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Treasury Chambers, Parliament Street, SW1P 3AG

6 July 1984

The Rt Hon Nicholas Ridley MP AMICE
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON SW1P 3EB

Dear N. Ridley,

Thank you for your letter to Nigel Lawson of 19 June about the impact of the Budget changes on the shipping industry.

We are most grateful to you for the measured way in which you have put forward the case made by the General Council of British Shipping for changes from our original proposals. As you know, I have seen the Council myself and discussed their case with them. As you recognise, economic arguments by themselves could not justify special treatment for the shipping industry, but I am fully aware of, and sympathetic towards, the arguments relating to our defence requirements and to the life-line for our international trade. I have also been approached by a large number of Members on our benches and am conscious of the pressure which they are exerting. For all these reasons, Nigel and I have sought to go as far as we reasonably can in proposing changes to be made at the Report Stage of the Finance Bill. We have tried to find changes which will be of real help but which are at the same time consistent with the underlying thrust of the Budget strategy.

We are making two changes to the capital allowances provisions which will be of general application. The first will be of particular value to the shipping industry because of the lumpiness of its investment. It is to give taxpayers the right during the transitional period to disclaim their first year allowances (at the rate of 75 per cent this year and 50 per cent next year) and take instead writing down allowances on the full amount of their investment. This will mean that, when a company replaces a ship and obtains the replacement in the same year as it makes the disposal, it will be able to set the writing down allowances for the new ship against the balancing charge arising on the old ship: if the secondhand value of the latter is high there may then be little or no tax to pay. We estimate that the cost of this change will be about £m50 over the next three years - it is of course only a transitional measure - of which about one-half will go to the shipping industry.

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Second we are proposing that taxpayers should also be able to disclaim their writing down allowances - this will be a permanent measure. At present writing down allowances have to be taken in the year in which they fall due: if they cannot be used in that year they are converted into tax losses and can then only be used in the future against the profits of the same trade. From now on, under this proposal, they will be able to postpone their whole depreciation pattern. If, on expenditure of 100, on which the allowances would normally be 25 in year 1, 19 in year 2, 14 in year 3 and so on, the company cannot use the 25 in year 1, it will, if it wishes, be able to leave the 25 to year 2, in which case the 19 will be available in year 3 etc. Unlike the previous change, this additional measure of flexibility will not be of wide application, and the cost is unlikely to be significant.

I now turn to measures specific to the shipping industry. As you know, one of the major purposes of our Budget strategy has been to try to get away from special reliefs and treat all capital expenditure, whatever its nature, on the same basis. This is essential if we are to remove the distortions in the old system of corporate taxation. As you may be aware, we are under very considerable pressure to provide special treatment for a range of industries and, as ever, to allow one special case makes it considerably more difficult to resist others, whatever their merits. There are, however, two specific measures which we think we can take.

The first, while important, is in effect giving shippers what is their due. Under the existing provisions, if a company disclaims all or part of the first year allowances on a new ship, it is doubtful whether the difference between the expenditure and the first year allowance qualifies for writing down allowances at all. With first year allowances at 100 per cent this point was immaterial, but clearly in the next two years it could be important. We shall put that right.

The second change is considerably more significant. We are proposing to retain free depreciation for new ships, on the basis that this is a feature of the tax system peculiar to shipping - in short, "squatters' rights". I should emphasise however that, once the transitional period is over, free depreciation will be limited to the amount of the writing down allowances which have become due at any particular time: unlike the old system the whole of the allowances will not be available to be taken as soon as the expenditure has been incurred. To return to my previous example with expenditure of 100, if the company does not take the allowance of 25 in year 1, then 44 (ie 25 + 19) will be available in year 2 or 58 (25 + 19 + 14) will be available in year 3 and so on.

The additional flexibility provided by this new style free depreciation will be valuable to shipping companies in enabling them to utilise group relief; and we estimate that over a period of years it will cost up to £m30 a year. Indeed we estimate that the total benefit to the shipping industry of the changes we are

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proposing compared with the Budget will be negligible this year, £m5 in 1985-86, £m20 in 1986-87, £m15 in 1987-88 and 1988-89, £m20 in 1989-90 and £m30 in 1990-91. The table attached shows a breakdown of these figures.

We are ready to announce these proposals at Report Stage. But the legislation will be in next year's Finance Bill: it would require too much recasting to make the change this year, and no-one will lose by the delay.

I am afraid we do not think we can go further than this. To do so would be to reintroduce into the capital allowances system the investment incentives which the Budget was intended to remove. To allow ships to be written off for tax on a 25 per cent straight line basis would be to write them off over a period of 4 years. Clearly the life of a ship is normally very much longer than that. There is, moreover, pressure to introduce such a rule generally, particularly in those industries where the assets have much shorter lives, and if we were to do so the cost would be of the order of £b2 and we would not be able to reduce the rate of corporation tax below about 40 per cent instead of the 35 per cent planned.

We have however given very careful thought indeed to the suggestion of reintroducing a rollover relief of balancing charges. I have also seen Ferdy Mount's letter of 18 June, covering a paper by Hambros on Government support for the shipping and shipbuilding industries. In the form in which it was put forward the proposed rollover would be administratively very difficult to operate for both the Revenue and taxpayers and would require a major re-ordering of the legislation. Accordingly we have looked instead at a somewhat more limited proposal which would have a broadly similar, though narrower, effect to allow writing down allowances to be carried back for three years (as first year allowances can be today) instead for just one year. The effect of so doing would be of significant help in avoiding or at least reducing balancing charges.

After very careful consideration, we have concluded that it would not be right to make this sort of change. To do so would effectively reintroduce an incentive element into capital allowances - up to 58 per cent of the cost of an asset (or potentially more in the case of the full rollover proposal) could be passed backwards into a previous year and then used to wipe out a charge. This would be taking allowances early in precisely the way which we are trying to stop generally in the Budget. This sort of flexibility was justified for first year allowances which were intended as investment incentives, but the accelerated use of allowances has no place in the new regime. Nor is there any clear reason why writing down allowances should be taken back further than other losses created by any other business expense.

The other issue affecting the shipping industry is, of course, the impact of the withdrawal of foreign earnings relief on seafarers. As a possible alternative to this relief, the GCBS have put forward

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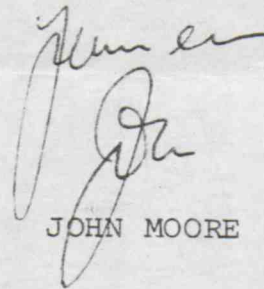
proposals for some kind of expense allowance for foreign-going seamen, and have met Inland Revenue officials to discuss their ideas in more detail. I have to say that we see no scope for any concession in this area.

The main reason is the point of principle that the Budget sought to move away from special reliefs and special arrangements to enable us to simplify the tax system and to reduce the tax burden across the board - in particular, to make a substantial increase in the personal allowances. To introduce, for example, the sort of special expenses deduction for seafarers adopted by the Scandinavian countries would thus be a move in the wrong direction. And it would add to the pressure from other groups for tax relief for particular expenses.

We have also looked carefully at the idea of exempting certain expenses payments along the lines of the way the Royal Navy's local overseas allowance is dealt with; I am afraid however that in the end we found this no more attractive. The payments that the local overseas allowances are designed to cover are the purely personal expenses which sailors incur in port. There is no question of their being tax free either for the Merchant Navy or for Royal Navy personnel. All that happens is that by way of Section 369 of the 1970 Taxes Act the Crown - in its unique position as both employer and tax gatherer - is spared the job of grossing up for tax and accounting for tax on what is plainly additional remuneration. The same considerations do not apply where the employer is a shipping company.

I hope that the concessions which I have been able to suggest, and in particular the retention of free depreciation in its modified form, will be of real assistance to the industry.

I am copying this letter to the Prime Minister, and to Michael Heseltine, Norman Tebbit and Tom King.



JOHN MOORE

EFFECT OF
BUDGET +
PACKAGE
ON SHIPPING

PSBR
COST
OF
PACKAGE

neg

neg

5

10

- 80

40

- 85

25

- 65

20

- 40

25

- 20

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from 107: Budget Pt 13.

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DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

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

19 June 1984

Dear Nigel

You were good enough to give me advance notice of the Budget changes in Corporation Tax, with their adverse effect on the shipping industry; and when I wrote to you on 7 March I said I thought we might need to consider concessions to shipping in some form, once we had been able to gauge the strength of the industry's reaction.

The industry has indeed reacted as I feared, and I understand you and John Moore have been discussing with the General Council of British Shipping representations both on Capital Allowances and on seafarers' Foreign Earnings Deductions. I know you will be considering these carefully.

I am writing to set out some policy considerations. The shipping industry is as you know in serious decline: in a decade it has halved in size, it is still shrinking, and shipping companies are still losing money. This is partly a consequence of the long worldwide shipping recession, partly of the uncompetitiveness of our industry, and especially its crew costs. The Budget changes therefore aggravate an already acute problem.

I realise of course that it is no accident that shipping is hit by the Corporation Tax changes; it is a low-yielding, capital-intensive industry, just what the changes are rightly designed to discourage. Nor is there any doubt that, with or without these changes, the industry will continue to shrink, until it reaches the point where its operations are profitable once again. There is no way of telling what that point will be. And it is not the only declining industry.

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However, there are two special reasons why the Government cannot be entirely unconcerned about its decline. The first is defence. As things stand, we have identified the defence requirements for merchant ships, both for military reinforcement and for naval support, and we know that at present we can meet them. But in a turbulent world, it is quite another thing to know what new requirements may emerge in a year or two, or to be sure we can meet them too. When British owners sell ships, they become unavailable for defence purposes; and even when they move them off-shore under other flags, they become less readily and certainly available. It is the inherently unknowable nature of future defence requirements that makes the present rate of decline of the merchant fleet so worrying, to say nothing of its extrapolation into the future. And it is in this light that we need to view measures to staunch the losses as a form of insurance of our security. Michael Heseltine will be better able to comment on the risks than me.

The second is broader and more political: the widely-echoed consideration that we are an island living by maritime trade. We reject the argument that this industry or that is "essential", because we know it pays us to concentrate on what we do best, to import what we do less well, and to let the international market be the test. But as those imports are carried in ships, shipping is liable to be seen as an essential industry if anything is. Of course we can import shipping services too: at present they are freely-available and cheap, too much so for our industry's health. But again it is another thing to prove that they will remain so, or that we can confidently put our lifelines into foreign hands, when the international scene is so disturbed.

Both of these arguments arouse strong political emotions. This is exploited by the interested lobbies, and the logical analysis you or I might apply is not easy to present to a sceptical and anxious public. So it is partly a question of feeling completely convinced in our own minds that the decline of our merchant fleet does not carry undue risks: and partly of carrying that conviction in public.

The Budget measures have sharply affected the industry's confidence. Companies grappling with recession are now wondering whether they will be able to invest advantageously even when it is over, at least under the British flag. Many Boards, which until now have been hanging on, seem to feel that they must now sell out or move offshore since they cannot see their way through to future profitability.

It is because confidence has to be restored that I hope you will give the industry's representations on the Finance Bill the most sympathetic ear you can. I know the GCBS has been pressing for a 3-year deferment in the Corporation Tax changes, followed by 25% free straight-line depreciation for new and second-hand ships, and the reintroduction of roll-over relief for balancing charges to encourage re-investment: and that for seafarers they want the Foreign Earnings Deduction retained, with a 90-day qualifying period instead of 30 days. I do not

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argue that these are necessarily the most cost-effective ways of helping them, or the ones least likely to have repercussions in other industries. But I hope they can be given some help and that you will bear in mind the concern I have expressed above when considering their representations. I have seen John Moore's very full letter of 14 May flagged to David Mitchell about the foreign earnings deduction; I still think that if you agreed, some substitute benefit could be worked out quickly.

I am copying this letter to the Prime Minister, and to the Secretaries of State for Defence, Trade and Industry and Employment.

Tomlinson
Nicholas

NICHOLAS RIDLEY

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