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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

ENTERPRISE PROPOSALS
THE 'ASSISTANCE TO SMALL FIRMS' PACKAGE

Note by the Central Policy Review Staff

1. Ministers plan to announce, as soon as possible, a package of measures to encourage the creation and expansion of small firms. Such a package is regarded as an important element in the Government's economic strategy for small firms are the section of industry and commerce most likely to respond quickly and flexibly and hence accelerate our economic growth. The report of the Interdepartmental Group on the Fiscal Aspects of the Strategy Exercise on Enterprise Proposals, which is circulated under cover of the Chancellor of the Exchequer's memorandum E(79)77, discusses a complicated series of possible contributions to such a package. In considering these, Ministers will need to weigh the alternatives in terms of:

(a) likely cost effectiveness (increase in investment and output as against tax forgone);

(b) likely sustainability (whether public and Parliamentary pressure will force extensions to the schemes such that the cost in terms of tax forgone and in administrative burden and complexity rises very greatly).

2. Judged against these criteria, the three groups of options seem to score as follows:

I. Minor concessions to lighten the impact on small firms of the present taxation system.

3. Five minor but generally useful concessions have been proposed (listed in paragraph 4 of E(79)77. Four seem acceptable, if unexciting. The CPRS believes, however, that the fifth measure (a reduction in the rate of corporation tax on small firms from 42 per cent to 40 per cent) is not worth doing. It will be easy to implement but will have very little effect.

II. Relief for capital losses.

4. Setting up new small firms (particularly where technological innovation is required) is a very high risk activity. Fear of losing all the money they have put in is a major constraint for potential investors. Allowing an investor to set off any eventual capital losses against his income tax liability has been proposed by the Secretary of State for Industry. It was also strongly recommended in a recent report by the Advisory Council for Applied Research and Development. A similar scheme is in operation in the USA. The likely cost is modest (£10m. to £25m. per annum) and the relief is likely to be both welcomed publicly and to be cost effective in terms of the increased activity it is likely to create. Its one disadvantage is that it is bound to be somewhat complicated to administer.

III. Income Tax relief for individuals putting equity into small firms.

5. This is the real nub of the matter. In terms of its potential cost (around £100m. per annum) this is a much bigger issue than action in the two areas described above. It is also the area which presents the greatest difficulties for administration, potential avoidance and pressures for extension. On the other hand, a 'small firms package' which included only the clutch of four minor measures in Group I above and the losses scheme in Group II is unlikely to have much impact on the economy. It will be seen for the very modest step which it is.

6. The Inland Revenue is understandably worried by proposals in the income tax relief area (tax avoidance possibilities, administrative complexity, etc.) and wants either to have no such concessions or to limit them to a narrow band of cases. The three most important restrictions are that the relief would not cover:

(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.

(a) Working capital. The Interdepartmental Working Group were agreed that such restrictions would greatly reduce the incentive to invest in new small service firms (which are major providers of employment) and in firms applying microelectronics where high calibre people rather than equipment need to be financed. It is agreed that allowing relief on working capital would result

in some tax avoidance but the CPRS believes that the scale of avoidance is likely to be much less than has been suggested. (See Annex A.) In the view of the CPRS relief for working capital is so much an integral part of the income tax relief scheme that Ministers should not proceed with a scheme along these lines if it cannot be included.

(b) Investment in the same line of business. Every year many small businessmen set up or take shares in new businesses in the same line of country as their existing businesses. It will be exceedingly difficult for Ministers to defend in public an incentive which retains this restriction. On the other hand, the Revenue have drawn attention to the dangers of large scale avoidance if this restriction is removed. The CPRS accepts this is indeed a real problem but believes that further efforts should be made to find alternative restrictions which Ministers will have greater chance of defending publicly. Annex B outlines three possible approaches which singly or combined might provide the basis of a solution. Ministers could ask the Revenue in consultation with other Departments to study this problem further.

(c) The self-employed. Past experience demonstrates that it would also be difficult in the face of public pressure and at the Committee Stage of a Finance Bill to hold the line that these 'reliefs' on income tax should be confined to investment in small companies and not allowed to the self-employed. The CPRS shares the Group's view that it is essential to hold this line and if there is doubt about the ability to do this the cost and the complications are such that the whole income tax concession element should be dropped.

7. Provided Ministers were prepared to give it sufficient priority, in terms of tax reduction it should be possible to announce in the 1980 Budget a scheme along the lines proposed by the Inland Revenue which excluded the self-employed but removed the restriction on working capital. It would make a considerable impact and produce substantial additional investment. But it would be costly (and much of the benefit would go to investors who would in any case have made their investments). It would also be administratively complex.

8. Ministers might wish to consider the cost of this scheme (about £100m.) against other possible measures in the income tax area which would be much simpler and involve less avoidance, e.g. a cut in the top rate of tax from 50 per cent to 60 per cent (£105m. per annum) or a reduction in the investment income surcharge from 15 per cent to 10 per cent (£75m.).

RECOMMENDATIONS

9. The CPRS recommends that Ministers should:

(a) not agree on a reduction in the small firms rate of corporation tax;

(b) endorse the four other measures in paragraph 4 of E(79)77;

(c) agree that the losses scheme should be announced in the 1980 Budget;

(d) decide whether further work should be done on the tax relief for individuals and, if so, give a steer on the direction such work should take.

Cabinet Office
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ANNEX A

The Revenue wish to impose this restriction because they believe that investors with portfolios of gilts and /or equities will set up new companies which are de facto financial companies to provide an umbrella for portfolio investment. While accepting that some (mainly professional tax-avoiders) might set up such highly artificial schemes the CPRS believes (as does outside Tax Counsel) that few ordinary investors or small businessmen would indulge in such schemes as:

(a) to obtain the full relief an investor would have to tie up his money for 5 to 10 years on the basis that he could only obtain relief on £10,000 per annum provided he left it in the business for 5 years. Given all the economic and political uncertainties few investors would want to tie up capital for such long periods.

(b) The relief would only be obtained if the new company were a genuine trading company. (At least part of the initial capital injection would be required to set up genuine trading companies.) If it transpired the company was really a financial rather than a trading company the relief would be clawed back. Few investors could be persuaded to channel their portfolio through a trading company which they did not control as this could jeopardise their chances of ever getting their portfolio investments out again.

(c) Most investors in small business invest in the hope of obtaining very much higher returns than are available on either gilts or quoted equities. This situation will not be changed by the introduction of the proposed relief.

(d) If, as recommended by outside Counsel, the legislation contains a provision to the effect that the relief will not be available if the main or sole benefit of the investment that might be expected to accrue to the investor was the obtaining of a reduction in tax liability, most would-be avoiders would be deterred.

(e) The great majority of small businessmen in this country are concerned with running their businesses and are just not interested in setting up highly artificial tax schemes especially as they already benefit from generous capital allowances, stock relief, leasing and self-administered pension schemes.

ANNEX A cont'd

(f) The scale of the relief i.e. £37,500 over three to five years for the investor paying the top rate of income tax and having an investment income of £15,000, is such as to be only of limited attraction to the London Tax Avoidance Industry.

ANNEX B

Where a businessman starts up or invests in a new company in his existing line of activity:

(a) Place onus of proof on investor to prove that the investment is in 'a genuine new business'.

(b) Deny relief where the 'sole or main benefit' is the tax relief.

(c) Restrict relief to investments in firms in the same line of business where the investor and associated persons, including fellow-investors in firms in that line of business, together own less than 50 per cent of the new firm.