Business Expansion Scheme

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Author: Antony Seely
Business & Transport Section

The Business Expansion Scheme (BES) was introduced in 1983 to increase the availability of finance to small firms, replacing the more restrictive Business Start-up Scheme introduced two years before. Originally the BES was intended to tackle the problems of business start-ups attracting investment, though in 1988 the scope of the scheme was extended to include investment in private rented housing. This change resulted in a substantial growth in BES investments, but it was also clear that the scheme was being exploited as a means of tax avoidance – and in his 1992 Budget speech the then Chancellor, Norman Lamont, announced the end of the BES from 31 December 1993.[1] Commentators often refer to the history of the scheme when discussing the difficulties faced by governments who wish to use the tax system to improve the reach or efficacy of business investment.

This note gives a short history of the scheme.

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A. Introduction of the BES

The Business Expansion Scheme (BES) provided tax reliefs for individuals who subscribed for shares in unquoted trading companies; that is, companies whose shares are not dealt in on the Stock Exchange or the Unlisted Securities Market. The BES was introduced in 1983, and it succeeded the more restrictive Business Start-up Scheme (BSS) launched in 1981. The then Chancellor Geoffrey Howe – now Lord Howe – announced the launch of the BSS in his 1981 Budget, arguing that "the individual private investor has for many years had little encouragement" to invest in business start-ups, and the scheme would "be a striking incentive to channel investment into small businesses."[2] In his 1983 Budget Lord Howe proposed a "major extension" of the scheme. Under the BSS outside investors were entitled to income tax relief at their highest rate on up to £10,000 (raised to £20,000 in 1982) invested in a new or recently formed unlisted company. By contrast, the BES would cover established unquoted companies as well as new businesses, and the maximum annual investment allowable for tax relief would be increased to £40,000. The Chancellor also announced that the scheme would

1 HC Deb 10 March 1992 c755
2 HC Deb 10 March 1981 c781

run to April 1987 – rather than April 1984, which had been the proposed lifetime of the BSS. He went on to give his reasons for this change:

> [These] proposals will transform the position of unquoted trading companies seeking outside equity. It is a further move towards removing the bias in the tax system against the personal shareholder, and a further measure to encourage wider share ownership. By concentrating help on those companies which do not have ready access to outside capital the scheme will assist many more small and medium companies to realise their undoubted potential for growth.[3]

The main features of the BES as introduced in 1983 were as follows. Generally shares had to be held for a minimum of five years for relief to be claimed on investments up to £40,000 a year. Income tax relief was given at the individual's highest rate of income tax. Relief was not given where the individual, along with his associates, owned more than 30 per cent of the company's equity or its assets on a winding up. Neither the investor nor any associate could be an employee or paid director of the company. Provided the shares in question were held for at least five years, no capital gains tax was charged on the profit made on the disposal of these shares.

When Lord Howe first announced the BSS he noted that the scheme would "relate only to genuine new business enterprises of the kind I have in mind" and that there would be "strict rules to ensure that it is not used for investment in financial or passive operations, or for tax avoidance."[4] However, many of the changes made to the BES since its launch were designed to frustrate attempts by taxpayers to use it for avoidance purposes, and to steer the scheme back to its original purpose of raising equity capital for high risk ventures. A short summary of these changes over its lifetime is given below:

The <u>1984</u> Budget excluded farming as a qualifying trade under the scheme. Companies formed to carry out research and development were included in <u>1985</u>, but ventures which primarily involved property development were excluded. In <u>1986</u>, all companies holding more than half their net assets in the form of land and buildings were excluded, as were companies whose "main purpose is to invest in objects, such as fine wines, whose value may be expected to rise over time." At the same time, companies engaged in the chartering of UK-registered ships were admitted to the scheme. Also from 18 March 1986, BES share issues were made free of capital gains tax on their first sale. The Chancellor announced in his 1986 Budget speech, that the BES would not end in April 1987 as originally planned but would continue indefinitely. In <u>1987</u>, the Chancellor permitted people investing in the first half of the tax year to claim part of the relief against the previous year's income to prevent too much end-year bunching of BES investments.

The <u>1988</u> Budget announced major changes to the scheme. First, a limit of £500,000 was placed on the amount any company could raise under the BES in any one year. This was to 'target' investment better on newer and smaller schemes. The limit for the ship chartering industry was set at £5 million because of its "special circumstances." Second, the BES was extended to include companies specialising in letting residential properties on the new assured tenancy basis. In this case, too, the annual investment limit was set at £5 million.

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[3] HC Deb 15 March 1983 c154
[4] HC Deb 10 March 1992 c755

The 1989 Budget closed a loophole whereby it had been possible to obtain double tax relief, on both the interest on money borrowed to buy shares in a close company and on the use of that money to invest in a BES. Two changes were made in the 1990 Budget. The ceiling on the amount of finance which most BES companies can raise was increased from £500,000 to £750,000 and the "locality rule" was abolished. This meant that a dwelling would not be excluded from a BES letting residential property if it increased in value beyond the £85,000 limit for each unit (£125,000 in greater London) simply as a result of improvements in their locality. In 1992, the Chancellor made it easier for the BES to be used for mortgage rescue schemes, where owner-occupiers in difficulties wished to stay in their homes as assured tenants.

B. The extension of the BES to private rented accommodation

As noted, in the 1988 Budget the then Chancellor Nigel Lawson announced that special provision would be made to allow investment under the BES in private rented housing as well as in trading companies. He set out his reasons for this change in his Budget speech:

> For years, the shortage of private rented accommodation has been an obstacle to labour mobility. The Government's proposals to deregulate new rents … will, over time, substantially increase the supply of housing for rent … But this will not happen overnight, and there is a case for a special incentive to speed up the process in the early years. I therefore propose to extend the business expansion scheme to include companies specialising in the letting of residential property on a the new assured tenancy basis. The BES is well suited to this task. Since full tax relief is given immediately, it should bring forward new investment straight away. The limit for this type of investment will be £5 million a year for any one company. Since the relief is specifically designed to provide an extra stimulus in the early years of deregulation, it will run only for investments made before the end of 1993. This change will powerfully reinforce the impact of decontrol is reviving the private rented sector of housing in Britain.[5]

However in the late 1980s, the buying and renting of housing was a relatively low risk business, compared to the other types of business that unquoted companies were engaged in. The use of assured tenancy schemes - where a qualifying company could buy houses, rent them for five years before selling, providing investors with a tax-free capital gain - gave individuals a relatively secure method for making tax free profits, at least before the slump in property prices in the recession.

As a result investment through the BES came to be dominated by this one sector. The annual amount invested through the BES rose strongly, from £210m in 1987-88 up to £421m in 1988-89. Moreover, 87% of this investment was in companies in the private rented sector. Indeed, the share of BES investment in this sector continued to grow. In the last year of the scheme's existence – 1993-94 – a total of £960m was invested of which 98% was in companies dealing in private rented housing.[6]

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5 HC Deb 15 March 1988 c1002
6 *Inland Revenue Statistics* 1995 edition p81

The reputation of the BES as a vehicle for tax avoidance was not improved by the use of "loan back" schemes which appeared in 1992. Under these schemes, an investor subscribed for shares in a BES company, paying 100 pence for each share. If he or she was a higher rate tax payer, they obtained tax relief at 40%, cutting the effective cost of the share to 60 pence. After a short period of time, say six months, the investor secured a loan on the basis of their BES shareholding, usually from the bank or building society which had set up the BES company, equivalent to, say, 72 pence per share. The loan was often "non-recourse." This meant that at the end of the BES' five year life, the investor would have nothing further to pay if the value of the shares fell short of the amount of the loan together with the interest that had accrued on it. A higher rate tax payer making the maximum allowable investment of £40,000 in a loan-back BES received £4,800 tax-free (12 pence on each share) for tying up their capital for only six months.[7]

Furthermore, the track record of those companies which had benefited from the scheme was not especially good. One piece in the *Financial Times* estimated that around half of the trading companies funded by public prospectus issues or collective funds between 1983 and 1994 had failed.[8] This piece also quoted a study of the BES carried out by the Small Business Research in 1988. This found that the take-up rate of the BES was low compared to other sources of equity finance, and that although the scheme was intended largely to benefit high technology businesses, the main recipients were in service sectors or in asset related businesses, "reflecting the attraction of the BES as a tax shelter for higher rate taxpayers with a predominant concern for security rather than risk."[9] Moreover, the performance of assured tenancy companies rose and fell with the property market, leaving many BES investors facing a substantial loss by the early 1990s:

> Many private investors were blinded by the tax benefits and failed to examine how safe their investment would be. Thousands were attracted by companies investing in apparently safer property assets, where typical returns of 17 per cent were cited (assuming a 10 per cent annual rise in house prices). The rest of the gain was the result of the BES tax break ... Many of those investing in assured tenancy companies expected to be able to cash in their shares after five years, when the gain on the sale would be exempt from capital gains tax. In reality, the property bubble burst and investors discovered the true risk of their early BES investments. With no market existing in BES shares, investors could not cut their losses when property prices began to fall.[10]

At the time of the 2003 Budget, the Government commissioned Kate Barker – a member of the Monetary Policy Committee – to conduct a review of issues affecting housing supply in the UK. In her interim report Ms Barker noted that previous governments had tried to use the tax system to encourage investment in this sector, notably with the BES, but this had not

7 "How the wealthy take money from the state", *Financial Times*, 17 March 1993
8 "Farewell, then, to the BES", *Financial Times*, 2 January 1994
9 Colin Mason et al., *Closing the Equity Gap? An assessment of the Business Expansion Scheme*, Business Research Trust 1988
10 "Dreams of gold that crumbled to dust", *Financial Times*, 5 August 1995; see also, "A tax dream that failed", *Guardian*, 14 September 1996

been a success; indeed the scheme "was widely seen as a costly deadweight loss to the Exchequer that achieved few of its original aims."[11]

C. Abolition of the BES

In his 1992 Budget speech the then Chancellor Norman Lamont confirmed that the BES for assured tenancies would not be extended beyond 31 December 1993. He went on to announce that the BES itself would also be abolished at this time:

> When my right hon. and learned Friend the Member for Surrey, East (Sir G. Howe) introduced it in 1983, the venture capital industry was in its infancy, and there was concern that the investment needs of small firms were not well understood and provided for. The BES has been extremely successful. Over £2 billion has been raised and invested in qualifying schemes of all kinds. And Britain now has a venture capital industry the equal of that anywhere in the world, outside the United States. But the provisions of the business expansion scheme have become ever more complex; and nowadays only a small part of the total invested goes to small businesses.
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> As my right hon. Friend the Member for Blaby (Mr. Lawson) made clear when they were introduced, the BES provisions for assured tenancies were intended to expire at the end of 1993. I have decided that it is unnecessary to continue the business expansion scheme beyond that date, not only for assured tenancies, but for other investments as well. BES will therefore come to an end on 31 December 1993. As I have said, it has fulfilled a useful purpose. But its removal will significantly improve the neutrality of the tax system; and some 45 pages of complex legislation will be removed from the statute book. As a result of my announcement today, there is likely to be some acceleration in investment, which will be welcome. In the long run there will be substantial savings, perhaps £130 million a year.[12]

As Mr Lamont predicted, investment in the BES rose strongly over its last two years, rising from £410m in 1991-92 up to £960m in 1993-94.[13] In his Budget the following year the Chancellor made one last change to the scope of the scheme. To tackle one of a series of "loopholes which have been exploited by people to avoid tax", Mr Lamont announced that no tax relief would be given to new loan back BESs, with immediate effect. As he went on to say, "the BES was set up to encourage investment in small business - not to provide highly subsidised loans for top-rate tax payers".[14] Loan back schemes appear to have been first launched in September 1992, and in the eight months since their introduction, it was estimated they had raised £568m in investment.[15]

In his November 1993 Budget, the Chancellor, Kenneth Clarke, proposed a series of measures to improve the supply of risk capital to small businesses, to deal with a particular problem he believed affected UK industry, arguing that "as a country, we generate plenty of budding entrepreneurs and any number of good inventions and ideas; yet all too often, those ideas stay

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[11] Kate Barker, *Review of Housing Supply: securing our future housing needs – Interim report: analysis*, December 2003 pp 119-120

[12] HC Deb 10 March 1992 c755

[13] *Inland Revenue Statistics* 1995 edition p81

[14] HC Deb 16 March 1993 c178. Legislation to this effect was contained in section 111 of the Finance Act 1993.

[15] "Abolition closes loophole", *Financial Times*, 17 March 1993

on the drawing board as money is channelled instead into the safer larger companies." He announced a number of changes in capital gains tax regime - specifically in reinvestment and retirement reliefs -; consultation on a new type of investment - the Venture Capital Trust -; and, the introduction of a new type of tax relief, designed to encourage investment in unquoted trading companies - the Enterprise Investment Scheme (EIS).[16] The creation of the EIS was not wholly unexpected. There had been a good deal of speculation before the Budget that the Chancellor would introduce a "son of BES" that would avoid some of the drawbacks of its predecessor.[17] Given the BES' history, it was unsurprising that when Mr Clarke announced the introduction of the EIS in November 1993, he emphasised that tax relief would not be extended to private rented housing schemes, as it had under the BES.[18]

In November 2000 Lord Howe of Aberavon gave the annual Hardman Memorial Lecture at the Institute of Chartered Accountants. Lord Howe's theme was tax simplification, and how the legislative process for creating and amending tax law might be improved to reduce the burden the law placed on taxpayers. Lord Howe argued that the formation of tax policy was dominated by two influences: advice from the revenue authorities, and "inspirational input from Chancellors who retain the misguided (and conceited) belief that tax changes can dramatically transform human behaviour":

> I must confess, and emphasise, that much of the complexity of which we complain has arisen from that fundamental misconception. I plead personally guilty, by way of example, to what has been described as "the best example of a behemoth that has never achieved its purpose": the Business Expansion Scheme, introduced in my 1982 Budget. I was warned at the time by the Inland Revenue that it could turn into a huge avoidance loophole. And so indeed it did. But I was at the same time urged in the opposite direction by a working party, which I had established specifically to design a more "enterprise-friendly" tax structure. So I consciously decided to accept the fiscal risk for the sake of the hoped-for structural reward. And I was wrong. I shall never forget the lesson.[19]

The history of the BES has been discussed more recently in the context of the Government's proposed reforms to capital gains tax, first announced in the Pre Budget Report in October 2007.[20] In spring 2007 private equity funds and the taxation of their executives came under intense public scrutiny. One concern was the use of taper relief on business assets to mitigate the CGT charge on 'carried interest' – so that executives paid tax on this type of gain at 10%. In an interview with the *Financial Times* in early June, Nicholas Ferguson, a leading figure in the industry, said, "any common-sense person would say that a highly paid private equity executive paying less tax than a cleaning lady or other low-paid workers … can't be right."[21] Writing in the paper at this time Martin Wolf argued, "Mr Brown [when Chancellor] thought he could induce people to do what he wanted. He has, instead, created

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16 HC Deb 30 November 1993 c934

17 "Small business sector steps up its demands", *Financial Times*, 11 November 1993

18 HC Deb 30 November 1993 cc 935-936. Legislation to effect the EIS was contained in section 137, schedule 15 of the *Finance Act 1994*.

19 Lord Howe, "Simplicity and stability: the politics of tax policy", *Hardman Memorial Lecture* 9 November 2000. This is available on the ICTA website at: http://www.icaew.com/index.cfm?route=133415

20 For details on this issue see, *Capital gains tax (CGT) : reforms from April 2008*, Library standard note SN/BT/4652, 22 April 2008

21 "Buy-out tax rate is 'lower than a cleaner's'", *Financial Times*, 4 June 2007

loopholes through which the well-advised rich have ridden coaches and horses."[22] A further article noted that the exploitation of taper relief by private equity was not an "isolated example" (*emphasis added*):

> Time and again, a tax break that is big enough to make a difference to the behaviour of entrepreneurs and investors ends up being exploited in a way that was not intended. Tax officials are left scrambling to close loopholes after too much money ends up subsidising low-risk assets, supporting businesses with no intention of expanding or cutting the tax bills of wealthy individuals. Meanwhile, there is no clear evidence that the tax incentives serve the purpose for which they were originally intended. Judith Freedman of the Oxford University Centre for Business Taxation says: "The UK has done a lot more on this front than other European countries. But it is built more on belief than on evidence."
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> The idea that the tax system should be used to influence people's behaviour has been a prominent feature of Gordon Brown's time at the Treasury. "The tax system sends critical signals about the economic activities a society wishes to promote and deter," he declared in 1997 … Difficulties have dogged efforts by successive government to improve incentives for investors in small, high-risk companies. The history of such tax breaks, which goes back more than 25 years, is one of repeated skirmishes between the UK's Revenue & Customs and tax advisers, as investors have tried to minimise the risks of the investments that attracted concessions.
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> *The most notorious examples arose from the Business Expansion Scheme, which was finally withdrawn in 1994 after a crescendo of criticism, most notably from the Labour party. Its demise came after a flood of schemes offering high guaranteed returns from property investments left even its champions struggling to justify the generous tax breaks.* It was succeeded by venture capital trusts and enterprise investment schemes, which were bound by more restrictions. Even so, the government has felt obliged to tighten the rules even further to focus them more firmly on smaller and riskier companies.
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> Mr Brown's boldest attempt to use the tax system to encourage the investment of time and money in growing companies was through a sweeping reform of capital gains tax. Introducing taper relief, which reduces capital gains tax over time, was attractive because of its simplicity: it automatically focused incentives on successful, high growth companies. In a series of concessions that expanded the scope and generosity of the relief, the Treasury created a system that was "one of the most favourable capital gains tax regimes in the industrialised world". Effective tax rates for business assets was just 10 per cent after two years.
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> Taper relief has ended up costing the Treasury much more than expected, having risen more than tenfold over the past four years. In 2006-07, it cost £6.02bn, much more than the £3.9bn collected in capital gains tax. Nobody knows, however, how much extra capital gains tax would be collected if the rules were tightened up. Champions of the new capital gains tax regime say that its real value lies in persuading entrepreneurs to remain in the UK after they sell their companies. But researchers are unclear whether it has succeeded in one of its original goals of creating an incentive for more workers to start businesses. A survey last year by PwC, the professional services group, found very little awareness of taper relief and

[22] "A new chancellor and a new chance", *Financial Times*, 29 June 2007

other incentives among small companies. Tax simply does not come into the thinking of most entrepreneurs, according to Rebecca Harding of London Business School. "There are some fantastic measures out there for setting up a business, but unless people have a really good accountant they don't understand what the benefits are."

Pressure is mounting for the rules to be revised to limit their generosity or focus the relief more narrowly on small, growing businesses. One of the most lasting consequences would be to strike a blow to the concept of using the tax system to promote enterprise. It would be an acknowledgement of the immense difficulty of designing incentives that are fair, targeted and generous enough to make a difference.[23]

[23] "Tax loopholes leave private equity investors to clean up", *Financial Times*, 11 June 2007