briefing notes

BUDGET 2002: BUSINESS TAXATION MEASURES

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1. Summary

Following the Budget, this Briefing Note examines some of the Chancellor's changes to business taxation. A number of Budget measures, including the new research and development tax credit for large companies and the exemption of capital gains on the sale of subsidiaries, are welcome and should improve the efficiency of the UK's tax system. All of these measures were subject to extensive prior consultation, and detailed commentary can be found in *The IFS Green Budget: January 2002* (www.ifs.org.uk/gbfiles/gb2002.shtml).

A number of other measures were not foreshadowed in the Pre-Budget Report. Three of these are examined here – the new 0% rate of corporation tax, the changes to North Sea taxation and the new anti-avoidance measures for stamp duty. These are the key conclusions:

- The new 0% corporation tax rate for companies with profits below £10,000 is potentially expensive. New IFS work shows that the cost could run to billions of pounds a year. This is substantially above any published government estimate. This tax change was particularly surprising as the rationale for it is unclear.

- While the changes to North Sea taxation will raise extra revenue, their design should minimise the disincentive for future investment. However, the reforms failed to tackle all the obvious problems with North Sea taxation and there remains a strong case for further reform. As stability is important to firms making long-term investment decisions, the lack of comprehensive reform is disappointing.

- The Budget introduced significant anti-avoidance rules to prevent companies from avoiding stamp duty when they buy property. As distinctions in stamp duty rates are based on legal rather than economic differences between transactions, this tax is always going to allow large avoidance opportunities. It is now time to examine whether stamp duty rates should remain at the same level for both commercial and residential property transactions.

There was no prior consultation on either the new 0% corporation tax rate or the changes to North Sea taxation. The drawbacks apparent in both these reforms again highlight the importance of consultation in business tax reform.

2. The 0% corporation tax rate

In the Budget, the Chancellor announced that he was cutting the 10% corporation tax rate for companies with less than £10,000 of taxable profits to 0%.[1] The introduction of a zero rate came as a surprise, and is a potentially expensive tax change, with costs likely to run to billions of pounds. The surprise is all the more acute as the rationale for this change is unclear.

Under the tax system, people who work for themselves can either be treated as self-employed and pay income tax on their profits and National Insurance contributions at a reduced rate, or they can incorporate. By incorporating, they can create a company in which they are the only shareholder and the only employee. If they incorporate, they can then pay themselves a salary on which they are liable to income tax and National Insurance contributions, but they can also pay out profits to themselves in the form of dividends. Any profits made by the company are first subject to corporation tax. Under the UK's system of taxing dividends, it is assumed that dividends have already borne tax at the company level, and so are effectively exempted from income tax at the lower and basic rates.[2]

As a consequence of the Chancellor's introduction of a 0% corporation tax starting rate, incorporation has become far more attractive than the self-employed route. Simply by setting up a company, a person can pay themselves the personal allowance of £4,615, and on top of that make profits of up to £10,000, which are paid out in dividends and face no tax liability. This implies that a person can earn almost £15,000 before they start paying tax.

Following the Budget changes, there are about 1.2 million people currently self-employed who could save over £500 of tax a year by incorporating. If all of these individuals did incorporate, it would cost the government just over £2.5 billion. The key assumption in calculating the cost of this measure is therefore estimating the number of people who will incorporate. Figures in the Budget indicate that the government believes the proportion is very low. Is this a reasonable assumption?

[1] The small companies corporation tax rate was also reduced, from 20% to 19%.

[2] Higher-rate income taxpayers face an additional charge on dividend income.

Many of the barriers to incorporating have been reduced in recent years. For example, previously, individuals' pension contributions were limited to a proportion of their earnings. As dividends do not count as earnings, this limited individuals' ability to save in a pension. But following the introduction of stakeholder pensions, individuals can now contribute £3,600 to a pension regardless of their earnings. They will also receive basic-rate tax relief on their contribution regardless of whether they have paid any tax on this income.

Another issue is whether people can get the advice necessary to set up their affairs as a company. It is, in practice, very easy to achieve this. Given the size of the potential tax savings and the large number of potential customers, it is to be expected that a large-scale, low-cost market for fairly standard and cheap conversion packages will emerge.

There remain some disadvantages to incorporation. For instance, losses cannot be offset against other personal income if they arise within a legally separate company. Nevertheless, given the size of the tax incentive now on offer from the government, a prudent assumption would be that at least a majority of those who can realise substantial tax savings will secure them. Table 1 shows the cost under a range of assumptions about the level of incorporation for basic-rate taxpayers. We assume that no one with a potential gain of less than £500 per year incorporates. Even at a 50% rate of incorporation for those with potential gains over £500, the cost would still amount to just over £1.2 billion.

Table 1. Cost of 0% corporation tax band

Proportion incorporating with gain in excess of £500	Cost
50%	£1.2bn
75%	£1.9bn
100%	£2.5bn

Notes: This costing is based on self-employed individuals incorporating and paying themselves a salary equal to the personal allowance and the remainder of their income in dividends. Only basic-rate taxpayers are included. The costing assumes that no one with a gain of less than £500 incorporates.

Source: Authors' calculations based on the Survey of Personal Incomes, 1998–99.

Is this a desirable way to spend government resources? It is difficult to see how providing a large tax incentive to people to change the form in which they do business will be beneficial. If the Chancellor wanted to cut the tax bills of this section of the economy, then a more efficient tax change would have also introduced an extended personal allowance for self-employed income, so people could have benefited from the change without having to alter the legal form of their business.

There are also distributional issues. As a result of the new 0% corporation tax rate, the potential difference in the tax treatment of those who are employed and those who work for themselves has increased substantially. Those who work for themselves and incorporate now face a substantially lower tax bill than those who are employed. As noted above, someone with an income of just under £15,000 could pay no tax if they set up as a company, whereas an employee with the same income would pay £3,827 in income tax and National Insurance contributions.[3]

3. North Sea taxation

Reforms of the taxation of North Sea oil and gas have been considered for some time. The Labour government had announced plans for reform in 1997,[4] but this initiative was abandoned because of the low oil price in 1998–99.[5] The comparatively higher oil price since 2000 has brought such tax reforms back onto the agenda. In the Budget, the Chancellor announced the introduction of an additional 10% tax charge on North Sea profits. At the same time, the treatment of investment spending was made more generous, so companies will be able to write off immediately most expenditure in their corporation tax calculation. The net effect of this is expected to increase tax revenues from the North Sea by about £0.6 billion by 2004–05.[6] The government also announced that it intends to abolish North Sea royalties, though it is consulting on the timing of this move. North Sea taxation is complex, so we start by explaining the current system, discuss what an ideal system would look like and assess whether these reforms move us in the direction of such a system.

The current North Sea tax regime has three layers of tax: licence royalties, petroleum revenue tax (PRT) and corporation tax. Licence royalties are based on revenues, while PRT and corporation tax are based on profits. Corporation tax is ring-fenced, so that losses on the mainland cannot be offset against profits from a continental shelf field. Each tax has its own allowances for capital expenditure. Royalties are deductible for PRT purposes, and both royalties and PRT are deductible for corporation tax purposes.

Further complication arises as not all fields are liable to all of these taxes. Only fields approved before April 1982 are liable for all three taxes. Since then, new fields are not liable for licence royalties, and fields approved since March 1993 are only liable for corporation tax. This means that tax rates on windfall profits, say resulting from an increase in the world oil price, differ substantially across fields. This is shown in Table 2.

Table 2. Tax liabilities and marginal tax rates

Date field approved	Taxes payable	Marginal tax rate
Up to 31/3/82	Royalties Petroleum revenue tax Corporation tax	69.4%
1/4/82 – 15/3/93	Petroleum revenue tax Corporation tax	65%
Since 16/3/93	Corporation tax	30%

[3] Assuming the Budget 2002 increases to National Insurance (NI) rates were already implemented, at an employer cost of £14,615 (£10,000 + £4,615), employer NI would be £1,133.28, employee NI would be £973.91 and income tax would be £1,720.28. The corresponding gross pay would be £13,481.72 (£14,615 – £1,133.28).

[4] HM Treasury, *Financial Statement and Budget Report*, 2 July 1997.

[5] Inland Revenue Press Release 124/98, 7 September 1998.

[6] HM Treasury, *Financial Statement and Budget Report*, 17 April 2002.

Before evaluating the Budget reforms, it is useful to think about how resources such as oil should ideally be taxed. Economic theory divides conventional measures of profits into two parts: normal profit and economic rent. Normal profit is the minimum rate of return needed to justify an investment – if this cannot be earned, then the investment will not be made. Economic rent is the return over and above normal profit. If a tax applies only to the economic rent element of conventional profit measures, then in theory it should have no effect on investment decisions. So it is generally efficient to reduce taxes on normal profits, making up any lost revenue as necessary by increasing the tax rate on economic rents. This reduces distortions to investment decisions, including incremental investment in existing fields. In the North Sea, such investment is particularly important because if fields are abandoned prematurely, the cost of reopening such fields later will be prohibitive.

Not all taxes distinguish between normal profit and economic rents. Corporation tax is charged on a conventional measure of profits. It therefore taxes normal profits and acts to deter investment, although this distortion is no greater for North Sea investments than for onshore ones. PRT provides more generous investment allowances than corporation tax and as such it is closer to a tax solely on economic rent. Licence royalties are a revenue-based tax and therefore reduce profits by a high share when profits are low, but only by a low share when profits are high. They can even turn an otherwise profitable investment into a loss-making one, which will clearly discourage investment.

The Budget changes will add an additional 10% charge that will be applied to the same base as corporation tax.[7] This will increase the marginal tax rate on all fields, though because of interactions with PRT and royalties, the increase will vary. The increased tax rates are shown in Table 3.

Table 3. Marginal tax rates after reforms

Date approved	Marginal tax rate	Marginal tax rate after 10% increase	Marginal tax rate after 10% increase and abolition of royalties
Up to 31/3/82	69.4%	73.8%	70%
1/4/82 – 15/3/93	65%	70%	70%
Since 16/3/93	30%	40%	40%

A new 100% first-year capital allowance for certain investment spending was also introduced. This allows companies to write off immediately most expenditure in their corporation tax calculation and can be interpreted as a step towards a tax solely on economic rent. The additional announcement of the abolition of licence royalties is sensible. These levies are the most distortionary taxes in the North Sea and their abolition will reduce the number of different tax treatments of fields from three to two.

[7] One important distinction is that financing expenses will not be deductible. This prevents companies from using debt to circumvent the ring-fencing of their North Sea activities. At the company level, this also reduces the bias towards debt financing that is often believed to result from the deductibility of interest costs.

But despite the positive assessment of the economic effects of the changes, the Budget reforms can be criticised for not going far enough. There will still be two categories of fields facing different tax treatments. While different views can be taken on the trade-off between the need to raise revenue and the disincentives caused by taxation, it is hard to see a rationale for differential treatment of fields depending on the date of their approval. There will therefore clearly be a case for further reform. As stability is important to firms making long-term investment decisions, the failure to tackle all of the obvious problems with North Sea taxation is all the more disappointing.

This failure may be related to the lack of consultation prior to the Budget announcements. This lack is especially surprising, given the abandoned 1998 consultation which contained a proposal strongly resembling the Budget 2002 changes. It is difficult to see why consultation was desirable in 1998 but not in 2002. If and when the government decides to resolve the outstanding problems with North Sea taxation, it should certainly consult widely to prevent further piecemeal reform.

4. Stamp duty on property

The Budget made a number of provisions intended to curtail the avoidance of stamp duty on commercial property[8] transactions. The provisions are expected to yield £150 million in each of the next two fiscal years, rising to £450 million in 2004–05.[9] This implies that the government expects that more than 10% of the current stamp duty yield on property, or around one-third of stamp duty revenues on commercial property, would be lost within three years if no action were taken.

One obvious reason why avoidance activity may have become more significant in recent years is the rising rate of stamp duty on property transactions. As shown in Table 4, since taking office in 1997, the government has gradually increased the rate of stamp duty on property transactions worth between £250,000 and £500,000 from 1% to 3% and on transactions worth over £500,000 from 1% to 4%.

Table 4. Stamp duty rates on property transactions

Transaction value (£000)	Before 8/7/97	8/7/97 – 23/3/98	24/3/98 – 15/3/99	16/3/99 – 27/3/00	28/3/00 to date
0 – 60	0%	0%	0%	0%	0%
60 – 250	1%	1%	1%	1%	1%
250 – 500	1%	1.5%	2%	2.5%	3%
500+	1%	2%	3%	3.5%	4%

The same rates apply to all forms of property whether it is used for residential, commercial or other purposes. But the rate increases will have affected a far higher proportion of commercial property transactions than residential property transactions.

[8] We use the term commercial property to mean non-residential property in general, including industrial property and land.

[9] HM Treasury, *Financial Statement and Budget Report*, 17 April 2002.

Nearly 90% of commercial transactions by value are worth more than £250,000 and therefore attract a stamp duty charge of 3% or higher. This compares with around a quarter of residential property transactions.[10]

Avoidance of stamp duty is likely to be much easier for companies buying and selling commercial property than for individuals buying and selling houses. For instance, a company could very easily transfer its property assets into a separate subsidiary and sell the shares in that subsidiary rather than selling the property directly. The shares purchased in the property subsidiary would be subject to the lower ½% rate of stamp duty on share transactions,[11] rather than the 3% or 4% charge if the property had been transferred directly. In economic terms, the two transactions are virtually indistinguishable, yet the stamp duty charge on one route is now up to eight times that on the other.

This rate differential gives companies a strong incentive to structure transactions in such a way as to avoid the stamp duty charge on property. The additional costs of so doing (for example, legal fees and management time) reflect real resources that could otherwise be put to productive use. The government's proposed anti-avoidance rules may curtail some of the most blatant avoidance activity, but the rate differential is so large that there is a danger that they will lead companies to engage in more costly avoidance schemes, adding to compliance and administrative costs.

Transactions taxes are not a desirable type of tax in principle, since they raise the cost of reallocating resources to where they are put to the best use. However, if stamp duty on property is to be retained, one alternative approach that the government might consider is to draw a distinction between residential and other property transactions, and levy different rates of stamp duty on each.[12] This might enable it to address the problem of avoidance on commercial property transactions more directly, as well as recognising the fact that commercial and residential property are already taxed differently. For instance, commercial property returns are generally subject to corporation or income tax, whereas the returns to owner-occupied housing are tax-exempt.

[10] Source: *Inland Revenue Statistics, 2000* (www.inlandrevenue.gov.uk/stats/survey_of_prop/sopieaw_t01_1.htm).

[11] They would not be liable to any stamp duty if the company were registered overseas.

[12] This year's Finance Bill already contains a definition of non-residential property for the purposes of the stamp duty exemption for land in disadvantaged areas.