19

Small Business Taxation

The diverse nature of small business organizations requires careful consideration in the design of the tax system. Small businesses include both self-employed sole traders, who are taxed as individuals, and small incorporated firms, which are taxed as companies. Many economic activities could be carried out either by an employee working for a company or by a self-employed individual. Similarly, many activities could be undertaken either by a self-employed person or by an individual who is the owner, manager, and sole employee of his own small company. If the tax treatment of the income derived from these activities differs substantially depending on the legal form in which they are conducted, the tax system is likely to have a significant impact on the ways in which small businesses are structured. Without good reasons for favouring one legal form over another, such distortions should be avoided. This requires both a similar treatment of income from employment and self-employment within the personal tax system and a similar treatment of income derived from small companies and from small unincorporated businesses within the tax system as a whole. The latter, in turn, requires some alignment of corporate and personal tax rates; while trading profits of unincorporated businesses are taxed at the proprietor's personal income tax rate, profits generated by small companies are taxed at the relevant corporate income tax rate, and are also subject to personal taxation when paid out to owners in the form of dividends and when any capital gains are realized through the sale of all or part of the firm.

As well as this variety of legal forms, a second fundamental reason why small businesses present important challenges for tax design is that income derived from small business activities generally reflects a mix of rewards for labour supplied by those who work for the business and returns to capital supplied by those who invest in the business. In the case of a small, owner-managed company, for example, the owner-manager has considerable discretion over the way in which he derives taxable income from the firm. Simply by choosing to pay himself a lower salary, he can increase the profits of the firm; and by choosing to distribute these profits, he can increase the share of his income that comes in the form of dividends. If the tax treatments of income in the form of wages and income in the form of distributed profits are substantially different, the tax system is likely to have a significant impact on the ways in which small business proprietors choose to take their remuneration. If, at the margin, the taxation of distributed profits is lower than the tax rate that applies to labour income, this ability straightforwardly to reclassify income for tax purposes can result in owner-managers of small firms paying less tax than self-employed individuals or ordinary employees who perform similar tasks for the same gross remuneration. This may also favour more economic activity being undertaken by small firms and less activity being undertaken by employees of larger firms, who cannot reduce their tax liabilities so easily. Avoiding these kinds of inequities and distortions will again require appropriate alignment of personal and corporate tax rates.

A separate question is whether the tax system should deliberately seek to increase the share of small businesses in overall economic activity. This could be appropriate if there are positive externalities or spillover benefits associated with activities undertaken by small businesses—for example, some small businesses may be particularly innovative, generating improvements in products or processes that can subsequently be adopted by other firms. A serious difficulty with this kind of argument, however, is the enormous heterogeneity found within the small business sector. Many small businesses may not be innovative at all and it is not clear that small size per se provides a good 'tag' for the kinds of activities (for example, innovation) that government policies may sensibly want to promote.

A different argument is that the market outcome may generate too few small businesses, or allocate too little activity to the small business sector, relative to the efficient level, as a result of barriers to entry or obstacles to growth within small businesses. For example, limited information about growth prospects of small firms, combined with high risk of failure, may make it prohibitively expensive for some small firms to raise debt or equity finance for expansion. While such financing constraints may be particularly important for small enterprises, it should be noted that there may be better policy responses than simply providing tax breaks for all small businesses. For example, loan guarantees or direct funding for particular activities may allow government support to be targeted more efficiently than through tax measures. The wide variety of firms within the small business sector again suggests that blanket support for all small businesses is unlikely to be an efficient policy response. If, for example, we were convinced that there is too little investment by small businesses as a result of financing difficulties, this would tend to favour fiscal support for investment by small businesses (for example, through enhanced investment allowances), rather than preferential tax rates for all small businesses, regardless of whether they want to invest or not.

A further argument is that complying with the tax system itself tends to impose disproportionately high costs on smaller businesses. All else being equal, some potential entrepreneurs may choose employment over self-employment if the additional burden of filing business tax returns is sufficiently high. Smaller firms may also be placed at a competitive disadvantage compared with larger firms by higher costs of tax compliance, relative to their size, and the scale of this disadvantage will tend to increase with the complexity of the tax system. There is certainly evidence that complying with the tax system involves fixed costs that are more significant for smaller businesses.[1] The extent to which this justifies preferential tax treatment for smaller businesses and, if so, what form this should take are more controversial. In particular, it is not clear that differences in compliance costs rationalize a lower tax rate on profits below some threshold level. Among the firms with profits below the threshold, this approach provides the least advantage to those with the lowest profits—yet it is far from clear that compliance costs will be lower in years when profits are temporarily low. It has also been noted that smaller businesses may have greater opportunities for tax avoidance or non-compliance—for example, by converting labour income into more lightly taxed forms of capital income, as discussed above, or by treating some forms of personal consumption as tax-

[1] See e.g. Sandford, Godwin, and Hardwick (1989) and Evans (2003).

deductible business expenses.[2] While the issues of differential compliance costs and differential avoidance and evasion opportunities are logically distinct, they both bear on how the size distribution of businesses may be influenced by the presence of the tax system. Ideally, both distortions should be reduced by simplifying the structure of the tax system and aligning the tax treatment of different sources of income.

Another feature of the tax system that may affect smaller and larger firms differently is the asymmetric treatment of profits and losses. When taxable profits are positive, they are taxed, but when taxable profits are negative, they generally do not attract a full tax rebate. Losses may be 'carried back' to offset against positive profits made in a limited number of previous years, which may produce an immediate tax repayment if the firm had sufficiently high positive taxable profits during the relevant period. When this carry-back provision is exhausted, however, losses can usually only be 'carried forward' to set against future taxable profits. When losses are carried forward, there is generally no compensation for the time delay before they can be used to reduce future tax payments. This implies that the value of future tax reductions associated with an additional £1 of tax losses today may be considerably lower than the tax paid on an additional £1 of positive taxable profits—particularly if there is a significant risk that the firm will cease trading before these tax losses can be used.

This asymmetric treatment of losses can discourage risk-taking by firms, since the government shares in the firm's pay-off if the investment is a success but does not fully share in the downside risk.[3] This effect may well be more important for smaller firms than for larger firms, partly because younger firms are less likely to have a past history of positive taxable profits than established firms and partly because more diversified firms are more likely to be able to offset losses on a new investment against positive taxable profits from their other operations.[4] While correct, this consideration again does not justify a preferential tax treatment for all small businesses. A more appropriate response in this case would be to allow a more symmetric

[2] See e.g. Slemrod (2004).

[3] Cullen and Gordon (2007) provide empirical evidence that this asymmetry has important effects on the behaviour of entrepreneurs in the US.

[4] For owner-managed firms, an offsetting consideration may be the owner's ability to convert losses into a lower salary, which permits lower tax payments immediately.

treatment of tax losses for all firms. This could be achieved either by permitting immediate rebates to be claimed in a wider range of circumstances, or by allowing tax losses to be carried forward with an interest markup to compensate for the delay before they can be utilized.

There may be some justification for targeted forms of tax support that would tend to favour some kinds of smaller businesses—for example, those undertaking significant expenditures on investment or research and development—more than a typical large company. However, it seems difficult to rationalize the nature and scale of generalized tax advantages for all small businesses that we see in the UK and in many other developed countries. The next section outlines the most significant of these tax breaks for small businesses in the current UK system. We then consider how a reformed tax system could provide a more neutral treatment of different forms of business activities, both by size and by legal form.

19.1. SMALL IS BEAUTIFUL, OR AT LEAST TAX PRIVILEGED

Over the last decade, the UK tax system has departed from the principle of applying similar tax treatments to substantively similar sources of income to a quite extraordinary degree. The most remarkable example was the zero rate of corporation tax, which applied to the first £10,000 of taxable company profits in the tax years 2002–03 and 2003–04. Combined with other features of the UK tax system—notably, the personal allowance below which personal income tax is not paid, the effective absence of personal income tax on dividend income for basic- (and lower-) rate taxpayers, and the absence of social security contributions on company dividends—this allowed the owner of a small company to earn up to £14,615 per year, in salary and distributed profits, free of any direct taxation. The entirely predictable response to this tax advantage was a sharp increase in the number of small businesses choosing to incorporate and operate as small companies.[5] Initially hailed by the government as a policy to promote enterprise, this response by small

[5] This behavioural response to the zero rate of corporation tax was widely predicted before the policy was implemented; see e.g. Blow et al. (2002). Crawford and Freedman (2010) provide evidence on the unusual extent of incorporations in the UK during this period.

business proprietors subsequently led to the same policy being characterized by the same government as encouraging unwarranted tax avoidance. The zero rate of corporation tax was first restricted to undistributed profits, and finally withdrawn.

Significant tax advantages for small businesses remain within the UK tax system. Table 19.1 compares the total amount paid in income tax and National Insurance contributions (NICs) by an individual who produces output valued at £400 per week, operating either as an employee, as a self-employed person, or as the owner-manager of a small company. Self-employed individuals pay significantly lower NICs than employed individuals, particularly when both employer and employee NICs are taken into consideration. This advantage is partially offset by lower entitlements to some state benefits for self-employed individuals. Nevertheless, actuarial estimates suggest that the value of additional social security benefits for a typical employee is substantially lower than the additional cost imposed by these higher NICs.[6] The absence of employer NICs results in slightly higher taxable income and hence personal income tax for the self-employed individual, but the net effect remains a significant inducement for individuals to choose self-employment over employment, in situations where they would otherwise be indifferent.

Table 19.1 also illustrates how the absence of National Insurance contributions on both company profits and company dividends provides opportunities for even greater savings for owner-managers of small companies. By paying themselves a wage below the earnings threshold for National Insurance (and also below the personal allowance for income tax), they can avoid any income tax or NICs on this component of their remuneration. By taking the rest of their remuneration in the form of dividend income paid out of company profits, the only tax paid is corporation tax on these profits. In the example, corporation tax is paid at

[6] For example, HMRC estimates the net cost to the government of reduced National Insurance contributions for the self-employed to be £1.5 billion in 2009–10. (Source: HM Revenue and Customs, 'Tax Expenditures and Ready Reckoners', http://www.hmrc.gov.uk/stats/tax_expenditures/menu.htm, table 1.5, updated June 2011.)

Table 19.1. Total tax and National Insurance contributions, by legal form, 2010–11 (£ per week)

	Employment	Self-employment	Small company
Value of output	400.00	400.00	400.00
Employer NICs	32.91	0	0
Gross wage/income	367.09	400.00	110.00
Employee NICs	28.28	0	0
Self-employed NICs	0	25.60	0
Taxable profits	0	0	290.00
Corporation tax	0	0	60.90
Taxable income	242.57	275.48	339.10
Income tax	48.51	55.10	0
Total NICs	61.19	25.60	0
Total tax	48.51	55.10	60.90
Total tax and NICs	109.70	80.70	60.90
Net income	290.30	319.30	339.10

Notes: The example uses: contracted-in Class 1 NIC rates of 12.8% for employers and 11% for employees; an earnings threshold of £110 per week; for the self-employed, the Class 4 contribution rate of 8% plus Class 2 contributions at the flat rate of £2.40 per week; a personal allowance of £6,475 per annum; the basic rate of income tax of 20%; and the small companies' rate of corporation tax of 21%. The individual is assumed to have no other sources of income.

Employment

Employer NICs are calculated as 12.8% of £(400–32.91–110), giving 12.8% of £257.09, or £32.91.

Employee NICs are calculated as 11% of £(367.09–110).

Taxable income is calculated as £367.09 minus £124.52, allocating a fraction ($^1/_{52}$) of the annual personal allowance to each week.

Income tax is calculated as 20% of taxable income.

Self-employment

Self-employed NICs are calculated as 8% of £(400–110), plus £2.40.

Taxable income is calculated as £400 minus £124.52, allocating a fraction ($^1/_{52}$) of the annual personal allowance to each week.

Income tax is calculated as 20% of taxable income.

Small company

The wage of £110 per week incurs neither employer nor employee NICs.

Taxable profits are calculated as £400 minus £110.

Corporation tax is calculated as 21% of taxable profits.

Taxable income comprises wage income of £110 per week and dividend income of £229.10 per week (with profits after corporation tax paid to the owner as a dividend).

Wage income of £110 per week is below the personal allowance, leaving no income tax to pay. Income tax is formally charged at 10% on dividend income for basic-rate taxpayers, but this is sheltered by the dividend tax credit, leaving no income tax to pay.

the small companies' rate of 21% on taxable profits of £290 per week.[7] For a basic-rate taxpayer, dividend income is formally taxed at 10%, but this tax liability is wholly offset by the dividend tax credit, leaving no personal income tax to be paid.[8] Moreover, no NICs are charged on dividend income. By taking a substantial share of his remuneration in the form of dividends paid out of company profits, rather than in the form of wages or salary, the owner-manager of a small company can thus enjoy a substantial saving in combined direct tax and National Insurance contributions, relative to both a self-employed individual with an unincorporated business and, still more, relative to an employee.

This example oversimplifies in some respects. For example, company dividends will generally be paid out less frequently than wages and salaries, which may limit the extent to which some small company proprietors can take advantage of this tax saving. Joint ownership of small companies may also restrict the ability of individuals to arrange their remuneration in the most tax-efficient way—although, conversely, in the case of joint ownership by couples, there are further opportunities to shift taxable income from individuals who pay income tax at a higher rate to individuals who pay income tax at the basic rate. Owner-managers of small companies may also prefer to pay minimum levels of National Insurance contributions, in order to maintain full entitlement to state social security benefits. Nevertheless, there remains a substantial tax advantage associated with reducing the share of income taken in the form of wages or salary and increasing the share of income taken in the form of distributed profits.

The advantage of being self-employed or the proprietor of a small company over being an employee also applies to individuals who are higher-rate taxpayers. Table 19.2 reports overall marginal tax rates, accounting for both direct taxes and National Insurance contributions, associated with a small increase in income (before both income tax and National Insurance). These are shown for each of the legal forms considered in Table 19.1 and for

[7] From April 2010, the preferential small companies' rate of corporation tax has been relabelled the small profits rate of corporation tax, which is more accurate if less elegant.

[8] This receipt of dividend income does not affect the (non-)taxation of the individual's wage income in our example, as the personal allowance is used against labour income before it is used against other sources of income.

Table 19.2. Marginal tax rates, by legal form, 2010–11

	Employment	Self-employment	Small company
Basic rate	39%	28%	21%
Higher rate	48%	41%	41%

Notes: The table shows the additional tax and National Insurance contributions payable on an additional £1 of income (before tax and NICs), expressed as a percentage of this additional £1.

Basic rate

For basic-rate taxpayers, the rates used are the same as in Table 19.1.

Higher rate

For higher-rate taxpayers, the rates used are: employer NICs at the contracted-in rate of 12.8%; employee NICs at the contracted-in rate of 1% for earnings above the upper earnings limit; the higher rate of income tax of 40%; self-employed NICs at the Class 4 rate of 1% for profits above the upper profits limit; and the small companies' rate of corporation tax of 21%. Dividend income is taxed at the formal rate of 32.5% and the effective rate of 25% (after accounting for the dividend tax credit).

both basic-rate and higher-rate taxpayers.[9] Higher-rate taxpayers pay some personal income tax on dividend income,[10] which reduces the advantage of incorporation relative to self-employment.[11] Compared with employment, there remains a substantial net saving for either form of small business activity, principally in the form of lower National Insurance contributions.

These National Insurance advantages apply generally for all small businesses. Other tax savings may be more significant for particular kinds of small businesses. Owners of small companies who plan to take much of the return on their investment in the form of a capital gain, by selling some or all of the shares in the firm to an outside investor, rather than in the form of

[9] The marginal tax rates shown for basic-rate taxpayers in Table 19.2 can be derived by increasing the value of output used in Table 19.1 from £400 per week to £401 per week and repeating the calculations. The marginal tax rates shown for higher-rate taxpayers can be obtained similarly, using the rates indicated in the note to Table 19.2.

[10] Each £1 of dividends received carries a tax credit of £0.11. For higher-rate taxpayers, the 'grossed-up' value of £1.11 is taxed at 32.5%, giving a tax liability of £0.36. The dividend tax credit is set against this liability, giving a tax payment of £0.25. For basic-rate taxpayers, the 'grossed-up' value of £1.11 is taxed at 10%, giving a tax liability of £0.11 before the credit, and hence no tax payment.

[11] The marginal tax rate of 41% for a higher-rate self-employed individual is simply the NIC rate of 1% plus the income tax rate of 40%. The marginal tax rate for a higher-rate small company proprietor taking additional income in the form of dividends is 40.75%, obtained as $0.21 + (1-0.21)\times 0.25 = 0.4075$, where 21% is the small companies' rate of corporation tax and 25% is the effective tax rate on dividend income.

dividend income, may further benefit from preferential tax rates on capital gains. Owners who are eligible for 'entrepreneur's relief' are currently taxed at only 10% on qualifying capital gains, although nominal capital gains are taxed, with no allowance for general price inflation.[12] Investors in small companies that qualify for special tax treatments such as the Enterprise Investment Scheme, or investments channelled through tax-favoured Venture Capital Trusts, may benefit from very generous personal tax treatments of the returns on their investments—although schemes like these at least have the virtue of being targeted towards specific types of small businesses where arguably there are particular reasons for this fiscal support.

The difference between the rate of corporation tax charged on 'small profits'—21% in 2010–11—and the standard rate of corporation tax charged on higher profits—28% in 2010–11—has narrowed in recent years.[13] This gap is due to narrow further, with announced reductions in the standard rate to 23% by 2014–15 and in the small profits rate to 20% from 2011–12. As discussed in the introduction to this chapter, it is difficult to think of the problem to which a preferential tax rate for all small companies provides an appropriate solution. A further disadvantage of the UK approach is that by eliminating any benefit of the small profits rate for companies with annual profits above £1.5 million, the system imposes a higher marginal rate of corporation tax on companies with annual profits between £300,000 and £1.5 million. This form of support for small companies thus introduces a disincentive for companies below the threshold to expand, adding a fiscal barrier to growth in a way that appears very poorly designed if the intention is to offset other disadvantages faced by expanding small companies.

The rationales for taxing company profits are quite different in the case of large corporations and smaller companies. For big businesses, much of the impact of corporation tax is likely to be shifted onto domestic workers, as we discussed in Chapters 17 and 18. The main rationale for a source-based

[12] This treatment may result in capital gains being more attractive than dividend income for higher-rate taxpayers, who pay income tax on dividend income, though not for basic-rate taxpayers. Chapter 14 provides more discussion of capital gains taxation in the UK.

[13] The small profits rate applies to taxable profits below £300,000 per year. The standard rate applies to taxable profits above £1,500,000 per year. Between these two thresholds, a higher marginal rate of corporation tax applies, so that all benefit of the small profits rate is clawed back from firms with annual taxable profits above £1,500,000.

corporate income tax is then to tax location-specific economic rents, and the appropriate tax rate will depend on the mobility of rent-generating business activities and on corporate tax rates charged in other countries. For smaller companies, a more important rationale for corporation tax is to protect the personal tax base, and the key is then to align the combined level of taxation implied by taxes on company profits and taxes on personal dividend income (and, in some cases, on capital gains) with those on income from employment and income from self-employment. As we discuss further below, this alignment of tax treatments for income from different sources can be achieved without requiring a special, low rate of corporation tax for smaller companies.

19.2. PROMOTING ENTERPRISE OR TAX AVOIDANCE? A RECIPE FOR COMPLEXITY AND CONFUSION

The taxation of small businesses in the UK over the last decade indicates a tension between the desire of governments to stimulate certain activities associated with particular kinds of small businesses and the concern of governments to protect the personal tax base when large numbers of small businesses take advantage of poorly targeted tax breaks. This conflict was particularly transparent in the curious case of the zero starting rate of corporation tax, as described in Section 19.1. However, the same tension underlies a range of complex anti-avoidance legislation that has been introduced or extended in recent years, with the aim of preventing certain types of small companies benefiting from general features of the tax system. Leading examples include measures aimed at 'personal service companies' or 'managed service companies', where an individual who might otherwise be employed by a larger firm instead sets up a small company which sells the same service to a single client, thereby permitting a substantial saving in National Insurance contributions.

The root cause of this tension is the difference between the overall rates at which income from employment and income in the form of distributed profits from a small company are taxed. The potential saving from converting wages or salary into distributed profits has encouraged a shift of economic activity away from employment within large firms and towards contracting between large firms and small, owner-managed companies.

Whatever one thinks about the economic case for subsidizing particular kinds of small businesses—for example, those that are highly innovative or that have considerable growth potential—it is difficult to rationalize tax advantages on this scale for all small businesses. Evidently, this view underpins the growth of anti-avoidance legislation in the UK.[14] However, by tackling symptoms of the problem, rather than addressing the difference in the rates at which labour income and capital income are taxed, the result has been a dramatic increase in the complexity of the legislation covering these aspects of small business taxation, rather than a coherent solution.

The lessons we draw from this experience are that the overall tax rates applied to income from employment, self-employment, and distributed profits need to be aligned much more closely than they are now in the UK. Any case for fiscal support for particular activities undertaken by small businesses should be reflected in targeted tax advantages for verifiable expenditures that are closely related to those activities, not in preferential tax rates for all small businesses. This support could include, for example, more generous tax allowances for research and development (R&D) expenditures undertaken by small companies than by larger companies (if there is compelling evidence that R&D by smaller companies tends to generate greater spillover benefits, or would otherwise be inefficiently low as a result of high costs or limited availability of finance). Similarly, it could include a more generous corporate tax treatment of investment expenditures undertaken by smaller firms (again if there is compelling evidence of higher social returns than for investment by larger companies), or a more generous personal tax treatment of investments that finance the expansion of some kinds of smaller businesses. There are already examples in the UK tax system of such more sharply focused tax support for R&D and investment by small enterprises, which could be refined or extended in line with developments in the empirical evidence on which they are based. Reducing the bias against more risky investments implied by asymmetric treatment of taxable profits

[14] Crawford and Freedman (2010) provide a detailed discussion of various special measures that have been introduced in the UK to limit the extent to which particular types of small companies can exploit these savings.

and losses has considerable merit in its own right, and would also be particularly beneficial for smaller enterprises.

Innovative small businesses, and those with high growth potential, would continue to benefit from fiscal support of this kind. However, the systematic tendency to shift economic activity away from larger companies, and towards smaller businesses which may have no particular capacity or desire to innovate or expand, would then be greatly reduced. As a result, the need for complex anti-avoidance measures, to prevent small companies being established primarily to take advantage of tax savings, would be considerably reduced. The tax system would also be fairer in its treatment of individuals with different opportunities to convert their income into different forms.

In the remainder of this chapter, we set out a range of possible reforms that would reduce these differences in the tax treatment of income derived from employment, self-employment, or running a small company. We begin by discussing more modest proposals that involve only changes to tax rates, within the broad structure of the current UK tax system. However, we conclude that more radical reform, involving changes to the personal and corporate tax bases that we have outlined in Chapters 14 and 17, would be required to achieve complete alignment of the tax treatments of income from labour and capital across different legal forms. This discussion focuses on reforms to the current UK tax system, but these basic principles could be applied in many other contexts.

19.3. ALIGNING THE TAXATION OF LABOUR INCOME AND CAPITAL INCOME

Closer alignment of the taxation of income from employment and self-employment could be achieved by increasing the National Insurance contributions paid by self-employed individuals towards the combined level paid by both employers and employees in respect of income from employment. Any difference should reflect only the actuarial value of differences in entitlements to state social security benefits, and these entitlement differences should be limited to benefits where it would be administratively difficult to extend full coverage to the self-employed.[15] Alternatively, NICs could be integrated with the personal income tax in one of the ways discussed in Chapter 5, and residual elements of the 'contributory principle' for state social security benefits be replaced by different entitlement rules, with equal treatments of employed and self-employed individuals in so far as this is administratively feasible.

To align the tax treatment of distributed profits with the tax treatment of income from employment, a piecemeal approach would be to introduce a tax on dividends paid by firms and/or on dividend income received by individuals, broadly equivalent to the NICs paid by employers and employees on wages and salaries.[16] Imposing a tax on dividends paid by companies to non-resident shareholders would be constrained by bilateral tax treaties with other countries, while treating resident and non-resident shareholders differently would be constrained by EU Treaty obligations. These factors point to reform of the tax treatment of dividend income received by UK taxpayers as the more promising way of aligning the overall tax rates paid on labour income and distributed profits. This is consistent with the taxation of company profits on a source-country basis and the taxation of personal capital income on a residence-country basis.

In the current UK tax system, higher-rate taxpayers are liable for additional personal income tax on dividend income, which requires higher-rate taxpayers who receive dividends to declare this income on an annual tax return. Basic-rate taxpayers are not liable for additional personal income tax on dividend income, so most basic-rate taxpayers who receive dividends are not required to file annual tax returns. Taxing dividend income received by basic-rate individuals would certainly require more basic-rate taxpayers to file tax returns. However, this would not apply to dividends on shares held in Individual Savings Accounts (ISAs), and there could also be a *de minimis* exemption for annual dividend income under some small amount, below which the tax revenue at stake would not justify the additional administrative and compliance costs associated with completing a tax return. With these arrangements, the main group of basic-rate taxpayers affected

[15] For example, this may be difficult where the level of a benefit payment is related to past earnings.

[16] Our discussion here assumes that National Insurance contributions have not been fully integrated with the personal income tax.

would be proprietors of small companies. With no tax advantage to dividend income, many small business owners could avoid this requirement by choosing to take regular remuneration in the form of wages or salaries, rather than distributed profits.

There are, however, important reasons why simply increasing the personal taxation of dividend income may not be attractive, in the absence of more fundamental reforms to the personal and corporate tax bases. In isolation, increasing taxes on dividend income would raise the rate at which the normal return on equity-financed corporate investments would be taxed. The UK tax treatment of shareholder income is unlikely to have any significant impact on the investment decisions of large corporations, whose shares are traded internationally. However, an increase in the cost of capital for smaller, domestic companies that may be particularly reliant on issuing new equity as a source of investment finance—particularly those where managers and owners may be the same, or closely related, individuals—would be an undesirable side effect of simply aligning the tax rates applied to labour income and distributed profits with no reform of tax bases. Saving behaviour would also be affected, and there may be important equity concerns—for example, in relation to retired shareholders who have saved out of taxed income and would then be faced with additional taxation of their dividend income.

These considerations suggest that full alignment of the tax rates applied to labour income and capital income should be accompanied by significant reforms of the personal and corporate tax bases. The rate-of-return allowance (RRA), which we outlined and discussed in Chapters 13 and 14, would exempt the normal return on capital invested in company shares (outside ISAs) from personal taxation. The allowance for corporate equity (ACE), which we considered in Chapters 17 and 18, would exempt the normal return on equity-financed investments from corporate taxation. The presence of these allowances for financing costs would not affect the marginal tax rates that apply to additional company profits or personal dividend income, so at the margin they would not affect incentives to convert labour income into distributed profits. Importantly, this would allow the tax rates at which personal dividend income is taxed for both basic- and higher-rate individuals to be increased, so as to align the overall tax treatments of distributed profits and income from employment, while at the same time reducing the cost of equity capital for small, domestic firms, compared with the current tax system.[17]

The introduction of an RRA for dividend income and capital gains on company shares within the personal income tax has other advantages, as described in Chapters 13 and 14—notably, avoiding the lock-in effect of a standard capital gains tax, and avoiding the taxation of purely nominal increases in share prices, resulting from general price inflation. Similarly, the introduction of an ACE has other advantages, as described in Chapter 17—notably, eliminating the tax bias in favour of debt-financing of corporate investment, and equalizing the tax treatment of investments in different types of capital, without any need for tax depreciation allowances to closely approximate true depreciation schedules.

In order to align the tax treatment of investments in unincorporated businesses with the tax treatment of investments in companies, it would also be appropriate to allow the RRA within the personal income tax to cover business assets used by sole traders and partnerships. This could be implemented on an optional basis, so that self-employed individuals with few business assets could choose to forgo the RRA, in return for simpler tax reporting (i.e. they could choose to have all their income taxed as labour income, should they prefer this arrangement).

A reformed tax system of this type could eliminate most of the existing incentives for small businesses to adopt particular legal forms purely for tax reasons, and for owner-managers of small companies to take their remuneration in the form of distributed profits rather than wages or salaries. The combinations of tax rates that would be needed to achieve full alignment of the tax treatments of these forms of income would depend on the extent to which National Insurance contributions are integrated with the personal income tax. As an illustration, suppose that NICs were to be fully integrated with the personal income tax, resulting in marginal personal tax rates of around 40% for basic-rate taxpayers and 50% for higher-rate taxpayers. Suppose also that the small profits rate of corporation tax were to be

[17] Standard corporate income taxes tend to raise the cost of capital for equity-financed investments, as explained in Chapter 17. This effect is eliminated by the ACE allowance. In so far as company investment decisions are influenced by personal taxes, the cost of capital for investment financed by issuing new equity is further increased by standard dividend income taxes. This effect can also be shown to be eliminated by the RRA. See e.g. Sørensen (2005).

abolished, with all corporate profits taxed at the standard rate of 28%. In this case, full alignment of marginal tax rates on income from employment, self-employment, and distributed profits would require (effective) personal tax rates on dividend income of around 17% for basic-rate taxpayers and around 31% for higher-rate taxpayers.[18]

Dividend tax credits would play no role in this system, and could be eliminated. Capital gains (or losses) on company shares (held outside ISAs) would need to be taxed at the same rates as dividend income, to align the tax treatment of distributed profits and retained profits. The RRA would be available to set against both dividend income and capital gains, and any unused allowance (i.e. if the sum of dividend income plus capital gains is less than the RRA for the current period) would be carried forward for use in later periods, marked up using a risk-free nominal interest rate. The RRA itself would also be calculated with reference to a risk-free nominal interest rate. As explained in Chapters 13 and 14, a neutral treatment of capital gains and other sources of income from capital is then consistent with taxing nominal capital gains on realization.

Targeted tax advantages for particular types of small enterprises could then be introduced within this system. If, for example, the government wishes to lower the cost of investment for small companies, this objective can be achieved by providing more generous tax allowances for investment spending by small firms. One approach is illustrated by the Annual Investment Allowance, introduced in the UK in 2008–09. In 2010–11, this provides a 100% first-year allowance for the first £100,000 of investment in plant and machinery by all companies.[19] For small firms, this effectively permits all investment in plant and machinery to be deducted from taxable income in the year the expenditure is incurred. This approach could be

[18] In this example, taxing company profits in excess of the ACE at 28% and taxing dividend income in excess of the RRA at 17% for basic-rate taxpayers ensures that any reported profits above the risk-free rate of return that are paid out in the form of dividends are taxed at a combined rate t given by $(1-t) = (1-0.28) \times (1-0.17) = 0.6$, giving an overall tax rate of 40%, in line with the personal tax rate that would be applied to reported income from employment (and to income from self-employment in excess of the RRA on unincorporated business assets). The corresponding calculation for higher-rate taxpayers requires $(1-t) = (1-0.28) \times (1-0.31) = 0.5$.

[19] This will be reduced to only the first £25,000 of investment in plant and machinery from April 2012.

retained within a corporation tax with an ACE allowance. As we discussed in Chapter 17, this expensing treatment is no more generous in present-value terms than any other depreciation schedule when combined with the ACE allowance. Nevertheless, by reducing tax payments in the period when investment outlays are incurred, the up-front allowance could be more valuable to small firms experiencing difficulties in financing their investment. This approach could be extended to cover investment in a broader range of assets. One could go further and allow more than 100% of the first (for example) £100,000 of investment spending to be deducted from taxable income—this kind of 'super-deduction' is currently available for expenditure on R&D.

The reforms to the personal and corporate income taxes that we have outlined here would address almost all of the distortions to the choice of legal form for small businesses highlighted by Crawford and Freedman (2010). One exception is the incentive for couples that face different marginal tax rates to transfer income from the partner with the higher marginal tax rate to the partner with the lower marginal tax rate. While this applies to some extent to all forms of (taxed) capital income, effecting such transfers can be significantly easier if both parties are employed by, or jointly own, the same small company. The opportunity for tax savings here stems not from different tax treatments of labour income and capital income, but from the combination of independent taxation of couples and a progressive rate structure in the personal tax system.[20] If both these features are retained in the design of the tax system, either there will be opportunities for couples to reduce their combined tax liability, or specific anti-avoidance measures will be required to prevent this.

19.4. CONCLUSIONS

This chapter has highlighted differences in the combined rates of income tax and National Insurance that apply to wages, income from self-employment, and distributed profits in the UK tax system. These differences distort

[20] Chapter 3 provides further discussion of the cases for independent or joint taxation of couples.

choices between employment, self-employment, and running a small company. They provide an inducement for labour income to be converted into less heavily taxed forms of business income, and are inequitable because some people can exploit these opportunities more easily, and to a greater extent, than others. They have resulted in complex anti-avoidance legislation which addresses symptoms rather than underlying causes of problems. There may be powerful arguments in favour of tax advantages for some activities undertaken by some types of small enterprises. These should be addressed using targeted tax measures, not by lower tax rates for all profits of all small businesses.

Small business taxation is inherently complex, involving the boundaries between personal and corporate taxes and between the taxation of labour income and capital income. This is an area where it is essential to have an integrated view of the tax system as a whole, and where design flaws in particular components are readily exposed. We have shown that the combination of a personal income tax with a rate-of-return allowance and a corporate income tax with an allowance for corporate equity fares particularly well here. With suitable alignment of tax rates—which in essence requires lower personal tax rates on dividend income and capital gains on company shares than on other sources of income, recognizing the corporate tax paid on the underlying profits—this approach could eliminate tax incentives to convert labour income into capital income, and avoid tax distortions to the legal form in which small business activities are conducted. In our view, this design would have much to commend it.