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20 November 1984

PRIME MINISTER

TAXATION OF PENSION FUNDS

The taxation changes affecting life insurance left the money managers of the City rueful. No sooner was the ink dry on the Budget statement than they decided that the next threat was to the enormous tax reliefs afforded to pension funds. They are now running a vigorous campaign against the idea of any tax imposition on pension funds.

A pension fund enjoys 5 different types of tax relief, which can be grouped under 3 headings:

a. **Tax relief on the employer and employee contributions:** the employer's contributions are an offset against Corporation Tax; 1 and the employee's contributions do not count in the computation of income tax. 2

b. **Tax free income 3 and capital 4 gains from investments in the fund.** The only tax paid by a pension fund is Stamp Duty on transfer of securities and properties.

c. **The tax-free lump sum:** 5 this is paid free of tax to the recipient. Pension payments are treated as taxable income.

SECRET

SECRET

There are several reasons why it would be a good idea to reduce this enormous tax advantage:

1. It encourages saving through large and impersonal funds at the expense of private saving and individual decision-making. These large funds do not account well to their members, and are the source of considerable economic power. A future Labour Government would control or nationalise them.

2. The tax reliefs are now extremely expensive: an estimated £3 billion of tax relief per annum.

3. We will never have wider share-ownership and an enterprise culture if all the time the bulk of our savings are amassed and channelled through a group of professional intermediaries.

The arguments put up by the institutional fund managers and by their friends in the larger industrial companies (eg Sir Robin Ibbs) are now being constantly voiced. They say:

i. Imposing a tax either on the contributions or on the investments would require increasing contributions or lowering benefits. The companies would represent it as a tax on employment.

SECRET

ii. If the tax system becomes too tough and no other changes are made, it could encourage more companies to give up the idea of private funding of pensions, and throw a bigger burden on the State Earnings-Related Pension Scheme (SERPS).

iii. If individuals were allowed to run their own pension monies, the large institutions fear that they might make a bad job of it and therefore reach retirement without the additional pension they should enjoy.

The Ibbs argument that it would lead to a big increase in funding costs is not necessarily true. Since 1976, pension funds have been generating good real returns; whereas their liabilities have been rising at a much slower pace. True, market values were depressed in 1976, but nonetheless most pension funds now have a substantial surplus available. If a tax were imposed, it would mean that surplus was no longer available for cutting contribution rates or for improving benefits; but there would be many cases of companies where no additional contribution was necessary.

Nor should we be too worried about the mythical individual who would make a mess of running his own arrangements. Individuals with no great skill would turn to professional advice, but they would be free to choose and free to go elsewhere if they were dissatisfied.

It would be necessary, if a tax were imposed, to get rid of SERPS as planned.

The choice between the different options

The Chancellor once favoured taxing lump sums, probably because:

a. The lump sum which is completely tax free, whereas the accumulated pension income which is paid out as a pension does, in the end, get taxed in the hands of the recipient.

b. Taxing lump sums means a once-only computation for each individual. It raises far less revenue than the other types of taxation, and would therefore be less "damaging" to pension fund cash flows.

However, there seem to me to be strong political arguments that outweigh these. If you are going to tax pension funds, you may as well be hanged for a sheep as for a lamb. Taxing lump sums may produce £400 million, whereas taxing the income and capital gains each year could produce well over £2,000 million. (The amount is a matter of great dispute, with the Inland Revenue - perversely and I think wrongly - arguing that in the early years you would lose revenue.)

In addition, taxing lump sums means that every one of the 12 million occupation pension members will at some point in their lives feel they have been cheated, and will have to pay a highly visible tax on their lump sum. Taxing the income on pension funds will not be visible to the individual members of the fund in any direct way, and involves far fewer computations, as there are far fewer funds than members.

The Revenue have produced a dreadful paper explaining why taxing income and capital gain is administratively complex. They seem to forget that the bulk of pension fund income in terms of number of payments comes from payments on UK equities. At the moment, UK equity dividends are paid net, and the pension fund therefore has to recoup the tax credit from the taxman in a complex series of calculations. If pension funds had to pay tax like everybody else, it would reduce the administrative complexity, as they would receive net dividends and do nothing else.

Conclusion

Another, say, £2 billion of revenue would come in very handy. Taxing pension funds is a vital step in encouraging wider share-ownership and wider wealth-ownership and individual responsibility. Of course there will be great squeals of protest, and some big guns will be rolled out. But it is possible to sell the policy as part of a movement

to encourage individual responsibility; and at the same time to give people back in higher income tax allowances, or lower income tax rates, the gains made from taxing pension funds.

JOHN REDWOOD

NBPM

AT 7/12

10 DOWNING STREET

AT

A £60m cash flow loss is only a little over 2% of the value of the fund.

Market movements in recent years would produce swings of 10-20% in values or several hundreds of millions of pounds. Investment policy will ∴ be much more important than this putative tax.

ICI could easily raise the running yield on the fund by selling overseas investments + buying gilts if income loss (as opposed to total return) so fascinates them.

JR

CONFIDENTIAL

10 DOWNING STREET

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MFJ

From the Principal Private Secretary

14 November 1984

Dear David,

When Sir Robin Ibbs was talking to me about another matter today, he said that he would like to raise one point wearing his ICI hat.

ICI had noted rumours in the newspapers that the Chancellor might be considering the taxation of pension funds in the hands of their trustees. He said that, in the case of ICI, taxation at the rate of 25 per cent would cause the company either to curtail pensions drastically, throwing more people back on to the state system, or to put in £60m a year. In other words, an extension of tax on these lines would not only be resisted by pension fund managers, who might be regarded as having a self-interest in objecting to it, but also by industrial companies like ICI. He said that, if this were being seriously considered, he would like the opportunity to make representations about it.

I said that it was unlikely that I would be able to tell him whether the matter was being seriously considered, but I would pass on his message to you.

Yours ever,

Robin Butler

David Peretz Esq
HM Treasury

CONFIDENTIAL

MFJAHV

File

MR. TURNBULL

Richards, Longstaff Limited

Date: 6 November 1984

Member of The British Insurance Brokers Association
Member of NASDIM. Pension Consultants

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Telephone (01) 407 4466 Telex 888893

Your reference:
PERSONAL

Our reference: WJMG/dr

J Redwood Esq
10 Downing Street
LONDON SW1

Dear John

Although you should have received a copy of my last Newsletter at the beginning of October, I have enclosed another as the content of the first page is most topical.

The paper I sent to you in May was for our internal consumption and, therefore, the figures were not checked and not as correct as I would wish; on the other hand, the reasoning was logical and based on a completely unbiased approach of the whole matter.

Therefore, I am writing to you as I believe that the Life Offices Association is lodging a paper with the Chancellor today in which figures, probably prepared by the Legal & General, are used. Although I have not seen these figures, I would think it highly probable that they are what one might expect from a motivated institutional body looking after their own interests first and foremost.

If the figures produced by the Actuaries state that a tax on investment income of pension funds would lead to a substantially higher funding rate being required, I suggest that they are incorrect, or at least it would be perfectly possible to produce many actuaries to disagree with them. In practice, even on the very rare occasion where there is a mature fund, the loss through tax of a small part of the investment income could not raise a funding rate, in my opinion, by more than 1%.

Although I try to keep an open mind, the following points could be made in favour of a far more embracing composite rate of tax on institutional funds etc as part of the general reform of taxation, which I am sure is rightly being tackled now. The political and financial points which occur to me are as follows:

...2

Directors: S.E. Scrope, W.J.M. Greener, M.C. Swann, D.R. Barnfather, J.G. Ruck Keene, P.J. Lonsdale, H.N. Lund, F.C.A., B.A. McKenna, Mrs. C.P. Nicholls, S.M. Searle, R.M. Smith, G.G. Watson.
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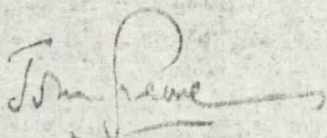
1) Institutions, in particular the large Insurance Companies, are becoming too dominant a force in the investment market. One of the main reasons for this is the very rapid growth in pension funds under their administration.

2) Pension funds themselves are growing, and at such a large extent that it is doubtful whether the country can afford such favourable tax treatment, nor the long-term lock-up nature of the funds.

3) As tax is deferred when income is invested in the fund, pensions will still outweigh all other saving investments, except the BES and possibly Employee Share Incentive Schemes, their tax advantage could be reduced without undermining provision for retirement.

I have great confidence that, with a lower standard rate of tax, a major boost could be given to the investment market and this would soon be shown in the ecomony. What is important must be to introduce the new sources of revenue on the investment funds and remove the inhibiting taxes, like Capital Gains Tax, at the same time as the standard rate is reduced. I do not think that phasing in this type of tax on investment income would achieve anything, it can be effective 100% from the date that is introduced.

Yours sincerely



W J M Greener
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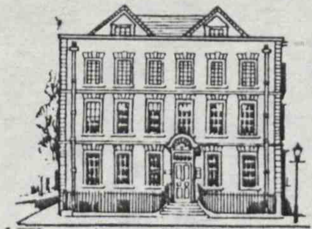


A GLIMPSE INTO THE FINANCIAL CRYSTAL BALL

When history is written the years 1945-1980 may be dismissed as a period of lost opportunity. Massive Government interference in a free enterprise society stunted the creation of wealth and produced an era of inflationary recession. We would do well to grasp the significance of the sea change which has come about by the withdrawal of that interference and what is following. This Government has removed the stranglehold on exchange control and is reducing taxes imposed for political and not fiscal purposes. It is reducing the money it takes out of the economy to pay for its own activities and is cutting back on the size of its direct involvement in the country's commerce.

After the firm but limited steps taken in 1980 each year has seen definite progress; we should all study the medium term effects and what may be in the pipeline. What is happening in this country is not dissimilar to that occurring in many other countries. France, after a disastrous bout of Government interference, has reversed these policies this autumn and Turkey is even de-nationalising the State Airline!

As the whole subject is too wide for this Newsletter we will concentrate on just 3 aspects, what future tax changes are logical, how these could affect the investment market, and, in brief, the changes the Government intends to introduce in the pension world.

Logical Taxation Changes

It is not an idle whisper that the Government wishes to see the standard rate of tax reduced to 25%, much of its policy appears to be geared to this figure. If the rate were only 25% it could be applied to a wide variety of tax situations, some of which are exempted at present. Many anomalies and so-called incentives might be removed "at a stroke". Unless the Chancellor increases indirect taxes which we think is most unlikely how can he balance his books? We think he must replace the 5% of lost tax by bringing into the tax-net certain exemptions and reducing certain allowances. We are therefore anticipating that the investment income of pension funds, provident funds, friendly societies, life insurance companies and building societies will be taxed at the same 25% rate, leaving only charities able to reclaim any deducted tax.

We have done some calculations on the new revenue, based on our estimate that there are assets of over £400bn producing investment income in these institutional funds. Our figures indicate that the Chancellor can afford this major change. Furthermore it should be politically acceptable. But what about the far-reaching repercussions on institutions and what they do for the community? If the Chancellor intends to bring in the composite 25% rate we feel certain that he will have thought it through very carefully indeed and no doubt listened to many points of view from political lobbyists. Presumably effective steps would be taken so that funds brought into tax do not move outside the UK Revenue net.

However momentous this move towards neutral taxation would be, following the phasing out of life assurance premium relief, the Chancellor's package is likely to cover two other issues, capital gains tax and what may be offset against higher rate tax. We expect the former, a political tax producing little net revenue and now all too complicated for the human brain, to be removed from all but gains which are short term or made in the course of business. We anticipate that the list of items off-setable against higher rate tax will be reduced.

It is characteristic for all Chancellors to try to make their mark, and Mr Nigel Lawson has the political climate to achieve more than most, if not all, of his predecessors. Because of this he must exercise extreme care when listening to the clamour from vested interests.

Effects of Possible Tax Changes on Investments

However it is characteristic of this Government to continue on course, and we should consider some of the consequences. We take the effect on pension funds first. The loss of a quarter of the investment income is likely to mean a $1\frac{1}{2}$% lower yield on the fund than it could have been. If this were replaced by a similar increase in capital appreciation, few actuaries will be sufficiently concerned to recommend an increase in the funding rate and so no increase in cost to the employer and employee need occur. In any case most funds have too high a funding rate for the financial conditions of the last four years and the prospects for the next four.

(continued on next page)

The removal of Capital Gains Tax has interesting and immediate implications for the private investor, and these would soon affect the institutions. CGT usually defers the realisation of profits, its removal could lead to the reverse.

Profits would be taken earlier from a huge pent-up reservoir whose dam could burst. Our line of thought considers how these "profits" (paper or real) could be used. We expect some of them to be used to re-pay loans and reduce the demand for overdrafts. In turn, this could modestly reduce interest rates. But if there are more sellers of equities and properties, will there be more buyers? Taking equities first, in the short term perhaps not, but in the medium term we think the market will find its own level although there will be more short term and fewer long term investors. While the American investor has the "mighty dollar" at his disposal, cheap stock on the London market is likely to be a rare occurence.

As for property, with high street property and agricultural land the main casualties, there could be a longer depressed period. The reverse could be the case for residential property, at present mostly exempt from CGT; this could be a beneficiary of a freer capital market.

The Changing Pension Scene - Mr Fowler takes the first step

Over half the £400bn locked up in institutional funds is money belonging to Pension Fund Trustees. To add another statistic, over 80% of pension monies accrue in funds whose members have been promised benefits, and so their entitlement is not a quantified part of the fund. Furthermore there are at least three different types of beneficiary and it is virtually impossible to treat all three with equanimity. This is contentious, there has been a reluctance to face the problem, but suddenly the whole issue is out in the open. With great fortitude Mr Norman Fowler has said that he will introduce legislation so that an employee of a company can have his own scheme and with it, subject to certain tests, he can contract out of the State Scheme. Last week he reiterated this on the BBC, but refused to 'anticipate the Queen's Speech'.

In the medium term this will lead to a different approach to pensions in all but the very large companies as only they can offer a progressive career right up to retirement age. As the pioneers of portable pensions in this country perhaps Richards Longstaff should be applauding loudly; we do in most respects, but our aim is to see that there is a fairer deal for the employer (unlikely at present), fairer for the employee (most unlikely at present) and complete partnership between employer and employee in future (sadly some extreme suggestions would ruin this).

And what about the State Scheme? The earnings related part of the State Scheme appears to be contrary to this Government's philosophy. All future Governments will thank this one if it is phased out in favour of an enhanced State Basic Pension. Then after laying down simple and clear ground rules the State should not interfere - there is excessive fiscal and administrative interference at present, - a legacy of former doctrines well orchestrated by vested interests.

What type of Pension Scheme can replace the Final Salary Scheme? If employer and employee are to co-operate it must be the *Unitised Contribution Based Scheme.* When we introduced this concept some time ago we named it The Longstaff Plan. It is nice to think our contributions to the debate should prove accceptable to many.

The Investment Scene

The theme of this Newsletter is the effect of the political change of approach to the creation of wealth in many countries, the withdrawal of Government interference and what is the impact on the investor? This is a fascinating scenario. Since 1980 the UK has "created many £bn's of new investment money in real terms". This is a tangible asset derived not only from the North Sea but also from an economy where wealth is being created. The same is true in other countries. If this was not the case the third world debt would destroy the Banking system. In Western Countries for more than 3 successive years, in broad terms, there has been a very healthy return on capital employed. In this Country some of this is absorbed by the sale of Government assets, but much is used to enhance the demand for assets particularly those with growth potential.

This pattern is likely to continue for several years. It points to an increasing value of an equity stake in a well run and profitable company, and the continued relative decline in value of investments in building societies and fixed interest securities. The latter could be major casualties as many pension funds invest in these for the gross return.

If the equity market is freed from the ramification of Capital Gains Tax, the market may become more volatile with greater demand for growth stocks, and move away from those with a duller future. Companies seeking to raise new equity, for good reasons, should find the market more receptive.

What are the lessons for the private investors? Just one for the immediate future - establish a firm link with your investment adviser - somebody you have selected as able to give positive advice and well versed in this fast changing investment scene. He must be able to advise you how to invest worldwide. Perhaps the next page of this Newsletter will appeal to you.

Mr Turnbull cc PS/CST
PS/FST
PS/EST
PS/MOS
Mr Culpin
PS/IR

cc B I

FROM: P L O'LEARY
INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

10 May 1984

File

1. PS/CHANCELLOR OF THE EXCHEQUER

2. PS/PRIME MINISTER

TAX TREATMENT OF PENSIONS: RUMOURS OF IMMINENT CHANGES

Speculation is rife that the Chancellor intends to announce in the next day or so changes in the tax treatment of pensions. It is rumoured that the tax exemption for lump sums will be withdrawn; or that retirement annuity relief will be restricted. The attached cutting from yesterday's Financial Times is typical.

The pensions industry has been particularly jittery since tax reform measures - including the withdrawal of life assurance premium relief were announced in the Budget. These latest rumours have therefore induced a state of panic, and it would be desirable to issue a formal denial (departing from the normal practice of not commenting on such speculation).

The Chancellor made it clear in his recent evidence to the Treasury and Civil Service Committee that he was not dedicated to the removal of all fiscal distortions, accepting that some may be justified for other reasons (extract attached).

---

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Mr Cassell
Mr Monger
Mr Culpin
Mr Lawrie
Mr Ridley
Mr Lord
Sir Lawrence Airey
Mr Isaac
Mr O'Leary
Mr Munro
Mr J P O Lewis
PS/IR

... We suggest that the line to take is as set down in the attached question and answer. { This makes it clear that no announcement of any sort is imminent, but does not inhibit Ministers' freedom to review the very generous tax treatment for superannuation once the main thrust of Mr Fowler's review is known.

PL

P L O'LEARY

The Chancellor wants the ~~[illegible]~~ any comment to be on the lines of the attached revised version.

He thinks it wrong to comment on such rumours in principle (because then when there is no denial, then people will assume they are true); and wrong to tie our hands to the results of the Fowler review.

DLCP
10/5

Suggested Question

Will the [Chancellor] comment on the recent press reports that changes in the tax reliefs for pensions are to be announced shortly.

Answer

No such announcement is contemplated. It would be quite improper to propose any major change in the tax treatment of provision for retirement until we know the direction which Mr Fowler's review is likely to take.

No. Hon member should not believe everything they read in the newspapers [If pressed: Hon member should know that Treasury ministers do not comment on rumours about tax changes]

FOURTH REPORT FROM

THE TREASURY AND CIVIL SERVICE COMMITTEE

4 April 1984

capital gains relief to corporate debt held for more than one year (making the relief similar to that applying to gilts) the Chancellor is creating a tax distortion rather than ending one.[48]

52. Similarly, the expanded scope of the Save-As-You-Earn and share option schemes exempts gains from income tax, and hence could be said to extend a tax privilege as opposed to reducing one.

53. Tax relief on mortgage interest and pension fund contributions is unaffected. The Governor of the Bank of England's views on this subject are clear:

> "I think in the narrow context of simply removing distortions to savings the Bank sees quite a strong case for movement into the areas you have cited [ie pension funds and mortgage interest]. But, in saying that, I emphasise one sees this as a central bank concerned with distortions in savings. There are much deeper social and political elements at work in this, particularly in relation to house mortgage borrowing and also in relation to pension funds."[49]

54. In this connection, given the commitment to the removal of distortions in his Budget speech, it is interesting to note the Chancellor's amplified view on this subject as given in evidence:

> "I would not like this Committee to labour under the delusion that I am dedicated to the removal of all distortions in the tax system. I think the presumption must be that the tax system should not have distortions, unless a particular case can be made for them, but it may be that particular cases can be made for particular distortions, and therefore it is not the case that one is dedicated to removing them all."[50]

He also acknowledged that the benefits of many tax privileges, for example, on existing life assurance contracts, had many years to run. He agreed that in some cases this made levelling-up an attractive, albeit expensive, option.[51]

Public Sector Capital Spending

55. Turning to the question of public investment—an area upon which we and our predecessors have reported in the past[52]—we note that there seems to be a close degree of agreement between ourselves and the CBI and TUC on this subject. In our last report on the Government's Expenditure Plans 1984–85 to 1986–87 we once again drew attention to the declining share of capital spending as a proportion of total spending. In evidence the President-elect of the CBI hoped that the Budget would have provided an opportunity to bring:

> ". . . about the reduction in what in industrial terms we call current expenditure and ensuring a bigger share of the total available for expenditure should go into the capital account."[53]

Further the CBI said that they were preparing a report detailing where increased expenditure in infra-structure should be directed. The TUC adopted a similar

[48] New distortions are also being created on the expenditure side. See QQ 454-6
[49] Q 94
[50] Q 376
[51] ibid
[52] HC (1981-82) 137, para 3.18; HC (1982-83) 49, para 48; HC (1982-83) 204, para 20; HC (1982-83) 286, para 44 and HC (1983-84) 285, para 31
[53] Q 123

Wednesday 9th May 1984.

FINANCIAL TIMES

Tax fears lift sales of pensions 8

BY ERIC SHORT

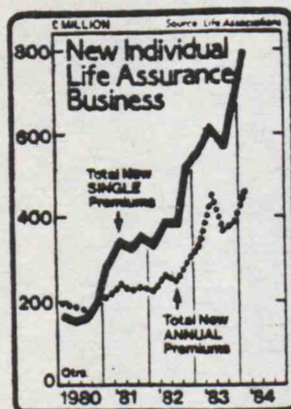
SALES of personal pension policies issued by life assurance companies soared yesterday on fears that Mr Nigel Lawson, the Chancellor of the Exchequer, may be about to tighten tax concessions on contracts linked to house purchase and other loan schemes.

Many life companies have streamlined their acceptance procedures for pension contracts to speed the flow of business. They fear that the Chancellor may insert a new clause in the Finance Bill ending the tax-free payment of lump sums.

However, there were indications in Whitehall yesterday that the Government would delay any action until it has seen a pensions policy report being prepared at the Department of Health and Social Security.

Under a personal pension available to the self-employed and others in non-pensionable employment, the policyholders can, somewhat illogically, convert part of their taxable pension into a tax-free lump sum.

This right also applies to company pension schemes, while in the Civil Service and other public sector pension schemes, the benefits are paid as part tax-free lump sum and part taxable pension.



Life companies have been marketing house mortgage and other loan schemes linked to personal pension contracts—the so-called pension mortgage scheme—since the Chancellor removed tax relief on life assurance premiums in his Budget on March 13.

Mr Robert McCrindle, parliamentary adviser to the British Insurance Brokers' Association, warned at the association's recent annual conference that selling pension contracts on mortgage facilities could result in action by the Chancellor.

Nevertheless, certain life companies have been offering attractive special terms on personal pension policies to encourage sales.

The rush mirrors the reaction to the Budget leak at the beginning of March which accurately forecast the removal of life assurance premium relief. Life business soared in the few days ahead of the Budget as life salesmen rushed to beat the deadline.

Figures issued yesterday by the three life company associations—the Life Offices Association, the Associated Scottish Life Offices, and the Industrial Life Offices Association—showed that new annual premiums on assurance in the first quarter of the year were 43 per cent higher than in 1983, at £405m against £283m. Life assurance premium relief only applied to regular premium assurance policies.

Traditional ordinary life business showed annual premiums up by 45 per cent to £232m, while linked life regular premiums were nearly 70 per cent higher at £109m.

Industrial life business, where premiums are paid weekly or four-weekly and collected by agents at the homes of policyholders, showed an 11 per cent rise to £64m. This business has been static in recent years.

The figures also showed steady growth in personal pensions in the first quarter. New annual premiums were 18 per cent higher at £53m and single premiums 22 per cent up at £109m. However, business transacted after Budget day on March 13 is unlikely to have appeared in the first quarter figures. The effect of the post-Budget drive for pensions business will show in the second quarter.

Life companies report that the loss of life assurance premium relief has had little effect on sales but no company has issued figures. However, building societies report that endowment mortgage sales were only 3 per cent down on pre-Budget levels even though business was affected by the loss of LAPR.

Daily Telegraph

Life groups fear pensions tax axe 19

THERE was growing concern yesterday that the Government intends to act this week on pensions tax relief.

Life insurance companies have asked the Treasury to clarify suggestions that measures are in hand which could result either in the reduction of top-rate tax relief on contributions by the self-employed or in the abolition of tax-free lump sum payments on retirement.

There was no official comment but some insurance companies, offering pension-linked plans, yesterday discussed contingency measures in case of a sudden announcement.

The possible changes would relate to people under sections 226 and 226(a) of the 1970 Taxes Act, covering both the self-employed and those working for companies who had opted for an individual scheme. That would involve more than 2 million people.

A Government decision to reduce the tax relief available on self-employd contributions from the current top rate of 60 pc. to a standard rate of 30 p.c. has been on the cards for some time, although the industry was hoping that the matter would not arise until the next Budget.

THE TIMES

Muddled issues on futures trading 17

As the number of futures contracts traded in London multiplies, so do efforts to change the tax treatment of futures trading. But the mounting campaign to persuade the Government and the Inland Revenue that futures trading should be looked on more favourably – a paper prepared by the British Federation of Commodity Associations has been sent to Mr John Moore, Financial Secretary to the Treasury, and to the Revenue's policy division – muddles two issues.

There is a good argument for taxing of legitimate hedgers on futures markets under Schedule D, Case I rather than Case 6, ie capital gains rather than income tax treatment. Futures markets have become investment vehicles, intimately bound up with the complex patterns for modern financial management; as such they deserve the same tax treatment as equity transactions on the Stock Exchange.

The Revenue case partly rests on the dubious precedent of Cooper v Stubbs (1925) and owes even more to policy decisions taken ad hoc in the early 1970s when conditions were very different than they are now when a systematic approach is needed. Incidentally, firms and individuals in the markets claim they often encounter great difficulty and long delays in obtaining clarification of their tax position from the Revenue.

But it does not follow, as the protagonists of tax changes imply, that reducing the tax liability from 60 per cent and alowing losses to be offset against other taxable income, would release a wave of liquidity in London futures markets. The very high liquidity of American markets owes a great deal to a makedly different, investment culture and to the existence of many people of means, ready and willing to speculate.

Nor will different tax treatment save future contrasts for which demand is weak, for example the currency contracts on the London International Financial Futures Exchanges. As the recent history of the Stock Exchange has demonstrated, London is essentially a professinal and institutional centre, and partly because of that the City has maintained remarkably its international standing. The assumption that what is good for Chicago (and, incidentally, may not have worked in New York) must be good for London is dangerous, and probably wrong.

More equitable tax treatment there should certainly be, but it is not a panacea for London's futures markets.

6/1

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15 March 1984

A N Ridley
Special Adviser

David Hunt Esq MP
House of Commons
London S W 1

Dear David,

BACKGROUND BRIEFING ON BUDGET FOR BACKBENCHERS

Following our discussions earlier today, I am sending over to you now 15 copies of a brief for yourself and your colleagues in the Whips' Office. It deals with the background to four issues:

- the kinds of policies affected by the withdrawal of Life Assurance Pension Relief;
- the withdrawal of Life Assurance Relief and other changes in the tax status proposed for the Friendly Societies;
- the extension of VAT to take-away food;
- the extension of VAT to all but new construction activity.

2. These briefs have drawn on advice from officials in the Inland Revenue, the Registrar of Friendly Societies, and the Treasury. And they have been approved by the Chancellor and the Economic Secretary. The Chancellor agrees with your suggestion that at this stage it would not be sensible to make them generally available to colleagues on the back benches. But to guard against the need for this, I am also sending a copy of the material to Peter Cropper at the Conservative Research Department, so that he can run it off and get it to the office in a hurry should you find this to be necessary.

3. When we discussed this possibility this morning, we both agreed that there was a difficult choice to be made as regards the degree of detail in which one describes the impact of the changes following the extension of VAT. At the moment I have gone in the direction of giving full information, in order to answer all questions, and in particular have included most of the key features of the two important Customs & Excise pamphlets which have been made available in their VAT Offices to anybody who wishes to explore the implications of the changes now proposed. But it is clear that it could well be better in the event, should a brief need to be put in your office for backbenchers, not to include the photo copies of those two pamphlets. If that should be needed, very small amendments would be needed to the preceding text in the initial two sections on VAT.

/4....

4. You will find that the legal complexities of the changes required to give effect to the changes proposed for the Friendly Societies are really rather complex. There is some recognition of this at the end of the brief, but I have - I am sure prudently - rather underplayed this. If, however, legalists should become upset or fascinated by the complicated procedures so required, we could no doubt ensure for fuller briefing for them in due course.

Yours ever

Adam

A N RIDLEY

P.S. I am also sending you alone one copy of the Treasury Press Release on the registered Friendly Societies, to which is attached an important letter from Ian Stewart which he sent them on Budget Day. For those who are less interested in the complexities and more interested in the politics, this could be helpful!

I EXTENSION OF VAT BASE TO TAKE-AWAY FOOD

1 Borderline problems are likely when the tax system does not treat all goods and services in an identical way. Until and unless uniform VAT is imposed, there will be unavoidable difficulty in areas such as food.

2 Up to now a big problem has been the very arbitrary distinction between food purchased for immediate consumption in an establishment, or for "taking away", which has been unfair to "eat-in" businesses.

3 The extension of the VAT base to include hot take-away food and drink should be the basis for a less arbitrary borderline when the administrative details have been ironed out.

4 The details of what the Government now proposes are set out in

a) Budget Ways and Means Resolution 13 "Restriction of Zero-Rating (Food)".

This makes it clear that the key extension is to any supply of hot food and drink for consumption off the business's premises. Hot food is in turn defined to mean

"Food which, or any part of which, -

(i) has been heated for the purpose of enabling it to be consumed at a temperature above the ambient air temperature; and

(ii) is at the time of supply above that temperature.

"Food" is already defined as including drink.

b) Reference was also made to this extension of the VAT base in the Customs & Excise Press Notice 894 issued on Budget Day. This in turn makes it clear that a more detailed Customs & Excise Notice BN 2/84 VAT is already available in VAT offices throughout the country giving "full details of the changes", a photocopied extract of the key points of which is below.

c) Customs & Excise will also be advertising in the national press by the end of Budget week setting out the relevant facts. This is clearly not something they can undertake in advance of the Budget, because of the usual complications of confidentiality.

5 The "meals on wheels" service provided by local authorities will not be affected by this change.

EXTRACT FROM CUSTOMS & EXCISE PAMPHLET BN 2/84

(AS SUPPLIED TO ALL VAT OFFICES)

Hot food

2. From 1 May 1984 you must apply the standard rate of VAT to all supplies of hot food and drink. For this purpose 'hot food' is food which has been deliberately heated, so that it can be consumed while still hot.

'Hot' means above room temperature. But certain freshly cooked food which is customarily consumed cold, such as a loaf of bread, may be zero-rated even if you sell it before it has had a chance to cool down.

Where a supply of hot food includes an essential ingredient which is cold, such as the bread roll enclosing a hot dog or hamburger, you should treat the whole supply as liable at the standard rate. The incidental provision of cold items which are not separately charged for, such as a dollop of mustard, tomato sauce or chutney, should be ignored.

Here are some examples of food which you must standard rate if you sell it hot:

* fish and chips, chicken and chips, pie and chips, etc.;
* chips sold on their own;
* Chinese, Indian, Greek, Italian and similar take-away meals and dishes;
* hot dogs and hamburgers;
* pies and pasties;
* toasted sandwiches;
* cups of tea, coffee, chocolate, etc.;
* cups of soup;
* roasted chestnuts.

Here are some examples of items which you may zero rate unless they are sold in the course of catering:

* fresh bread;
* sandwiches and rolls with a cold filling;
* cold pies and pasties;
* prawns, jellied eels and similar seafoods;
* cold milk and milk shakes, iced tea and iced coffee (but remember that most cold drinks are standard-rated—for further information see the leaflet on food);
* cold cooked meats.

Mixed supplies

3. If you make 'mixed supplies' of standard and zero-rated items, for example a take-away hamburger and milk shake, a cup of tea and a plain biscuit, or a meal consisting of hot and cold dishes, sold

at a special inclusive price, you will need to work out the tax value of each supply in order to calculate how much tax is due. You will find more about this in Notice 700 *The VAT guide*, paragraph 14.

VAT EXTENSION TO ALTERATIONS ETC.

1 The borderline problem with construction activity is much the same as is encountered with food. Up till now it was drawn between services which were classed as "alterations", on which no VAT was chargeable; and "repairs and maintenance" which have always carried VAT.

2 The base is now being extended in such a way that in effect only "new structures" will be free of charge. This should in due course be easier to police.

3 The details are provided for as follows.

a) - Ways and Means Resolution 14.
"Restriction of Zero-Rating (Construction of Buildings, etc)"
This is a fairly complex Resolution which cannot easily be summarised.

b) - They are also referred to in Customs & Excise Budget Day Press Notice 894, which in turn refers to a special Customs & Excise Notice "BN 3/84 VAT: Construction Industry" which is also already available at VAT offices. A photocopy of all its relevant pages is attached.

c) - They will also be the subject of advertisements in the national press by the end of Budget week.

4 In effect the change of the coverage amounts to the following "New structures" are defined fairly tightly, and are only extended to include a very small number of essentially immoveable fixtures and fittings such as fitted kitchen units and cupboards, and a very narrow range of other miscellaneous installations. Amongst those things which will, therefore, come into VAT charge will be:

- Central Heating
- Double glazing
- Loft and cavity wall insulation, damp proofing
- Wall extensions and loft conversions
- First time provisions of inside bathrooms and WCs
- Erection of private garages
- Garden sheds, greenhouses, etc

Another important exclusion arises over buildings which are substantially re-constructed by builders. Up till now the rule which was operated was that where the re-constructic work was worth more than 50% of the ultimate sale value of

the building, the builder or developer could reclaim VAT on the inputs he had used. Henceforward he will not be able to do so. Such work clearly falls outside the concept of a "new structure". Henceforward such work will be technically in the (somewhat confusing) "exempt" category.

5 This extension of the VAT base will not have a significant impact on business costs; and over three-quarters of construction industry output will still be either zero-rated or tax-deductible by the purchaser.

NOTICE BY THE COMMISSIONERS OF CUSTOMS AND EXCISE

BUDGET 1984

VALUE ADDED TAX: CONSTRUCTION INDUSTRY

General

1. As announced by the Chancellor of the Exchequer in his Budget Statement, all building alteration work is to be standard-rated for VAT from 1 June 1984. A number of other VAT liability changes affecting builders will also happen then. This Notice tells you about all these changes and what you must do as a result. It supersedes some of the material in Notices 708 *Construction Industry* and 742 *Land and Property*. VAT Notice 715 *Construction Industry: Alterations and Repairs and Maintenance* is cancelled with effect from 1 June. If you are not already registered for VAT you should read the VAT leaflet *Should I be registered for VAT?* This tells you all you need to know about VAT registration requirements.

All of the publications mentioned in this Notice are available, free of charge, from local VAT offices.

Nothing in this Notice overrides the legal requirements.

Work to existing buildings

2. From 1 June all work done to any existing building (including the provision of additional fixtures or equipment) will be standard-rated. It does not matter whether the work is described as alteration, improvement, reconstruction, enlargement, renovation or repair: all such work must be taxed at the standard rate of 15%. The tax must be charged on the total price of the job (labour and materials). For work which is in progress on 1 June, please see paragraph 14 below.

Double glazing

3. The installation of double glazing also becomes standard-rated.

Supplies of reconstructed buildings

4. Notice 742, paragraph 26 and Notice 708, paragraph 20 explain in what circumstances you can be treated as a 'person constructing

a building ' and zero rate the sale or the grant of a long lease of an existing building which you have reconstructed. From 1 June this zero rating will no longer be available. From that date all supplies of reconstructed buildings, by sale or by the grant of a lease, whether long or short, will be exempt (unless they are of standard-rated holiday accommodation). If you make such supplies, this change to exemption may affect how much input tax you can reclaim and you should read Notice 706 *Partial exemption*. If your only supplies are sales or lettings of reconstructed or refurbished property (*i.e.* you do not build new property for sale or supply building services to clients), you will no longer be entitled to be registered and you should notify your local VAT office in good time before 1 June.

New buildings

5. If you supply building services in the course of the construction of a new self-contained building, your supply will remain zero-rated. If you sell or grant a long lease in, or in any part of, a new building you have built on your own land, you can, as before, zero rate your supply (Notice 742, paragraph 22). There will, however, be changes from 1 June affecting the liability of certain fixtures in new buildings and of garden buildings. These are explained in paragraphs 6 to 9 of this Notice.

Furniture and kitchen appliances in new buildings

6. Fitted furniture, whether supplied ready assembled or finished off on site, can at present qualify for zero rating if it is supplied by the person who fits it. From 1 June such furniture, other than units or work surfaces installed in kitchens in new buildings, will in all circumstances be standard-rated (although a separate charge made by a sub-contractor for installing it in a new building will still be zero-rated).

7. Some kitchen appliances, such as built-in split level cookers, which can at present qualify for zero rating will also become standard-rated in all circumstances.

8. The rules governing input tax are to be changed so that if you build houses or flats on your own land for sale or long lease and you install fitted furniture (in rooms other than kitchens), or appliances such as cookers, ovens, hobs, fridges, freezers, washing and dish washing machines, you will not be able to reclaim the VAT you incur on them as input tax.

Garden buildings

9. From 1 June the construction of a building in the grounds or gardens of private residences will be standard-rated. The only exceptions will be the construction of an additional self-contained dwelling and the construction of a detached garage at the same time as the building of the dwelling and to be occupied in conjunction with it. The main effect of this change is to tax detached garages,

greenhouses, garden sheds and similar buildings at the standard rate whether or not they are erected by a builder. (Garages, storage space etc. built onto existing houses will be taxed as alterations/extensions of existing buildings.)

Demolition

10. The demolition of a complete building remains zero-rated.

Civil engineering works

11. All work to an existing civil engineering work will become standard-rated from 1 June. The construction of a complete civil engineering work remains zero-rated except when the work is in the grounds or garden of a private residence when it remains standard-rated.

Professional services

12. Professional services, such as those of architects and surveyors, remain standard-rated in all circumstances except when the services relate to land or buildings situated outside the United Kingdom.

Operative date

13. All these changes take effect from 1 June 1984. This means that tax will be due at the standard rate on all supplies of building services affected by the changes made on or after that date. The date on which a supply is regarded as being made for VAT purposes is governed by the tax point rules set out in Notice 700 *The VAT guide*, Section V. Special rules affecting the building industry can be found in Notice 708 *Construction industry*, Section III. If you use a retail scheme, you should refer to Notice 727 *VAT : Retail schemes*, Appendix C. **Remember**, these changes in liability may mean that you have to change to another scheme.

14. The transitional rules for registered builders not using a retail scheme are as follows:

(*a*) **Work completed before 1 June.** You need not charge tax even if you do not invoice your customer until after that date.

(*b*) **Work not started before 1 June.** This is liable to the tax except to the extent that the customer pays **before 1 June.** (The issue of an invoice prior to 1 June for work which, if carried out before that date, would have been zero-rated is not a tax invoice and has no effect.)

(*c*) **Work in progress at 1 June.** Provided that you can apportion the supply in a realistic way, you are entitled to zero rate that part of the job done before 1 June and charge at 15% for the balance. Alternatively if your customer agrees to pay for the whole job **before** 1 June, then the whole job attracts the zero rate.

If you need more detailed information about how to account for tax on work done around the date of the change you should read *The VAT guide*, Appendix F.

LIFE ASSURANCE PREMIUM RELIEF (LAPR): POLICIES AFFECTED BY WITHDRAWAL

1. As Life Assurance policies are an ingredient in a number of very different kinds of insurance contract or financial arrangement, it may be helpful to set out, as far as is possible, some indications of what is and is not affected by the proposed abolition of LAPR.

2. This relief was restricted to a limited class of contracts, which only accounted for about a third of total life office premium income in 1982. Such "qualifying policies" had to meet several conditions:

- a term of 10 years or more;
- multiple premium contributions, paid at least once a year;
- limited variation in the size of annual contribution.

In addition an individual could only qualify for relief on premia up to 1/6th of the individual's income, or £1,500, whichever was the greater.

3. It follows therefore that the abolition of LAPR on future contracts will affect any insurance contract or financial arrangement involving a contract with an individual which would be deemed a "qualifying policy" on the above criteria.

4. It _also_ follows that, since there is no way in which one can exhaustively list all those classes of financial arrangements which _include_ qualifying policies and those that do not, there is no way in which one can list those arrangements which are affected by the abolition of LAPR.

5. However certain general points are worth noting about arrangements which are _not_ affected, usually because they are more closely related to superannuation arrangements. These include

- Retirement annuities for the self-employed.
- Trade Union Provident Funds
- Occupational Pension Schemes

6. See also the Budget Day Inland Revenue Press Release "Life Assurance Premium Relief".

FRIENDLY SOCIETIES: WITHDRAWAL OF LIFE ASSURANCE PREMIUM RELIEF AND OTHER CHANGES

As the role and tax treatment of the Societies are not widely understood, it may be helpful to set out the background to the withdrawal of LAPR and other important changes proposed in their tax status.

LAPR

1. The Societies' original purpose was self-help, as with many other "mutual" organisations such as the Oddfellows, Burial Societies and so on, in the days when there was no welfare state. Until 1966 all their business was tax-exempt. Though their role is less important than it was, there are still many such bodies. Most are small, collecting modest sums from and paying modest benefits out to their members. So their activities are dwarfed by the conventional Life Assurance industry. A few have become very large however, such as the "Royal Liver"; and a fair number - both large and small - have over the years operated increasingly aggressively in marketing the services they have to offer.

2. Like the ordinary Life Assurance Company, they offer two convenient savings instruments in life insurance form: contracts for lump sums; and annuities. Typically these were "qualifying policies", like many other Life policies, and conferred eligibility for LAPR on the individual who took them out (if he had headroom within the Inland Revenue ceiling of 1/6th of income or £1,500, whichever was greater). The Budget has therefore proposed abolition of LAPR on new Friendly Society policies, as on all other qualifying policies. But other important changes are also to be made to the tax treatment of the Friendly Societies.

3. Friendly Societies are faced with one complication, which does not affect life assurance companies, in adapting to the abolition of LAPR for new policies. Societies' contracts with members are based on their rules, and in most cases a member's entitlement to deduct LAPR is set out in a 'scheme' originally prescribed in an order by the Chief Registrar, and then annexed by the particular society to those rules. So societies could have problems in writing new business on the new "gross" basis until the amendment of the Finance Bill legally removes the right to LAPR in respect of new contracts. The Chief Registrar has accordingly made an order under the Finance Act 1976 amending the 'scheme' so that it does not apply to new contracts.

Change in Tax Status

4. Two forms of Friendly Society have evolved since 1966, operating under significantly different tax régimes.

5. The "Tax Exempt". Until now these societies operated with

- complete corporation tax (CT) exemption on their profits, in contrast to ordinary life assurance companies, who have received "franked" income already taxed at 30 per cent paid CT at the privileged but substantial "pegged rate" of 37½% on their income from other sources;
- complete capital gains tax exemption, in contrast to the 30% rate paid by ordinary life offices;
- no tax of any kind payable by the society or the policy holder when the benefits are distributed.

But all of this was subject to the rules of the society providing that the maximum sum assured on any life or endowment business was (latterly) £2,000; and the maximum annuity £416 per annum.

6. The "mixed business" Societies. These were, as their name suggests, transacting:

- both on a tax-exempt basis, with the same unusually liberal régime as their tax-exempt brethren, in which case they were able to do so provided their rules stipulated even tighter maxima of £500 for sums assured, and £104 p.a. for annuities;
- and on a non-exempt basis, with much higher limits of £50,000 on sums assured, and £5,000 p.a. on annuities;
- in their non-exempt business the societies' tax treatment was identical to that of any ordinary life insurance company, but naturally this division of the societies' activities into two distinct categories has required them to operate with notionally separate funds for each class of business!

7. As can be seen, the tax-exempt societies enjoyed a double advantage. First, they were able to market larger lum-sum untaxed undowment annuity policies than the mixed societies. Second, both classes of society were able to compete on privileged terms with ordinary life offices even if subject to the severely limited minima set out in their rules.

8. The tax-exempt societies in particular, including latterly some specially set up for the purpose, have been very aggressive in

marketing their policies, in a manner not consonant with their traditional philosophy. Clearly, if they do so, this is unfair both to the mixed-business society, with its lower limits, and the conventional life insurance company with its tougher tax régime.

9. In addition the Government's general desire to introduce more neutrality and even-handedness into the operations of financial institutions naturally raised the issue of whether there is now any justification for special tax-exemption for the societies.

10. The Government has concluded that these two special problems called for the following changes in the treatment of their new business:

a) Since the societies' traditional social role is still valuable (e.g. in providing death benefits) they should be allowed to continue to write tax-exempt business, subject to modest limits in keeping with the nature of that business.

b) These limits will be significantly above (half as much again) those followed up till now by "mixed business" societies, at
£750 for maximum sum assured
£156 for annuities.

c) They will apply to all societies, both tax-exempt and mixed business.

d) In addition as far as their conventional non-exempt business is concerned, mixed business societies will be permitted to operate under higher limits from May 1 1984, which will be
£60,000 for sums assured (previously £50,000)
£6,000 p.a. for annuities (previously £5,000 p.a.)
The £60,000 ceiling on sums assured will enable societies to issue insurance policies associated with house purchase loans up to the Building Societies' current special advances limit.

11. In sum the effect of these changes is to
- reduce the unfair competition by tax-exempt societies and the abuse of their special tax status;
- enhance the traditional role of the mixed-business societies, for which continued tax-exemption up to modest levels is clearly justified; and to increase the opportunities open to them in their taxable business.

12. It should be noted that since these changes in tax status depend on the societies changing their rules. The constitutions of the Societies differ considerably; but in the traditional ones, consultation of the membership and a General Meeting may be required,

which can take some time. Thus the administrative and legal procedures required to give effect to these changes are inevitably more complex than most changes in tax law.

13. For further details of these measures. see the Treasury Press Notices "Registered Friendly Societies" and "Friendly Societies Tax Exempt Limits", to which is attached a letter sent by the Economic Secretary to the Chairman of the Friendly Societies Liaison Committee on March 13.