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CC/BG



Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6460

Switchboard 01-213 3000

Prime Minister 4
A number of weekly
small suggestions.
DRS 7/1

John Mogg Esq
Private Secretary to the
Secretary of State for
Trade and Industry
1 Victoria Street
LONDON SW1

7 January 1986

Dear John

1986 BUDGET

Lord Young was most grateful to your ^{attached} Secretary of State for sending him a copy of his letter of 23 December making suggestions for measures in the 1986 Budget.

... You may in turn like to see the attached notes which Lord Young has himself sent to the Chancellor covering a number of matters related to the Budget in which this Department is particularly interested. As you will see the submission concentrates on four main themes. These are encouraging self-employment, encouraging the availability of finance to small companies, encouraging wider share-ownership and participation, and finally further measures to reduce the burdens on business.

I am sending a copy of this letter and enclosure to David Norgrove (No 10).

Yours ever

Leigh

LEIGH LEWIS
Principal Private Secretary

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BUDGET SUBMISSION

Self-employment

A number of positive steps could be taken to encourage self-employment.

1. The burden of paperwork on the self employed (and the Revenue) in claiming minor expenses to offset against income is excessive. We should consider a small business allowance to replace claims for minor items of business expenditure. If expenditure exceeds the allowance, claims could be submitted as now. The intention is to set the allowance at a relatively low level so that loss of revenue would be minimal but time wasting arguments about minor expenses are removed. This would be a relatively minor simplification to reduce the burden of paperwork on new start-ups and the small self-employed business.
2. The self employed pay National Insurance Contributions on a flat rate basis (weekly Class 2 contributions) and on a profits related basis (Class 4 contributions collected twice in the tax year by Inland Revenue). It would simplify the system, and remove the complication of claiming the small earnings exemption limit, if the Class 2 contribution were abolished. The reduction in contributions should be recouped by increasing the contribution rate on Class 4 contributions. This redistribution of the burden of payments would help start-up businesses and the lower paid self-employed, at the expense of the higher paid self employed. It would also ease the burden of paperwork on the self employed.
3. "Right to be self-employed". Although there must be doubts as to whether changes in tax and employment status greatly affect enterprise, there is a need to clarify the law on self-employment and to make it easier for people to become self employed. The risk of reclassification for tax purposes may deter some people from self-employment and the existence of disagreements between DHSS and Inland Revenue over whether someone is self-employed highlights the need for clarification in this area. We would not argue in favour of a single test for self employed status but the tests applied need to be clear and established to encourage self employment.

Finance for small companies

Improvements in the flow of finance to small companies could be made in a number of ways.

1. Loans made by charitable trusts to assist small firms and start-ups should be included within the scope of charitable purposes. This has proved possible but required a fairly complicated legal procedure to achieve. If this could be made easier by a change in regulations or legislation a new source of money for new entrepreneurs could be tapped.
2. Capital Transfer Tax diverts entrepreneurs into tax planning and can weaken a company which is being transferred. CTT should not be payable while assets are retained in the business being transferred. A 100 per cent relief from CTT on the transfer of business assets would achieve this, at an annual cost of about £70 million.
3. Venture Capital Funds are providing an important source of finance for companies. Some have moved off shore to avoid the double Capital Gains Tax (on the funds and on the investors) when investments are sold by unquoted capital venture funds. CGT exemption for unquoted capital venture funds would be desirable to remove the complexity of venture capital funds operating offshore. The cost of exemption would be minimal.
4. There are also some minor changes in company taxation which cost very little but are technically worth making.

"Disincorporation relief" When companies become incorporated, relief exists for Capital Gains Tax and to allow the carry forward of trading losses, but similar reliefs do not exist for businesses which disincorporate. Companies which disincorporate should be allowed the same reliefs that are available to companies which incorporate.

Corporation Tax on associated companies. The rules which aim to prevent abuse of the lower rate of corporation tax for small profits (below £100,000) by disaggregating companies, can have anomalous effects. Associated companies may be charged the full rate of tax even though total profits would be below £100,000. The cost of overcoming this problem should not be great through technical changes in corporation tax.

Ownership/participation

1. Abolition of stamp duty on the transfer of shares will encourage direct share ownership and help to reduce the cost of raising new equity. It may also help to encourage the development of an OTC market. If the cost of abolition (about £170 million) is excessive within the Budget arithmetic, a cut in the rate of stamp duty to $\frac{1}{2}$ per cent would still be worthwhile.

2. We should look for further ways to encourage employee share schemes. One approach would be to widen the scope of the executive share option schemes to encourage the spread of schemes to smaller companies with limited equity capital. Too much of the benefit of the present arrangements is going to executives in large companies when we want to encourage real entrepreneurs who take risks in starting or joining small companies. To achieve this, the definition of "material interest" could be widened to 25 per cent of ordinary share capital for unquoted companies. We also need to encourage wider general employee share schemes. One approach would be to look for ways to make all-employee share schemes more attractive to employers and employees such as increasing the allocation limits under the 1978 Finance Act. Profit Sharing Schemes and the limits on options in the 1980 Finance Act Share Option Scheme.

3. Some specific changes could be made to encourage employee controlled companies (ECC's) and particularly to enable ECC's to expand subsequently while remaining employee controlled. Detailed changes are given in the attached note. Costs should be minimal.

Burdens on business

Some changes which would have a major impact in reducing burdens on business also affect revenue. Three issues which are consistently raised with us by business are identified below.

1. VAT threshold. Our scope to raise the VAT threshold will, of course, be determined by negotiations with the European Community. If we gain flexibility the threshold should be raised substantially.

If negotiations do not succeed, then, as well as normal indexation, we might to look for other ways to make progress in this area within EC rules, for example exempting very small firms, or very small firms in a wide range of sectors.

2. The P11D threshold has not been indexed against inflation and has reached a point where the £8,500 threshold catches a wide range of employees not normally regarded as higher paid. Unless very drastic simplification of the information required from companies can be achieved a substantial increase in the threshold - to around £15,000 to take account of inflation - is needed to reduce the burden of compliance.

3. The Keith recommendations on VAT which were introduced in this year's Budget have drawn a lot of criticism over VAT penalties and record keeping. It would be in keeping with the decision on the Keith recommendations on Inland Revenue taxes to undertake a thorough review of both penalties and record keeping requirements. We would urge that the penalties be imposed only after a longer time period - and much less rigidly - and that the record keeping be reduced to three years, at least for small firms.

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EMPLOYEE CONTROLLED COMPANIES (ECCs)

Given the increasing interest in the establishment of enterprises in which employees themselves own a controlling interest and our desire to encourage wider share ownership among employees there are sound political reasons for giving further encouragement to employee controlled companies. There are 5 specific areas where small, but helpful changes could be made.

1. The special interest relief for employee controlled companies introduced in the 1983 Finance Act has been helpful. But the relief is available broadly only where the shares are acquired before or within 12 months after the company becomes employee controlled. Without creating a precedent for a general relief for employees taking out loans to invest in the companies which they work it would be helpful to extend the employee buy-out relief so that all new employees in an employee controlled company have the chance to make use of the relief upon joining. The relief might be extended, for example, to all employees within 12 months of taking up employment within an ECC. This would be helpful in preventing the creation of different categories of employees and would reduce discrimination between employees in ECCs and their counterparts in close companies or partnerships. This would also avoid a situation where growth is slowed down unnecessarily because new members are unable to obtain as many shares as existing members, unless an ECC was prepared to revert to being a conventional company.

2. It would also be helpful to those employees who wish to take over and run their companies if the present definition of an employee controlled company could be enlarged to include those where the shares are owned both by the employees themselves and by a trust which holds the shares on behalf of the employees. At present buy-out reliefs are only available in circumstances where there is a clear right to individual ownership within a trust. This would also be of particular benefit in circumstances where the shares were given to a trust at below market value to ensure that the capital base of the business did not become weakened by shareholders seeking to realise any immediate gain or by the need to buy and sell shares from those leaving or joining at market price to ensure that employee control did not become diluted.

3. Employee controlled companies are effectively prohibited from making use of the Employee Share Ownership Schemes under the 1978 Finance Act because they issue different classes of shares to employees and outside investors. This arises from the necessity to ensure that employee shares are redeemable and that the shares can therefore be retained on the retirement or resignation of an employee and that new recruits are therefore able to "buy in" into the business. If external finance in a form of equity investment is being raised, for example in a management buy-out, two classes of shares are automatically created within one class inevitably being redeemable. While it would not be right to introduce an advantage to ECCs which other businesses could not make use of this might be avoided if all shares issued by an ECC could ~~not~~ be classified as being of one type for the purposes of the 1978 legislation so long as the only difference was that the employee was obliged to sell his share back to the company on his retirement. This proposal has been made on a number of occasions by the cooperative movement and it could be a useful means of ensuring that the impetus behind the recent popularity of employee share ownership is not reduced. A particular concern is that if the shares were all of one class and freely tradeable, it would not be clear at any one time whether the business remained in control of the employees.

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4. At present ECC's benefit from a concession which exempts the owner from capital transfer tax liability if his shares are donated to a trust which owns 50% or more of the shares within 12 months of the donation. However if some shares change ownership in this way but the remainder are brought back by the company at less than their market price because the owner is anxious to hand over the company to the employees, a CTT liability arises. While any extension of the present exemption may involve a risk that value could be passed from one shareholder to another with no CTT liability this could be overcome by, for example, restricting the relief to circumstances where all directors sold their shares at the same time at a price which represented less than their full market value. Such a change would be helpful in encouraging the creation of ECCs and would provide those who have built up the business with an important mechanism by which he could hand it over to the employees without incurring any adverse tax liability. This would allow the Owner of the business to hand it over to the employees and still retain some value for himself.

5. In order to further improve the climate for widening share ownership among employees another small but nonetheless helpful improvement would be an upward adjustment to the allocation limits under the 1978 Finance Act Employee Share Ownership Schemes which were last changed in 1983.