11. Corporation tax and entrepreneurship

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Summary

- Labour has changed corporation tax rates in seven of its 11 years in office and plans to change them again next year and in 2009–10. This has caused considerable uncertainty and upheaval, particularly for the owners and managers of companies with profits below £50,000 per year.
- Throughout Labour's time in office, the tax and National Insurance system has provided incentives to be self-employed rather than employed, and incorporated rather than unincorporated. The introduction (at 10%) and subsequent reduction (to 0%) of a 'starting' rate of corporation tax on those with profits below £10,000 substantially increased the incentive for small businesses to incorporate. Many new companies were set up as a result, but it is not clear how many were the type of 'entrepreneurial' businesses the government wanted to encourage.
- The removal of the starting rate, together with the planned increase in the small companies' rate in 2008–09 and 2009–10, suggests that the government has now acknowledged that creating tax incentives that favour one legal form over another may not be the most sensible way to encourage entrepreneurship.
- The government's experiment with the 0% starting rate may have alerted people to the tax incentives favouring incorporation, even though they are no longer as large as they were. Stemming the continued tide of incorporations may require further increases in – and perhaps even the abolition of – the small companies' rate. This may be no bad thing, as the economic rationale for a distortion in the tax system in favour of companies with low profits is far from clear.

11.1 Introduction

Since Labour came to power in May 1997, there have been only four years in which it has not changed corporation tax rates in the UK. This does not seem a helpful contribution to the stable business environment that Gordon Brown has so often stated is vital for investment and economic growth.[2] Furthermore, after 11 years of almost relentless change – particularly for companies with annual profits below £50,000 – the proposed 2009–10 system looks remarkably similar to its 1996–97 predecessor. Can we conclude that the government has sensibly given up using targeted corporation tax cuts to try to encourage entrepreneurship?

[1] This chapter builds on work undertaken as part of C. Crawford and J. Freedman, 'Small business taxation: a special study of the structural issues surrounding the taxation of business profits of owner-managed firms', forthcoming, which forms part of the Mirrlees Review (http://www.ifs.org.uk/mirrleesreview).

[2] See, for example, Budget Speech 2006 (www.hm-treasury.gov.uk/budget/budget_06/bud_bud06_speech.cfm).

11.2 Corporation tax rates and entrepreneurship

In his first Budget as Chancellor in July 1997, Gordon Brown reduced both the main and the small companies' rates of corporation tax (the latter applying to companies with profits below £300,000 per year[3]), from 33% to 31% and from 24% to 21% respectively. This was to be the first of many changes to corporation tax during Gordon Brown's time as Chancellor – including the introduction and subsequent withdrawal of the now infamous 0% starting rate.[4] Table 11.1 summarises these changes, presenting corporation tax rates from 1996–97 to 2009–10.

Table 11.1. Changes to corporation tax rates under Labour

Financial year	Main rate of corporation tax	Small companies' rate of corporation tax	Starting rate of corporation tax
1996–97	33%	24%	n/a
First term			
1997–98[a]	31%	21%	n/a
1998–99	31%	21%	n/a
1999–00	30%	20%	n/a
2000–01	30%	20%	10%
Second term			
2001–02	30%	20%	10%
2002–03	30%	19%	0%
2003–04	30%	19%	0%
2004–05	30%	19%	0%[b]
Third term			
2005–06	30%	19%	0%[b]
2006–07	30%	19%	n/a
2007–08	30%	20%	n/a
2008–09[c]	28%	21%	n/a
2009–10[c]	28%	22%	n/a

[a] These changes were announced in Gordon Brown's first Budget, in July 1997, and were backdated to April 1997.
[b] 19% for profits distributed to shareholders.
[c] This assumes that changes announced in Budget 2007 are implemented as announced.
Sources: *Tolley's Corporation Tax*, various years.

Table 11.1 shows that the main rate of corporation tax has fallen only gradually during Labour's time in office; indeed, the 2007 Budget announcement of a reduction to 28% from April 2008 was the first main-rate change in 10 years. The small companies' rate has also seen relatively little change over this period, being only 1 percentage point lower in 2007–08 than it was in 1997–98. However, the introduction (April 2000), reduction (April 2002) and

[3] For companies with profits between £300,001 and £1.5 million, a system of relief operates, such that the average tax rate for these companies is gradually brought into line with the main rate of corporation tax (which applies to profits above £1.5 million per year). Kenneth Clarke announced in the November 1996 Budget that the small companies' rate would be reduced to 23% from April 1997, but this was superseded by Gordon Brown's July 1997 Budget announcement of a cut to 21%, which was to be backdated to April 1997.

[4] The starting rate of corporation tax – originally introduced at a rate of 10% in 2000–01, before being reduced to 0% in 2002–03 – applied to all annual profits below £10,000 per year. For profits between £10,001 and £50,000, a higher marginal effective tax rate applied, to bring the average tax rate into line with that of the small companies' rate for companies with profits of £50,000 per year.

subsequent withdrawal (April 2006) of a 'starting' rate of corporation tax led to considerable variation in marginal and average tax rates for companies with low profits over the same period.

Encouraging entrepreneurship?

The starting rate was, according to Budget 1999, introduced to 'give new incentives for men and women to start their own business';[5] it was intended to 'encourage investment and enterprise'[6] and to promote job growth. Such statements are common in government rhetoric concerning small businesses, and there may be an element of truth to them. The problem is that individuals seem – to the extent that it is possible for them to do so – much more likely to respond to tax incentives by relabelling or altering the timing of existing transactions than by undertaking new entrepreneurial activity.

In this case, the starting rate provided a tax incentive for self-employed individuals (or employees) to incorporate (i.e. relabel existing activity by establishing a company). Such an incentive arose because, while the profits of self-employed individuals and employees are taxed under the personal tax system, individuals running their business as a company can choose whether their profits are taxed under the personal or corporate tax system, by extracting them as a salary or as dividends (or capital gains[7]) respectively. This flexibility enables owner-managers of companies to take advantage of any difference between the two effective tax rates.

Figure 11.1 illustrates how the percentage of gross income or profits paid in tax and National Insurance (NI) contributions (for a business making £15,000 per year) has changed between 1996–97 and 2009–10 for an employed individual,[8] a self-employed individual and an individual who chooses to incorporate.[9] Figure 11.1 makes clear that there has been a tax and NI advantage to self-employment (relative to employment) and to incorporation (relative to self-employment or employment) throughout Labour's time in office. But while the incentive to be self-employed rather than employed has not changed significantly over time – the percentage of gross income or profits paid in tax and NI has remained roughly constant for both employees (at around 25%) and the self-employed (at around 18½%) – the same cannot be said for incorporated businesses.

The line for incorporated businesses in Figure 11.1 is drawn assuming that the owner-manager takes the personal allowance – just over £5,000 – as salary (on which no income tax or NI contributions are paid) and extracts the remaining profits – just under £10,000 – as

[5] Budget Speech, 1999 (www.hm-treasury.gov.uk/budget/budget_99/budget_report/bud99_report_speech.cfm).

[6] Budget Report, 1999 (www.hm-treasury.gov.uk/budget/budget_99/budget_report/bud99_chap03.cfm).

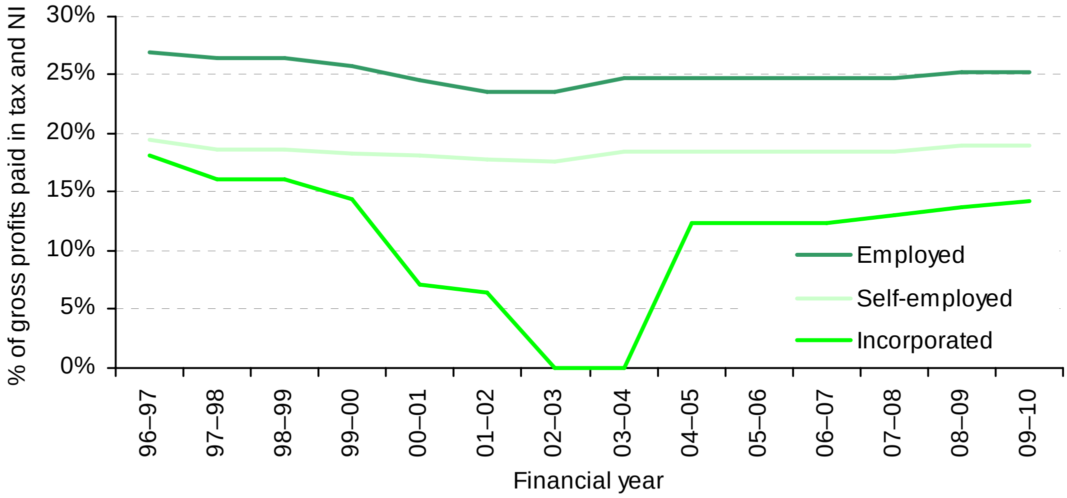
[7] Extraction of company profits as capital gains is not considered in this chapter. For details on capital gains tax reform, see Chapter 10.

[8] The employed individual can be thought of as the sole owner-manager of a company who chooses to extract all of his company's profits as salary (rather than dividends or capital gains).

[9] Figures for 2008–09 and 2009–10 have been calculated on the basis that the relevant changes announced in Budget 2007 are introduced as described therein. This includes: increase of the upper earnings and profits limits by more than inflation in 2008–09, followed by alignment in 2009–10 with the income tax higher-rate threshold; elimination of the starting rate of income tax and reduction of the basic rate of income tax to 20% in 2008–09; increase of the small companies' rate of corporation tax to 21% in 2008–09 and 22% in 2009–10.

dividends (on which corporation tax and income tax on dividend income are paid).[10] This minimises tax liability. Following the introduction of the 10% starting rate of corporation tax in 2000–01, the percentage of gross profits paid out in tax and NI contributions fell from 14.4% to 7.2%. And once the starting rate had been cut to 0% in 2002–03, the percentage of gross profits paid out in tax and NI fell to 0%.

Figure 11.1. Percentage of £15,000 gross income or profits paid in tax and NI contributions over time, by legal form



Notes:
All allowances and thresholds used in these calculations are in 2007–08 prices. (The author would like to thank James Browne of IFS for providing these figures.)
The tax calculations for the employee take into account both employers' and employees' National Insurance contributions, i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).
It is assumed that the incorporated individual pays themselves a salary equal to the personal allowance (roughly equivalent to an 18-hour week on the national minimum wage), with the remaining profits extracted in the form of dividends (on which corporation tax and income tax on dividend income must be paid).
Sources: Author's calculations using: *Tolley's Income Tax*, various years; *Tolley's National Insurance Contributions*, various years; *Tolley's Corporation Tax*, various years; and HM Treasury, *Budget 2007: Report*, March 2007 (www.hm-treasury.gov.uk/budget/budget_07/report/bud_budget07_repindex.cfm).

The calculations underlying the 2002–03 figures are shown in Table 11.2. This table compares the tax and NI contributions of an employed individual, a self-employed individual and an individual who chooses to incorporate, whose business earns £15,000 and who minimises their tax liability. For each individual, the figures indicating total tax and NI as a percentage of gross receipts are the same as those (for 2002–03) in Figure 11.1. These percentages translate into a tax saving of £3,527.64 for an individual who chooses to incorporate (and of £865.66 for a self-employed individual) compared with an employee with the same gross income.

[10] Dividend income is taxed at a rate of 10% up to the higher-rate threshold and at 32.5% above this level. However, this is offset by a dividend tax credit – to reduce the distortion arising from the double taxation of dividends (once at the corporate level and once at the personal level) – which reduces the effective tax rates to 0% and 25% respectively. Assuming that this owner-manager has no other taxable income (or, if they do, that this additional income does not push them above the higher-rate tax threshold), this essentially means that all dividend income will be taxed at an effective income tax rate of 0%. (Of course, some corporation tax will have already been paid on this income in all years except 2002–03 and 2003–04 – during which the 0% corporation tax rate applied to distributed profits.)

Table 11.2. Tax and NI contributions to be paid on £15,000 gross income or profits in 2002–03, by legal form[a]

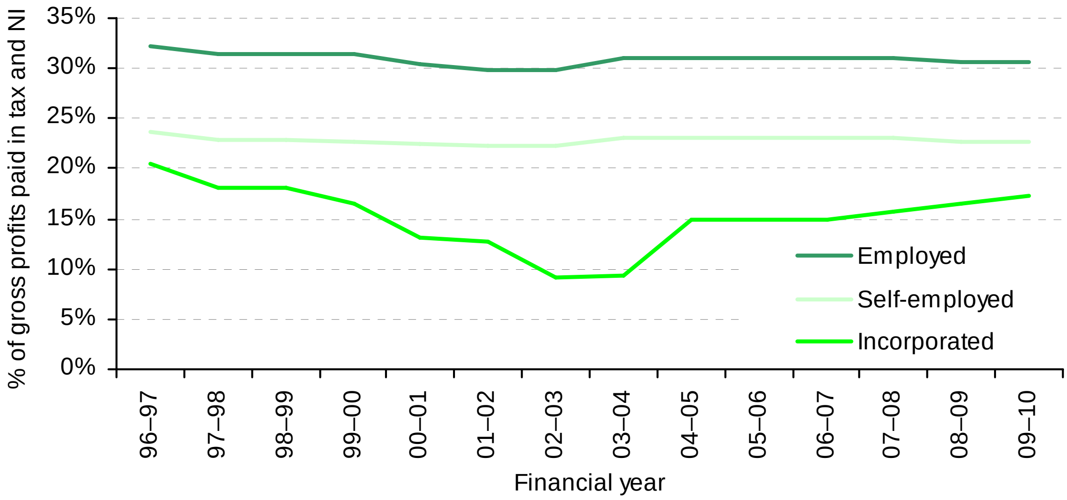
	Employed	Self-employed	Incorporated
Gross income/profits	£15,000.00	£15,000.00	£15,000.00
Salary	£13,978.57[b]	£15,000.00	£5,305.00[c]
Tax and NICs to be paid			
Income tax	£1,640.58	£1,865.30	£0.00
Class 1 employees' NICs	£865.62	n/a	£0.00
Class 1 employers' NICs	£1,021.43	n/a	£0.00
Class 2 NICs	n/a	£120.01	n/a
Class 4 NICs	n/a	£676.67	n/a
Corporation tax	n/a	n/a	£0.00
Total tax and NI to be paid	£3,527.64	£2,661.98	£0.00
Net income/profits	£11,472.36	£12,338.02	£15,000.00
Total tax and NI as a % of gross income/profits	23.5%	17.7%	0.0%
Increase in net income/profits (over employee)	–	£865.66	£3,527.64

[a] All allowances and thresholds used in these calculations are in 2007–08 prices. (The author would like to thank James Browne of IFS for providing these figures.)
[b] The tax calculations for the employee take into account both employers' and employees' National Insurance contributions (NICs), i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated). Employers' NICs must be paid on top of an employee's salary, hence an individual whose business makes £15,000 profits (but who chooses to extract it all in the form of salary) must pay themselves a salary below £15,000 (leaving sufficient profits to pay employers' NICs on top of this).
[c] It is assumed that the incorporated individual pays themselves a salary equal to the personal allowance (roughly equivalent to an 18-hour week on the national minimum wage), with the remaining profits extracted in the form of dividends (on which corporation tax and income tax on dividend income must be paid).
Sources: Author's calculations using: *Tolley's Income Tax*, various years; *Tolley's National Insurance Contributions*, various years; *Tolley's Corporation Tax*, various years; and and HM Treasury, *Budget 2007: Report*, March 2007 (www.hm-treasury.gov.uk/budget/budget_07/report/bud_budget07_repindex.cfm).

Given that the main driving force behind the tax differentials illustrated above has been changes to the starting rate of corporation tax – which only applied to profits up to £10,000 per year – it is perhaps not surprising that the tax incentive to choose incorporation over self-employment or employment decreases as profits rise. Figure 11.2 shows the percentage of gross income or profits paid out in tax and NI by an employed individual, a self-employed individual and the owner-manager of a company whose business makes £25,000 profits per year. This graph presents roughly the same pattern as that observed in Figure 11.1, with the exception that the benefit derived from incorporation is slightly smaller than it was in the case of a business making £15,000 annual profits. The exception arises because a marginal corporation tax rate of 23.75% is charged on annual profits between £10,001 and £50,000, increasing the tax liability considerably for a company with profits within this range.[11]

[11] Above the higher-rate threshold, the effective tax rate on dividend income would also increase (from 0% to 25%), thus reducing the tax incentive to incorporate still further.

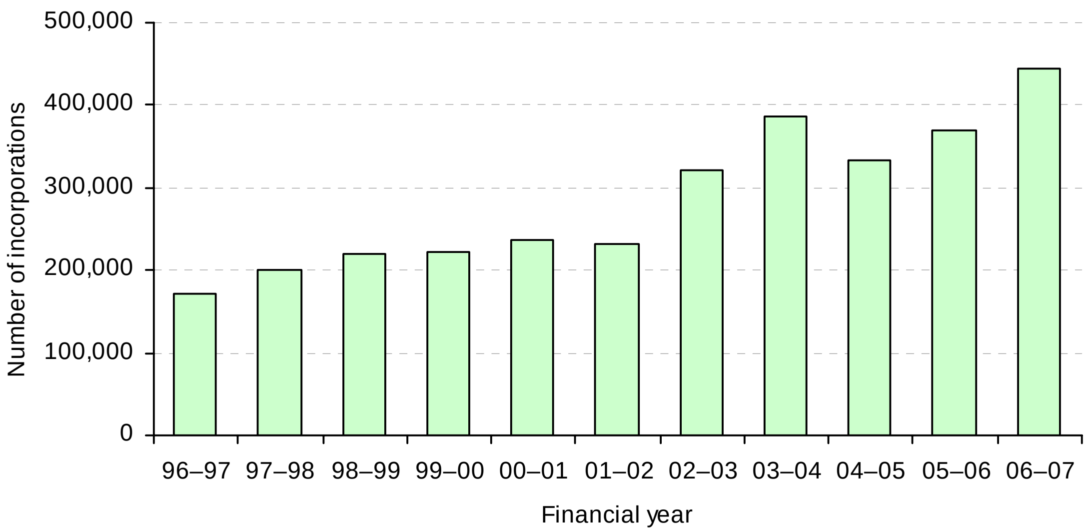
Figure 11.2. Percentage of £25,000 gross income or profits paid in tax and NI contributions over time, by legal form



Notes: See Notes to Figure 11.1.

Given the magnitude of the tax savings highlighted above, it is not surprising that many new companies were created in the years following the introduction of the starting rate. Figure 11.3 shows that in 2002–03 (when the starting rate was reduced to 0%), just over 320,000 new companies were created – up almost 90,000 from just over 230,000 in 2001–02. Following the removal of the 0% rate for distributed profits (in 2004–05), the number of new companies created per financial year fell by around 54,000 (from 387,000 in 2003–04 to 333,000 in 2004–05).[12]

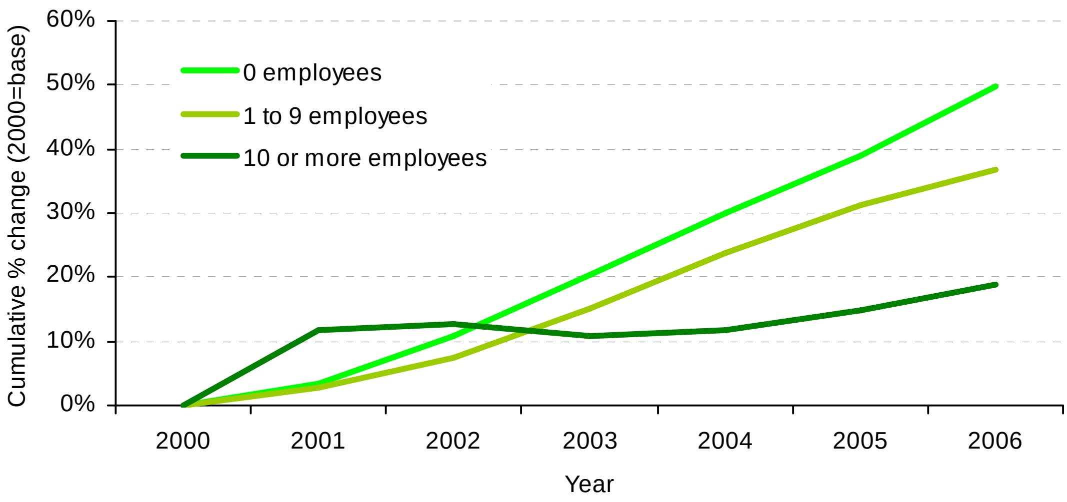
Figure 11.3. Gross incorporations in Great Britain



Source: Author's calculations using data provided by Companies House.

[12] The large number of new companies created in 2006–07 is likely to reflect the announcement (in December 2006) of the introduction (in April 2007) of legislation to tackle Managed Service Companies. This led many businesses to set up their own Personal Service Companies to try to circumvent this new legislation. For more details, see HM Treasury and HM Revenue & Customs, *Tackling Managed Service Companies*, December 2006 (http://www.hm-treasury.gov.uk/media/B/2/pbr06_managedservicecompanies_453.pdf).

Figure 11.4. Cumulative percentage change in the number of companies in the UK from 2000 to 2006, by number of employees



Sources: Authors' calculations using DBERR SME Statistics, 2000 to 2006. This graph is also used in C. Crawford and J. Freedman, 'Small business taxation: a special study of the structural issues surrounding the taxation of business profits of owner-managed firms', forthcoming, which forms part of the Mirrlees Review (http://www.ifs.org.uk/mirrleesreview).

Furthermore, many of these companies had no employees (other than the owner-manager), supporting the notion that at least some may have been created purely for tax purposes. Figure 11.4 shows the cumulative percentage change in the number of companies with 0, 1 to 9, or 10 or more employees in the UK between 2000 and 2006. This graph shows that the rate of growth has been greatest for companies with no employees (closely followed by companies with between one and nine employees) – increasing by approximately 50% (from just over 300,000 in 2000 to just over 450,000 in 2006).[13]

Whilst these figures are not proof of a causal impact of the changes to the tax system on incorporation rates, they are consistent with a significant response to the tax incentives created by the government.

2008–09 and beyond

The tax and NI incentives to be incorporated rather than unincorporated (or employed) were reduced still further by announcements made in Budget 2007: in particular, the increase in the small companies' rate of corporation tax by 3 percentage points from its 2006–07 level of 19% – to 20% in April 2007, 21% in April 2008 and 22% in April 2009 – and the elimination of the starting rate of income tax and reduction of the basic rate of income tax to 20% in April 2008. These changes will have the effect of increasing the effective tax rate paid on dividends (or capital gains) and, for many working-age individuals, decreasing the effective tax rate paid on salaries,[14] thereby reducing the incentive to relabel income through incorporation.

[13] Accessed via http://stats.berr.gov.uk/ed/sme/. Note that it is not possible to make comparisons with earlier periods because the definition of companies with no employees changed in 2000.

[14] Individuals earning between the personal allowance (just over £5,000) and approximately £18,500 will face a higher effective tax rate on labour income as a result of these changes (see Chapter 14 for more details).

Figure 11.1 shows that, compared with the impact of the starting rate on the incentive to incorporate, the combined effect of these changes is very small. Nevertheless, they are certainly a step in the right direction. But there is a danger that the government's doomed experiment with the 0% starting rate has highlighted the tax advantages available through incorporation to such an extent that the number of individuals switching legal form will remain higher than it was in 1996–97, despite the fact that the tax incentive is no longer significantly larger than it was at that time.

With this in mind, it may not be enough simply to return to the 1996–97 position to stem the additional flow of tax-motivated incorporation that occurred in the intervening period: it may be necessary for the government to go further towards alignment of the effective rates across the corporate and personal sectors. This would be considerably aided by further increases in – and perhaps the eventual removal of – the small companies' rate of corporation tax, which may be no bad thing (albeit unpopular with small-business lobby groups) as its economic rationale is unclear.

To eliminate effective tax rate differentials entirely, more radical reform would be needed. This might include the integration of income tax and NI (or at least an increase in the rate of NI contributions paid by the self-employed), which would reduce or eliminate tax differentials between the self-employed and employees. Such a change would need to be accompanied by an increase in the tax liability of incorporated individuals – perhaps through an increase in dividend tax rates – to ensure that the tax differentials between incorporated and unincorporated businesses did not increase as a result. Any net revenue raised could, of course, pay for tax cuts elsewhere.

11.3 Conclusion

The last decade has seen many changes to corporation tax rates in the UK, including the introduction and subsequent withdrawal of a starting rate of corporation tax. The planned increases in the small companies' rate, together with the changes to income tax, announced in Budget 2007 mean that in 2009–10, the combined tax and NI incentive to incorporate (rather than to be employed or self-employed) will have almost returned to its 1996–97 level.

Whilst these changes extend the period of instability under which small companies have operated in recent years, they are necessary to undo the self-inflicted damage caused by the 0% starting rate. However, the fact that the number of new companies being created did not fall back to its 1996–97 level following the removal of the starting rate suggests that simply reverting to the status quo may no longer be sufficient. Thus, whilst the government may have concluded that creating tax incentives to choose one legal form over another may not be the best way to encourage entrepreneurship, it may now need to introduce further reforms if it wishes to return the rate of tax-motivated incorporation back to its 1996–97 level.