

BUDGET SECRET
BUDGET LIST ONLYTreasury Chambers, Parliament Street, SW1P 3AG
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16 February 1988

Paul Gray Esq
10 Downing Street
London SW1

Dear Paul

You asked for supplementary notes about a few points on the Budget.

Gainers and Losers

2. The first point you raised was gainers and losers from the Budget package. About 25 million people will gain from the income tax reductions. That will be far and away the largest distributional effect. I attach a table giving details. Inevitably, the biggest gains go to those on the highest incomes - ie those who currently pay most tax.

3. Of the other measures, the doubling of company car scales will affect the 1½ million people who currently have company cars. The vast majority of these - roughly 98 per cent - will gain more on income tax than they lose on car scales, most much more. The only net losers will be those on modest incomes but with expensive company cars - a measure of the distortions introduced by the present system.

4. There will be swings and roundabouts on CGT. Those who have held assets since the 1960s or 1970s and have large paper gains will benefit substantially, because they will be free to sell without paying any CGT at all on gains made before 1982, when we introduced indexation. Those, such as pensioners, who have relatively low incomes and modest capital gains will benefit because they will only have to pay CGT at 25 per cent, instead of 30 per cent now. The losers will be those with larger, more recent gains or larger incomes, who will now pay at 40 per cent; but this will still be a lower effective rate than, for example, in the American system, because we have indexation and they do not; and the vast majority of those affected will be substantial gainers from the package overall.

5. Anyone paying inheritance tax will gain. No-one with an existing covenant or maintenance payment will be affected by the changes to those items, since the changes affect only future covenants and maintenance arrangements.

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Mortgage Interest Relief

6. The second point you raised was mortgage interest relief. There are two items here: the switch to the residence basis and the ending of relief on home improvement loans. Both apply only to future loans: there will be no change for any existing arrangements.

7. Home improvement loans have become a form of cheap consumer credit. Less than 10 per cent of them are used to finance new extensions, loft conversions etc. The great bulk of the rest go on double-glazing and central heating, which could reasonably be expected to be met out of savings. Half the loans are for less than £3,000.

8. It is indeed virtually impossible to police whether the tax relief is used to finance home improvements at all. The present regime has been severely criticised by the PAC on these grounds. Abolition of the tax relief will yield about £300 million by 1990-91, which will help to finance the income tax reductions.

9. The switch to the residence basis will be widely welcomed by those who rightly see it as unfair that an unmarried couple can get two slices of mortgage interest relief on their family home, whereas a married couple can get only one. The proposal was included in the 1986 Green Paper on the Reform of Personal Taxation. It will attract some criticism from "sharers" who club together to buy a house jointly: but the most likely result is that such houses will be converted into separate flats, so that each counts as a separate "residence".

10. The Chancellor has consulted Mr Ridley, who is content. He has also informed Mr Ridley that the Budget will include a measure to stimulate the supply of private rented accommodation via the BES scheme.

Maintenance and Covenants

11. On maintenance and covenants, the essential point is simple. In the vast majority of cases, the tax system has nothing to do with income transfers between individuals. If, for example, a husband gives a housekeeping allowance to his wife, or an allowance to a child who is a minor, that is no concern of the Inland Revenue. Yet if a parent covenants money to a student child above the age of 18, we tax the student, only to give relief to the parent. And if a divorced man pays maintenance to his wife, we tax the wife only to give unlimited relief to the husband. The objective of the changes is, so far as possible, to get the tax system out of these transactions.

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12. The practical application is of course more complicated. We shall need a clear explanation available on Budget Day; and you may like to see the attached draft of a Treasury Press Notice. This is very much work in progress, which still needs polishing.

13. For most students and their parents, the reform should be broadly neutral. No-one who has made an existing covenant will be affected at all. For the future, parents will lose tax relief on covenants, but (except for those on high incomes) will benefit from a proposed 25 per cent reduction in the parental contribution to student grants paid at the mandatory rates. The typical family should get much the same financial support as before, but in a simpler form.

14. The Chancellor has consulted Mr Baker, who is content, subject to one or two minor points of detail which are now being worked out.

15. There will be no change on covenants to charities.

16. In the case of maintenance payments, future recipients will no longer have to bother with the Inland Revenue. In future some ex-husbands will get less tax relief than they would under the present system; but they will be those who are sufficiently well off to make large maintenance payments, and so are likely to be substantial gainers from the rest of the Budget package.

17. The Chancellor has consulted the Lord Chancellor, who is content subject to further consultation over the details, which is under way.

Independent Taxation

18. On independent taxation, as well as maintenance and covenants, we hope to have a clear explanation available in a Treasury press notice. I attach the latest draft. Again, it is work in progress, which we shall be refining further.

Yours

Alan

A C S ALLAN

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<u>Gross Annual Income</u>	<u>1987-88 regime</u>	<u>Proposed 1988-89 regime</u>	<u>Gain</u>
3,000	-	-	-
4,000	55	-	55
5,000	325	225	100
6,000	595	475	120
7,000	865	725	140
8,000	1135	975	160
9,000	1405	1225	180
10,000	1675	1475	200
15,000	3025	2725	300
20,000	4375	3975	400
25,000	6195	5360	835
30,000	8485	7360	1125
35,000	10985	9360	1625
40,000	13730	11360	2370
45,000	16380	13360	3020
50,000	19380	15360	4020
60,000	25380	19360	6020
70,000	31380	23360	8020

Notes

- (1) 1987-88 regime is: basic rate 27 per cent; married allowance £3795; higher rates 40/45/50/55/60 on threshold of £17900/20400/25400/3300/41200 of taxable income.
- (2) Proposed 1988-89 regime is: basic rate 25 per cent; married allowance £4075; higher rate 40 per cent, on threshold of £20000 of taxable income.
- (3) Figures do not include NICs, for which no changes are proposed.

MAINTENANCE AND COVENANTS PAMPHLET: FOURTH DRAFTINTRODUCTION

1. The tax system for maintenance payments and covenants has become far too complicated, and produces anomalies and distortions in the way people organise their private finances. It also makes unnecessary work for taxpayers and the Inland Revenue alike. The Government has therefore decided to introduce a reform of the system, bringing a major simplification by taking most arrangements out of the tax system altogether.

2. This pamphlet explains why the changes are being made and how the new system will work.

SUMMARY OF THE CHANGES

3. The new system will apply to new maintenance payments and deeds of covenant. Existing arrangements will not be affected. The people making the payments will continue to get tax relief on them, and the recipients will pay tax on the money they receive, in the same way as now, for as long as the payments continue. And tax relief will still be given for all covenants to charities.

4. For new maintenance payments under Court Orders or agreements made on or after 15 March:

- the person receiving the payments will not have to pay tax on them;
- a man maintaining his ex-wife (or a woman maintaining her ex-husband) will get tax relief on the payments made, up to a limit equal to the single allowance;

- there will be no tax relief for any other maintenance payments.

5. For payments made under new deeds of covenant, other than to charities:

- the person who receives the covenanted payments will not have to pay tax on them;
- no tax relief will be given to the person making the covenant;
- parents of students starting new courses will stand to benefit from a reduction in the parental contribution to the student grant, to balance the fact that tax relief will no longer be available on covenants made after Budget Day.

THE CASE FOR CHANGE

6. The present system, for both maintenance payments and covenants, is too complicated, produces anomalies and unfairness, and can penalise people who want to work.

Maintenance Payments

7. One in [twelve?] of the population now either makes or receives maintenance payments. The vast majority are made by divorced or separated men to their ex-wives.

8. There is no reason for the tax system to be involved simply because the payments are made under a particular kind of legal agreement. What should be recognised is the expense arising from the breakdown of a marriage, and hence of the need to maintain two households.

9. The system should be as simple and straightforward as possible. In fact, it is extremely complicated.

- Most maintenance payments are paid gross, and the ex-husband has to claim tax relief separately. And if the wife is above the tax threshold, she has to pay tax on the payments she receives. This makes work for the taxpayer and the Inland Revenue alike. And overall, no tax is raised in many cases, because the wife's tax bill is cancelled out exactly by the husband's tax relief.
- A further complication is that some maintenance payments are paid with tax already deducted. In that case, where the wife's income is below the tax threshold, she has to get a repayment from the Revenue. This makes more work for all, and delays the time when the wife or child gets the full amount of the money.

10. The system can also penalise marriage itself. A few couples, generally well-off and well advised, have gained extra tax relief by remaining unmarried. They take out maintenance orders against each other for the cost of raising their children, and get tax relief on the payments, which married couples are unable to do.

11. [The Courts have recently established that a divorced parent can get a Court Order against him or herself for the cost of educating his children who are living with him, and get tax relief for it. Given the tax advantages mentioned above that are open to unmarried couples with children, that could mean that the only parents who would not get tax relief for the cost of maintaining their children would be those who got married and stayed married!]

12. The system can also be a disincentive for the ex-wife (or ex-husband) who wants to go out to work.

Because the maintenance payments are taxable, she may find she has to pay tax on the first £1 that she earns.

Covenants

13. Similar problems arise from the present tax treatment of covenants.

14. Apart from those to charity, most covenants are made by parents' supporting their student children. But it is difficult to imagine a more convoluted way of getting State support into the hands of students.

15. The parent has to go through the legal rigmarole of making a covenant, and supplying evidence of payment. The Revenue then have to check the student's income, and repay him or her the tax that had been paid.

16. As covenant income itself is taxable, many students are discouraged from taking holiday jobs, because they will have to pay tax on the first £1 of their earnings. This is scarcely the best way of introducing young people to the tax system or to paid work.

17. Covenants can also be used by unmarried couples to gain a tax advantage that is not available to married couples, by covenanting money to their own children and getting tax relief for that.

THE NEW SYSTEM

18. The Government has therefore decided on a radical reform.

Maintenance Payments

19. People receiving maintenance payments under new Court Orders or agreements will not have to pay tax on

them. [Nor will they have to put them on their tax return.] This will simplify the tax affairs of some A million people.

20. A man maintaining his ex-wife will get tax relief on the payments he makes, up to a limit of [£2500], equal to the single person's allowance. This recognises the cost of helping to maintain a second household. If there were no limit, a few well off taxpayers could get large amounts of relief, far in excess of that available to the ordinary married man.

21. No relief will be available for other maintenance payments.

22. Thus the treatment of maintenance payments will be more generous than it is now, in the vast majority of cases. The husband will get the same relief as he does now, and the wife will not have to pay tax on the payments she receives.

23. The system will be

- simpler, with one claim for relief;
- fairer, with no tax penalty on marriage;
- and better for incentives, with the wife able to earn up to the single allowance without having to pay tax.

Covenants

24. With the exception of covenants to charities, new covenants (made on or after Budget Day) will be taken out of the tax system altogether. The payers will not get tax relief, and the recipients will not have to pay tax on the money they get.

25. The main beneficiaries from the existing system have been parents of students. They will be given broad

compensation through a reduction in the parental contribution to the student grant. Thus support for students will be concentrated in the grant system.

26. Students will be able to earn up to the tax threshold without paying tax.

27. Other covenants are, in effect, a gift from one person to another, often from grandparents to grandchildren. There is no reason why these gifts should get tax relief simply because they are made under a legal agreement. This relief is therefore being abolished, as part of the Government's policy of removing special tax reliefs, where possible, and using the revenue saved to reduce the general burden of taxation.

Conclusion

28. These changes will bring a radical simplification of the tax system for ordinary people, sweeping away two different systems of taxing maintenance payments, the unintelligible legal mumbo-jumbo surrounding covenants, and the inevitable bureaucracy that follows both.

- The whole system will be easier to understand.
- All those receiving payments will find their tax affairs easier to handle.
- Student support will be simplified.

PAMPHLET ON INDEPENDENT TAXATION: THIRD DRAFT**MAIN POINTS****What is Independent Taxation?**

1. The Government is proposing a new system for taxing married couples.

- Independent taxation for husbands and wives.
- Complete privacy and independence for married women.
- An end to the tax penalties on marriage.

The new system will be introduced in April 1990, as soon as the necessary preparations can be made.

2. The Government's reform sweeps away the system of taxing husband and wife as a unit, which lasted for 180 years.

3. Under the new system:

- A husband and wife will be taxed as separate individuals.
- Each will have their own tax allowance and set of tax rate bands.
- The wife will have the chance fill in her own tax return, if she wishes.
- The married man's allowance and the wife's earned income allowance will be replaced by a new married couple's allowance. For simplicity, this will normally be given to the husband, bringing his total allowances up to the level of the old married man's allowance,

but if he does not have enough income to use it, his wife can do so.

THE CASE FOR CHANGE

4. The present system for taxing married couples is based on treating husband and wife as one taxpayer, with the husband legally responsible for filling in tax returns and paying the couple's tax. For income tax purposes, a married woman's income is deemed to be her husband's.

5. This principle dates back to the introduction of income tax in 1805. Not surprisingly, it produces results which are unacceptable in today's world.

6. First, a wife cannot have privacy or independence in her tax affairs. Her husband is responsible, in law for filling in the couple's tax return, so she has to give him details of all her income - whether earnings, interest on her savings, or even the profits of her own business. This is absurd, in an age when two out of three married women are in paid work, and millions more have savings of their own.

7. Second, the system means couples can actually have to pay more tax simply because they are married. This affects, in particular, couples where the wife has a certain amount of savings income, but would not have to pay tax if she had her own tax allowance against this.

8. Tax penalties on marriage can occur for various other reasons. The most important of these is mortgage interest relief: a married couple are entitled to mortgage interest relief on loans up to £30,000, whereas an unmarried couple can have relief on up to £30,000 each.

9. It is clearly unacceptable that the tax system should penalise marriage.

10. The Government has therefore decided on a major reform, which will remove these problems, giving privacy and independence to married women, and removing the tax penalties on marriage.

THE NEW SYSTEM: INDEPENDENT TAXATION

11. The basic principle of the new system is that husband and wife will be taxed completely independently - on earnings, savings, pensions, and any other income. Their incomes will no longer be added together, and each partner will pay their own tax, independent of the other.

12. As now, most taxpayers will not need tax returns. But when one is needed, the wife will have the chance to fill it in herself, if she wishes, and handle her own tax affairs.

13. The married man's allowance and wife's earned income allowance will be abolished. All taxpayers, male or female, married or single, will have a personal allowance (in 1987-88 terms, £2425, for people under 65).

14. Married couples will also receive a new married couple's allowance. The married couple's allowance and the personal allowance together will be worth the same as the present married man's allowance. So, in 1987-88 terms, the married couple's allowance would be £1,370 (the difference between the present married man's allowance of £3,795 and the single allowance of £2,425).

15. The new married couple's allowance will go in the first instance to the husband, so he will see no reduction in his tax threshold as a result of the change to the new system. But if he has insufficient income to

make use of the allowance he will be able to transfer it to his wife. The result is that no couple will pay more tax, and many will pay less.

16. Examples 1 and 2, in Annex 1, show how the new system will work.

COUPLES IN PARTICULAR CIRCUMSTANCES

Taxpayers over 65

17. Pensioner taxpayers will see a number of benefits from Independent Taxation.

18. As now, taxpayers over 65 will get a higher tax allowance (and those over 80 a higher allowance still). Married women will qualify in their own right for this allowance, rather than the wife's earned income allowance. They will be able to set this allowance against income of any kind, including investment income and pensions based on their husband's contributions, where the wife's earned income allowance is not available.

19. There will be a higher rate of married couple's allowance for couples where one or both is over 65, and a higher rate still if either partner is over 80.

20. As now, all the age allowances will be subject to an income limit. They will be withdrawn by £2 for every £3 of income above the limit, until they reach the level of the ordinary allowances. Under Independent Taxation, husband and wife will each have their own income limit, whereas at present a single limit applies to their combined income.

"Breadwinner Wives"

23. At present, because all the couple's income is treated, for tax purposes, as the husband's, the wife is able to set the married man's allowance as well as the wife's earned income allowance against her earnings, if her husband cannot use his allowance. This means that the couple where the only breadwinner is the wife pay a lot less tax than the couple where the only breadwinner is the husband.

24. Under Independent Taxation, both couples will be treated in the same way. If the husband has no income, the wife gets the married couple's allowance, so her total tax allowance will be the same as a husband whose wife has no income. If the husband has a small income, but not enough to make full use of the married couple's allowance, his wife can use the balance.

25. If these rules were introduced straight away, some 'breadwinner wives' would see a reduction in the value of their tax allowance. The Government has therefore decided on transitional arrangements to make sure that they do not lose out.

ENDING THE TAX PENALTY ON MARRIAGE

26. The introduction of Independent Taxation eliminates automatically the most common tax penalty on marriage: the taxation of the wife's investment income at her husband's top rate of tax. The Government is also taking steps to eliminate other tax penalties. Some of those changes will come into effect before the main change to Independent Taxation in 1990.

Mortgage Interest Relief

27. At present, mortgage interest relief is available on a loan of up to £30,000 for the purchase of a home. But two single people sharing a home can get relief on loans up to £30,000 each, whereas a married couple share a single ration of relief. This creates a widely resented tax penalty on marriage.

28. For new mortgages, taken out from August 1988, the limit on relief will apply to the house or flat, irrespective of whether there are one or more borrowers, married or single, living there. This puts unmarried couples on the same footing as married couples, and eliminates the tax penalty on marriage.

Capital Taxes

29. The problems of the absence of privacy for married women and the tax penalty on marriage arise for capital gains tax in the same way as for income tax. A married couple share one annual exemption for capital gains tax, whereas single people have one each, and the husband has to deal with the couple's CGT affairs.

30. From April 1990, under Independent Taxation, husband and wife will each have their own annual exemption, and partners will be responsible for their own affairs.

31. Transfers of assets between husband and wife will remain exempt from CGT and Inheritance Tax.

Additional Personal Allowance

32. At present, unmarried couples can each claim the Additional Personal Allowance if they have two or more children living with them. This means that between them, they get more allowances than a married couple.

33. [From April 1989], the rules for the Additional Personal Allowances will be changed so that an unmarried couple can get no more allowances in total than a married couple.

Maintenance and Covenants

34. A few unmarried couples exploit the present tax reliefs for maintenance and covenanted payments to gain a tax advantage not available to married couples. The Government is introducing a major reform of this area. For new maintenance arrangements and covenants (except to charities), the person receiving payments will not have to pay tax on them, and tax relief - up to a specified limit - will be given only to men maintaining their ex-wives. This will eliminate the tax penalty in this area. (A separate pamphlet/press release gives further details.)

TIMETABLE FOR CHANGE

35. Some time will be needed to prepare for the new system. Independent Taxation will therefore come into operation from April 1990.

36. Taxpayers do not need to take any action themselves. During the previous tax year, local tax offices will need to get in touch with some taxpayers to ask for the

information they need to run the new system. That will involve, in particular, setting up records for married women as taxpayers in their own right, and transferring information onto these records from their husbands' tax records.

ANNEX

Example 1 - husband and wife both earning

Take a couple where the husband earns £10,000 and the wife £5,000.

Present system

Husband:	10000	Wife:	5000
<u>less</u> married man's allowance	3795	<u>less</u> wife's earned income allowance	2425
so pays tax on	6205	so pays tax on	2575
so tax bill is	1675.35	so tax bill is	695.25

Independent Taxation

Husband:	10000	Wife:	5000
<u>less</u> single allowance	2425	<u>less</u> single allowance	<u>2425</u>
<u>less</u> married couple's allowance	<u>1370</u>		
so pays tax on	6205	so pays tax on	2575
so tax bill is	1675.35	so tax bill is	695.25

The couple's tax bill is unchanged.

Example 2 - husband earning, wife with investment income

Take a couple where, again, the husband earns £10,000; the wife has no earnings, but has £500 investment income, in dividends on shares inherited from her parents.

Present system

Husband earns	10000	Wife's income is taxed with husband's
<u>plus</u> wife's investment income	<u>500</u>	
so total income	10500	
<u>less</u> married man's allowance	<u>3795</u>	
so pays tax on	6705	
so tax bill is	1810.35	

Independent Taxation

Husband earns	10000	Wife's income	500
<u>less</u> single allowance	2425	<u>less</u> single allowance	<u>(2425)</u>
<u>less</u> married couple's allowance	<u>1370</u>		
so pays tax on	6205	so tax bill is	0
so tax bill is	1675.35		

The couple's tax bill is £135 lower.

Example 3 - "breadwinner wife"

Husband has no income; wife earns £10,000.

Present System

Wife earns	10000
<u>less</u> wife's earned income allowance	2425
<u>less</u> married man's allowance	<u>3795</u>
so pays tax on	3780
so tax bill is	1020.60

Independent Taxation, with transitional allowance

Wife earns	10000
<u>less</u> single allowance	2425
<u>less</u> married couple's allowance	1370
<u>less</u> transitional allowance	<u>2425</u>
so pays tax on	3780
so tax bill is	1020.60

The value of the transitional allowance will fall over the years, as the other allowances are increased, and it will disappear when the combined value of the single allowance and the married couple's allowance reaches the present allowance for a "breadwinner wife".

Example 4 - Pensioner Couple

Take a couple who are both over 65 where the husband has an occupational pension and the State pension, and the wife has a pension based on her husband's contributions.

Pensioner Couple

(Both over 65 under 80)

Now:

Husband:	£	Wife:	£
Occupational Pension	3000		NIL
NIRP (including Cat B for wife)	<u>3427*</u>		
	6427		
Age Allowance	<u>4675</u>		
	1752		
Tax	£ 473.04	Tax	NIL

Independent Taxation

Husband	£	Wife	£
Occupational Pension	3000	NIRP Cat B	1287*
Own MIRP	<u>2140*</u>	Age Allowance	<u>2960</u>
	5140		NIL
Age Allowance	<u>4675</u>		
	465	Tax	NIL
Tax	£ 125.55		*1988-89 Levels.

So couple pay £347.49 less.