



Secretary of State for Trade and Industry

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The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1

Prime Minister²

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18/12

Dear Nigel,

1987 BUDGET

This seems an appropriate moment for me to give my suggestions for the inclusion of measures in your coming Budget which I feel would help commerce and industry to contribute effectively to the increase of national wealth.

You have made clear your intention to continue the process of reducing the burden of personal taxation. I share your priorities on this, and would be happy to see the bulk of any room for manoeuvre used for this purpose. Last year, you decided to offset in small part a reduction in the basic rate of income tax by increasing some of the higher rate thresholds by less than the rate of inflation. I recognise the reasons for this; but the later moves substantially to reduce the higher rates of personal tax in the United States leave us somewhat exposed in what is increasingly an international market for senior managers in industrial and commercial companies. I would therefore hope that the thresholds for higher tax rates could at least receive the benefit of full indexation this year.

I have chosen my proposals for changes in taxes which directly affect business so that they do not to a significant extent reduce the scope for action on personal taxation. Some of my specific suggestions are set out more fully in the enclosed memorandum. If there are points in them which your officials wish to follow up with mine, I hope they will do so, as in previous years.

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BOARD OF TRADE
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In the field of corporate taxation, you announced in your 1984 Budget the rates of corporation tax to apply for the four year period from April 1983 to April 1987. It would be most helpful to industry in planning for the short to medium term if in your coming Budget you are able to announce the rate of corporation tax for 1987/88, and give a clear indication of your intentions for subsequent years. I naturally hope that you will find scope for some reduction in the present rate of 35 per cent; but in any event I regard it as most important that there should be no increase.

The particular aspect of corporate taxation on which I and my colleagues in DTI have received the greatest volume of representations from industry in recent months has been the tax treatment of R and D. It is commonly alleged that a number of our competitors have a more favourable fiscal regime for R&D, to the point where it pays some UK-based companies to carry out R&D abroad. We have agreed that there should be a review in the next few months of R&D taxation in other countries, and I do not propose to make any new proposals pending the outcome of the review. But I would urge you to look again at the two specific proposals made in Leon Brittan's Budget submission last year, for the extension of tax relief to expenditure incurred by a consortium on R and D before trading begins, and for the clarification of the definition of research used for the Scientific Research Allowance.

I set out the case for the first in some detail in my letter of 17 March to John Moore, and will not repeat the arguments at length. In part the proposal is a response to representations we have received from industrial companies and financial institutions; but I believe that it would have at least as much value in stimulating a new and flexible approach by industry, financial institutions and higher education to commercially oriented R & D. We are both concerned about the relatively poor R & D performance of British industry. I believe that this proposal offers one of the most cost-effective means available of stimulating an improvement. I am pleased that our officials have made good progress, on a "without prejudice" basis, in elaborating a possible scheme. I am content with the outline that has been prepared and I very much hope that you will be able to include it in the Budget.

We also receive a good many complaints that the Scientific Research Allowance, which you decided in last year's Budget to retain, is of little value because the definition of scientific research has proved in practice both narrow and uncertain. I understand that this concern is not at present matched by a significant increase in the Inland Revenue case load on the point. Nonetheless, I believe it would help industry at very little cost if the definition could



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be clarified by making it more specific and relating it more closely to how R&D is actually carried out in industry. Section 1.174-2 of the US Internal Revenue Code, while doubtless unsuitable for incorporation in UK law as it stands, illustrates an approach which I think industry would find more helpful.

I should also like to propose some further changes in the tax treatment of financial services. I very much welcomed the reduction in the rate of Stamp Duty on securities transactions to $\frac{1}{2}$ per cent from the date of the Big Bang. But this still means that transaction costs in London are higher than in other financial centres apart from Tokyo, and leaves the City at a competitive disadvantage at a critical moment in the evolution of a world securities market. There remains a strong case for the complete abolition of Stamp Duty on securities transactions, but I realise that the revenue loss would be significant. A further reduction of $\frac{1}{4}$ per cent be a great help to the City's competitive position, and on past form much of the apparent revenue loss would be offset by an increased volume of turnover. (I note that the yield of the 1 per cent Stamp Duty on securities transactions in 1985/6 was 15 per cent greater than the yield of the 2 per cent duty two years earlier.) The reduction of the main Stamp Duty on securities to $\frac{1}{4}$ per cent would also make possible a pro rata reduction, to $\frac{3}{4}\%$, in the new tax on the transfer of shares for the purpose of creating depositary receipts. as well as the halving of Stamp Duty Reserve Tax.

The changes to be introduced under the Financial Services Act in the range of investments permitted to authorised unit trusts will require parallel changes in the provisions defining the tax status of the trusts. Our officials are well advanced in the preparation of proposals to achieve this. I am sure that you agree that the scope of the tax changes needs to be wide enough to enable us to achieve our purpose of allowing unit trusts greater flexibility in their choice of investments within a firm regulatory framework. I also hope that you will look again at the $\frac{1}{4}$ per cent unit trust instrument duty. The amount of tax collected is quite small, and the duty is an increasing handicap to the trusts, and particularly to money market funds, in competing with other investment media.

I have two suggestions to make on the tax arrangements for life insurance. The Stamp Duty of 50p per £1000 insured distorts competition between savings media and is widely seen as discriminating against life insurance companies. More specifically, the application of this duty to the reinsurance in the UK of life policies written abroad is a major burden for UK



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reinsurers and seriously handicaps them in international competition for this business. This latter change would only cost about £1m and I do hope you can agree to meet it.

Like my predecessors, I have been concerned that the exemption from double capital gains charges enjoyed by unit trusts and investment trusts has not extended to unquoted venture capital companies, with the result that they have been compelled to establish residence off-shore. I am delighted therefore to hear that a solution to the problem seems to have been found that does not require legislation. I hope that continuing discussion on the tax treatment of venture capital fund managers' profit on their personal stake in the funds will have a similarly successful outcome. If solutions on both points enable the funds to come back on shore, the revenue effect will be positive.

I have also been following the progress of discussions at official level on disincorporation relief. It seems clearly right that the relief available when unincorporated traders incorporate should be matched for businesses which decide to disincorporate; and I understand that this is now accepted in principle. I recognise that to translate this into legislative terms is not straightforward, but I hope that you will be able in the Budget at least to indicate your intention to introduce disincorporation relief.

You are, I understand, looking again at the tax advantages enjoyed by dual resident companies, the cost of which has now reached substantial proportion. I have already written to Norman Lamont to say that I am content with your proposal to curtail this relief.

On VAT, I fully support your efforts to secure agreement at Community level to a new directive which would permit a substantial increase - even beyond the 35,000 ecu proposed by the Commission - in the turnover threshold above which firms must register; and I hope that you will as a minimum increase the present threshold of £20,500 in line with inflation. The proposals in the consultative document on VAT and small businesses will also in the main be welcomed by industry, and I would particularly urge the early introduction of an option for smaller traders to account for VAT on a cash basis. But I hope you will reconsider the suggestion that firms with a turnover below the registration threshold should no longer have the option of registering. This could have a serious effect on a substantial number of repayment traders.



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My final point is small in the context of the Budget as a whole but could have serious implications for jobs on Merseyside. I understand that Customs and Excise are considering a proposal to abolish the long-standing excise charge on matches and lighters. I appreciate that those duties may have to go eventually in part of wider moves to harmonise excise duties in the Community. But their early removal would gravely threaten 300 jobs at Bryant and May in Liverpool, and my own view is that abolition of the duties in the coming Budget would not be a good idea.

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

PAUL CHANNON