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The Rt. Hon. Nicholas Ridley MP
Secretary of State for Trade and Industry
Rt Hon John Major MP
Chancellor of The Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

NBRM
RACG
11/12

Department of
Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Enquiries
01-215 5000

Telex 8811074/5 DTHQ G
Fax 01-222 2629

215 5422

Direct line PE4AHO

Our ref

Your ref 11 December 1989

Date

Dear John

1990 BUDGET

I am writing in good time before the 1990 Budget, to give you my views on the overall fiscal strategy which I consider would best promote the long term interests of business; and to make a number of suggestions for tax changes which I believe would strengthen the supply performance of the economy.

You stressed, in presenting the Autumn Statement, that fiscal policy would remain tight, notwithstanding the modest increase in planned public expenditure in 1990-91. I am sure that this is right; I believe that for business, the most important objectives of the Budget, and indeed of macroeconomic policy generally, should be a lower rate of inflation, and the reductions in interest rates which that will in time make possible. I do not think that further reductions in personal taxation should be a priority for 1990; and I would support an increase in real terms in indirect taxes, and specifically in the main excise duties, if that is necessary to balance the reductions in business taxes which I favour, while keeping the overall fiscal stance tight.

I have considered carefully the arguments in favour of more generous capital allowances, particularly for plant and machinery. After two years of rapid growth in industrial investment, the rate of increase is now forecast to slow down or even to go into reverse in 1990 and 1991, just when industry needs to be equipping itself for 1992. To tackle this problem, I would favour an increase from 25% to 35% in the rate of writing down allowances for plant and machinery bought or leased from next April. There would be little or no cost in 1990-91; I understand that the cost would be approximately £1.2bn in 1991-92 rising to £1.9bn in 1993-94.



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If you are unable to accommodate a change of this magnitude in your overall Budget strategy, I have a more limited suggestion. The present system for writing down the value of capital investment for tax purposes may not fully reflect the speed with which some of the key equipment needed to update our manufacturing systems is itself evolving rapidly, and the modernisation of a number of our industries is constrained by supply problems in this area. I have in mind particularly equipment for the production and testing of electronic components and microprocessors. I should therefore like to suggest an improvement in the present writing down arrangements for short life assets. Where a taxpayer nominates an item of plant or machinery as a short life asset, and the nomination is accepted by the Inland Revenue, he should be permitted to claim a 35% writing down allowance, on a straight line basis; and the present arrangement should be retained whereby the outstanding balance of the cost, less any realisation on disposal, is written off when the asset is scrapped or sold. If necessary to combat avoidance, these special provisions could be limited to the category of assets mentioned above.

I have also considered the case put to me for a cut in the main rate of corporation tax. The CBI argue for this strongly, now that the yield of corporation tax is over £20bn a year, and the financial position of companies is less strong than it was. But the increased yield of corporation tax is due overwhelmingly to the return of companies to reasonable levels of profit; and the overall tax burden on companies in the UK, including social security contributions as well as corporate tax, compares favourably with that in most other industrial countries. Levels of company taxation abroad are falling, and we must ensure that we are not left behind in this process. But for the moment the tax rate in the UK remains competitive, and I see no strong case for a reduction this year. I assume, however, that if you did decide to reduce the basic rate of personal taxation, you would, as on previous occasions, extend the reduction to the "small companies" rate of corporation tax.

My other main proposal is that the Stamp Duty of $\frac{1}{2}\%$ on all securities transactions should be abolished. Stamp Duty now represents 75% of transaction cost for the largest securities transactions. It is becoming a real threat to the competitive pre-eminence of the London securities market in the European time zone. The German authorities have announced their intention to abolish their equivalent tax, and similar moves are expected in the Netherlands and in France. There is also a practical reason for abolishing Stamp Duty on securities transactions in the next Budget. Significant private sector resources are about to be devoted to updating the mechanics of share transfers. It would be wasteful for these to have to



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accommodate the collection of Stamp Duty if that is to disappear soon anyway. I recognise that this change would be expensive, at a cost of some £750m a year; but I believe that the benefits of maintaining London's lead as a financial centre are fully commensurate with the cost.

The low level of turnover at which traders are required to register for VAT is a continuing source of unnecessary aggravation to small businesses. I would therefore urge you to increase the registration threshold by the maximum amount permitted by the Sixth VAT Directive, as has been done in every recent Budget. There is, as I am sure you agree, a strong case on merit for a very much larger increase. I hope that you will make renewed efforts to persuade your colleagues in other member states of the benefits this would bring to smaller businesses throughout the Community.

As you know there has been a good deal of recent discussion of the use of fiscal measures and other market mechanisms as instruments of environmental policy. I am sure that this will remain an important topic in the medium term; and we shall need to look critically at initiatives which might work to the disadvantage of the UK's relatively energy intensive industries. I have no general proposal in this area. But I should like to make one specific point.

This relates to tax incentives for the early introduction of cars fitted with catalytic convertors. We have dropped our objection to the use by other member states of tax incentives for this purpose. But it is important that we should continue to resist proposals for such incentives here. The manufacturers are already moving as fast as they can, so there would be a lot of deadweight; and insofar as tax incentives did affect purchasing decisions, overseas manufacturers, whose development of convertors is more advanced, would benefit disproportionately.

I have a number of more detailed and technical proposals. These cover the capital gains of unincorporated traders; wider share ownership; the taxation of futures, options and unit trusts; the administration of VAT; and the taxation of company cars. They are set out in the enclosed memorandum.

I am copying this letter to the Prime Minister and Norman Fowler.

John Major
N. Fowler



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DTI PROPOSALS FOR ACTION IN THE 1990 BUDGET

CAPITAL GAINS OF UNINCORPORATED BUSINESSES

1 Companies are able to set off trading losses from one accounting period against capital gains arising in the same period or in the previous twelve months. But there is no provision for unincorporated traders to set off trading losses against capital gains for tax purposes. This creates a distortion to the disadvantage of unincorporated traders for which there is no economic justification and which should be removed. It is accepted that any relief must be restricted to gains arising on disposals of business assets. This can be achieved if the definition of qualifying assets used for CGT roll-over relief is also used to define the gains which can be set off against trading losses. It is therefore proposed that the trading losses of an unincorporated trader should be able to be set off pound for pound against capital gains realised on the disposal of business assets.

WIDER SHARE OWNERSHIP

2 It is suggested that further fiscal measures should be introduced which would promote personal saving, particularly in the form of wider individual share ownership. Three specific measures are suggested, which are not mutually exclusive.

i) **Personal Equity Plans.** The maximum amount which an individual may invest each year in a PEP should be increased substantially from the present level of £4,800.

ii) **Capital Gains Tax.** A substantial increase in the personal exempt amount, now £5,000, would increase the relative attraction of individual share ownership to reasonably substantial private investors, since a far higher proportion of "switches" within an individual portfolio would escape CGT.

iii) **Stamp Duty.** It would make individual equity ownership more attractive to private investors if Stamp Duty were abolished on all securities transactions of less than £5,000 value. At that level, abolition would reduce transaction costs by about a quarter, and go far to redress the balance of advantage now enjoyed by collective investments. Given the present structure of dealing charges, and the administrative burden involved, the "unbundling" of larger transactions would not be a major source of avoidance.

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TAXATION OF FUTURES AND OPTIONS

3 The present tax treatment of futures and options (FAO's) creates a degree of uncertainty for some important categories of investing institutions which inhibits their use of FAOs to pursue systematic strategies to reduce risk. This uncertainty arises because proceeds from FAO transactions received by pension funds, unit trusts, and investment trusts may be classed as trading income (and thus subject to Schedule D Case I treatment) rather than investment income (and thus subject to CGT, from which they are exempt). The Inland Revenue's view on what transactions constitute investment (as opposed to trading) for tax purposes effectively limits them to FAO contracts undertaken to hedge specific risks on specific assets. In practice this prevents pension funds etc pursuing systematic strategies (for example based on stock index futures or options) to reduce the risks that arise from wider movements in the market. If the Revenue take a similarly restrictive view in relation to on-shore FAO funds when these are authorised by the DTI (probably early next year), the viability of these funds will be seriously reduced.

4 This limitation on the institutional use of the London FAO markets reduces their competitiveness against, in particular, their French equivalent, the MATIF (which poses an increasingly serious competitive threat to LIFFE in any event). If imposed on authorised FAOs, it will drive this category of business either to Paris or off-shore. It is therefore proposed that Treasury Ministers should use the 1990 Finance Act to ensure that investment strategies using FAOs either to hedge specific risks within an investment portfolio or to reduce a general risk to a portfolio should be treated as investment activity for tax purposes.

UNIT TRUSTS

5 The 1989 Budget contained important changes in the taxation of unit trusts, which will enable UK resident unit trusts to compete more effectively with trusts based overseas. UK-based unit trusts are now well placed to compete for the business of individual UK resident taxpayers. But unit holders who are resident abroad, or who are companies, still face a tax regime on their holdings which is less favourable than those in some other countries, and this is likely to limit the ability of UK based unit trusts to market their products to such customers and thus to remain fully competitive in Europe. The Unit Trust Association (UTA) has submitted detailed proposals intended to remove this problem at an estimated cost of £15 million year. It is hoped that the UTA proposals will receive sympathetic consideration.

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6 It is also proposed that money funds, which cannot be marketed throughout Europe under the UCITS Directive, should nevertheless be afforded the same treatment as UCITS so as to remain competitive within the UK. Without this, the authorisation of these funds in the UK is likely to be ineffective.

VAT THRESHOLD

7 It is understood that Treasury Ministers are seriously considering a substantial simplification of the rule requiring traders to register for VAT when their quarterly turnover exceeds specified limits, or when they expect their annual turnover to exceed the annual registration threshold. The proposal under consideration is understood to be that traders should be required to register only when their annual turnover actually exceeds the annual threshold. This would greatly ease the administrative burden on small businesses of monitoring and record keeping; and it would give businesses reaching the turnover threshold the benefit of up to nine months additional VAT free trading. The cost is estimated at £80-100m a year. It is proposed that this helpful simplification should be introduced in the 1990 Budget.

VAT REGISTRATION PERIOD

8 Traders are required to register for VAT within thirty days, once they exceed the registration threshold. Many small businesses have accounting systems which cannot reliably establish turnover in a previous period within thirty days, and they may unwittingly exceed the time limit and become liable for heavy and automatic penalties. The administrative burden would be substantially eased if the time limit for VAT registration were extended from 30 days to 60 days.

VAT BAD DEBT RELIEF

9 Bad debt relief should be given within the VAT system without the need for formally declared insolvency. Such relief could be effected either by providing annual relief based on the traders/companies' annual accounts, where the bad debt write-off and provision figures would be available and could be reconciled back to the accounts (Inland Revenue accepted procedure); or providing quarterly relief based on information supplied by the trader, with provision for adjustment following the completion of the trader's annual accounts.

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VAT DEFAULT SURCHARGE

10 Where a trader habitually makes late VAT returns he is liable to a default surcharge which increases in steps over time to a maximum of 30% of VAT paid late. The severity, and the non-discretionary nature, of the penalties have long been a source of complaint from small business, and Customs and Excise are understood to have reviewed the operation of the surcharge. It is hoped that a way can be found of mitigating the impact of the default surcharge on small businesses, without removing the incentive to timely compliance.

COMPANY CARS

11 In each of the last two Budgets, car benefit scales have been increased well above the rate of inflation. But the scales still fall some way short of reflecting true value to the individual of a company car. If and when the stage is reached where an individual is assessed for income tax on the full economic value of the benefit of a company car, discrimination against passenger cars in the operation of corporation tax and VAT should also cease. This would involve abolishing the annual limit of £2,000 on the writing down allowance on a company car; and ending the rule that input VAT on the purchase of passenger cars cannot be offset against output tax on sales. Once a company car ceased to be a tax efficient perk, and cars were bought by companies for business reasons, there would be no case for treating the company's expenditure on cars less favourably than its expenditure on other business assets.

