

CONFIDENTIAL

27 February 1984
Policy Unit

PRIME MINISTER

At the best of times, people do not like the Inland Revenue. They like the Inland Revenue even less if it appears that it is taking upon itself discretionary or high-handed powers.

The decision to bring the taxation of building societies into line with banks was right. The building societies are requesting permission to behave like banks, and should therefore be taxed accordingly. Several building societies have, in the last year or two, become more aggressive gilt-edged traders.

The danger is that a sensible measure is now going to be attacked, as it appeared to be a commando raid by the Inland Revenue squads. It is important to get across in presenting and defending the policy that:

1. the Chancellor approved it: it was not a spontaneous Inland Revenue decision taken without political backing;
2. the building societies wish to become more like banks;
3. the building societies themselves confess that it might only delay or modify a little the next movement down in building society interest rates;
4. the decision is to enforce existing law, and therefore did not need any legislative changes.

The press will try and run "me-too" stories. For example, is the Inland Revenue about to pounce on heavy trading in gilt unit trusts? Will the Inland Revenue make moves against life insurance companies? Is the Inland Revenue about to clamp down on the Business Expansion Scheme, where some of the practices are becoming undesirable? Are the Friendly Societies a legitimate gap in the tax laws, or is some action necessary there? Why do different individuals in different tax districts receive widely varying treatment in a whole variety of cases?

The Budget can be used as an opportunity to set the record straight. It should be made clear that:

CONFIDENTIAL

*not really.
It is the
Board of I.R.*

- i. The Inland Revenue is under the thumb of Government, and not an independent fiefdom capable of making up the rules as it goes along.
- ii. Those areas where Revenue action might be necessary in the year ahead should be outlined in the Budget. The obvious one to warn about is abuse of the Business Expansion Scheme.
- iii. The Budget should make clear in its presentation of the new tax measures governing savings institutions that these measures then represent a stable framework, and the Revenue would not take action during the year to change these rules. This would reassure those involved in life companies, unit trusts, and Friendly Societies. The Budget is, after all, a legitimate commando raid against anyone, when the beaches may be manned but war has been declared.

It would be a pity if a Government dedicated to reducing taxes, and thought to be sympathetic to the entrepreneur against the taxman, should become characterised as one which allowed the Inland Revenue to operate in a high-handed manner.

If you feel there is any justice in these comments, you could put these thoughts to Nigel Lawson at your next meeting.



JOHN REDWOOD



10 DOWNING STREET

Prime Minister (2)

To note JR's comments and the piece put out under Conservative Research Dept colours (but clearly written in Inland Revenue). Briefing will be available for Questions tomorrow.

There is a danger in JR's (iii). In providing reassurance against sudden changes in tax treatment, we must not inadvertently make pledges against further changes on policy grounds.

AT

27/2

File

PRIME MINISTER'S QUESTIONS

BUILDING SOCIETIES: TAX TREATMENT OF PROFITS ON GILTS

The Inland Revenue announced on 23 February that, following advice from Treasury Junior Counsel on the meaning of the present tax law, they proposed to tax building societies' profits from realisations of gilt edged stock as trading income rather than as capital gains. They will thus be charged to corporation tax at the special building society rate of 40%, instead of being subject to capital gains tax at 30% or being free of tax if the gilts had been held for at least 12 months.

2. Attached are notes for supplementaries and copies of:-

- a) the Inland Revenue Press Notice;
- b) the Building Societies Association's Chairman's letter of 24 February to the Chancellor; and
- c) the Chancellor's reply to the BSA Chairman.

3. The announcement has led to speculation about other changes affecting banks or building societies, in particular composite rate tax. Mr Jim Craigen (Glasgow Maryhill) has a priority written PQ down for answer on Tuesday 28 March, referring to the composite rate of tax for banks:-

"To ask Mr Chancellor of the Exchequer if he will publish in the Official Report or place in the Library the letter he has sent recently to the banks proposing the imposition of the composite rate on interest-bearing personal accounts."

If the subject of composite rate tax for banks is raised, the Prime Minister could say:-

either "That is a separate matter and I understand the Hon member for Glasgow Maryhill has a question to my rht hon Friend about it"

or if the question refers specifically to a letter to the banks:-

"In the course of his duties as Chancellor, my rt hon friend ~~has~~ confidential exchanges with many bodies and it is not his practice to make them public."

The substantive reply to the PQ is likely to follow the second wording.

4. As regards the effect on interest rate margins the BSA have been saying that the additional tax would have been £120m in 1982, equivalent to 0.2% on the after tax margin. Some societies have, however, been quoting an effect of $\frac{1}{2}$ % on their margins. The reasons for this discrepancy are that the effect differs markedly from society to society, and some are quoting the effect on margins before tax. Given the variations, the complications involved in presenting any figure and the risk of challenge on them, it is best not to quote any specific figure.

BUILDING SOCIETIES: TAXATION OF GAINS ON GILT-EDGED STOCK

NOTES FOR SUPPLEMENTARIES

Impact on mortgage rate

Building society interest rates for both borrowers and investors are a matter for societies themselves, in the light of competition in the market place. The change in the application of existing tax law which the Inland Revenue has announced will only affect societies margins by a small fraction of 1 per cent. The main influence on the next move in the mortgage rate will be societies' decisions on their rates for investors, particularly as regards premium rates for notice account.

Lack of notice or consultation

The matter was market sensitive. It would not have been fair to give building societies notice of it before other participants in the gilt edged market, and consultation would have created much uncertainty in that market.

Apply to future acquisitions, not disposals

The Inland Revenue could have applied the change to past years, but decided that would not be reasonable. The decision to apply the changed interpretation of the law to disposals after the Revenue's announcement will enable societies to arrange their future disposals in the knowledge of the way they will be taxed.

Implications for other financial institutions

There are no implications for other institutions from this decision which - as the Press Notice said - relates solely to building societies. The matter turns on the use of the securities as part of the trade of a building society, not, as some reports have implied, on the question whether or not the societies are dealing in gilts.

Revenue oppressiveness

The Revenue is acting in accordance with the legal advice it has received. If any society disagrees with this view it will be able to do so before the Courts in the usual way. The manner of the Revenue's approach was dictated by the market sensitivity of the matter. Ministers were aware of the advice and the action which the Revenue took.

Why not in the Budget/Finance Bill

It is not possible to change the law so as to give it an effect which the Government's legal advisers believe it to have already.

Timing of announcement

Right for the Inland Revenue to announce what they planned to do once legal advice had been received. As regards the time of day, any other time would have been more awkward than 5pm.

Comparison with National Savings

National Savings Certificates are tax-free as a term of the prospectus. That is not true of gilt edged stock.

Societies in danger

This does not affect the prudential position of societies. It does not apply to past periods and has no significant effect on their reserve position.

[Societies will have to take the tax position into account when deciding on future policies - including interest rate margins.]



INLAND REVENUE Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01-438 8892 OR 8706

[3x]

23 February 1984

BUILDING SOCIETIES : TAXATION OF GAINS ON REALISATION OF GILTS

In the light of legal advice which they have received, the Inland Revenue have today informed The Building Societies Association that any proceeds from the realisation of gilt-edged securities and other similar stock form part of the trading profits of building societies. Accordingly such proceeds should be taxed at the special rate of 40% laid down for the income of building societies, and not, as has been the case hitherto, as chargeable gains subject to the rules of capital gains tax. The Inland Revenue propose to apply their revised view of the law to any gains realised by societies after today. As a result, gains made by building societies will be taxed in the same way as those made by banks.

NOTE TO EDITORS

The income of building societies is chargeable at the rate of 40% (or 38% in the case of a society whose profits do not exceed £100,000). Their capital gains are taxable at 30%, but gains on gilt-edged securities are exempt if the security has been held for at least 12 months. Under the view of the law the Inland Revenue are now taking, their gains from disposals of gilt-edged securities will be regarded as part of their trading profits and hence treated in the same way as their income.

This decision is confined to building societies. It brings the taxation of their gains on the realisation of gilts into line with that of banks. It has no implications for other institutions operating in the market.

A copy of the Inland Revenue letter to The Building Societies Association is attached.
