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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

EQUITY INVESTMENT SCHEME - TAX RELIEFS FOR SMALL FIRMS

Note by the Central Policy Review Staff

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1. On 12 December the Ministerial Committee on Economic Strategy, while leaving the Chancellor to make his judgement in the light of the available resources nearer the time of the Budget, invited him to consider larger and more attractive schemes of tax relief for investment in small firms when drawing up his Budget proposals. In particular, tax relief for equity investment in new firms was felt to be very attractive. The Chancellor has considered the possibilities further but feels unable to proceed with a 'start-up' scheme in this year's Budget.

2. The Chancellor proposes a small firms' "enterprise package" consisting of:-

(a) a 'risk-sharing' or 'venture capital' scheme whereby an investor would obtain tax relief if his investment failed;

(b) abolition of apportionment of the trading income of close companies;

(c) more generous reliefs for retirement annuities of the self-employed;

(d) extension of relief for interest on loans for investing in family companies;

(e) stamp duty relief for sales over the counter of shares in unlisted companies;

(f) capital tax concessions;

(g) possible action on demergers.

The risk-sharing scheme (a) is estimated to cost £10m./£25m. a year, and items (b) to (e) £35m. a year.

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3. The Secretary of State for Industry and the Secretary of State for the Environment feel that these do not amount to a sufficiently dramatic package to revitalise the small firms sector. They believe that some form of relief for 'start-ups' would be more effective and presentationally more attractive.

4. The desirability of a 'start-up' scheme is common ground and some avoidance must in practice be accepted, though kept within bounds. So far the only scheme which has been devised within tolerable limits of cost and avoidance requires complex drafting and is of narrow application:

(a) it excludes the self-employed;

(b) it is not open to existing small businessmen to invest in related businesses or to expand their own but would be largely limited to employees, the non-employed, and self-employed investing in a totally new line of business;

(c) it does not cover investment in working capital (the need of many small firms in the service sector and in technologically advance industry) but only investment in tangible assets.

5. The Inland Revenue advise that it would not be possible to widen any of these restrictions in time for the Budget without opening the way to considerable loss of revenue (in £100s of millions) through recirculation o existing capital and other artificial devices. The Chancellor proposes further study of the difficulties in time for possible action in next year' Budget.

6. A very rough estimate of cost is £100m. a year - double the Chancel "enterprise package".

7. The Inland Revenue also advise that if the 'start-up' scheme were to introduced it would <u>not</u> be practicable to proceed this year with the risk-sharing scheme. This is because the two schemes have substantial interlo If the two schemes were introduced together as they stand, an investor coul first receive tax relief on making an investment and again if it failed. Officials have done enough work to be reasonably certain that either schem on its own could be introduced but the Revenue believe that further study the policy and technical implications of overlap would be needed before th could both be introduced and this would not be practicable in time for thi year's Budget. There are also constraints in terms of space in the Financ

Bill and resources for the necessary preparatory work - both schemes involve long and complex legislation. If this is accepted, Ministers have in effect to choose between the 'risk-sharing' scheme and the 'start-up' scheme.

8. Given that a choice has to be made, the view of the CPRS is that the risk-sharing scheme is likely to be the more effective in stimulating new investment and costs much less (£10m./£25m. as against £100m.). The most powerful inhibition in setting up a new business is the risk and penalties of failure. The risk-sharing scheme will act directly on this constraint.

9. The Secretaries of State for Industry and for the Environment take the view that without a start-up scheme the package will lack conviction. The Chancellor has questioned whether a narrow start-up scheme (with all the restrictions set out in paragraph 4) would have such impact.

10. Ministers will wish to consider:

(a) the cost: the start-up scheme would cost £100m. compared with about £10m./£25m. for the risk-sharing scheme;

(b) how effective the scheme would be, given that the risk-sharing scheme would not be possible at the same time;

(c) whether they would be able to hold the line in current and future Finance Bill debates against pressure to include more people within the scope of the provision - many of whom it is agreed in equity should be included. Concessions on these matters could be very costly indeed.

11. If Ministers decide not to go ahead with introduction of a start-up scheme in this year's Budget they will want to consider whether further work on making the scheme more attractive without substantially increasing the cost should be put in hand. If so, the CPRS recommends that outside Counsel should be associated with this work to give an independent view on the risks of avoidance. But no mention of the possibility of a future start-up scheme should be made in the Budget speech or debates, for this could have perverse results by leading people to hold off from investment in the year ahead.

Cabinet Office
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