

SECRET

Note: Discussion with PM 27/2
and agreed.

AT 28/2



7

PRIME MINISTER

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

BOND WASHING

As a result of complex legal advice I have received in the course of today the essence of which is set out in paragraph 5 below, I need to announce immediately one of the measures which I was planning to include in my Budget Statement - namely, provisions to put an end to bond washing.

2. Bond washing is a practice which has been going on for many years, predominantly in gilts. It involves the turning of income on a fixed interest security into capital gains so that it is charged, if at all, at lower rates of tax. The possibility arises because such securities are quoted on the Stock Exchange inclusive of accrued interest until the security goes ex dividend, and up to now that part of a stocks' capital appreciation which is in fact attributable to the coupon has been treated by the Revenue as capital gain rather than income. This has meant that someone buying a gilt as soon as it has gone ex dividend can sell it just short of 6 months later cum dividend and thereby take his first coupon as a capital gain - which of course gives him the advantage of the 30 per cent capital gains tax rather than higher rate income tax. If he holds the stock for more than a year, he can do better still since capital gains are then exempt from tax altogether. In that case, the third coupon which the purchaser would expect to receive is effectively tax free; and the same goes for the second coupon if the purchaser takes advantage of the market's special ex dividend rule.

3. Bond washing is a well-known abuse of the tax system which needs tackling in its own right. Our best estimate is that it is costing us some £300 million a year in revenue; and although there may be some offset in slightly lower gilt

SECRET

prices, I am sure there will be a significant net revenue benefit if we introduce counter measures. But perhaps even more important is the link with another reform which I wish to introduce. As you are aware, indexation for CGT purposes at present does not apply to the first 12 months of the ownership of an asset. This has made the tax enormously complicated for the Revenue and taxpayer alike, and we have had repeated representations from the City. I propose to remove the 12 month rule as from Budget day, but have only felt able to do so if at the same time I take action against bond washing. The reason for this is that, with the ending of the 12 month rule, capital gains tax will effectively be even lower than it is at present, and therefore the incentives to bond wash would be even greater than they are already.

4. My proposal for tackling bond washing, which is fully supported by the Bank, is relatively straightforward. In future, that part of the value of a fixed interest security which represents its coupon will be taxed as if it were accrued income, as in the United States. The new arrangement would come into effect in a year's time, but this means that there would have to be anti-forestalling provisions in the meantime in order to avoid a bond-washing bonanza over the next 12 months.

5. I had intended to announce the CGT and bond washing reforms together in the Budget. But I have today been advised by the Treasury Solicitor that, once it could be held that a decision had been taken to proceed against bond washing, we either have to announce it immediately or make no further sales of gilts until the announcement. This is based on the view, which is held even more strongly by the Bank's legal advisers, that the existing rules which permit bond washing are constructively part of the gilts prospectus; and therefore once it could be held that we had decided to change the rules, that is something we would have to disclose before we issue any further gilts. The lawyers are also fairly clear

that the Government Broker could not continue to sell stock which he holds from earlier issues.

6. From the legal standpoint, we have probably already reached the point of decision. In the circumstances, I have three possible options.

7. First, we could stop further gilt sales forthwith until the Budget. But this would be a highly unattractive course. To start with, we need additional sales on a substantial scale; otherwise the money figures for banking March will be very bad indeed. Furthermore, if the Bank were to stay out of the market for the next three weeks, or even for a much shorter period, the market would have no basis on which to trade and the consequent disruption to the gilt-edged market would be very damaging.

8. The second possibility would be to exempt all further gilt sales between now and the Budget from the bond washing measures. This too, would be highly unattractive. It would look very odd to create what in effect would be a special class of 'bond washing bonds', and it would set an undesirable precedent to announce in the Budget that a decision having effect from that day would not apply to transactions which had taken place subsequent to some particular day on which the decision to proceed was taken.

9. The third option is to announce immediately. Given the serious drawbacks of both the first two courses, I have concluded that this is the best way forward.

10. I propose, therefore, that the Revenue should put out a press notice before the market opens tomorrow morning and answer an arranged PQ later the same day.

SECRET

File



8 DSC

10 DOWNING STREET

From the Private Secretary

28 February 1985

BOND WASHING

The Prime Minister has seen the Chancellor of the Exchequer's minute of 27 February and has discussed it with him. She agreed with his proposals and agreed that in the light of the legal advice that he and the Bank had received, it was necessary to make an immediate announcement.

The Prime Minister is, however, concerned at the implications of the legal position as now interpreted. She would be grateful if this could be reviewed in order to establish a position in which the Government is able to discuss proposals, take decisions and announce them in a sensible manner.

I am sending a copy of this letter to John Bartlett (Governor of the Bank of England's Office).

Andrew Turnbull

Mrs. Rachel Lomax,
H. M. Treasury.

JGLADT

SECRET