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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

ENTERPRISE PROPOSALS

Memorandum by the Chancellor of the Exchequer

The priority items within our strategy exercise include a number of proposals for fiscal action to encourage enterprise and the growth of the small firms sector. These suggestions have been considered by an interdepartmental group of officials in two reports, copies of which are attached. The first report deals with the proposals as a whole; the second takes a more detailed look at one particular suggestion - for tax relief for individuals investing in small firms.

2. The Group tried to assess the cost effectiveness of the measures but did not attempt to judge between them. From a budgetary point of view my problems go much wider. There are a number of tax changes, some of them very costly in revenue, which might be regarded as deserving a high priority. We are committed to easing the burden of the capital taxes, which at present can be so damaging to small businesses, and I must retain room to do something about that. The capital gains tax currently yields £600m a year, capital transfer tax £360m and the investment income surcharge £230m a year.

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On the income tax, simply to restore the value of income tax thresholds and bands to their value a year ago will be expensive - the 1977 Finance Act indexation requirements will cost about £2,200m in a full year and revalorising the higher rate thresholds and bands a further £230m. At the same time we must go into 1980/81 with a public sector borrowing requirement that looks both credible and compatible with our money supply target: otherwise all our policies are at risk. Against this background I suggest that we should concentrate at this stage on compiling a sensible and imaginative package of enterprise measures that might be introduced over the next year or so. Whether it will be possible to implement some or all of them in my next Budget must wait until the 1980/81 prospects are much firmer.

3. In any event the financial constraints I am likely to face for some years ahead limit the scope for experiment and innovation. Moreover, while I accept that a narrow fiscal incentive can be useful, if properly conceived, we must not lose sight of the fact that the real obstacles to enterprise go much deeper, and centre around such factors as the performance of the economy as a whole, the pervasive uncertainty of inflation, low profitability and even perverse legislation in non-fiscal areas. For these reasons selective measures we adopt would be best directed at this stage towards small firms, as opposed to the company sector as a whole. If the measures are carefully chosen they may give a good return at reasonable cost to the revenue.

4. The basis of such an approach might be the measures considered by the Working Group in paragraph 2.3 of their report. They are:

- (i) Abolish the rules for apportioning the trading income of "close" companies (under which their undistributed income can sometimes be charged to tax as if it had been distributed).

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- (ii) More generous tax reliefs for self-employed people who take out retirement annuities.
- (iii) A reduction in the rate of corporation tax for small companies, from 42 per cent to 40 per cent.
- (iv) Widening of the circumstances in which tax relief is available for interest on loans taken out for the purpose of investing in closely controlled (usually family) companies.
- (v) A new relief from stamp duty to assist the marketing of unlisted companies.

Some of these changes have been pressed for by the CBI and others, and I am sure that they would be widely welcomed.

5. That package is fine so far as it goes, but I recognise that it would not contribute a great deal towards a business revival. The measure which has attracted most attention would be to provide an investor with relief against his income tax for funds used to buy shares in small companies. The Working Group discusses a possible scheme in a separate report. Another possibility, less imaginative but still an innovation, would be a scheme under which investors who sell their holding in a small company at a loss, or lose their investment entirely, can set off that loss against their income tax liability.

6. Both these schemes would be complex.

- (i) The losses scheme is the less complicated, its cost modest (£10-25 million a year) and it is relatively secure against abuse. Its purpose is to reassure investors, by reducing the risk element when committing funds to unquoted companies, both existing and new ones.

(ii) The equity investment scheme is more radical and imaginative. In particular, it focuses on the objective of encouraging the start-up of a new business. However, it raises a real dilemma. In the basic form discussed in the officials' report, it is hedged around with a host of restrictions which would complicate it and rob it of much of its attraction. I do not believe they could be justified against criticism in the House and elsewhere. Even in this narrow form, it would cost at least £100 million a year. Yet if we relax these restrictions the whole thing becomes totally unmanageable and the cost would be virtually open-ended.

7. Reluctantly, I have to conclude that the equity investment scheme discussed in the report is not a runner, and I cannot envisage that it is likely to be one in the future. The losses scheme on the other hand is more acceptable, and I recommend that we authorise the necessary legislation to be drafted, in the hope that it can be included in the 1980 Finance Bill.

8. The report discusses a number of other proposals:

(i) A new institutional measure - sometimes referred to as a Small Firms Investment Company - to help entrepreneurs with ideas to make contact with individuals with venture capital.

(ii) A proposal for the extension of relief from VAT on bad debts. An outside body is currently evaluating the present limited relief, but officials suggest that we should put in hand an immediate review of our own.

(iii) A suggestion by the Secretary of State for Industry for a tax holiday for a period of years for all new businesses. This is an attractive idea, but it

- raises very tricky issues, not only of revenue cost (which again could run into hundred of millions), but also of fair competition and presentation.
- (iv) An investment rebate scheme - suggested by the Secretary of State for the Environment - which would involve a system of grants. It has the attraction of being very much simpler to set up and administer than a tax incentive. But at a time when we must keep public expenditure under tight control, I must rule out absolutely any new commitments which could amount to up to £150 million.
- (v) A scheme, also proposed by the Secretary of State for the Environment, under which companies whose tax investment allowances exceed their profits, would be awarded further allowances to pass on to the individuals investing in them. I am afraid that an arrangement of that sort just could not be fitted into the tax system, and I propose the idea should be dropped.

Recommendations

9. Selective tax measures can, in my view, make only a limited contribution towards generating a more dynamic economy. Our broader tax policies and the elimination of inflation are very much more important in this respect. But limited measures, at reasonable revenue cost, could more than pay their way.
10. For this reason, I invite colleagues to agree that:
- (i) We accept the list of small firms' measures described in paragraph 4, for possible early implementation; and

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- (ii) we accept in principle a losses scheme, as described in paragraph 6(i);
- (iii) we ask officials to carry out further work on proposals (i) and (ii) in paragraph 8.

G.H.

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REPORT OF THE INTERDEPARTMENTAL GROUP ON  
FISCAL ASPECTS OF THE STRATEGY EXERCISE

ENTERPRISE PROPOSALS

1. INTRODUCTION

1.1 The Strategy Exercise includes a number of tax proposals. Some of these might be appropriate for early introduction, possibly in the 1980 Budget and Finance Bill. This Report of a Working Group of officials which met under Treasury chairmanship and which included representatives of a wide range of departments, the No. 10 Policy Unit, the Central Policy Review Staff and the Bank of England, has directed its attention towards measures to encourage and help small firms and to promote investment. A separate paper examines one of these measures in detail. A further set of proposals, mainly relevant to longer term policy on the relationship of taxation and savings, is being examined by a separate Group.

1.2 The first issue is the possible components of a small firms package. These are dealt with in Section 2 of the Report, and fall into the following groups:

- (i) A number of specific measures to lighten the impact of the present tax system on small firms. Most of them have been pressed by the representatives of small firms and the self-employed. (para. 2.3)
- (ii) Measures to encourage the take-up of equity in small firms:
  - (a) Income tax relief in respect of losses incurred following investment in a small firm. (paras. 2.6 to 2.10)
  - (b) Income tax relief for individuals investing directly in new enterprises. (paras. 2.11 to 2.13). This is the subject of a separate report.

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The report also refers briefly to the possibility of an institutional device to channel funds from investors into small firms, possibly coupled with some income tax concession. (paras. 2.16 to 2.18)

- (iii) A measure to encourage the growth of the small firms sector. The Secretary of State for Industry has proposed a tax holiday to meet this purpose. (paras. 2.19 to 2.23)

1.3 The second issue, examined in Section 3 of the Report, is the possibility of tax measures directed towards encouraging expansion by companies with a record of success. There are two "accelerator" schemes for encouraging winners developed from suggestions by the Secretary of State for the Environment:

- (i) The transfer of tax allowances to investors in successful companies - to attract a flow of external finance. (paras. 3.2 to 3.5)
- (ii) An investment rebate scheme - to strengthen incentives to invest in physical assets by successful companies. (paras. 3.6 to 3.11)

1.4 Section 4 of the Report contains the Group's recommendations.

1.5 In their examination of these accelerator and small firms measures the Group agreed that as far as possible the measures should meet the following criteria:

- (i) The revenue cost should not be excessive. The Group was not in a position to judge how far the cost of particular proposals may be accommodated within the Budgetary constraints likely to face the Chancellor of the Exchequer. Nor was it able to define "excessive" in any precise sense. It was noted that revenue forgone to meet these schemes implies less available for other purposes, including income tax reductions.

- (ii) The measures should give reasonable prospect of value for money. The Group was able to make only a broad judgement as to how far the measures would succeed in the purposes assigned to them. For this reason it is important that if measures of an experimental kind are adopted they should be carefully monitored and subject to periodic review in the light of experience.
- (iii) The measures should be comprehensible to businessmen. This is an argument against very complicated provisions.
- (iv) The measures should not require many additional staff.

## 2. SMALL FIRMS

2.1 The case for encouraging small businesses is taken as read. A major need is to improve the tax environment for the small businessman. The 1979 Budget income tax reductions have made an important start, and capital taxation is under review. The measures discussed in this Report are more selective in their impact but could contribute towards the following specific objectives:

First, the need to attract additional funds into small firms, especially from individuals, to help fill the equity gap.

Second, the provision of incentives to encourage "start ups".

Third, the need to encourage existing firms - especially if they are successful - to develop their success.

Finally, as in the company sector generally, the need to improve profitability.

2.2 Much of the Group's effort has been directed towards the construction of a small firms package, for possible announcement



prior to the Budget. A major component of such a package was envisaged as a measure which would encourage individuals to invest in the equity of small firms. This relates to the issue of the "equity gap" which is sometimes referred to as the Aunt Agatha problem. The aim is to encourage individuals to invest in a new business of their own and to stimulate a readier availability of equity finance from individuals with local or personal knowledge. The Group has examined two schemes. The first involves income tax relief for equity investment in small firms. This scheme raises a whole complex of difficult issues which are examined in detail in a separate report. The second scheme gives income tax relief for losses incurred in equity investment in small firms. The Group has also considered a wide range of less far reaching but useful measures. These are examined in the next section. The appendix contains a brief account of some other relatively minor proposals on which no action is recommended.

#### SPECIFIC MEASURES TO LIGHTEN THE IMPACT OF THE PRESENT SYSTEM

2.3 The following five proposals look genuinely promising, and both cut the tax bills of small companies and increase the incentive to put effort and cash into small businesses. Most members of the Group recommend them as firm components of a small firms package.

- (a) End the apportionment of trading income of "close" trading companies. The apportionment rules, which charge certain undistributed income of close companies as though it had been distributed, were designed to deal with the inducement to avoid high income tax rates by holding income via a company. The reduction to 60 per cent in the top rate of income tax narrows the gap between that rate and corporation tax rates, and so reduces the need for such rules. Although the number of trading companies still subject to apportionment is not now large, the psychological impact of altogether removing this form of apportionment after (effectively) over 50 years will be great. Its practical impact means that management time is saved by not having to waste effort on these complications. If the gap

between the top rate of income tax and the rate of corporation tax does not widen significantly in the future, the risk of loss from tax avoidance is not likely to be large. On this basis, the Group recommends the ending of the apportionment of trading income of close trading companies. The cost of the change would probably not exceed £5 million.

Some apportionment rules will still be needed, eg. in respect of the investment income of trading companies.

- (b) Improvement in the retirement annuity relief scheme to help people running their own business to make adequate provision for retirement or for premature death. Possible improvements would involve:

- (i) Raising the ceiling (at present £3000) on premiums ranking for full relief;
- (ii) Raising the percentage of earnings (at present 15 per cent) which qualify for relief;
- (iii) Allowing the carry forward of unused relief for up to 6 years (at a cost of 40 additional staff) so that a self-employed businessman can make up in later years for his failure to make full use of his current relief.

Changes to the retirement annuity provisions would mitigate a disadvantage that the self-employed have to face compared with employees. In view of the substantial cost of making changes in this area, the Group recommends a minimum package - of increasing the ceiling for relief to £6000, increasing the percentage of earnings which qualify for relief from 15 to 16 per cent, and extending the carry forward of unused relief - at a cost of around £30 million. More generous

changes might be envisaged if the budgetary situation permits. An increase in the rate of relief to, say, 17½ per cent would cost an additional £35 million.

- (c) A reduction in the "small companies" rate of corporation tax, by 2 per centage points, from 42 per cent to 40 per cent (combined with an increase in the limit for marginal relief from £100,000 to £110,000). This would bring the small companies rate of corporation tax back to the level originally proposed when the present system of corporation tax was introduced in 1972, and into line with the other "preferential" rate of corporation tax for building societies, co-operatives etc. It would cost about £20 million a year. Some members think that the reduction in the rate would be cosmetic and unlikely to encourage additional investment, and that the sum could be used more cost-effectively elsewhere. But the majority view is that this change would be worth including in a small firms package as a sign of the Government's awareness of the need to improve post-tax rewards.

- (d) Interest relief for borrowing for investment in close companies. The proposal here is to relax the conditions for tax relief for interest paid on money borrowed for investment in, or lending to, a close company in which the borrower has a material interest (broadly this means control of more than 5 per cent of the ordinary shares). At present he is required to have worked for the greater part of his time in the company's business. That condition could be abolished. The proposed change would give some encouragement for a person to invest in small firms. The revenue cost of the change would probably be small. Any consequential increase in bank lending could be ignored as "de minimis".

- (e) Stamp duty relief for certain dealers who act as brokers in the share of unlisted companies. The aim would be to encourage the build-up of the market in shares of unlisted

companies in order to make it easier for small firms to raise equity finance. The revenue cost of the change would be negligible.

#### VAT on bad debts

2.4 A relatively minor proposal which the Group is not able to recommend at this stage would be to extend the relief from VAT on bad debts. Such relief is available at present only when a trader is owed money, which includes a VAT payment, by a debtor who has been declared formally insolvent. In value terms this covers about half of all bad debts. With standard rate at 15 per cent there is a case for making relief on bad debts comprehensive. Representations have been made to this effect. However, the existing scheme was introduced in October 1978 and its effects (so far) are being monitored and evaluated by an outside body. The Group recommends that, rather than wait for a report from this body, the case for extending relief be examined by Customs and Excise, the Treasury and the Departments of Industry and Trade in advance of that report.

#### EQUITY FINANCE FOR SMALL BUSINESSES

2.5 The five small firms measures described in the shopping list above represent reasonably good value. They would not cost a lot: about £55 million. They would be relatively simple to administer. They could be implemented fairly quickly. And the ending of the apportionment of trading income could have an important psychological effect. But Ministers will want, if possible, to provide a more powerful stimulus which could dramatically encourage investment in small firms, both by proprietors and from outside interests. The Group has considered two possibilities here: first, a scheme to help offset losses incurred from investing in a small firm; and, second, a tax relief for funds directly invested in small firms' equity at the start-up stage. The possibility of providing incentives through an institutional framework has also been noted.

a. A capital losses scheme

2.6 This scheme would give a new form of relief to an individual who subscribed to shares in an unquoted trading company and who suffered a loss either as a result of the shares becoming worthless or on an armslength sale of them. He would be able to set the loss off against his income for income tax purposes (possibly up to a limiting amount) instead of it being available only for set off against capital gains. Losses incurred after the starting date for the scheme would qualify regardless of the date of the investment but there is a considerable element of risk that the new relief would go on paper losses concealed in packages which, overall, would be profit making. The existing anti-avoidance legislation against the creation of artificial capital gains losses would need to be applied and tightened.

2.7 Capital losses relief would provide partial cover against the risk of loss, and so indirectly provide an incentive to investment. The Government has improved the rewards for risk-taking, through the reduction in the top rate of income tax. In the small firm area, these rewards can be large. But the risks are very much higher than is the case with most other forms of investment. A losses scheme would help to reduce this risk element, which is claimed to be a formidable deterrent to investment in a small business.

2.8 It is not possible to quantify how far a scheme of this type would in practice lead to a higher level of investment in small firms. Some members of the Group doubt if there would be many cases in which the availability of tax relief would induce a businessman to invest in a project in which he would otherwise see an unacceptable risk of making a loss. Because of the uncertainties costing the proposal is difficult, but our best estimate is that the cost should not be high - perhaps £10-25 million a year.

2.9 The Inland Revenue's advice is that, in the absence of a suitable definition of a small firm, and to ensure that the administrative and compliance costs are not excessive, the scheme would

have to apply to unquoted companies generally - the large ones as well as the small. This would include some very substantial companies, and to that extent would be wasteful and relatively unsuited to its objective.

2.10 In spite of these defects, some members of the Group believe that the scheme would encourage investment in small firms, and would sharpen up a small firms package at relatively low revenue cost. On the other hand, a package which has as its centrepiece a measure which minimises losses, may not look sufficiently positive. If Ministers wish to go ahead, the precise details, such as what limits should be placed on the amount of relief available to any one person, could be settled in the light of further examination by the Inland Revenue.

b. Tax relief for new investment in the equity of small firms

2.11 An alternative scheme for encouraging equity investment - perhaps more imaginative and experimental - would be to provide tax relief for funds actually invested in a small firm.

2.12 A suggestion of this kind was put forward by the Secretary of State for Industry. Under his scheme, an individual would be allowed to deduct from his taxable income the amount (subject to a specified limit) of any new investment in the share capital of a small firm falling within a suitable definition. The Group examined proposals by the Department of Industry for a scheme on these lines, using the proposed "proprietary company" definition described in the Green Paper on company law. The Department envisaged that a scheme, subject to the following provisions, would have a substantially beneficial effect in securing an increase in investment and activity by small firms:

- (i) Qualifying investment would be subject to an annual limit of perhaps £10,000. An individual would be able to set this investment in a firm fully within the scheme against his personal income tax liability;

- (ii) The benefit would apply only to genuine new additions to the firm's capital.
- (iii) The cost should be limited to £50-75 million.

The Inland Revenue advice, which the Group accepts, is that it would not be feasible to construct a scheme along these lines which would be able to meet the required provisions.

2.13 The major problem in devising a scheme of this sort is to reconcile the aim of encouraging additional investment in small businesses with the need to avoid an unacceptable loss of tax through the recycling of funds purely for the purpose of securing a tax advantage. Any scheme would, therefore, need to have a number of important restrictions. The features of a possible scheme have been devised by the Inland Revenue, and are examined in detail in a separate report by the Group.

Relationship between a losses scheme and an equity investment scheme

2.14 Conceptually, both a losses scheme and an equity investment scheme could exist together, though at the cost of adding two very complex schemes to an already over-complicated tax system. But an investor could not have the benefit of both. The losses scheme would apply over a much wider range of investment possibilities than would an equity scheme. Where the investor had the option between the two, he would normally choose the equity investment relief for its certainty and immediacy.

2.15 For operational and legislative reasons, however, there could be no question if implementing both schemes at the same time:

(a) If Ministers decide to proceed with a losses scheme, and authorise legislation to be prepared immediately, it should be possible to draft in time for the 1980 Finance Bill.

(b) An equity scheme would pose problems of a different order. If Ministers wished to proceed with a scheme on these lines, work would have to be given overriding .../

priority; and the possibility of a losses scheme would have to be dropped, or at least postponed until a later year. Even then, it may well not be possible to prepare legislation in time for the 1980 Finance Bill; and there could, in any event, be no question of providing time for consultations and discussion of draft legislation with outside interests (which the Inland Revenue would normally regard as essential in a scheme of this kind).

c. A possible institutional framework for relief

2.16 In view of the difficulties in providing tax relief directly to individuals putting money into small firms, as highlighted in the equity investment scheme, it has been suggested that any relief might be channelled through an institutional medium. In addition, a particular feature of the "equity gap" which would not be met by the present proposals is the difficulty which potential entrepreneurs may have in making direct contact with investors who have the necessary venture capital.

2.17 One way of matching demand for funds with their supply could be a special small firms institution, such as the proposal for Small Firms Investment Companies (SFICs), referred to by the Wilson Committee. There are a number of variants here, ranging from institutions operating on a national basis to small, local investment clubs.

2.18 The SFIC suggestion has a number of difficult problems, which need careful examination, and the question of any fiscal reliefs could also be considered. The concept of a SFIC lies outside the immediate scope of the present review, but work on it has been put in hand, and, if Ministers wish, a separate report will be prepared.

ENCOURAGEMENT FOR START-UPS: A TAX HOLIDAY FOR NEW BUSINESSES

2.19 Capital allowances and stock relief are particularly helpful to new manufacturing concerns and in some cases must extinguish completely any liability to tax for a number of years. The

Secretary of State for Industry suggests, however, that a clear and unequivocal exemption from tax for a specific period for all new businesses (whether manufacturing or otherwise) would represent a powerful stimulant to start-ups which many businessmen might prefer to the availability of the capital allowances. The scheme would allow companies to opt for one or the other system.

2.20 Essentially the case for a tax holiday of this sort is that it is simple, certain and easily understood - there is no threat of clawback, for example, if stock values unexpectedly fall. The appeal would be to the unsophisticated businessman just starting up.

2.21 In spite of the apparent simplicity of a tax holiday, in practice there would be enormous difficulties, not so much of administration but more associated with the economic consequences:

- (i) It would produce a bias in tax treatment in favour of new companies, as compared with otherwise similar businesses already in existence.
- (ii) It would also involve discriminatory treatment between incorporated and unincorporated (self-employed) businesses in otherwise similar situations. The self-employed builder, for example, would be taxed on the whole of his profits up to his marginal rate of income tax, while his competitor, who was operating as a company, could build up his business out of untaxed profits, though he would still bear tax on his personal remuneration. The Department of Industry view is that there can be no question of a tax holiday scheme exempting completely for several years all new businesses of the self-employed - including accountants, barristers, shopkeepers, window cleaners and bricklayers on the lump - would be out of the question and would go far beyond the present proposal because it would relieve them of taxation even on their personal remuneration. The Inland Revenue believe that a distinction of this kind between companies and the self-employed could not be

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justified. If such a distinction were made, there would be widespread incorporation, with tax losses building up after a few years to something like £600 million a year.

- (iii) It would be difficult to prevent existing businesses reorganising and recommencing in such a way as to obtain the new business exemption. In practice, therefore, if very much larger amounts of revenue are not to be put at risk, the tax holiday provisions would need to include restrictive provisions designed to ensure that it applied to genuine new businesses.

2.22 The Group was divided about this proposal. Some members felt strongly that there was no case for a tax holiday of the sort envisaged. It would seem to create serious presentational and political difficulties for Ministers arising out of the problems of definition, feasibility, equity, fair competition and cost. Other members, on the other hand, considered that a tax holiday might be highly effective in helping to rejuvenate the private sector and that it should not be ruled out as a possibility.

2.23 There was agreement in the Group that the scheme should not be given priority for the proposed package. The Group does, however, recommend that the proposal should be looked at again in a year or so's time in the light of experience gained following any further work which Ministers may wish to set in hand on the proposal for tax relief for equity investment in new firms (paras. 2.11 to 2.13) where a number of the conceptual problems are similar, as well as in the light of budgetary conditions.

### 3. ENCOURAGING WINNERS

3.1 The Secretary of State for Environment sees it as essential to the Government's strategy that the minority of fully profitable and efficient concerns - of whatever size - should be encouraged. He has, therefore proposed that firms which are both profitable and expanding their investment should be rewarded. There are two legs

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to his proposal. The first would be directed towards encouraging those investing in a successful business. The second would assist successful businesses themselves.

### Transfer of investment allowances

3.2 This scheme, developed from a suggestion by the Secretary of State for the Environment, would bring together two objectives:

- (a) An additional investment incentive for companies designated as winners; and
- (b) Tax relief for equity investment in such firms.

3.3 Winners are defined as existing small businesses whose tax allowances exceed their profits because of the high level of their investment in physical assets and stock. It follows that those businesses would have no taxable profits against which to offset allowances in respect of any new investment. But, to satisfy the conditions of the scheme, <sup>an</sup> underlying record of profitability would need to be demonstrated. If such a firm undertakes additional investment, a limited tranche of extra allowances associated with this investment would be transferable, under conditions and limitations, to individuals making new equity investment in the business.

3.4 The Group preferred the simpler and more obviously effective grant scheme discussed in paragraphs 3.6 to 3.11, as a means of helping "winners". Some of the complex problems raised by an equity investment <sup>scheme</sup> would also apply to this scheme. Furthermore, while this scheme is intended only to apply to firms with established profit records and investment, it would not in practice apply to those who have taxable profits - which may, indeed, be a mark of success.

3.5 A characteristic of this proposal is to make a company's additional tax allowance available to its shareholders. This would introduce a major new feature within the tax system, and would

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involve a significant breach of the central structure of the present corporation tax system. The fundamental implications and risk of manipulation to secure a tax advantage would be multiplied over and above those foreseen in the equity investment scheme. In the time available, the Group was not able to go beyond these general observations. However, the implications of introducing a transfer scheme might be included in further studies if Ministers so wished.

### Investment rebate scheme

3.6 The Secretary of State's proposal here is for an experimental scheme, to reward all manufacturing firms which have proved profitable and which are expanding their investment. The aim would be to make the cash available quickly in the faith that the firms would use the extra resources to increase their market share and their investment, not necessarily in the year in which the cash was paid but over a period. Firms which had achieved a target rate of profits set significantly above average profits in manufacturing industry over the last three years would be eligible for cash to finance 80-100 per cent of that part of their investment in productive assets which was more in real terms in 1980-81 than this year. The scheme, and that at paras. 3.2 to 3.5 above, would both come within a proposed expenditure limit of £150 million.

3.7 The Department of the Environment agree with the general view of the Group that these objectives could not be met for the larger firm through the tax system, and are best achieved through a system of grants.

3.8 There are a number of important practical difficulties and policy questions raised by the scheme. In the interests of administrative simplicity, and with the aim of making early payments, it would be necessary to accept, and defend, some rough justice between applicants and the risk of abuse. Some firms which were not winners could well qualify for grants, and others with better prospects would not. If grants were paid out on the basis of intentions, it would be necessary to have arrangements to claw them back if in the

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event the proposed investment did not go ahead. It would be necessary to defend the scheme against comparison with other schemes of selective assistance and against the charge that it did not demonstrably offer value for money. In particular, commentators would be likely to point out that the grants would be in aid of a good deal of investment which firms were carrying out anyway; and would pay for most or all of that investment with no assurance on how much, if any, further investment will be stimulated. An alternative approach, which would avoid some of these difficulties and could meet the objective of rapidly stimulating new investment, would be a selective scheme of the more conventional kind under the 1972 Industry Act.

3.9 In deciding what priority to give to the Secretary of State's objective of encouraging the efficient minority of firms, Ministers would need to consider the following factors:

- (i) Whether the prospects for new investment have changed sufficiently to justify the introduction of new grants to industry, soon after the decisions to reduce the level of public expenditure generally, and of assistance to industry in particular.
- (ii) If so, and bearing in mind the points summarised in the preceding paragraph, whether the proposals for grants of this type are the best way forward, and in particular how such a scheme could be reconciled with the Government's revised regional policy and its overall attitude to industrial subsidies.
- (iii) How to find the public expenditure provision (provisionally proposed as up to £150 million) for any new scheme, and the additional staff (estimated at 100) to run it.
- (iv) Whether there are EEC issues which should be explored.

3.10 The Group believes it would be possible to devise a revamped Selective Investment Scheme, geared to securing acceleration in

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investment in manufacturing industry (at the cost of offsetting public expenditure savings elsewhere), which would go some way to meeting the Secretary of State's objective. A scheme of this type would provide for grants to successful companies undertaking additional investment, which would not otherwise have taken place. The grants would be paid as soon as the qualifying expenditure had been incurred. The scheme would, however, mark a reversion to a limited interventionist approach.

3.11 The Group considers that the general investment rebate scheme would be justified only if Ministers felt it essential to pay grants swiftly to those firms expanding their investment, and were willing to defend the manifest rough justice of such a scheme.

#### 4. RECOMMENDATIONS

##### Small firms

##### a. Specific measures to lighten the impact of the present system

4.1 The Group recommends:

- (i) Ending apportionment of trading income of "close" trading companies. Cost: about £5 million.
- (ii) Improvement in the retirement annuity scheme, by
  - (a) increasing the ceiling for relief, from £3000 to £6000,
  - (b) increasing the percentage of earnings which qualify, from 15 to 16 per cent,
  - (c) allowing the carry forward of unused relief for up to 6 years.
 Cost: £30 million annually and 40 additional staff.
- (iii) A reduction in the small companies rate of corporation tax from 42 to 40 per cent, and an increase in the marginal relief limit from £100,000 to £110,000. Cost: £20 million annually. (A minority of the Group

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were opposed to this measure on the grounds that the money could be better used elsewhere.)

- (iv) Interest relief for borrowing for investment in close companies. Cost: negligible.
- (v) Stamp duty relief for dealers acting as brokers in shares of unlisted companies. Cost: negligible.
- (vi) Further interdepartmental examination of a proposal to extend the relief from VAT on bad debts. Cost: probably small.

#### b. Equity finance for small businesses

4.2 The Group has discussed two possibilities for a measure in the 1980 Finance Bill to encourage equity investment in small business:

- (a) A capital losses scheme, under which individuals in small firms would get income tax relief for capital losses on this investment.
- (b) A scheme for giving individuals tax relief for direct investment in small firms equity (as described in the Group's accompanying report).

4.3 The losses scheme would be less complicated than the equity scheme, less open to manipulation, and less expensive (£10-15 million a year). It could be prepared in time for the 1980 Finance Bill. It would not be possible to introduce a losses scheme and an equity scheme at the same time, but if it were decided to give priority to an equity investment scheme, there would be no problem about announcing the Government's intention to introduce a losses scheme in a future year.

4.4 An equity investment scheme would be far more complex and much more open to manipulation simply to gain the tax advantage. On the

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other hand, it would break new ground and look much more imaginative. To keep the potential cost within acceptable limits (about £100 million) it would need to be confined to start-ups - which Ministers might in any event welcome - but would also involve a complex web of restrictions. Some of these restrictions would make the scheme vulnerable to pressure for widening the coverage, which Ministers might find difficult to resist. It would be feasible to relax one of the restrictions - that concerned with the exclusion of working capital - but at a cost which it is not possible to quantify.

4.5 Even if it is decided to give priority to an equity investment scheme, it may not be possible to complete its preparation in time for the 1980 Finance Bill. It would not be feasible to announce an intention to introduce an equity scheme at some future date - this would tend to hold up investment in new firms until the position was clarified.

4.6 The Group was divided on the relative desirability, practicability and risk of avoidance in these two schemes. The questions for Ministers are:

- (i) Whether either or both of the schemes should be developed;
- (ii) If both schemes are to be developed, which is to have priority, and which left for a later year;
- (iii) If an equity investment scheme is to be developed, what are their reactions to the questions posed in paragraph 10 of the Report on Tax Relief for New Investment in the Equity of Small Firms?

4.7 The Group recommends that further work be carried out on the possibility of new institutional measures, such as Small Firms Investment Companies.

#### c. Further encouragement for start-ups

4.8 The Group recommends against giving priority to a tax holiday for new businesses, but recommends that further consideration be

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given to the proposal in a year or so. The potential cost could be considerable, unless the scheme is carefully devised.

d. Encouraging winners

4.9 The Group recommends against a transferable allowances scheme for the immediate future, but believes the possibility might be looked at again in the light of experience gained with an equity scheme if such a scheme is introduced.

4.10 The Group sees arguments both for and against direct aid to successful companies. If Ministers wished to give such aid, and the necessary public expenditure provision could be accommodated, the best course would be a scheme developed from the existing Selective Investment Scheme. This could involve commitment of up to £150 million in the first year, but with the actual expenditure spread over the PES period, and about 100 additional staff. Faster aid to successful companies would imply a scheme which resulted in much rougher justice.

Total Costs

4.11 The costs of those items, discussed above, on which Ministers are invited to decide for possible introduction in the 1980 Budget are:

	£m
1. Specific measures to help small firms	55
2. Losses scheme	10-25
3. Equity scheme confined to start-ups (rough guess)	100
4. Investment rebate scheme	150

ITEMS REJECTED FROM THE SPECIFIC MEASURES TO LIGHTEN THE IMPACT OF THE PRESENT SYSTEM

Tax relief for company trading losses against shareholders' income

1. The proposal is that the individual shareholders of a small trading company should be able to elect to set the company's trading losses against their own income for tax purposes, either (under one variant) of the same year or (under another) of say three years before the start of the trade by the company. The proposal is similar to a scheme in existence in the US.

2. The objective would be to increase equity investment by individuals in small companies. It would do this by providing a cushion of personal tax relief where the company makes losses. The cushion would (a) reduce the investor's risk of loss and (b) put him in funds with which to bolster the loss-making company.

3. In practice, it would be necessary to confine the relief to companies starting new businesses. Consequently, the measure would be especially useful in giving relief to shareholders for start-up losses.

4. The problems with a scheme along these lines are:

(i) It would breach the distinction between a company and its shareholders which is fundamental both in company law and to corporation tax.

(ii) A definition of a "small" company which is both suitable and workable would have to be found. No such definition exists at present.

(iii) Relief would open the door to tax avoidance in a number of ways at the cost either of a considerable loss of revenue or of many pages of complex legislation.

Annual accounting for VAT purposes

5. The proposal would enable small traders to furnish annual, rather than quarterly, VAT returns and to make quarterly advance payments on

the basis of the previous year's accounts. The proposal is not new and Customs and Excise had full discussions with trade bodies on its advantages and disadvantages less than two years ago. The almost unanimous view then was against it, and other changes in VAT accounting and return form requirements have since been made for the benefit of small firms. The Group agreed that the proposal should not be pursued.

#### VAT Licence System for Small Traders

6. The proposal would allow small firms to purchase a VAT licence at a cost equivalent to the anticipated net revenue raised from the trader under the normal VAT system. The licence fee would be individually assessed, along the lines of the French "forfait" system. The proposal was considered when VAT was being introduced in 1973 and rejected because it was felt that it would not relieve the burden of VAT on small traders and because it would have been costly to administer. Nothing has happened since to alter this assessment.

1 December 1979

## REPORT OF THE INTERDEPARTMENTAL GROUP ON FISCAL ASPECTS OF THE STRATEGY EXERCISE

### TAX RELIEF FOR NEW INVESTMENT IN THE EQUITY OF SMALL FIRMS

1. The interdepartmental report of officials on the Enterprise Proposals refers briefly to a scheme designed to encourage the take-up of equity in small firms by offering income tax incentives to investors. This report by the group describes and considers the scheme in detail.
2. Since the emphasis is on encouraging relatively large sums of money into small firms, the group did not look at the French scheme - the Loi Monory - which is essentially concerned with small investment (£500 per household) in large firms. In any case, the possibility of introducing a Loi Monory scheme is being examined by a separate group.
3. The problem of any scheme designed to give tax relief for equity investment in small firms is to avoid a vast loss of revenue from what the group described as the "re-cycling" of money between individual companies, between companies and their proprietors, and between self-employed businesses and the corporate sector, simply for the sake of a tax advantage, even though there is little or no new investment in the small business sector as a whole. Apart from the huge Exchequer cost - potentially many hundreds of £ million - this kind of exploitation would discredit the tax system and perhaps Government strategy more generally. At the same time, the group accepts that some risk would have to be taken if a scheme is to be sufficiently attractive to achieve its purpose.
4. No other country has yet succeeded in developing a scheme of this kind and the group has, therefore, been breaking new ground. The Inland Revenue, however, have undertaken an intensive (though necessarily preliminary) study, which has identified the features described more fully in the Appendix, which in their view a scheme of this kind would need to reflect.

(i) The scheme would have to be confined to "start-ups". To allow relief for investment in shares of existing companies, or for companies set up to takeover existing businesses, could be highly cost ineffective - perhaps involving tax losses of upwards of £1,000 in a year (representing much of the present corporation tax yield from small companies, and a significant slice of the present income tax yield from the self-employed). This is because there is no way within the existing tax system by which the Revenue could distinguish new investment in a scheme of this kind from the artificial re-cycling of capital.

(ii) A "start-up" would be defined as a bona fide trading company which had been in business for less than 3-5 years, and which was not merely an old business in new clothes. This means that the relief would be limited to strictly new business ventures - ie it would not be available for take-overs, for incorporation of existing business or for a new company started up by a businessman (whether self-employed or a company director) in the same line as his existing business.

(iii) The relief would be conditional on new physical investment or on investment in stocks, as defined under the current stock relief scheme. Broadly speaking, this would exclude financial assets and working capital other than stocks.

(iv) The relief would apply only to new issues of equity capital and would not cover the purchase of existing shares or the provision of loan finance.

(v) Income tax relief would be given at the investor's marginal rate up to a limit of say £10,000 to £20,000 a year, subject to an overall limit for each investor of (say) £50,000. The maximum tax relief for any individual, at existing tax rates, would be £37,500.

(vi) The tax relief would be clawed back if the shares were sold or the investor withdrew capital directly or indirectly from the business within, say, five years, or if the company's capital investment was not maintained.

(vii) It would apply only to investment in companies. If the scheme were extended to unincorporated businesses (ie the self-employed) the effect would be equivalent to a tax holiday for anyone putting money in his own business. (On the other hand, the self-employed would argue that they too need working capital, which they would have to meet out of taxed income.)

(viii) Quoted companies (and their subsidiaries), and large unquoted companies, would be excluded.

All this would have to be backed up by a host of detailed provisions before the broad outlines in (i) to (viii) above could be turned into a legislative scheme.

5. A scheme on these lines, however, poses serious difficulties. It would be complicated, with perhaps 15 pages of legislation. It would be expensive to administer, and it would be tricky for the ordinary investor to understand. Even so, it would be narrow in scope - in particular because it would exclude:

(a) Investment in working capital (as distinct from physical assets).

(b) Investment where a businessman starts up a new company in his existing line of activity.

(c) The self-employed.

6. Even with all the exclusions the scheme might be expected to interest some eligible investors and so lead to additional investment in new small firms. It should also encourage investors who have decided to set up a new firm to raise their sights and increase the size of their initial investment. On the other hand, there can be little doubt that, as with most tax incentives, the greater part of the relief would go to investors who would have invested in any case. Moreover, this relief would be in addition to the allowances available for fixed investment, so that the revenue cost could be higher than the investment generated. But, so long as the scheme attracted the kind of investment intended, the full restrictions listed in paragraph 4 would keep the revenue cost for the first year or so within a total of say £100m.

7. The effect of the restriction for working capital - (a) above - would be significantly to reduce the attraction of the scheme for many small companies in the services sector, as well as many in areas of high technology, such as micro-electronics where much of the capital is not in physical assets but to pay the salaries of highly qualified staff for a period until companies begin to make profits. To waive this restriction would allow a man to get tax relief for transferring his private fortune to be held in the name of the company. How serious this problem would be in practice is open to some dispute. Some members of the group argue that the problem would not be that great since to exploit the loophole, certain conditions would have to be satisfied - for example, the individual concerned would have to demonstrate that the investment was in a genuine new trading company. The Inland Revenue believe, however, that where the opportunities existed, the scope for exploitation would be obvious and the scale of potential tax losses would be large.

8. To go further and drop the restrictions in (b) and (c) in paragraph 5 above would substantially alter the nature of the scheme.

It would change the scheme from one directed to start ups to one where tax relief was available for any type of investment, whether new or not. The cost of that sort of scheme would be enormous and open-ended. Yet the restriction in (b) would rule out obviously deserving cases - including some of the probable main potential sources of growth in the small business sector - such as the electronics engineer already in business, who wants to develop his existing business, or to set up another business in the same line. The problem is that it has not proved possible to distinguish between the genuine new business and the situation where the owner of an existing business so arranges matters that his business is wholly or partly transferred into a "new" one. Without the restriction, there are two obvious avenues of abuse. First, an existing businessman could claim tax relief for feeding existing business assets to a new company. Second, he could in practice arrange a tax holiday on the profits of his existing business, by similarly channelling them into a new company.

9. Before deciding on the merits of alternative approaches to incentives to invest in small firms, as set out in the group's report on Enterprise Proposals, Ministers will need to come to a view on the merits of an equity investment scheme of the kind described in this paper. If they feel that a scheme of this sort deserves serious consideration, they will need to accept that the starting point would have to be the framework set out in paragraph 4. The Working Group has not felt able to put forward for discussion a scheme which did not incorporate the kind of restrictions referred to there, and which would cover all investment in small firms.

10. The questions for Ministers, therefore, are:

(a) First, would they be prepared to accept a narrowly-drawn scheme, as set out in paragraph 4 - which (though by no means proof against exploitation) seeks to ensure that at least the bulk of the Exchequer cost would be in respect of genuine investment in small businesses - but would be very difficult to justify because it excluded so many obviously deserving cases; and, if so, would they be able to resist the inevitable pressures to extend it?

(b) Second, would they favour a scheme which relaxed the restriction on physical investment and stock - (a) in paragraph 5. The dropping of that restriction would not affect the structure of the scheme, but would expose it to greater risks of manipulation. Even without this restriction a scheme of this kind would still exclude the kinds of new business investment - many of them obviously desirable - described in paragraph 8 and Ministers will similarly need to consider whether they could resist pressures to extend it.

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4 December 1979

## INCOME TAX RELIEF FOR EQUITY INVESTMENT IN SMALL FIRMS

1. This appendix describes in detail some of the main features which the Inland Revenue identify as needed for an equity investment scheme directed towards start-ups.

### "Start ups"

2. The relief would be for investment in new issues of equity shares of bona fide trading companies in the United Kingdom within (say) 3 years of the trade commencing. (The possibility of problems with the EEC by excluding foreign companies has not been considered.)

3. It would need to be provided that the purchase of new shares was not offset by, for example:

- Repayment or sale of existing equity shares
- Repayment of loans from the investor to the company
- Extending of loans or informal credit by the company to the investor
- Meeting of investor's obligations by the company
- Transfers of assets between the investor and the company at an over-value or under-value.

### Defining a "start-up"

4. There are a number of transactions which may in form but not in substance, represent new business investment:

- A new company may adopt a new letterhead and make just sufficient cosmetic changes in an existing business to be able to claim, as a matter of law, that it is carrying on a new trade.
- A new company set up alongside an existing company, into which the trading assets of the former company are progressively transferred (ie enough 'new' investment in the 'new' company each year to eliminate the annual tax liability of the proprietor).
- The simple takeover of the whole or part of an existing business.
- A new company - typically a "service company" - may provide services for an existing business, which the business originally provided for itself.

Many other possibilities can be envisaged.

5. The Inland Revenue believe that the only way of containing (though not eliminating) a major loss of revenue through tax planning of this kind would be to deny relief to an investor who puts his money into a new company in the same line of business as his existing business or company, or into a new company which does a significant amount of its business with an existing business or company controlled by the investor or his associates. There are various ways this restriction might be defined, but broadly it is likely to confine the relief primarily to employees etc starting up new businesses of their own, rather than businessmen already engaged on their own account.

#### The self employed

6. The scheme would be confined to companies and would not apply to the unincorporated business (the self employed). This would obviously be a source of complaint and pressure to extend to the self employed could be expected. In practice, if this were to be accepted the revenue cost of the scheme would be very large indeed. However, it is a continuing complaint from the self-employed - in particular from the professions, such as the Bar Council - that they have to provide for working capital out of income taxed at a top marginal rate of 60 per cent, whereas companies can add to their capital free of tax (to the extent of stock relief), or after the small companies rate of 42 per cent.

#### Eligible securities

7. Relief would apply only if the company had one class of equity shares carrying all the usual rights, and there were no conditions attached to the shares involving an accompanying "arrangement" to dispose of the shares, or the underlying rights in them or the business of the company.

#### Associated persons

8. The scheme would treat as one the investor and his associates - that is, including his close relatives (in particular husband and wife) his business partners, trustees of settlements and so forth.

#### Financial limits

9. There should be a de minimis exclusion (say £1,000 in any year) and an upper limit - £10,000 or £20,000 in any year with a £50,000 limit overall.

10. The relief would be available at the investors marginal rate or limited to the basic rate - carried forward or back for a 5 year period from the date of the investment.

#### Use of the funds

11. So as to limit the scope for an investor setting up no more than a financial company to hold his portfolio, ie a trading company as an umbrella for financial investment, and carrying the tax advantages, a qualifying investment would need to be matched by evidence of physical investment either in fixed assets or stocks.

#### Clawback

12. If within, say, five years before or after the original investment the shares were sold, funds were withdrawn, the physical capital not maintained, or transactions incurred which conflicted with the qualifying requirements, the relief would be (as appropriate) denied or clawed back. Beyond five years the investor would be free to withdraw his money without tax penalties.

4 December 1979