to which they are entitled?

Yes. Because only basic rate relief can be given under the new system, those entitled to relief at the higher rates will continue to get that relief through their PAYE codings or tax assessments. The mortgage interest paid will, of course, still be taken into account in determining whether a taxpayer is in fact liable to tax at the higher rate.

Does the scheme only affect mortgages?

No. Some improvement loans which qualify for tax relief will also come within the scheme. The scheme can also apply to certain loans used to purchase an annuity by a borrower who is over the age of 65.

Will borrowers be obliged to pay more?

No. At present, except for endowment mortgages, the net cost of a mortgage gradually increases, because as the capital debt is paid off, the interest element in the monthly payments goes down and so the tax relief also goes down. Under the new scheme, some lenders, notably the building societies and local authorities, may propose a change in the way borrowers pay back their loans, so that future net payments remain constant, except when interest or tax rates change. Compared with the present pattern, the borrower's payments would be slightly higher in the early years and slightly lower in later years. The legislation permits the lender to propose this change, but it also gives existing borrowers the right, if they wish, to keep their payments at a lower level (the amount they would have had to pay at the beginning of 1983/84 if the lender had not proposed the change).

Lenders who wish to propose this change have to notify individual borrowers, and the borrower will then be able to see what his options are and decide.

Are option mortgages affected by the change?

Yes. The option mortgage scheme comes to an end on 31 March 1983. For those with an option mortgage, the subsidy will normally be replaced by the benefit of tax relief, whether or not they pay tax. After March, an option borrower will become like, and have the same rights as, any other borrower. In general, option borrowers are likely to find that their payments will be little, if any, different under the new scheme. The individual borrower will hear from his lender how he is affected and what choices he may have.

How will people know whether they are affected?

Borrowers should hear from their lenders, who will tell them whether and exactly how their payments are affected.

B. THE 1982 FALLS IN MORTGAGE INTEREST RATES

Why are PAYE codes for 1983/84 being reduced to recover mortgage interest relief for 1982/83?

Allowance for mortgage interest relief in PAYE codes for 1982/83 were originally calculated on the basis of building society interest rates in force at the time. But during the course of 1982, mortgage interest rates were reduced. This means that the original estimates of relief in PAYE codes were too high, and insufficient tax was deducted during 1982/83. The purpose of the adjustments to 1983/84 codes is to recover the excess relief. An important benefit of the new system of giving relief is that for most borrowers this kind of adjustment will not be necessary in future years because the relief will be given in the calculation of the mortgage payments and not through PAYE.

Why were PAYE codes for 1982/83 not adjusted when interest rates changed?

When PAYE codes are adjusted, they operate to correct the tax position from 6 April to the date of their operation. Where, as in the case of the fall in interest rates, allowances are reduced, the results can be heavy deductions of tax on the first pay day the new code is applied. To avoid heavy deductions, reduced codes are usually applied only from the date they are received; arrears are not collected during the year but in a later tax year. If codes had been adjusted in August/September, they would have been applied only from the date of receipt. There would still have been arrears to recover in 1983/84.

But it was clear in August 1982 that there would be a second reduction in interest rates (this was announced on 12 November 1982). Any recoding in August/September would have been incorrect by December. All the calculations of arrears would have had to be revised and would have been confusing to the taxpayer.

Because only part of the arrears could have been recovered in 1982/83 and this at the cost of confusion for the taxpayer, it was decided to make one comprehensive adjustment in 1983/84.

Borrowers should remember that the reductions in their mortgage interest in August and November 1982 were, of course, larger than the resulting reductions in tax relief.

## CHANGES IN MONTHLY INCOME AFTER INCOME TAX AND MORTGAGE PAYMENT

### NOTES

1. The diagram overleaf is illustrative only. The timing and size of changes will depend on the precise details of an individual's mortgage and income tax position.
2. The diagram illustrates the position of a married PAYE taxpayer with gross monthly income (a) of £750 (a little over average earnings), with a 25-year term repayment mortgage of £16,000 taken out at the beginning of 1982/83. (£16,000 is around the level of the average new building society loan at that time; the average outstanding mortgage is lower, about £10,000.) The solid black line on the diagram represents the amount of monthly income after income tax and mortgage payment. From April 1983 it applies to the borrower who stays on the gross payment profile. The broken line (-.-.-) represents the same amount for the borrower who in April changes to a 'constant net' payment profile.
3. The shaded areas labelled 'Excess Relief' represent that part of the increase in net income which would not have occurred had it been possible to change tax codes in 1982/83 to reflect fully and immediately the reduction in interest rates leading to a fall in the amount of interest actually paid.
4. Two offsetting changes in net income are shown for April 1983. (The timing of these two events will vary from individual to individual, according to the date of their mortgage payment and pay day.)—
  - (i) An increase associated with the fall in mortgage payments resulting from the new tax relief arrangements (MIRAS). These will amount to £40 for a borrower who maintains the former 'constant gross' repayment profile and £32 for a borrower who changes to a 'constant net' profile; and
  - (ii) a decrease (of £60) due to the larger tax deductions from the pay packet.
5. The £60 reduction in tax relief consists of three components:
  - (i) £40 arising from the removal of mortgage relief from tax codings (at the new 10 per cent rate). This is counter-balanced by the reduction in mortgage payments.
  - (ii) £14 reduction in the relief due on interest payments from April (reflecting the fact that the current 10 per cent rate of interest will apply).
  - (iii) £6 recovery of the excess relief given in 1982/83 (corresponding to the shaded areas) when relief was given on 13½ per cent interest rate, although the actual rates had fallen successively to 12 per cent and 10 per cent.
6. Amounts are shown to the nearest whole £.

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(a) The changes in (but not the levels of) net income would be the same for any married man with a mortgage of the specified amount paying tax through PAYE and liable to tax only at the basic rate.

CHANGES IN MONTHLY INCOME AFTER TAX AND MORTGAGE PAYMENT (SEE NOTES OVERLEAF)

