

## 8. Issues in business taxation

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### Summary

- Corporation tax revenues have come in below expectations in recent years, but the Treasury is still confident that they will rebound strongly over the next few years. Recent trends may reflect the difficulties of the financial sector, but corporation tax revenues are also under long-term pressure from international tax competition and anti-discrimination decisions by the European Court of Justice.
- Corporation tax rates in the UK are low relative to those in other G7 and European countries, but the gap is narrower than it used to be. The accession of 10 new members to the European Union, most of which have very low corporate tax rates, may intensify downward pressure on tax rates in the older EU countries.
- Most national corporate tax systems discriminate against transactions with foreign countries. In recent years, multinational companies have been more successful in challenging such discrimination at the European Court of Justice. The UK has tended to respond by making the tax system less generous to domestic companies, but that may be difficult if 'group relief' is outlawed.
- The government's attempt to help small companies through a zero corporation tax rate prompted a rush by unincorporated businesses to change their legal status, reducing income tax revenue. The government says it wants businesses to determine their legal status for commercial rather than tax reasons, but this is difficult to achieve as long as labour and capital income are taxed differently.

### 8.1 Introduction

This chapter will briefly consider two issues. First, it will describe some of the threats the UK corporate income tax system is facing. These include the downward pressure on corporate income tax rates as a result of international competition for the location of activity and reported profits. At the same time, national provisions aimed at restricting tax avoidance by profit shifting are under threat of challenges at the European Court of Justice.

The second issue considered is the taxation of small businesses, which is also linked to problems faced by policymakers in responding to possible tax avoidance. Here the concern is that small business proprietors may avoid personal income tax by converting salaries into relatively lightly taxed corporate profits. Section 8.3 will discuss the general issues of taxing businesses differently from individuals, and the specific issues caused by recent tax reforms.

## 8.2 Corporation tax under pressure

The UK corporation tax system is under pressure for two main reasons: first, because of international tax competition; second, because of new case law established by the European Court of Justice (ECJ). This section will consider each issue in turn.

### Tax competition

Tax competition refers to the idea that countries compete for the location of internationally mobile economic activity and/or reported incomes by lowering their corporation tax rates. In an increasingly integrated world economy, this process is likely to intensify. While economic theory offers differing predictions as to where such a process will ultimately lead, the prevalent view is that corporate income tax rates are under downward pressure.<sup>1</sup> There is less agreement on whether this is beneficial, harmful or irrelevant.<sup>2</sup>

While this phenomenon is not new, the accession of 10 new countries to the European Union in May 2004, most of which have very low tax rates on corporate income, may lead to an intensification of the competitive pressure.<sup>3</sup> Table 8.1 shows that compared with the other G7 countries, the UK currently has the lowest corporate tax rate once any local tax rates are allowed for. Compared with the other old EU member states, however, the UK rate is close to the average. Within the enlarged EU, the UK's rate is only the 14<sup>th</sup> lowest, and almost 4 percentage points above the average, as the very low average tax rate of 18.9% among the new member states drags down the overall EU average.

**Table 8.1. Statutory corporate income tax rates, including local taxes**

	UK Tax rate	G7		EU15		EU25	
		Average rate excl. UK	UK rank	Average rate excl. UK	UK rank	Average rate excl. UK	UK rank
1984	45	51.3	2	47.0	6	-	-
1994	33	43.8	1	35.7	4	-	-
2004	30	37.6	1	31.5	5	26.2	14

Notes: All averages are unweighted means. The EU15 average contains all 14 countries other than the UK, even in years in which some were not yet member states of the EU. Where multiple corporate tax rates were available, the manufacturing rate was chosen. Typical local taxes and surtaxes are included. A rank of 1 indicates the lowest corporate tax rate.

<sup>1</sup> For a survey of the theoretical literature, see J. Wilson, 'Theories of tax competition', *National Tax Journal*, 1999, vol. 52, pp. 269–304.

<sup>2</sup> To give just one example for each case: tax competition may be harmful if the downward pressure on corporate taxes reduces the overall taxing capacity of a welfare-maximising government; it may be irrelevant if there are other taxes that can be raised at the same cost instead; and it may be beneficial if governments are thought to overtax for political economy reasons.

<sup>3</sup> While the generosity of a tax system does not only depend on the tax rate, but also on the definition of the tax base (i.e. rates of allowances etc.), tax rates are likely to be the most important factor for tax competition. This is, first, because of their relevance for profit shifting, and, second, because more mobile firms are generally also more profitable, and allowances play a relatively minor role in determining their tax payments. See M. P. Devereux, R. Griffith and A. Klemm, 'Corporate income tax reforms and international tax competition', *Economic Policy*, 2002, vol. 17, pp. 451–95.

It is also noteworthy that the UK's competitive position regarding the corporation tax rate has changed over the last 10 years, with the distance between the UK and the G7 and EU15 averages having decreased considerably. This demonstrates that keeping a tax rate competitive is a dynamic process and could require frequent adjustments.

As a large economy without a land border with any of the new member states, the UK may at first be less affected by the competition for economic activity, compared with the member states bordering the new ones. Austria, which shares borders with the Czech Republic, Slovakia, Hungary and Slovenia, has, for example, already reacted by cutting its corporation tax rate from 34% to 25% from 2005. If other countries follow suit, particularly Germany, then it is likely that the pressure on the UK will also increase. Concerning the competition for reported profits, there may be more immediate pressure, as these are less dependent on geography.

### **Developments at the European Court of Justice**

Most of the European treaty law affecting the taxation of corporate income dates back to the EC Treaty of 1958. Any new measure affecting direct taxation still requires unanimity in the Council of the European Union. What has changed in recent years is that companies have been more successful when taking national governments to court over infringements of Treaty rights.

The relevant rights are the free movement of labour, goods and capital and the non-discrimination provisions. These rights limit the extent to which cross-border transactions can be taxed differently from purely domestic ones.

Most national tax systems are discriminatory regarding transactions with foreign countries, partly because much more tax is at stake than in domestic transactions. That is because domestic tax revenue clearly falls if taxable profits are shifted from a domestic corporation to a foreign corporation, but may well be unaffected if taxable profits are shifted between two domestic corporations.

To prevent multinational firms from artificially reporting profits in low-tax jurisdictions, a range of legislative measures are used. One example is the transfer-pricing legislation for international transactions. This applies when the price charged for transactions between different firms within one group are not allowed to be chosen freely, but instead must be set as they would be between two unrelated parties (arm's length principle). Without such a rule, companies could manipulate the price charged in order to shift their profits to the subsidiary facing the lowest tax rate. Many countries also try to limit the benefit of certain allowances to domestic taxpayers or domestic investments, particularly when they are aimed at achieving policy goals, such as encouraging spending on research and development through a tax credit.

If a tax rule concerning foreign transactions is considered discriminatory, there are in principle two ways to achieve conformity with European law: either the more beneficial rules for domestic transactions can be extended to foreign ones, or the more stringent rules can be applied domestically as well.

The approach taken in the UK so far has been the latter. Hence, since April 2004, UK transfer-pricing legislation has applied to domestic as well as international transactions. Similarly, finance leasing is under reform. Previously, finance leasing allowed lessors to

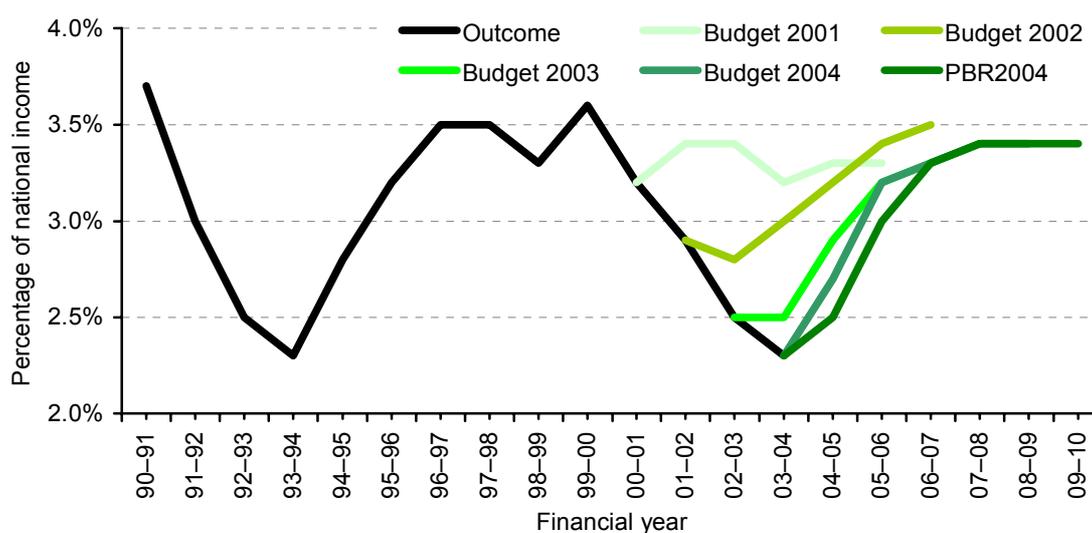
obtain capital allowances only if an asset was leased to a UK firm. The current reform proposal is to disallow the capital allowance to the lessor. Instead, the lessee will be allowed to claim the allowance. However, this will be of little benefit to many lessees, as a major reason for using a finance lease is that the lessee does not have profits against which to use the allowances, i.e. such lessees are tax-exhausted. For such tax-exhausted firms, the cost of capital will be increased by the proposed reform.

Many important issues are still unresolved. For example, group relief, which allows firms to deduct the losses of loss-making subsidiaries from the profits of profitable ones, is restricted to UK subsidiaries. If the courts decide that group relief does not conform to EU law, then the UK government will face the choice of repealing it entirely or allowing it globally (or at least EU-wide). The former option would increase taxes for profitable UK groups with loss-making subsidiaries, while the latter would imply giving tax relief for losses abroad. Previous decisions have generally reduced the generosity of the tax system to domestic companies, but some observers question whether the government will be prepared to take a similar approach in this case because of the size and influence of the groups affected.

## Conclusion

Faced with the multiple pressures of tax competition and legal restrictions on national tax laws, the future of corporation tax and its revenues does not look bright. Tax competition may require further rate cuts, or lead to further shifting of activity or paper profits out of the UK, both of which would tend to reduce revenues. The legal restrictions mean that it may become more expensive to raise corporation tax revenues. Even so, the government continues to be optimistic about prospective corporation tax revenues. Figure 8.1 shows recent out-turns and Treasury forecasts for corporation tax receipts. As the early forecasts turned out to be too high, later forecasts shifted the expectation of a recovery of revenues further into the future. But they continue to be optimistic about the eventual level of revenue. The current weakness

Figure 8.1. Corporation tax revenue projections and outcomes



Note: These figures exclude corporation tax revenues from the continental shelf.  
Sources: National Statistics, Pre-Budget Reports (PBR) and Budget Reports.

of revenues could still be a temporary effect – for example, reflecting the lagged effect on the financial sector's fortunes of the decline in the stock market since its peak in 2000. But the longer the forecast recovery in corporation tax fails to materialise, the more likely it seems that it is caused by more permanent changes, such as the ones described above.

The government should take the threats to corporation tax seriously, and a series of consultation documents suggest that it is well aware of them.<sup>4</sup> However, it seems unlikely that national policy will be able to resolve all these problems, which are caused by international forces. A more promising route to consider would be Europe-wide solutions, such as the European Commission suggestion of tax base harmonisation and formula apportionment.<sup>5</sup> Under such a system, firms would calculate their pan-European profits, which would subsequently be allocated to different member states based on apportionment factors such as the capital stock, the number of employees and/or sales in each member state. There would thus be no need to identify profits for each country separately. Each member state could continue to apply tax at a different rate.

The alternative to a multilateral solution would be to accept declining corporation tax revenues and raise the required money elsewhere. A more extreme solution would be to leave the EU, which would remove the pressure from the ECJ, although at potentially enormous political and economic costs. However, the effects of globalisation, such as increased tax competition, cannot be tackled unilaterally.

### 8.3 Small business taxation

The previous section discussed how large multinational companies might be able to reduce their tax payments by shifting their profits into low-tax jurisdictions. This is more difficult for small businesses, which typically operate only domestically. Such businesses, however, face other choices that affect their liability to tax, such as the choice between different legal forms in which to operate. Depending on the legal form, their profits are taxed under either the personal income tax (e.g. sole traders, partnerships) or the corporation tax system (e.g. limited companies, corporations). If a business decides to incorporate, then profits can be paid out as a salary or as dividends, this choice also having tax implications. A recent government Discussion Paper<sup>6</sup> raises these and other issues arising in the taxation of small business. This section will provide a brief background discussion of the general issues, followed by an analysis of recent government policy in this area.

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<sup>4</sup> The main ones are, in reverse chronological order: Inland Revenue, *Corporation Tax Reform*, Inland Revenue Technical Note, 2004 ([http://www.inlandrevenue.gov.uk/pbr2004/sup\\_ct-reform-tech-note.pdf](http://www.inlandrevenue.gov.uk/pbr2004/sup_ct-reform-tech-note.pdf)); Inland Revenue, *Corporation Tax Reform: The Next Steps*, Inland Revenue Technical Note, 2003 (<http://www.inlandrevenue.gov.uk/pbr2003/ct-reform.pdf>); HM Treasury / Inland Revenue, *Corporation Tax Reform: A Consultation Document*, TSO, London, 2003 ([http://www.inlandrevenue.gov.uk/consult\\_new/corp-tax-reform.pdf](http://www.inlandrevenue.gov.uk/consult_new/corp-tax-reform.pdf)); HM Treasury / Inland Revenue, *Reform of Corporation Tax: A Consultation Document*, TSO, London, 2002 ([http://www.inlandrevenue.gov.uk/consult\\_new/taxreform\\_final.pdf](http://www.inlandrevenue.gov.uk/consult_new/taxreform_final.pdf)).

<sup>5</sup> European Commission, 'Towards an internal market without tax obstacles', Communication from the European Commission COM(2001) 582 final, 2001 ([http://europa.eu.int/eur-lex/en/com/cnc/2001/com2001\\_0582en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2001/com2001_0582en01.pdf)). For more details, see European Commission, 'Company taxation in the internal market', Commission Staff Working Paper SEC(2001) 1681 final, 2001 ([http://europa.eu.int/comm/taxation\\_customs/resources/documents/company\\_tax\\_study\\_en.pdf](http://europa.eu.int/comm/taxation_customs/resources/documents/company_tax_study_en.pdf)).

<sup>6</sup> HM Treasury, *Small Companies, the Self-Employed and the Tax System*, Discussion Paper, TSO, London, 2004 ([http://www.hm-treasury.gov.uk/media/8EB/69/pbr04small\\_companies\\_228.pdf](http://www.hm-treasury.gov.uk/media/8EB/69/pbr04small_companies_228.pdf)).

The focus here is on corporation tax rates, but it should not be forgotten that there are also other tax measures aimed at small businesses, such as the research and development tax credit, which is more generous for small than for large business.

When we discuss the tax rates faced by ‘small’ companies, it should be noted that these in fact apply to any firm with low levels of profits, irrespective of size. While it is true that small companies generally have small profits in absolute terms, there are also large firms that only make small profits, and these would also benefit from these rates. For simplicity, though, and because the main rate for firms with low profits is officially called the ‘small companies’ rate’, we will continue to speak about small firms rather than firms with low profits.

## **The Treasury’s Discussion Paper**

While a consultation on the topic of small business taxation is very welcome, it would have been even more useful if it had taken place before implementation of some of the recent policy reforms discussed below. The government’s Discussion Paper provides a lengthy description of characteristics, legal structures and the tax treatment of small business in the UK. But it does not contain any concrete reform proposal and is likely to be followed by further consultation rather than any immediate policy decision.

The paper does, however, make some statements about the government’s aims. It states, for example, that ‘the Government believes that the choice of legal form that a small business takes should reflect commercial rather than tax considerations’ (paragraph 1.7). Whether such a choice can ever be tax-neutral is discussed below. The paper also stresses that ‘the Government is keen to encourage the growth of small businesses’ (paragraph 1.2). The link to legal forms of running a business is not clear. To the extent that there are obstacles to the growth of small firms, the obvious approach would be to tackle them directly. For example, if there are capital market imperfections, then subsidised loans might be helpful, irrespective of the legal form of the business.

Instead of going through the Discussion Paper in detail, the following will provide, from an economic perspective, a general discussion of the issues arising in small business taxation.

## **Small business taxation from an economic perspective**

Economists distinguish between two main approaches to taxation: comprehensive income taxation (CIT) and expenditure (or consumption) taxation (ET). The first attempts to tax all income of individuals, irrespective of its source. Its main advantage is that two individuals with the same ability to pay, as measured by income, will face the same tax charge. This also ensures that there are no incentives to transform one type of income into another. The second approach aims to tax only consumption, thus leaving any savings untaxed. The advantage of this approach is that it does not distort saving and investment decisions. Among economists, there is no agreement which of the two approaches is preferable.

The tax system in the UK, as in most other countries, is a mixture of these two models. While returns from savings, such as interest, dividends and rents, are generally taxable, the tax rate

is often lower than the one on labour income.<sup>7</sup> Some returns to capital, such as from owner-occupied housing or funds held within private pension funds or Individual Savings Accounts, are exempt. Overall, then, the UK tax system taxes returns to capital more lightly than returns to labour. A more explicit system achieving such an outcome is a dual income tax (DIT), as used, for example, in Sweden. In such a system, there is a relatively low flat tax rate on capital income and a progressive tax schedule for labour income.<sup>8</sup>

Any tax system, such as the UK's, that taxes capital and labour income differently will encounter a difficulty when trying to tax small businesses, particularly owner-managed ones. For such businesses, the distinction between capital and labour income may be hard, if not impossible, to make. A profit-making self-employed entrepreneur, for example, as owner and worker simultaneously, will have great difficulty distinguishing his profit (the return on his capital invested) from the remuneration he receives from his input of labour. The sum of the two is therefore often referred to as mixed income.

Unless labour and capital income are taxed at the same rate, it is therefore unavoidable that otherwise identical small businesses will be taxed differently depending on the assumed partition of income into salaries and profits. While this will cause some distortions to the choice of how to conduct a business, these can be limited by ensuring that tax rates do not vary too much across different legal forms. Until 1997, this was to some extent achieved in the UK by keeping the basic income tax rate and the small companies' corporation tax rate at the same level. It would be difficult, however, to ensure that the tax system never affects an individual's choice between the different legal forms that are available, as suggested in the Discussion Paper. This would require the government to abandon the current differences in the taxation of capital and labour income, which does not seem to be its policy.

## Taxation of small business under Labour

When Labour came into office, the main corporation tax rate stood at 33% and the rate for small companies, defined as those with profits of less than £300,000, at 23%.<sup>9</sup> The new government immediately reduced both rates by 2 percentage points in 1997, and thereby broke the previous link between the basic rate of income tax and the small companies' rate, as the basic rate of income tax remained at 23%.

In 1998, the government announced a further percentage point cut in both corporation tax rates from 1999. This was followed in 1999 by the introduction of a new starting rate of 10%, for companies with profits of less than £10,000.<sup>10</sup> The 1999 Budget also announced that the basic rate of income tax was to be cut from 23% to 22%, but the gap between the rate of tax on companies with low profits and the basic rate of income tax had still been widened considerably.

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<sup>7</sup> Even more so if National Insurance is taken into account.

<sup>8</sup> As the share of capital income that is reinvested is higher than the savings rate for labour income, the DIT taxes savings more lightly than consumption on average.

<sup>9</sup> Firms with profits of up to £1.5 million receive some benefit from the lower tax rate, as marginal relief ensures that the tax saving from the lower tax rate on the first £300,000 of profits is withdrawn only gradually.

<sup>10</sup> Marginal relief ensures that for firms with profits exceeding £10,000, the average tax rate rises gradually, until it reaches the small companies' rate as profits reach £50,000.

In Budget 2002, the small companies' rate was reduced to 19% and, as a surprise measure, the starting rate was reduced to 0%. The latter measure increased the benefit of running a small business as a company to an unprecedented extent. Research published by IFS at the time predicted that the revenue cost of this measure could potentially exceed £1 billion per year.<sup>11</sup> Official predictions, however, stood at only a quarter of that figure (Budget 2002). While no final estimates of the actual cost have been published, they are likely to have been much larger than the government expected, as in Budget 2004 the 0% rate was again abolished, although this was portrayed as the closure of a loophole.<sup>12</sup> Indeed, the system is now very complex, with a minimum rate of 19% on distributions, but still a 0% rate on reinvested earnings if profits are less than £10,000.<sup>13</sup>

## Conclusions

The taxation of small businesses, whose incomes are a mixture of returns to capital and labour, is complicated. While the recent government Discussion Paper suggests that the choice between different legal forms in which to do business should be neutral with respect to taxation, this section has argued that it is likely to be impossible to achieve such neutrality completely under a system that generally taxes returns to capital and labour at different rates. It is, however, advisable to ensure that differences in tax rates applied to different legal forms do not become too large, as otherwise revenues are at risk.

Recent government policy has not followed this principle. First, the government increased the relative benefits of the corporate form considerably by introducing a 0% tax rate on the profits of small firms. This increased the incentive to incorporate to an unprecedented extent, leading to fears of significant revenue losses. The 0% rate was then de facto abolished, although this was achieved by introducing a complex system with a minimum rate of 19% on distributions.

Businesses often raise concerns about the increasing complexity of regulations and the tax system. Maybe it would be better to think about how to ease these burdens on small businesses rather than trying to help them with a low tax rate that only applies under very limited circumstances. Fortunately, this is one of the issues raised in the Discussion Paper (paragraph 5.4) and further progress in this area would be welcome.

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<sup>11</sup> L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, *Budget 2002: Business Taxation Measures*, IFS Briefing Note no. 24, London, 2002 (<http://www.ifs.org.uk/bns/bn24.pdf>).

<sup>12</sup> In his Budget 2004 speech, the Chancellor said, 'But I will close the loophole by taxing distributed profits at 19%, bringing the tax on distributed profits for those small companies into line with other companies'.

<sup>13</sup> The system works as follows. A company making a profit of below £50,000 pays tax at 0% on the first £10,000 and 23.75% on any additional profits, so that its average tax rate ranges from 0% to 19%. Any distribution of the profits will lead to a further tax charge, equal to the difference between the average rate and the 19% rate applied to the distribution. This implies that where profits are below £10,000, there is, in effect, a split rate of 19% on distributions and of 0% on retained earnings.