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Prime Minister

CONFIDENTIAL

Qa 04376

TL 11/12

To: MR LANKESTER

From: SIR KENNETH BERRILL

Small Firms Package

1. You will have seen that the CPRS has circulated a note on this subject (E(79)82) which (a) recommends that Ministers should endorse a number of useful but limited measures but (b) takes a neutral approach on the major proposal, i.e. that individuals should be able to set off up to £10,000 or £20,000 invested in new small firms against their income tax liability. Sir Keith Joseph's paper, E(79)83, gives his support to (a) but pleads strongly for (b) also.

2. As the Prime Minister has expressed interest in this area, it might be helpful to spell out rather more fully:

(a) the economic pros and cons of the proposal;

(b) the administrative/avoidance considerations.

3. The scheme set out in the paper is a more limited version of a proposal put forward by Sir Keith Joseph which covered income tax relief for investment in both new and existing firms. I think the concentration on start-ups is justified as it is very much more difficult to find external risk capital for new comapnies than for existing companies with a few years' track record. The incentive (provided some of the restrictions were removed) would undoubtedly result in additional investment. It will also encourage people who would have invested in any case to invest more. All this should have a beneficial multiplier effect on the economy. On the other hand, the incentive is quite costly (say £100m.) at a time when the Chancellor is about to launch another exercise to cut back public expenditure. Such a sum might be used in alternative ways, e.g. to cut the investment income surcharge from 15 per cent to 10 per cent (£75m.) or to reduce the top rate of income tax from 60 per cent to 50 per cent (£105m.). There can be little doubt that most of the incentive will go to people who would have invested in any case (some 70,000 new companies are set up every year). Even if all the proposed Revenue restrictions are imposed (which in my view would make the scheme unviable) there is still likely to be a certain amount of avoidance.

4. In the light of the Prime Minister's earlier remarks in E about the need to temper the Revenue's natural anxiety to curb avoidance with the desirability of giving positive stimulus to the small firms sector, the CPRS has followed the discussions on the dangers of avoidance in great detail. Indeed, with the agreement of the Treasury and the Revenue we retained free of charge Tax Counsel (from Mr Peter Rees's Chambers) to advise on the problems to which the Revenue have drawn attention, which are spelt out fully in the report on tax relief for new investment in the equity of small firms attached to E(79)77.

5. Most of the restrictions which the Revenue propose are reasonable and defensible. They do not undermine the main political economic benefits of the scheme, although they inevitably lead to complicated legislation. Without them the scheme could be open to large-scale avoidance. There are, however, two restrictions which it would be essential to remove (or deal with in a different way) if Ministers wish to proceed with such a scheme, namely that the relief would not be available for

(a) working capital; or

(b) businessmen who set up new businesses in their existing line of business.

For the reasons explained in some detail in our paper the CPRS believes the restriction on working capital can be removed without danger of widespread avoidance. Tax Counsel strongly agrees with this view. The Revenue are now reluctantly willing to see this restriction dropped. If it is maintained the scheme is almost certainly not worth going ahead with.

6. Counsel also believes that ways could be found of dealing with the second problem, probably by putting the onus on such businessmen to prove, if necessary, that their new business is a genuine one. This is not wholly satisfactory and will be time-consuming for both investors and the Revenue. These points are not unnaturally emphasised by the Revenue. On the other hand, Ministers would find it impossible to defend an incentive which would benefit a widgets manufacturer who invested in, say, a new tobacconist, but would not benefit him if he set up a genuine new widgets factory.

7. If the Prime Minister considers it is worth doing further work on the scheme outlined by the Revenue with a view to omitting or altering some of the restrictions, she might consider proposing that outside Tax Counsel as well as other Departments should be associated with the work. While such an approach is unlikely to be welcome to the Revenue, it might help counterbalance their natural concern with avoidance.

8. I am sending a copy of this minute to Sir Robert Armstrong.

KB

11 December 1979