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- SIRD WASS
- MR RYRIE
- MR LITTLER
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21 January 1980

*Sir Keith*

ASSISTANCE TO SMALL FIRMS AND THE EQUITY  
INVESTMENT "START-UPS" SCHEME

When we discussed, at E Committee on 12th December, possible fiscal measures to assist small firms, it was left that I would give further thought to the possibility of an enterprise package for the Budget in the light of the discussion. There was strong support from yourself and others for a scheme for encouraging the start up of new businesses through the provision of tax relief for individuals investing directly in them. You have emphasised the point in your letter to me of 15th January.

I entirely understand the enthusiasm there is among colleagues for an equity investment scheme, if we can only design one which will stand up. Since the meeting, I have examined the scheme as devised by officials in more depth. I am bound to say, however, that I have not yet been able to satisfy myself that we have a scheme which makes practical sense or which, if it were modified to look more sensible, I feel certain would be sufficiently tight to avoid unacceptable tax losses. There can be no doubt that a scheme much less restricted than in the FASE report would be wide open to abuse. We are not talking here of fringe manipulation - as my officials have emphasised from the outset, I am quite happy to live with that as a price for achieving a scheme with real impact - but about the certainty of really massive loss of tax through what could be the most easily concocted arrangements, and often resulting in no new genuine investment whatsoever. On the other hand, while the FASE scheme limits these avoidance opportunities, it is drawn so narrowly as to be indefensible.

"Fiscal Aspects  
of Strategy"  
Exhibit

ie. it contains  
nothing in  
working capital,  
investment in  
new business,  
and investment  
by self-employed.

I believe it might be fruitful, however, to put in hand further work to see whether there is any way of achieving

in same line of activity.

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The Rt. Hon. Sir Keith Joseph, Bt., MP.



our two aims - an effective and attractive incentive, with a reasonable cost to the Exchequer. The FASE proposals are a beginning at least, and I think take us nearer a possible solution than seemed possible in the past. It does mean, though, that it will not be possible to implement a scheme in the coming Finance Bill. A longer time-scale would have a number of advantages, not least in that it would allow us to consult rather more widely than we have done, even if it has to be on a confidential basis.

.....

Some colleagues have asked me for a more detailed explanation of the problems of an unrestricted scheme - particularly the avoidance possibilities - and the attached note may be of some help. I have also included in it a reference to the sort of issues which I think need to be considered in the further work. If you and Michael Heseltine agree, I propose to ask the interdepartmental group of officials (FASE), who produced the previous report, to undertake this further examination and report to us in MISC 14. Your officials will, of course, be fully involved in the review. The work could be handled alongside the study, already under way, of ideas, such as the Small Firms Investment Company concept, which are designed to bring together potential investors and small businesses seeking venture capital.

I know that David Mitchell has taken a very close interest in all this, and I wonder whether it would be useful if, before the further work begins, he were to have a talk with one or two of my Treasury and Inland Revenue officials about the problems set out in the note. David may have some new ideas to inject. Indeed, you and Michael may feel that you would like to take part in this initial discussion.

Meanwhile I have in mind that the Budget could include a convincing enterprise package, made up of the following main elements. First, concessions on capital taxation, following the capital tax review. Second, I think we should go ahead with the risk-sharing scheme (the so-called "losses" scheme, but we must certainly find another name for it) under which income tax relief will be given for capital losses incurred in investing in unquoted companies. Third, I would like to include four of the five other measures which we looked at in E. The most important of these is clearly the abolition of the rules for apportioning the trading income of close companies. But I also see a worthwhile case for more generous tax reliefs for self-employed people who take out retirement annuities, extension of the relief for interest on loans taken out for the purpose of investing in family

/companies



companies and stamp duty relief to assist the marketing of unlisted companies. Fourth, I have it in mind to introduce a new relief - to which both industry and the accounting profession attach considerable importance - for the costs incurred by businesses in raising loan finance. Fifth, subject to the further discussion which I wish to have with you and John Nott, I hope I shall be in a position to make some positive move on easing de-mergers.

I will also see whether it might be possible to say something in my Budget Statement, in very broad terms, about the examination we are giving to the possibility of an equity investment scheme. But we shall need to think carefully about the wisdom of this. We must avoid running the risk of achieving exactly the opposite of what we intend, through people holding back from new ventures while they wait to see what may emerge.

I am copying this letter to Michael Heseltine, and also to the Prime Minister and colleagues on E Committee, and to Sir Robert Armstrong.

A handwritten mark, possibly a stylized initial or a checkmark, consisting of a vertical line on the left and a horizontal line extending to the right.

A handwritten signature in cursive script, appearing to read 'Geoffrey Howe'.

(GEOFFREY HOWE)

## A SCHEME FOR TAX RELIEF FOR INDIVIDUALS INVESTING IN SMALL FIRMS

### Objectives

1. The aim of the FASE report was to examine the feasibility of a scheme to encourage individuals to invest in small firms, by giving tax relief on the amounts invested. The concept of the scheme is simple enough. Individual A, say with a marginal tax rate of 60 per cent, invests £10,000 in small firm X; he finds £4,000 from his own resources, and the remaining £6,000 is provided by the Exchequer in the form of tax relief.
2. The scheme has to be geared to encouraging individuals to invest sums of the order of £10,000 to £50,000 - the sort of tranches which, according to the equity gap theory, are most required by small firms. This puts the scheme in an entirely different league from the French Loi Monory, where relief is restricted to £500 new equity investment per person per year.
3. FASE recommended that the relief should apply only to start-ups, and not to investment in existing small businesses. This was because, first, the cost needs to be kept within bounds, and second, Ministers themselves have tended to favour concentration on the encouragement of new businesses.
4. FASE envisaged that the relief would have to go wider than just Aunt Agatha (the outside investor), since it would be unreasonable to exclude individuals who wished to invest their own funds in their own new firms.

### Problems

5. FASE has not gone so far as to design a possible scheme. What it has done is to identify the main constraints that would need to be built into any scheme.
6. One important problem is the sheer complexity of the necessary legislation, making the scheme expensive in skilled staff to administer, and perhaps unattractive to the ordinary businessman unused to seeking specialist advice.

7. More fundamental is the dilemma that:
- i. a broadly-based scheme appears to be unmanageable, with a possible Exchequer cost of several hundred million pounds, with no guarantee that at the end of the day there would be a penny of new investment in small businesses; whereas
  - ii. a scheme capable of being contained within an Exchequer cost of, say, £100m would need to be so narrowly defined as in practice to be indefensible.

Cost effectiveness and avoidance

8. The problems centre round the difficulty of ensuring that the relief goes only to genuine investment by an individual which is channelled into a business, and retained there. This would have to be monitored without all the arrangements - for example an annual statement of a taxpayer's total assets and liabilities - on which the Revenue authorities would expect to draw under a fully-fledged expenditure tax. Even in its much more limited concept, the French Loi Monory in fact uses the institutional arrangements of the commercial banks to achieve just this.

9. Without this kind of defence, there are three main sources of easy abuse:

- i. circulation and re-circulation of capital between the business and the investor;
- ii. circulation and re-circulation of income between the business and the investor;
- iii. the placing of all or part of the capital or profits of an existing business within a new one.

10. Circulation of capital. Firms can be used as a straight conduit for funds, so some way would have to be found to prevent the same tranche of investment capital being recycled and accumulating successive amounts of relief. To take the simplest possible example: individual A invests £10,000 in firm X, obtaining up to £6,000 tax relief. X then lends the money back to A, who makes a second investment in X (or a separate investment in Y), claiming a further £6,000 relief. And so on. Hence, a means must be found of ensuring that the initial investment is not financed by X, but remains in X. The necessary legislation would be complex, in particular in having to provide for clawback, and policing it would be a real problem.

11. Circulation of income. The directors or shareholders of a business could withdraw money in the form of directors' remuneration or dividends (attracting relief from corporation tax for the company), and could subsequently reinvest the same money in the company, attracting in the course of that simple transaction the new income tax relief. There is virtually no effective way of controlling that kind of arrangement. But it means that any company within the scheme could in effect enjoy a tax holiday from corporation tax on all its profits. It is one reason why FASE concluded that the scheme would have to be confined to start-ups (where companies would normally be making little taxable profit) rather than extended to small companies generally (where the amount of corporation tax at risk would be over £500 million).

12. Transfers of businesses. The more intractable problems arise from the fact that the creation of a "new company" does not necessarily imply the creation of a "new business". It would present no difficulty for the owners of an existing business to shift part or all of its assets, or indeed its profits, into a new company, and claim tax relief of up to (say) £30,000 per investor for nothing more than the placing of existing business assets under a new corporate label. Intensive work by the Inland Revenue, and subsequently in FASE, found no way of solving that problem, short of confining relief to the case where the new company is not in the same line of business as, and does not conduct a substantial amount of its business with, an existing business in which the investor has a significant interest.

13. But even with the start-up condition, the relief remains wide open to abuse. Hence, the FASE view that further restrictions would be required. For example:

- i. A new business could be used simply as a haven for an investment portfolio. Thus, A sets up company X and lodges in it his personal holding of £10,000 of gilts, continuing to receive the benefit of the interest in the usual way. As a result of that simple manoeuvre, he obtains £6,000 relief. Hence, the proposal that only funds invested directly in physical assets - plant, machinery, stock, premises - should qualify for relief.

- ii. The problems of distinguishing between personal and business funds in the case of an unincorporated business means that the scope for abuse would be even greater for the self-employed than for companies. Indeed, it would be open for anyone self-employed to claim a tax holiday on the whole of his income. Those who originally proposed the Aunt Agatha scheme recognised that the self-employed would have to be excluded.

Narrow scope of the scheme

14. FASE recognised that a scheme incorporating these sort of restrictions would end up drawn extremely narrowly. In particular:

- i. There would be obvious political difficulties over having to exclude the self-employed.
- ii. The crucial definition of a "new" business, while necessary to control tax avoidance in excluding firms started by businessmen already involved in the same line of activity, would, first, involve formidable practical problems and, second, look extraordinarily perverse by apparently withholding relief from anyone with previous practical experience in the business concerned.
- iii. Limiting relief to investment in physical assets would exclude investment in working capital. That exclusion does not make a lot of sense in terms of practical business operations, and would look particularly unfair to those businesses, eg in the high technology field, whose main requirement for capital may be the purchase of expertise rather than the purchase of equipment. FASE recognised that the working capital exclusion might be dropped, but noted that it would add to the risk of abuse and, therefore, the cost of the scheme - although no estimate was possible of the likely size of this cost. The extent of possible exploitation is a matter of judgement, on which FASE was divided.

15. In the light of past experience, and indeed of what Ministers themselves have said in earlier Finance Bill debates on the self-employed, a scheme defined in these narrow terms could not in practice be defended. But the risk to the Exchequer if the scheme as it stands were extended - either intentionally or through irresistible pressure - would be unacceptable.

Further work

16. If further work is to be commissioned, with time to examine the problems and possibly to consult more widely, then the areas on which effort needs to be concentrated include:

- i. Whether it is possible to construct a more acceptable and workable definition of a "new" firm - ie one which clearly identifies genuine start-ups involving completely fresh operations and entirely divorced from any existing business.
- ii. Subject to the conclusions at i, consideration needs to be given to a whole range of technical problems. For example, consideration would need to be given to how far the relief - which would clearly be very considerable - could be available through carry back against previous years' tax. More difficult issues would be such things as clawback of past relief, definition of associated persons, changes in share ownership, definition of bona fide trading etc.
- iii. A scheme as envisaged in the FASE report would apply to start-ups generally, whatever the purpose of the business. It would be worth considering whether there would be a case for restricting the relief to selected areas of activity - say manufacturing industry. This would have the advantage of confining the possible scope for tax loss, and arguably might be consistent with wider economic considerations.