

stability in their monetary and fiscal policies'.⁵ For the benefits of stability, it might appear preferable to stop constant tinkering with the system. This is, however, not always an option, as the UK's corporate tax system is facing pressures over which the government has little control.

First, in a global economy, the UK's corporate tax system is in competition with those of other economies, both in the EU and beyond. If the UK's system became uncompetitive, both real activity and reported profits could move elsewhere and reduce the UK's corporate tax revenues. So the UK must ensure that its system remains competitive. Competitiveness is an unstable concept, as it depends not only on UK legislation, but also on the actions taken by other countries.

Second, the UK's tax legislation is increasingly under threat of challenges at the European Court of Justice, as multinational companies have become more willing to take national governments to court if their tax systems appear to be in breach of the European Community Treaty. The implications for the UK are that any legislation that seems to compromise the fundamental freedoms or the non-discrimination provision of the treaty needs to be revised. To the extent that current legislation favours domestic firms or transactions over EU ones, there are two possible courses of action: the beneficial rules can be extended to the EU level, or they can be repealed. As will be seen from the discussion of transfer prices and finance leases below, the general approach being taken by the government is to repeal them rather than to bear the potentially enormous revenue cost of extending benefits EU-wide.

Issues from the previous consultation

The 2002 consultation included reform proposals covering three main areas: the taxation of capital assets, the schedular system and the distinction between trading and investment companies. A common theme underlying all of these is the closer alignment of tax calculations with company accounts.⁶

The tax system currently grants firms capital allowances to provide relief for the depreciation of assets. Firms can deduct these allowances in the calculation of taxable profits. The allowances are set by the government and may in practice differ quite substantially from actual depreciation. The main suggested change to the taxation of capital assets is to abolish capital allowances and instead allow firms to deduct accounting measures of depreciation in the calculation of taxable profits. This would lead to a substantial reallocation of tax payments between firms in different sectors, because accounting depreciation rates depend on the expected lifetime of assets and hence vary across industries, while capital allowances are at fixed rates, e.g. 25% for most plant and machinery. In aggregate, statutory capital

⁵ HM Treasury, Budget Speech 1997, lines 9–10.

⁶ For a full discussion of the issues raised in aligning tax and accounting definitions of income, see G. Macdonald, 'The taxation of business income: aligning taxable income with accounting income', Tax Law Review Committee Discussion Paper no. 2, Institute for Fiscal Studies, London, 2002, and G. Macdonald and D. Martin, 'Tax and accounting: a response to the 2003 consultation document on corporation tax reform', Tax Law Review Committee Discussion Paper no. 4, Institute for Fiscal Studies, London, forthcoming.

allowances are likely to be higher than reported depreciation rates.⁷ Hence, tax revenues would be expected to increase, as would the average cost of capital. In the longer term, this change could affect the quality of company accounts, as there would be an incentive to report exaggerated depreciation charges in order to minimise corporation tax liabilities.

The schedular system limits the extent to which past losses can be offset against current profits generated by the same firm from different activities. There is, for example, a schedule for property income (Schedule A) and one for trading income (Schedule D Case 1). For each schedule, and in the case of trading income for each trade, profits have to be calculated separately and any losses can generally only be offset in the current year. The proposed reform is to abolish this system or to reduce the number of schedules. This would be a welcome simplification and provide additional loss relief for integrated firms with a complex range of activities. Consideration should, however, be given to corresponding changes to group relief, the legislation specifying the extent to which losses can be offset against profits of other subsidiaries within a group, to preserve a similar treatment between integrated firms and groups.

New issues in the 2003 consultation

The most important new proposals in the latest consultation were a change to the tax treatment of finance leases and the extension of transfer pricing legislation to domestic transactions. The latter proposal was confirmed in the 2003 Pre-Budget Report and is set to be implemented from April 2004, although details are still subject to further consultation.⁸

Finance leasing

Firms without taxable profits (tax-exhausted firms) do not benefit directly from capital allowances. One way around this is to finance an asset by a finance lease. This transfers almost all the risks and benefits of ownership to the lessee, but the lessor remains the legal owner who is entitled to capital allowances. Provided the lessor makes taxable profits, a share of the benefits of capital allowances can be passed on to the lessee via lower leasing costs. The 2003 consultation document suggests moving the entitlement to capital allowances from the lessor to the lessee, and furthermore restricting the deductibility of leasing fees to just the finance cost element of the fee.

The economic effect would be to reduce the scope for tax-exhausted firms to benefit from investment allowances. This would raise the cost of capital of such firms, which are often small and medium-sized enterprises (SMEs) or new start-ups. It would also increase corporation tax revenues.

A likely motivation, though not acknowledged in the consultation document, is that the current system may be in breach of the European Community

⁷ See estimates in A. Klemm and J. McCrae, *Reform of Corporation Tax: A Response to the Government's Consultation Document*, Briefing Note no. 30, Institute for Fiscal Studies, London, 2002 (www.ifs.org.uk/corptax/bn30.pdf).

⁸ Inland Revenue, *Corporation Tax Reform: The Next Steps*, Inland Revenue Technical Note, London, 2003 (www.inlandrevenue.gov.uk/pbr2003/ct-reform.pdf).

Treaty. As lessors are only allowed full capital allowances if the lessee is a UK resident, the current rules are likely to be in breach of the non-discrimination provisions. Moving the allowances to the lessee would achieve the aim of providing allowances only when the lessee is UK-resident without any open discrimination. When the lessee is tax-exhausted, as is typically the case when finance leases are employed, the allowance will be of little value.

Transfer pricing

Transfer prices are the prices used for transactions between related parties – for example, two subsidiaries of the same group. In such a transaction, the global group profits are unaffected by the price used, but profits in each subsidiary will depend on it. The higher the price, the more of the profit will appear in the accounts of the seller. When the parties are located in different countries, there is an incentive for the global group to choose a transfer price that shifts as much of the profit as possible to the country with the lowest tax rate.

To prevent such shifting of profits, most countries have introduced transfer-pricing legislation. The general principle is that transfer prices should mirror those prices charged between unrelated parties, which are often referred to as ‘arm’s-length’ prices. Where such prices do not exist – for example, for products that are not traded on any market – a number of guidelines have been developed specifying the calculation of transfer prices. Internationally, these have been standardised by the OECD. The UK follows these guidelines, but currently applies them only to international transactions.

The consultation document proposes to extend this legislation to domestic transactions.⁹ A technical note published with the 2003 Pre-Budget Report confirmed these proposals and provided further details.¹⁰ The main consequences of these changes will be increased compliance costs for companies and administrative costs for the Inland Revenue. Tax consequences will be minimal, as very little tax is at stake in domestic transactions.¹¹ Again, the motivation for this change is linked to the European Community Treaty, and in this case this is even alluded to in the consultation document.¹² As the

⁹ It also proposes to subsume the thin-capitalisation rules under the transfer-pricing rules and hence also to apply them domestically.

¹⁰ Inland Revenue, *Corporation Tax Reform: The Next Steps*, Inland Revenue Technical Note, London, 2003 (www.inlandrevenue.gov.uk/pbr2003/ct-reform.pdf).

SMEs will be exempt from transfer-pricing legislation, even for international transactions. This is subject to exceptions: the transaction must be with a country with which the UK has a double tax treaty containing a non-discrimination provision. For medium-sized companies only, the Inland Revenue will have the power to require transfer-pricing adjustments in ‘exceptional’ cases. For large firms, there will be a two-year transition period, during which no penalties will apply if the firm merely fails to fulfil the documentation requirements.

¹¹ Some tax may be at stake for transactions between a loss-making and a profitable part of a group – for example, where one subsidiary has accumulated losses from previous years that are not covered by group relief.

¹² The document states that ‘Except in limited circumstances, the UK legislation on transfer pricing applies only where one party to the transaction is not within the charge to UK tax. This aspect of the rules has led to uncertainty about the appropriateness of the UK rules in the light of the evolving jurisprudence of the European Court of Justice’ (p. 15, para. 3.8).

current transfer-pricing legislation applies only to international transactions, it could be seen as discriminatory. The abolition of such legislation would be extremely risky, as it would permit firms to shift profits to tax havens. Hence, for legal reasons, the only solution seems to be to apply the legislation to all transactions, even if that implies higher compliance and administrative costs and has no underlying economic logic.

Conclusions

Having discussed the pressures the UK corporate tax system is facing and the reforms under consideration, one might ask whether and to what extent the proposals address the difficulties.

Concerning proposals from the previous round, the merits of schedular reform are relatively clear, those of changes to capital asset taxation more debatable. But neither deals with the big pressures the UK corporate tax system is facing. Their prominent role in two rounds of consultation is therefore questionable.

The new proposals are clearly in response to the development of European Court of Justice judgements. In the case of transfer pricing, this was even acknowledged. But while these proposals address some inconsistencies between UK law and the European Community Treaty, many other major areas of uncertainty remain.¹³ Also, by making the UK's tax system less attractive, they could jeopardise the competitive position of the UK as a location for investment.

The current situation is inherently unstable. As any solution aiming at the roots of the problems, such as an EU-wide corporate tax code or a renegotiation of the European Community Treaty, currently seems infeasible for political reasons, it is very likely that the years to come will be marked by further rounds of corporate tax reform.

6.2 The 0% starting rate of corporation tax

The 2002 Budget announced a new 0% corporation tax rate for companies with taxable profits below £10,000. This represented a cut in the rate for the smallest companies from 10% to 0%, the 10% rate having been introduced only two years previously. The new 0% rate and a reduction in the small companies' rate from 20% to 19% announced at the same time were introduced as measures to support entrepreneurial and growing companies.

Budget 2002 costed the introduction of the 0% rate (together with the small companies' rate reduction) at £20 million in 2002–03 and £265 million in 2003–04. But subsequent work published by IFS suggested that the costs might run much higher, potentially to over £1 billion per year.¹⁴ This is

¹³ These include controlled foreign companies (CFC) legislation, group relief, dividend taxation and exit charges. For details, see S. R. Bond and A. Klemm, *Corporation Tax Reform: A Response to the Government's August 2003 Consultation Document*, Briefing Note no. 40, Institute for Fiscal Studies, London, 2003 (www.ifs.org.uk/corptax/bn40.pdf).

¹⁴ L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, *Budget 2002: Business Taxation Measures*, Briefing Note no. 24 (www.ifs.org.uk/corptax/bn24.pdf).

because for people who work for themselves, the reduction in the corporation tax rate increased the attractiveness of incorporation, as opposed to being treated as self-employed under the tax system. The government now appears to be taking steps to mitigate a potential loss in tax revenues, by reducing the differential tax treatment between incorporated and unincorporated businesses. The 2003 Pre-Budget Report announced that

the Government is concerned that the longstanding differences in tax treatment between earned income and dividend income should not distort business strategies, or enable reductions by tax planning of individuals' tax liability, and that support should continue to be focused on growth. The Government will therefore bring forward specific proposals for action in Budget 2004, to ensure that the right amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company ...¹⁵

This section discusses the incentives to incorporate created by the 2002 change, which businesses are most likely to be affected, and evidence on trends in incorporation and overall self-employment.

Incentives to incorporate

People who work for themselves can choose either to be treated as self-employed under the tax system or to incorporate and create a company in which they are the sole employee and shareholder. If they opt to be self-employed, they pay income tax on their profits and National Insurance (NI) contributions at a reduced rate. If they incorporate, they can pay themselves a salary on which they are liable to income tax and full NI contributions, but they can also pay out profits to themselves in the form of dividends. Before dividends are paid out, any profits are first subject to corporation tax. Dividends that are paid out are assumed already to have been subject to corporation tax, and are effectively exempted from income tax at the lower and basic rates.¹⁶ Dividend income is also not subject to NI contributions.

Since the introduction of the 0% corporation tax rate, the incorporation option has become more attractive. By setting up a company, individuals can pay themselves the personal allowance of £4,615 and on top of that make profits of up to £10,000, which they can pay to themselves in dividends and on which they will face no tax. An individual can therefore make profits of almost £15,000 before they start to pay any tax.¹⁷

¹⁵ Para. 5.91 of HM Treasury, *Pre-Budget Report December 2003*, Cm. 6042, The Stationery Office, London, 2003, (www.hm-treasury.gov.uk/media/E00A9/pbr03chap5_197.pdf).

¹⁶ Higher-rate income tax payers are subject to an additional tax charge on dividend income. For details of the income tax and NI system, see Box 4.1.

¹⁷ Individuals who incorporate and pay themselves a salary above the lower earnings limit would receive credits towards NI benefits such as the State Second Pension and incapacity benefit.

Table 6.1 provides some illustrations. Columns 1, 2, 4 and 5 show the tax liability faced by someone who is treated as self-employed under the tax system compared with someone who is treated as incorporated, for two levels of pre-tax profits – £15,000 and £30,000. It is assumed that the individual who is incorporated pays themselves a salary equal to the £4,615 personal allowance, and takes the post-corporation-tax profits in the form of dividends. As described above, an individual with profits of £15,000 can pay virtually no tax (£91) if he is incorporated. This compares with a tax and NI liability of £2,985 if he is treated as self-employed. As can be seen in the final rows of the table, there are differences between the tax and NI liabilities under the two different tax treatments at both levels of pre-tax profits, but the difference in the share of tax and NI in total profits is greater at the lower level of pre-tax profits.

Table 6.1. Tax and NI liability, self-employed versus incorporated, per year

	(1) Self- employed	(2) Incorporated	(3) Incorporated, no 0% rate	(4) Self- employed	(5) Incorporated	(6) Incorporated, no 0% rate
Pre-tax profits	£15,000	£15,000	£15,000	£30,000	£30,000	£30,000
Income tax	£2,050	-	-	£5,350	-	-
National Insurance	£104 (Class 2) £831 (Class 4)	-	-	£104 (Class 2) £2,031 (Class 4)	-	-
Corporation tax	-	£91	£1,973	-	£3,654	£4,823
Total tax and NI	£2,985	£91	£1,973	£7,485	£3,654	£4,823
Net income	£12,015	£14,909	£13,027	£22,515	£26,346	£25,177
Total tax and NI as a % of profits	19.9%	0.6%	13.2%	25.0%	12.2%	16.1%

Note: Figures in the columns headed 'Incorporated, no 0% rate' are based on a system where the 19% corporation tax rate applies to all taxable profits up to £300,000.

Source: Authors' calculations based on the 2003–04 tax system.

Other recent changes have also increased the attractiveness of incorporation, such as the introduction of stakeholder pensions, which allow individuals to contribute £3,600 to a pension regardless of their earnings. Previously, contributions were limited to a proportion of earnings, and as dividend payments do not count as earnings, this limited individuals' ability to save in a pension. Nonetheless, there are some disadvantages to incorporation. For example, an individual cannot offset losses that arise within a legally separate company against other personal income, and there will also be some costs incurred when setting up a new company.

Table 6.1 also shows, in columns 3 and 6, the amount of tax that an incorporated individual would pay if the 0% tax rate were not in operation and the small companies' rate of 19% applied to all taxable profits below £300,000. For an individual considering, for example, leaving employment and setting up a new incorporated business, the incentives created by the introduction of the 0% rate can be seen by comparing column 3 with column 2 and column 6 with column 5. What these comparisons show is that the incentives created by the introduction of the 0% rate to set up a new incorporated business will be greater the *lower* the expected (taxable) profits of the company. This suggests that the 0% rate is not particularly well targeted at the type of high-growth businesses that might be expected to be important drivers of productivity improvements.

Trends in the number of incorporated businesses and in self-employment

There is some evidence to suggest that the introduction of the 0% corporation tax rate has led to an increase in the number of incorporated businesses. Table 6.2 shows numbers of new incorporated businesses in Great Britain over the last six financial years. The 0% corporation tax rate came into force in April 2002, and the following year saw 43% growth in the number of new incorporations, far higher than in the preceding four years. To understand what is happening to the stock of registered incorporated businesses over this period, it is necessary also to take into account the number of businesses being removed from the register. Figure 6.1 shows the number of new incorporations alongside the number of removals. The stock of incorporated businesses has been continuously increasing since 1997–98, but experienced a notable increase during 2002–03.

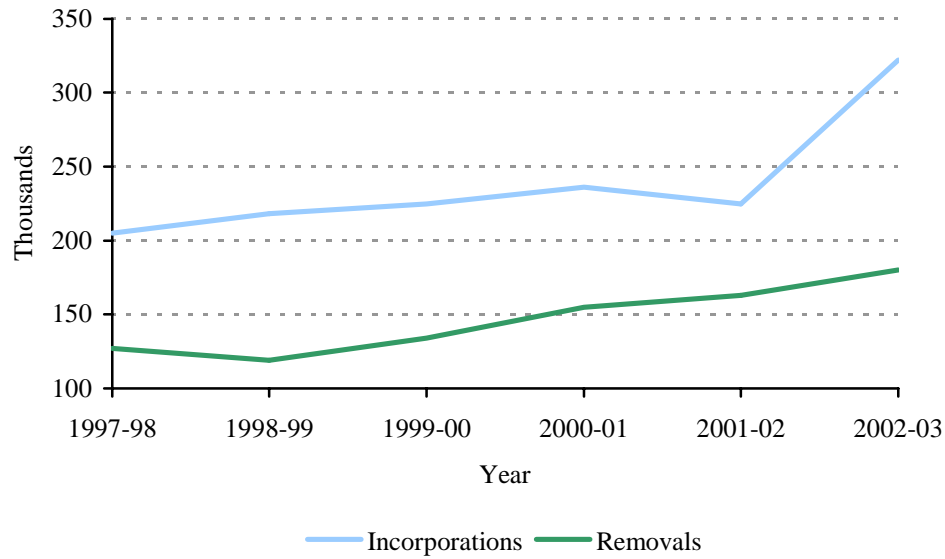
Table 6.2. New incorporations

Year	Number of new incorporations (thousands)	Growth rate of number of new incorporations
1997–98	205	
1998–99	218	6%
1999–2000	225	3%
2000–01	236	5%
2001–02	225	–5%
2002–03	322	43%

Source: *Companies House Annual Report and Accounts 2002–2003*, The Stationery Office, London, 2003 (www.companieshouse.gov.uk/about/pdf/annrep20023.pdf); authors' calculations.

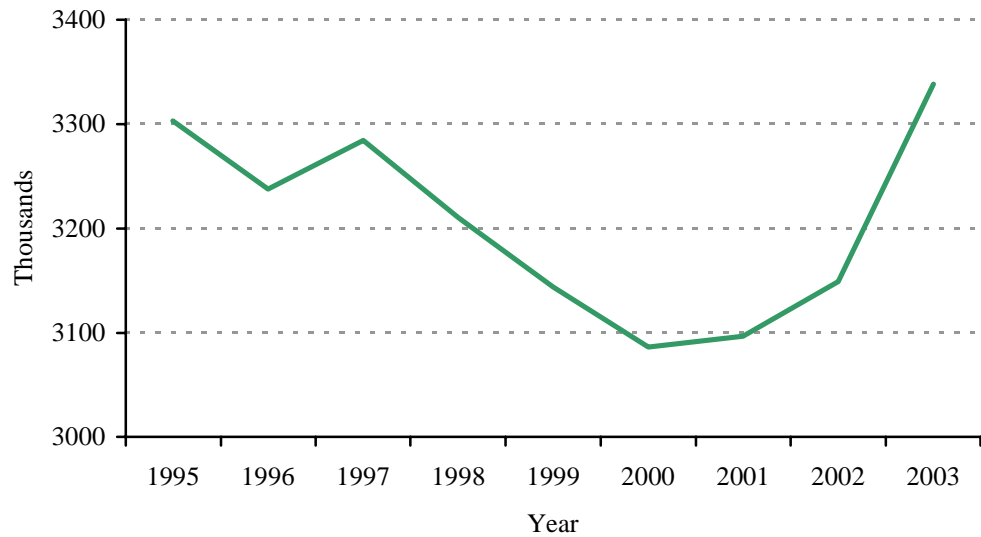
Unfortunately, it is not possible to use these figures to distinguish the extent to which the increase in the stock of incorporated businesses is due to individuals setting up new businesses and to what extent it is due to individuals with existing unincorporated businesses choosing to incorporate. Other evidence indicates that the overall number of self-employed individuals (including those who are incorporated) has risen between 2002 and 2003. As shown in Figure 6.2, this rise brings the number of self-employed individuals back to a level similar to that in the mid-1990s.

Figure 6.1. New incorporations and removals from the register



Source: *Companies House Annual Report and Accounts 2002–2003*, The Stationery Office, London, 2003 (www.companieshouse.gov.uk/about/pdf/annrep20023.pdf).

Figure 6.2. Numbers of self-employed individuals (full- and part-time, including incorporated)



Note: All figures are from Spring Quarter (Mar–May).

Source: Table B.1 of ONS, *Labour Market Trends, January 2004*, The Stationery Office, London, 2004 (www.statistics.gov.uk/downloads/theme_labour/LMT_Jan04.pdf)

Conclusions

The reduction in the corporation tax rate for the smallest companies from 10% to 0% created incentives for individuals to set up new incorporated businesses. But these incentives are not particularly well targeted at the types of high-

growth businesses that might be expected to be important drivers of productivity improvements. Furthermore, the tax change created incentives for self-employed individuals to incorporate and change their organisational form without necessarily any change to the business activity they undertake, but with potentially significant implications for tax revenues. The Chancellor now appears to be considering steps to reduce the differential tax treatment between the self-employed and incorporated businesses, possibly by increasing dividend taxation. A simpler solution, if there is a concern over tax avoidance, would be to remove the 0% corporation tax rate. However, frequent changes to the tax system, particularly if made without prior consultation, do not lead to a stable environment for businesses making long-term investment decisions.

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