

(16th November 2006 revised version 19th March 2007)

**THE ICAEW TAX FACULTY HARDMAN MEMORIAL LECTURE
SMALL BUSINESS TAXATION – THE INDEFINABLE IN PURSUIT OF THE
UNACHIEVABLE?**

Judith Freedman, KPMG Professor of Taxation Law, University of Oxford.

I INTRODUCTION

Colleagues are always surprised at the enthusiasm that tax professionals manage to have for their subject. To the uninitiated, tax is the driest, most technical subject they can think of. Amongst academic lawyers and many students there is still astonishment that anyone could find the subject bearable, let alone interesting. Teachers of tax law battle with this prejudice all the time- a hurdle to be overcome before one can get on to the substance.

Philip Hardman was one of the people I was fortunate enough to meet very early on in my career who convinced me that tax could be exciting. Sadly, I did not have the privilege of knowing him at all well, but I was involved in one transaction, when I was in practice, on which we worked with him. I have no idea what the transaction was, but I do have a memory of him practically bouncing around his office with excitement when someone (definitely not me, I was just the note taker) made a clever point. Since then I have been very lucky to have had the opportunity to work with many others who have made tax intellectually exciting, but I can't remember anyone else *bouncing* in quite the same way.

It is conventional to say that one feels honoured to give a memorial lecture but I do genuinely feel very honoured to have been invited to give this one; first, because of the person we are remembering and secondly because of the very distinguished speakers who have given this lecture before me. It would be invidious to name anyone in particular, but I have learnt a great deal sitting in this hall over the years listening to them, and also in helping to publish some of them in my capacity as joint editor of the BTR.

Thirdly, I feel honoured – and not a little daunted- because of the exceptionally highly qualified audience sitting before me now. Most of you know a lot more about small businesses on the ground than I do. I hope that we can see this as a two-way process and not merely a lecture. My aim is to do what I think academics should do in this situation- that is to suggest a **framework for discussion and highlight some key points that are all too easily forgotten amidst the practical debates.** I do not pretend to have a miracle answer, but I shall set out some thinking about this topic which may seem to have rather lost its way following the launch of a debate by HM Treasury in its December 2004 paper, *Small companies, the self-employed and the tax system.*¹ Despite excellent responses to that paper, not least by the ICAEW Tax Faculty,² Government and commentators alike seem somewhat overwhelmed by the enormity and complexity of the problems. What is happening now is that individual problems are being dealt with on a piecemeal basis; it might be thought that that is the only way something of this enormity can be dealt with in practice, but I would like to question that. We are seeing some valuable work on administrative burdens on small businesses³ and are anticipating a paper shortly on alignment of income tax and NICs. These are very useful and necessary steps forward, and have grown out of the debate so far, but there is a danger that we might lose sight of the **central structural issues**, which is what I want to focus on tonight. These might seem too difficult, or less important than big corporate tax issues currently on the table, but I shall argue that we need to seize the time and look at them now rather than meddling on the sidelines with what to large numbers of people are major irritants, undermining confidence in the tax system more widely than their economic importance might seem to suggest. I shall be very grateful for any comments and thoughts at the end of the lecture, not least because I am, with the help and advice of others, writing the chapter on small business taxation for the Mirrlees Review⁴ and I would genuinely welcome your

¹ HM Treasury Discussion Paper, December 2004

http://www.hm-treasury.gov.uk/media/8EB/69/pbr04small_companies_228.pdf

² ICAEW, TAXREP 22/05, *Small Companies, the Self-Employed and the Tax System.*

<http://www.icaew.co.uk/index.cfm?route=116030>. See also joint response of CIOT and ATT, <http://www.tax.org.uk/attach.pl/3449/2762/SmallCosandSelfEmployed%20finalsub010405.pdf>; Redston, 'Small Business in the Eye of the Storm' [2004] *British Tax Review* 566.

³ Inland Revenue/ HM Customs and Excise, *Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small businesses*, March 2005. http://www.hm-treasury.gov.uk/media/A62/4A/bud05_working_towards_new_relationship_370.pdf

⁴ Institute for Fiscal Studies, *Reforming the Tax System for the 21st Century: The Mirrlees Review*, <http://www.ifs.org.uk/mirrleesreview/>

input. I would like to thank those who have already assisted me with this thinking from the Mirrlees Review group and especially Claire Crawford of the IFS who has prepared the graphs for me. However, at the moment none of this represents the views of anyone but myself.

There are three key points I want to make in this lecture.

First: small business taxation policy should concentrate on equitable tax treatment of small businesses (whatever their aims and objectives). Where the aim of policy is to encourage a particular kind of activity or growth, the focus should be on that kind of activity and not the size of the business, if tax really is thought to be the right tool to use.

This may seem obvious but is often lost in discussion about small businesses and the economy, encouraging enterprise and so on. As I shall try to illustrate in the first part of my lecture, focussing tax policy on small businesses with the hope of achieving something indirect will inevitably disappoint. But if we keep to the forefront the need to treat all businesses fairly and give them a stable tax backdrop to their real concern of doing business, then we can help all small businesses and not miss our target by trying to use a blunt tool for too many different tasks.

Second: Small business tax policy should not fall into the trap of attractive complexity or complex deregulation. These are concepts that I shall endeavour to explain but which essentially mean that in the attempt to make things better, and often in response to taxpayer pressure, policies make them worse. Frequency of change may also come under this head.

Third: small business tax policy is central to business tax design and not some addendum to the main agenda of large business taxation. The structural problems of the dividing lines between employees, self-employed and incorporated businesses do not arise just because a few taxpayers are attempting to avoid tax but are a consequence of a tax system which taxes income from different sources very differently. When decisions are being made to increase those differences, small businesses should not be ignored in the hope that some minor adjustment can be found to deal with them. Nor can taxpayers be blamed for trying to move into a more

favourable category; something they will see as relating to the equity of the tax system and not as an avoidance or incentive issue.

Large businesses and the headline rate of corporation tax are attracting all the attention at the moment, but the changes that are happening there have implications for small business taxation too. There is a fundamental tension between the downward pressure on corporation tax rates and the need for alignment of rates and structures at the smaller end of the scale. The latter is needed to prevent inequity and distortion of commercial decisions in the choice of business form and behaviour for tax purposes. This tension has to be addressed as part of the overall design of business tax – it cannot be dealt with as a mere afterthought. The tension should be harnessed as a means of reviewing business rates across the board and the rationale for variations. Whilst a totally flat tax is not thought by many to be practical or even desirable, some alignment may be helpful.

II WHY INDEFINABLE AND UNACHIEVABLE?

‘Small business’ means different things to different people- from the micro firm with no employees (or at least fewer than 10 employees), to the private company about to go public. Projects with academics from many disciplines on an ESRC initiative on small businesses, with company lawyers and business representatives on the company law review and with tax experts looking at small businesses have all shown me that a central problem in discussing this area is that different people are talking about different things, different needs and different objectives.⁵ There is a tendency to start talking about a relief in the context of micro businesses, only to find that there is pressure to extend the relief to a larger group. Why stop with the very smallest? Where should the line be drawn? Politicians not only mean a variety of things when they talk about small businesses but also conveniently switch from one meaning to another- for example, starting off by talking of the importance of growth and

⁵ The author participated in a major small business study funded by the ESRC and involving interviews with a large number of small business owners during the 1990s. Her own project, forming part of this initiative, involved gathering information from over 400 small firms, including a number of face to face interviews, and resulted in a number of directly related publications, including "Legal Form, Tax and the Micro Business", (with Godwin) in Caley, Chell, Chittenden, Mason (eds.), (1992) *Small Enterprise Development* (Paul Chapman Publishing Ltd.) and "Incorporating the Micro Business: Perceptions and Misperceptions", (with Godwin) in Hughes and Storey (eds.), (1994) *Finance and the Small Firm*, (Routledge).

innovative businesses in one breath and then slipping into giving figures for the increase in the total number of businesses in the other. We see the same phenomenon in papers from HMRC and Treasury for example in the 2004 small business taxation consultation paper.⁶ This undisciplined rhetoric of growth and increase in numbers does much damage to clear thinking in this area.

For this reason my title starts with: *the indefinable*. This seems pretty negative and the rest- *in pursuit of the unachievable* even more so. But the *unachievable* part is a consequence of the *indefinable* part of the title. If we could only define what we were aiming to do and who we were aiming it at, the unachievable part might fall away.

Facts and figures

Small firms do matter.

For this section of the lecture I shall use the definition of small firm employed in the Small Business Service statistics (0-49 employees).⁷ In 2005 these firms accounted for 99.3% of all firms and for 47% of the employment in the UK. This does not mean, however, that they are the ‘engine of the economy’ deserving of extensive state support. This is something of a myth and can mislead policy makers. Most small businesses are nothing of the sort. There has been a raging academic debate about the extent to which small businesses are the job creators and some of the earlier work showing the importance of small businesses for job creation has been discredited by economists such as Bennett Harrison⁸ and David Storey. Professor Storey has shown that “most small firms do not grow and a handy rule of thumb is that over a decade 4% of small businesses create 50% of the jobs in small firms. The typical small firm is unlikely to survive for a decade and will create few additional jobs beyond those with which it started.”⁹ Some critics have also argued that job quality is poorer in small firms, although other research has shown that workers may not mind this because of compensating factors in a small business environment.¹⁰

⁶ See fn 1 above.

⁷ Small Business Service SME Statistics for the UK 2005.

http://www.sbs.gov.uk/SBS_Gov_files/researchandstats/SMEstats2005pr.pdf

⁸ Harrison *Lean & Mean* (1997) Guilford Press; Storey, *Understanding the Small Business Sector* (1994) Routledge.

⁹ Storey, Review of Harrison, (1995) *Small Business Economics* 7:337-340.

¹⁰ Curran, Kitching, Abbott and Mills (1993) *Employment and Employment Relations in the Small Service Sector Enterprise- A Report*, Kingston Business School, cited in Storey’s review above.

My point is that this job creation /engine of the economy debate misses the point of the tax policy issues.¹¹ Small businesses play many roles in society and in the economy – some of them clearly do provide employment and they *can* stimulate the economy by their interaction with large firms and by contributing to productivity. So-called life-style firms also play an important social role in local economies and for the people involved in them. But to say they all matter in some way is not to support the argument that small business is necessarily deserving of taxpayer subsidy. It implies only that they do deserve to be treated fairly. Given that picking winners in terms of economic growth and job creation seems impossible, it is more sensible to focus support on treating all business equally and to focus any incentives on any specific activity to be encouraged directly. The evidence is that most business are very small indeed and will stay that way, so subsidies aiming at growth will be a deadweight cost unless aimed at that growth activity directly rather than at small businesses generally. All small businesses, however, growth or not, deserve a stable and fair environment which does not impose tax and compliance costs over and above those suffered by other businesses.

Micro-businesses and employees

In 2005¹²:

- There were an estimated 4.3 million private sector business enterprises in the UK.
- Around 73% of this total had no employees at all (other than the owner).
- About 95% of these private sector businesses were micro-businesses (with fewer than 10 employees).
- Micro businesses account for over 32% of all employment.

Figure 1

It can be seen from this graph that although the number of small businesses has been increasing, almost all of that increase comes from businesses with no employees other

¹¹ A similar, but more general, point is made in Bannock, *The Economics and Management of Small Business*, (2005) Routledge 42.

¹² Source SBS SME Statistics, see fn 7 above.

than the self-employed owner-director or company director.¹³ The percentage falling within that category was 73% in 2005, up from 69% in 2001, for example. Much of this must reflect the increasing tax and National Insurance Contribution incentive to move away from employment and towards self-employment or incorporation.

Although arguably less important than larger small businesses as ‘engines of the economy’ it is this group of owner-managed micro businesses and especially those which only employ themselves and maybe family members which gives rise to the greatest structural problems and so this group is at the centre of business tax design. Especially as the group is growing it warrants attention. Being qualitatively different from other firms, these firms are my focus in this lecture.

Small companies

Figure 2

Many **companies** are also very small and also have no employees other than employee directors-

- 39% of companies have no employees under this definition in 2005.
- Around 25% of all UK businesses are incorporated in 2005.
- This percentage has been increasing and was 18% in 1996.
- This is partly but not entirely explained by the nil rate of corporation tax for companies with low profits introduced in 2002 and removed in 2005. It will be interesting to see how this progresses. Other reasons are NICs and removal of corporate law and accounting regulation and costs on small companies (audit, easier annual returns, changes in meetings requirements, further simplifications in the 2006 Companies Act such as no longer needing a company secretary, and it now being even easier not to have meetings may increase this).
- Partnerships are declining in number. Presumably partnerships are more likely than one-person firms to respond to pressure to incorporate or to set up an LLP. The numbers of LLPs small but not in relation to the number of partnerships, which is relatively small anyway.
- More interesting is the climb back up of sole proprietorships especially in 2004 when the Non-corporate distribution rate was introduced to counteract

¹³ This point has also been made by Chittenden and Sloan in ‘Quantifying Inequity in the Taxation of Individuals and Small Firms’ [2007] *British Tax Review* 58.

the effects of the nil rate. How these figures develop in the next available statistics will be interesting.

III. USING SIZE AND OTHER CHARACTERISTICS TO TARGET RELIEFS. A QUESTION OF TARGETING

We can now turn back to my first key point, which was that small business taxation policy should concentrate on equitable tax treatment of small businesses whatever their aims and objectives.

I have already explained that most small firms will not grow or be engines of the economy even if some are or will be. If government targets tax reliefs at small businesses on the basis only that they will perform an economic miracle, disappointment will follow and there will then be the inevitable backlash, these same small business owners being criticised for perfectly reasonably taking advantage of reliefs that were not intended for them in the minds of ministers, although they were designed for them in terms of the legislation.

Therefore, small business taxation policy should focus on correcting for any inherent biases against small firms within the tax system.

Incentives or attempts to correct for non-tax based market inefficiencies affecting small business through the tax system are more contentious. There are arguments that use of the tax system is justified to correct for the power of larger firms, asymmetric information and financing difficulties.¹⁴ But if the problem is not one arising from the tax system in the first place, it is not clear why it should be assumed that tax is the way to solve it. If the tax is not specifically a small business tax, which it normally will not be, then aiming at small businesses will require special thresholds, which takes us back to definitional issues.

The need for such incentives, their efficiency and the suitability of the tax system for delivering them will be a question that applies not only to small businesses but more

¹⁴ See OECD, (1994) *Taxation and Small Businesses*, discussed further in Freedman, 'Small Business Taxation: Policy Issues and the UK' in Warren (ed), (2003) *Taxing Small Business - Developing Good Tax Policies* (Australian Tax Research Foundation Conference Series, No 23).

generally, and so is not then a small business issue. Even the removal of market barriers is only a small company issue per se if it is firms of a certain size facing those barriers (as opposed, for example, to new firms, which may be a different matter).

OECD guidance on best practice supports this analysis. It suggests that the tax system has a potential role in limiting the cost disadvantages faced by small businesses in complying with tax legislation, encouraging the creation of **new** small businesses and ensuring the continuation of small businesses when control passes from the founder of the firm to another person.¹⁵ Beyond that, since there is no such thing as a tax on business per se there is not necessarily any reason to provide special relief through the tax system.

As to incentives to grow, the impossibility of picking winners and the tiny percentage of small firms which will actually grow whatever is done with the tax system makes it very questionable that small firms should be targeted. It is going to make much more sense to target particular activities if the tax system is to be used at all. This should help to eliminate the *unachievable* part of my title.

So, of course all businesses *of whatever size* deserve **fair** treatment. If there is something about taxation that is intrinsically unfair to smaller businesses, then this needs to be addressed in order to provide a balance. But it is not necessarily the case that any further form of special consideration, reliefs or incentives should be given to businesses just because of their **size**. Where size is used as a proxy for some other characteristic such as being new, or being a growth or entrepreneurial firm, this seems to be doomed to failure, since nearly all businesses are small and the size characteristic, however defined, tells us little about the characteristics of the business or its needs.

Nil rate example- size and other unhelpful characteristics

This is too easy a target, so I am not going to spend too long on it, but it did happen and it does illustrate my point perfectly, so I cannot ignore it.

¹⁵ OECD, (1997) *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*.

The dramatic and predictable failure of the nil rate of tax for corporations with low profits is a good example of a policy initiative which fell into the **size trap**. A business with very few employees may be a non-growth life style business or a high tech business just starting out. A business with low profits may indeed be an unprofitable business which is likely to fold, a very happy and contented life style business which needs no further encouragement, or a promising firm which is making a big investment in its future and so keeping profits low. Thus any attempt to use such a definition is going to be unhelpful, unless it really is that particular size element that is being targeted.

The nil rate tax experiment also tried to target growth and entrepreneurship through the **proxy of incorporation**. This is really no better than size as a test of how to target tax advantages. Storey cites some empirical evidence that incorporated firms are more likely to grow than unincorporated ones- hardly surprising given that a firm which needs to raise finance will incorporate and also that many firms will start out as unincorporated and then incorporate as they grow so that arguably the choice of incorporated legal status is a result rather than a cause of growth.¹⁶ Obviously, even if incorporation is a characteristic of growth businesses, it does not follow logically from the fact that incorporated firms are more likely to grow that if one encourages them to incorporate for tax reasons they will grow- it is only if they were making an undistorted decision to incorporate for commercial reasons that this was a growth indicator, and even then there were many incorporated firms which did not grow.

As we all know, the introduction of the nil rate in 2002 was followed by behaviour which all taxpayers and their advisers saw as both rational and entirely predictable but which government preferred to consider as an ‘unintended consequence’¹⁷ and a form of tax avoidance. In other words, businesses incorporated to obtain the tax benefit of

¹⁶ Storey, fn 8 above, p. 140 –‘United Kingdom studies consistently point to more rapid growth being experienced by limited companies than by either sole proprietorships or partnerships’. Storey admits, based on Freedman and Godwin (in Hughes and Storey, fn. 5 above) that since they found 40% of incorporated firms had started life as unincorporated firms any association between limited company status and growth could be considered to be reversed, with the change in legal status a consequence rather than the cause of growth.

¹⁷ See HMRC Regulatory Impact Assessment for Changes to the Corporation Tax Structure March 2006, <http://www.hmrc.gov.uk/ria/ria-corporation-tax.pdf>

the zero rate even if they did not intend to grow. This is a natural outcome of the use of size and other indirect characteristics as a proxy for what is really being targeted.

Special reliefs that genuinely target size as opposed to something else are most likely to be related to the **regressivity of tax burdens**, which is well established in many studies to be related to size. 'The size of the business is a key factor in determining compliance costs, and most of the studies confirm that smaller businesses carry disproportionately higher compliance costs.'¹⁸

The recent KPMG study of administrative burdens suggests that the burden is higher for the very smallest businesses in relative, though not absolute terms (that is relative to the total resources available to the business).¹⁹

This is really only one example of a general problem of economies of scale for small firms, but since this is a state imposed burden, it makes sense to try to relieve small firms of anything which makes the burden greater than that of other taxpayers. Some argue that regressivity is balanced by non-compliance amongst small firms²⁰ but whatever the evidence for that non-compliance, making compliance harder is not the way to reduce it- the answer must be to make compliance easier and then to enforce it rigorously. Simplification and assistance with compliance may also make non-compliance easier to detect. Even here, however, the real answer will often be to relieve burdens *for all* as far as possible. Other issues which might seem to weigh heavily on small firms due to size are really just further examples of lack of economies of scale, for example restrictions on losses, since they are less likely than larger firms to be able to set these against other profits in the same year so there may be a case for a longer carry back, for example.

Where the tax system is used to tackle incentive and other issues which do not arise initially from the tax system, the only special factor about small business in the context of this debate is that the schemes need to be accessible and not too complicated for the small firms to use.

¹⁸ Evans, 'Studying the Studies: An overview of recent research into taxation operating costs' (2003) 1 *eJournal of Tax Research* 64.

¹⁹ KPMG (2006) *Administrative Burdens: HMRC Measurement Project*.

²⁰ Pissarides and Weber (1989) 'An Expenditure-based Estimate of Britain's Black Economy' *Journal of Public Economics* June 39:1, pp 17-32; Feldman and Slemrod 'Estimating Tax Non-compliance with Evidence from Unaudited Tax returns' *Economic Journal* (forthcoming).

We have seen that share investment schemes to provide finance through the tax system such as business enterprise schemes are not always discriminatory enough to hit their target, or need to be made discriminatory by anti-avoidance measures which then serve to complicate the system. The cost effectiveness even of the revised schemes is still unclear.²¹ Incentives, for example to engage in research and development (R&D), are unlikely to be very relevant to the very smallest firms for which this²² is simply not an issue, quite apart from the fact that IFS research suggests that the evidence that R&D tax credits address the issue of growth is unclear.²³ But whatever the arguments are about these reliefs it makes much more sense to target them at particular activity and not confine them to a particular size of firm. This is supported by the history of the R&D credits. The enhanced R&D relief was originally introduced for small and medium sized enterprises (SMEs) but extended to all in the Finance Act 2002. The reliefs are likely to be just as important or more so to larger firms as the IFS shows, and in the case of the financing schemes, more so to the larger of the small firms since many really small firms are not seeking outside finance. The only argument for extra assistance to small firms may be in providing help to access such schemes, which relates directly to the size of the firm because there may be a lack of knowledge of the reliefs or they may be perceived as too difficult to claim. The recent announcement of help for small businesses to claim R&D would fall into that category.²⁴ This is in the same category as schemes to prevent regressivity of compliance costs.

²¹ Boyns, Cox, Spires and Hughes, *Research into the Enterprise Investment Scheme and Venture Capital Trusts*, Report of Public and Corporate Economic Consultants prepared for the Inland Revenue, April 2003 <http://www.hmrc.gov.uk/research/summary.pdf>

²² Between 2000- 2006 there were only 22,000 claims for R&D credits in total (HMRC Press Release 1 Nov 2006).

²³ Abramovsky, Griffith and Harrison, *Background Facts and Comments on 'Supporting Innovation: Enhancing the R&D Tax Credit'*, IFS Briefing Note 68; PricewaterhouseCoopers (2006), *Enterprise in the UK: Impact of the UK tax regime for private companies*.

²⁴ HMRC Press Release 10 Nov. 2006

<https://www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=241316&NewsAreaID=2&NavigatedFromDepartment=False>

IV TARGETED RELIEFS - TRAPS TO AVOID- COMPLEX AND ATTRACTIVE DEREGULATION

My second point was that small business tax policy should not fall into the trap of attractive complexity or complex deregulation. Even if special small business measures are confined to those which genuinely relate to size and the problems of size, we should continue to be wary about them. Many reliefs start out as a response to pressure from small businesses or a response to what they might be thought to want, only to end by causing greater cost. Small businesses are not necessarily simple. For example they often involve families or other close personal relationships.

In the context of company law reform I have argued against **complex deregulation** which produces a range of problems including the proliferation of size thresholds.²⁵ These may actually create barriers to growth by making business owners reluctant to exceed the threshold for some special kind of accounting treatment, for example. This was the reason for the “think small first” policy in company law reform; the aim here is to add on requirements for larger companies where possible rather than making small companies make an election. This is more difficult to do in a tax context, but we should still beware of creating thresholds.

In similar vein, Steven Dean of Brooklyn Law School has argued that relying on taxpayer preferences to guide simplification efforts may produce forms of deregulation that are not simplifications at all: **attractive complexity**.²⁶ The example he gives is that of the check-the-box regime in the USA which resulted from taxpayer pressure and may well have been popular as a means of reducing tax burdens, but which most certainly has not produced tax simplification, but rather opportunities for more choice and manipulation. It is not necessarily (indeed it will usually not be) the smallest businesses which will gain most from this type of response to taxpayer demand. Once a relief is under discussion, there is pressure from lobby groups for it to be available at higher and higher levels and so to larger small firms. There is not always a logical place to draw the line once the relief is made

²⁵On the phenomenon of *complex deregulation* in company law, see Freedman, ‘One Size Fits All - Small Business and Competitive Legal Forms’ (2003) 3(1) *The Journal of Corporate Law Studies* 123.

²⁶ Steven Dean, 'Attractive Complexity: Tax Deregulation, the Check-the-Box Election and the Future of Tax Simplification' (2005/6) 34, *Hofstra Law Review*, 405.

available in principle,²⁷ and it is these larger firms which can take most advantage of the reliefs and so get the benefit. The introduction of elections and options for small businesses to assist them may actually create expense by increasing choice and the need to take advice. Although there may be a resulting tax saving, this might be outweighed by the fees they have to pay to advisers and the management time taken in learning about and considering the available elections.

It may be that there are circumstances in which business would prefer to live with a less than perfect provision, on the basis that a fairer or more precise provision would be more costly to operate. The costs of change *per se* need to be taken into account in policy making too: change can in itself *create* cost as the recent KPMG report points out.²⁸ The temptation to keep inventing new schemes needs to be avoided.

The Chartered Institute of Taxation make this clear in their response²⁹ to the 2005 HMRC Consultation on the administrative burdens of the tax system on small businesses.³⁰ In answering the question, ‘What might enhance the existing range of VAT simplification schemes available to small businesses?’ they state

‘...there are those amongst us who feel that the question posed here is the wrong one. Stability is more important than more simplification schemes and simplification of the system is more beneficial than more schemes to counteract the complexity.’

Here is a direct example of practitioners on the ground resisting what has been called above complex deregulation. Previous lobbying has produced a form of Dean’s attractive complexity that consists of an array of small business VAT options. Deciding whether to opt for them itself creates cost. For example, the flat rate VAT is used generally only if it will produce a cost lower than using regular VAT accounting, which requires advisers to work the figures for both methods so that there is a

²⁷ An example of this process is the debate over the statutory audit.

²⁸ Fn 19 above.

²⁹ CIOT and ATTA, *Working Towards a New Relationship: Priorities for Reducing the Administrative Burdens of the Tax System on Small Businesses* 28 June 2005 at p.10. There were clearly different views on the Committee since they also state the alternative view that the VAT cash accounting scheme could be extended to direct taxation to make it more popular.

³⁰ Inland Revenue/ HM Customs and Excise, note 3 above.

compliance cost rather than the intended saving.³¹ This comment suggests that some small business advisers at least recognise the downside of adding so-called simplification schemes rather than eliminating choices.

Yet HMRC still agonises about why people are not using its simplification schemes. On its website³² it suppresses surprise that, in relation to VAT annual accounting, ‘more than a million businesses are invited but ‘only about 10,000 think they can go to the ball’. HMRC thinks the businesses are overlooking the advantages, and so as announced in the 2006 Budget they are increasing the turnover below which businesses are eligible from £550,000 to £1,350,000.³³ If no-one will come to your party, throw a bigger one! Have they thought that maybe there are reasons why no one wants to come? The take up for other VAT simplification schemes – cash accounting and the flat rate scheme are higher, though still far off all those eligible, but it is not clear why this should be of concern to HMRC other than because the take up of these schemes represents some kind of target for helping small firms. But is it a sensible target?³⁴

Similar issues might arise around a debate that has blown up in the tax press recently over cash accounting for income tax for small firms.³⁵ Would it really help? To whom

³¹ The view that the flat rate VAT can be a trap for the unwary and involves a lot of work for advisers was supported following my lecture by Benneyworth, ‘Watch out- Flat rate VAT disaster!’ *AccountingWeb* 27 Nov. 2006; St John Price, ‘Pros and cons of the VAT Flat Rate Scheme’ *AccountingWeb* 1 Dec. 2006.

³² HMRC, *Spreading the Cost of VAT for clients* <http://www.hmrc.gov.uk/news/annual-accounting-note.htm>

³³ <https://www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=263096&NewsAreaID=2&NavigateFromDepartment=False> This increase has now been extended to the cash accounting scheme also, for which European Commission approval was required- see <https://www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=263096&NewsAreaID=2&NavigateFromDepartment=False>

³⁴ Since this lecture was delivered, the National Audit Office report *HMRC Helping newly registered businesses meet their tax obligations* (HC 98 Session 2006-7, December 6 2006) has revealed (at p.27) that take up rates for VAT schemes are 22% for the cash accounting scheme, 16% for the flat rate accounting scheme and 1% for the annual accounting scheme. The NAO reports that the ICAEW consider that the simplification schemes should not be used as a substitute for simplifying the whole tax system but notes that its discussions with organisations representing the views of small businesses suggested that cash accounting would be more popular if it could also be used for income tax.

³⁵ *Accounting Web*- 19th October 2006, ‘What do you think? Cash accounting for small businesses’ – 10 October 2006; R. Murphy, ‘The case against cash accounting’, <http://www.taxresearch.org.uk/Blog> and see NAO report, *ibid*. For an interesting contribution following my lecture see Truman, ‘What’s in a name?’, *Taxation* 23 Nov. 2006. Truman argues that a cash accounting scheme such as he has in mind would be designed for businesses that are not businesses at all in the sense that they are not run by entrepreneurs. If such a provision were introduced, it might be very hard to contain it in this way and to police the limits. Truman also cites the Australian simplified tax system for small businesses,

would it apply? How would the line be drawn? Presumably it is intended only for unincorporated firms but that creates a distortion based on legal form. Companies need to follow accounting standards for company law reasons. Is not the real reason that it is perceived to be necessary because accounting standards are generally proving unsuitable for SMEs in some respects? If so the would it not be better to make sure those accounting standards are improved for a whole range of businesses (SMEs/unquoted businesses) rather than introducing a special rule for a few very small firms? Moving to cash accounting for the very smallest firms might reduce complexity (though for the reasons given below it might not) but it would also open the way to manipulation, which is of course what the accounting standards are there for in the first place. Might it not also cause those small businesses to be misled, because properly drawn accounts have an important management function? Would the small business then need two different sets of accounts? How is this helpful?

One major issue is that a move to cash accounting would almost certainly be followed by anti-avoidance legislation, which would create another layer of complexity. So, what appears initially as a good, simplifying idea turns out to be an invitation to complexity. One argument is that small business taxpayers are effectively using cash accounting anyway so we might as well legitimise it. But as soon as this step is taken there will be upward pressure for the regime to apply to bigger and bigger businesses. A system that might be appropriate for VAT will not necessarily work for a conceptually entirely different profits tax. A tax on profits *prima facie* requires a profit calculation. And even very unsophisticated businesses will want to make deductions for accrued costs. We might want to consider moving towards a conceptually different tax for small businesses, as proposed in the US by the US President's Panel,³⁶ such as a cash flow tax which would allow small businesses to expense all business-related expenses immediately. This, however, would be a radical

which used to operate on the basis of cash accounting. However he notes that it has recently changed. Indeed it has, as it was not a success. Take-up of this scheme in Australia has been much lower than expected (27% in 2005); M. Dirkis, 'Tax change or tax reform: Business tax reform evaluated' 2006 (publication forthcoming; supplied to author by M. Dirkis). Part of its lack of popularity related to compulsory cash accounting, and in particular the inability to make deductions on an accruals basis (which in Australia is sometimes possible even if receipts are on a cash basis). As a result the law has been changed so that cash accounting is no longer available for new entrants to the scheme: *Tax Laws Amendment (2004 Measures No 7) Act 2005*. My thanks to Australian colleagues M. Dirkis, C. Evans and Gary Payne for this information.

³⁶ President's Advisory Panel on Federal Tax Reform (2005), <http://www.taxreformpanel.gov/final-report/>

change of tax base that would need to be examined properly, at root, and not as an administrative relief. This is an example of the need to think carefully about proposing supposed small business reliefs which could turn very complicated indeed.

Similar conclusions to those above are reached in a US paper sponsored by the US Small Business Administration in March 2006 on Federal Tax Policy and Small Business which ends by stating ‘The current tangle of short –term tax changes and temporary provisions [in the US] surely makes small business planning more difficult than it needs to be, even if those provisions provide tax reductions to affected taxpayers’.³⁷

VI TACKLING THE STRUCTURAL ISSUE

My third and probably most important point is that small business tax policy is central to business tax design and not some addendum to the main agenda of large business taxation. Any design for a tax system, whether it be a new approach to corporation tax, a consideration of how flat or progressive taxes should be, or the question of integrating tax and national insurance contributions, needs to take account of how to deal with the blending of income from labour and from capital within the smallest firms. This takes us to the very difficult question of tax and legal structure.

Tax and legal structure

Most of our recent high profile problems relating to small firms in the UK have revolved around the issue of legal form- the so-called IR35 (special rules for the taxation of personal service companies), settlements legislation and *Jones v Garnett*³⁸ and the issue of tax driven incorporation.³⁹ If it is not possible to prevent the very smallest businesses from using corporate form but at the same time there is a pressure to tax income from invested capital, including shares, differently from income from labour, then we have a problem. Employees cannot be ignored in this picture because the possible modes of delivering labour run through a spectrum from employment

³⁷ Bruce and Gurley-Calvez, ‘Federal Tax Policy and Small Business’ March 2006 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904641

³⁸ [2005] EWCA Civ 1553.

³⁹ For further discussion of these issues see ‘Why taxing the micro-business is not simple — a cautionary tale from the ‘Old World’ Freedman, 2006 JATTA Vol 2, No 1, 58 http://www.atax.unsw.edu.au/atta/jatta/jattavol2no1/5_Freedman_JATTA_vol2_no1.pdf

through to provision via a company with unincorporated businesses in the centre of the spectrum. We may be very clear about the differences at each end but there is much blurring at the dividing lines.⁴⁰

Incorporation has been available to small firms since limited liability companies were introduced in the 19th century. In 1855, the House of Commons voted by a large majority to remove a minimum capital requirement originally inserted into the 1855 Limited Liability Bill. The express purpose of this amendment was to avoid creating a monopoly in favour of large companies.⁴¹ There is nothing new about small firms dominating the corporate form. *Salomon v Salomon*⁴² was, after all, a case which was fought over whether small businesses were “abusing” incorporation and it was decided that they were not. It is clear that the argument that incorporation should be made less accessible to small firms has not found favour. Following the *Centros* decision in the ECJ,⁴³ the barriers to incorporation elsewhere in Europe, such as a minimum capital requirement, are under attack since owners may incorporate in the UK where there are no such barriers so it is easy access to incorporation which is prevailing across Europe and we are not going to be able to put that cat back in the bag.

Accepting that incorporation is open to the smallest firms, there is then a tension between current global pressures to reduce corporate tax rates and the pressure to align tax treatment of income from capital and income for labour in the context of small businesses.⁴⁴ Add social security contributions (National Insurance) into this mix and we have a very difficult conundrum with considerations pushing in different directions. In the UK we already have a lower rate of corporation tax for small companies (the definition of which for this purpose includes the majority of UK

⁴⁰ This is discussed at length in Freedman, *Employed or Self-employed?* TLRC Discussion Paper (IFS, 2001) <http://www.ifs.org.uk/comms/dp1.pdf>

⁴¹ Formoy, *Foundations of Modern Company Law* (Sweet and Maxwell, 1923); discussed further in Freedman, ‘Small Businesses and the Corporate Form: Burden or Privilege?’ [1994] *Modern Law Review* 555.

⁴² [1897] A.C. 22 (H.L.)

⁴³ Case C-212/97.

⁴⁴ See, for example the proposals discussed by the ICAEW in TAXREP 22/05, n. 2 above, at para. 74.

companies⁴⁵). Since this is below the higher rate of progressive income tax and well below the basic rate of income tax on employee income when that is combined with employer and employee NICs, there is a continuing tax pressure to incorporate and convert income from labour into dividends as well as to split this converted income with family members. Removal of the nil rate does not remove these incentives to incorporate. The easiest answer would be to align all these rates of tax on all forms of income⁴⁶ but this would run counter to current trends in favour of differentiating income from labour and capital. As soon as there are any differences between social security payments for employees and the self-employed and between taxes on labour and on capital, the problems will commence.

The **small companies' rate** is already one of the causes of the tax driven choices. If the main corporate tax rate was to go down this would be a good chance to align it with the small companies' rate as the Forsyth Commission⁴⁷ has pointed out. This would not on its own remove the incentive to incorporate but it would help to achieve neutrality and to remove a complex relief with burdensome anti-avoidance provisions which must consume much tax planning time for little obvious overall economic benefit.⁴⁸

Slide 3

Within an owner-managed business the profits made by the owner will be a blend of a return on capital and earnings from his work. In the very smallest businesses there will be little or no capital invested other than human capital which, although important, is generally very difficult to reflect in the tax system. But there might also arguably be a return for risk of other kinds or for self-generated goodwill. At one

⁴⁵ In 2004-5, from a total of 831,885 corporate taxpayers, only 39,190 companies paid corporation tax at the full rate and a further 34,305 at the marginal small company rate: T11.3, HMRC statistics at http://www.hmrc.gov.uk/stats/corporate_tax/11-3-corporation-tax.xls.

⁴⁶ Including social security contributions.

⁴⁷ Tax Reform Commission (appointed by Conservative Party), *Tax Matters*, October 2006.

⁴⁸ Complexities include the very wide anti-avoidance rules to prevent splitting of income between associated companies which are then cut down by extra-statutory concessions: see S13(3) and s 13 AA Income and Corporation Taxes Act 1988; ESC C9 and *R v IRC, ex p Newfields Developments Ltd.* [2001] [STC 901](#) (HL).

extreme there may be only small differences between the economic activities of an employee and a self-employed person working for a small number of clients. At the other end of the spectrum there can be large unincorporated businesses with a number of employees and partners. Incorporation does not necessarily intersect this spectrum at a particular size level.

Differences in legal form may not seem always to reflect the underlying economic differences yet they do have real implications for the tax system because they affect the character and quality of income and the rights of the taxpayer over that income. This in turn has implications for tax system design and these legal characteristics cannot always be ignored or ‘looked through’ simply because they do not fit with economic substance. Removing one set of distinctions could increase distortions elsewhere. For example if tax and social security contributions were integrated, so that the employed self-employed distinction was diminished, tax on earned income would become higher and the distortion between incorporated and unincorporated firms would increase, unless corporation tax and the tax on dividends was also increased by an amount reflecting social security contributions.

Attempts to remove the distortions might involve ignoring the legal differences between these payment types and taxing according to economic substance, but this can be very difficult because the existence of different legal organisational forms makes a real difference to the quality of income. If a shareholder does not have a right to have dividends distributed to him there will be greater difficulty in taxing him on this sum than if he does have such a right, due to basic ability to pay principle. Immediately the liability to pay the tax will need to shift to the company that controls the dividends for an obligation to pay to be feasible, although if the shareholder is the sole or controlling owner imposing an obligation on him may be reasonable.

There is of course a standard view amongst economists that there should be no corporation tax because corporations are legal fictions and the real incidence of the tax falls elsewhere⁴⁹ but in the end they tend to accept that we need a corporation tax “ if it is not feasible for one reason or another to allocate undistributed profits for

⁴⁹ That is on customers, shareholders and employees: see Kay and King, *The British Tax System* (5th ed., OUP 1990) p. 153.

personal income tax to individual shareholders”⁵⁰ - a practical reason but one with a real legal rationale. However in the case of closely held /owner managed companies it may be feasible to allocate profits in this way and to tax these profits as if they were profits of the business in the same way as profits of an unincorporated firm. This would prevent the business owners from taking advantage of a lower rate of tax and the credit for dividends, but there would still need to be consideration of the NICs problem.

Integration of NICs with income tax is a partial answer to this problem but seems a long way off, even if there is a review going on. Classification of all or some of the income from both incorporated and unincorporated firms as income from labour, and charging some level of NICs on that, would be another possible way forward. This has been suggested in some shape or form by the Tax Faculty and CIOT⁵¹ so is not pure academic musing,⁵² but it would not be politically easy. It would be unpopular in so far as it increased taxes on small business owners (though it might make it possible to reduce NICs across the board).

Small business owners would argue that they take a degree of risk and responsibility which should be compensated by lower taxes than those levied on employees and that they do not enjoy the same social security benefits as employees. There are three responses to be made to this. First, it is not clear that all employment is less risky than self-employment. Many people are engaged in short term or casual employments and yet they still pay tax and NICs as employees. Secondly, although people paying employee NICs may receive some benefits not available to the self-employed, the gap is not as great as it once was. The 2006 Budget Financial Statement shows that the reduction in National Insurance contributions for the self-employed *beyond that attributable to reduced benefit eligibility* is £1.9 billion.⁵³ Thirdly, if it is government policy that the tax system should try to recognise an increased degree of risk carried

⁵⁰ Report of a Committee chaired by Professor J.E. Meade, *The Structure and Reform of Direct Taxation*, (IFS, 1978), Ch 12 p. 227.

⁵¹ See papers cited at fn 2 above although more recently the CIOT has welcomed the more limited approach in HMRC’s consultation on ‘Tackling Managed Service Companies’ rather than ‘fundamental change that would affect a much greater number of workers and engagers’. CIOT 1 March 2007.

⁵² Although it has also been suggested by other academics- see Chittenden and Sloan, ‘Quantifying Inequity in the Taxation of Individuals and Small Firms’, [2007] BTR 58.

⁵³ Budget 2006 FSB, *Table A3.1: Estimated costs of principal tax expenditures and structural reliefs.*

by the self-employed then this recognition should take the form of clearly stated and transparent reliefs rather than the current rather haphazard differences between the employed and self-employed.

A radical structural change would upset the losers, of course, but it would at least treat business owners in a fair way across the piece, according to standard rules, rather than picking out some of them for application of IR35 or the settlements legislation and leaving others to benefit from a rather beneficial system. The IR 35 legislation is requiring the case law to carry a burden it cannot bear and the settlements legislation likewise is being applied to a situation which it is not designed to cope with. Further elaborations and ant-avoidance provisions are likely.⁵⁴ A tailor made and holistic solution would be far preferable, even if initially painful.

A Nordic Solution?

Recharacterisation of the profits of incorporated small businesses to treat some part of them at least as labour income for tax purposes can be found in the Nordic system. This recharacterisation became necessary due to the Nordic system of dual income tax which taxes income from capital at a low flat rate equal to the corporate tax rate (giving full credit for corporation tax) with progressive tax on labour income.⁵⁵ Small business taxation was seen as the “Achilles Heel” of this scheme when it was proposed and it was considered vital to tackle this problem.⁵⁶ This new business tax design for large business necessitated the development of a solution for small business.

For unincorporated firms, given that it is not possible to observe the working hours of the self-employed,⁵⁷ the designers of this scheme start from the other direction and calculate an imputed return to business assets (as recorded in the balance sheet). This return is taxed at the lower rate for income from capital and the rest is taxed as labour

⁵⁴ Indeed the proposals to deal with managed service companies (fn 51 above (put forward after this lecture was delivered) are one manifestation of this: instead of root and branch reform, yet more complexity is to be introduced to deal with a specific situation.

⁵⁵ Sorensen, ‘Neutral taxation of Shareholder Income’, *International Tax and Public Finance* (2005) 12, 777-801. For a similar problem in the US context and a proposal to deal with it in a similar way see US Treasury Study, *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single Shareholder S Corporations*, May 2005, Reference no. 2005-30-080.

⁵⁶ Sorensen, *ibid*, p780.

⁵⁷ Assessing a ‘market wage’ is a problem we have in our system – see *Jones v Garnett*, fn 38 above.

income (including social security payments). The scheme is optional since it requires detailed book-keeping. Those choosing not to adopt it can be taxed on the whole of their income as labour income and thus escape the book-keeping requirements.

In the case of closely held corporations, the problem is similar but dealt with in a slightly different way because there are likely to be non-active shareholders in the picture. The Norwegian system is to exempt shareholder income below an imputed normal rate of return – the rate of return allowance ('RRA'). This has already been subject to a corporation tax at a rate corresponding to the capital income tax rate and is therefore not taxed further. Beyond that, dividends are taxed at a rate that, added to the corporation tax rate, corresponds to the top marginal rate of tax on labour. Only distributed dividends are so taxed and there are allowances to ensure that retained profits increase the basis on which the RRA is based. If the income distributed falls short of the RRA in one year the unutilised RAA may be carried forward and deducted in a later year.

One problem is that this system recognises only monetary investment whereas some would argue that it should also allow for the return to self-generated goodwill and to allow for risk. This can be done in various ways; for example there could be a cap on the amount of income to be treated as labour income since above a certain amount, or based on a percentage of the wage bill in relation to other employees. This would recognise that there may be investment other than physical investment in which case it is likely that profit represents some kind of return to goodwill or risk. In Norway an allowance was given along these lines at one point but has now been withdrawn as it was considered to be too generous and often resulted in *negative* labour income. The previous scheme in Norway also distinguished active and passive shareholders, but this was abused and so removed from the current scheme. Since this new system was not introduced in Norway until the start of 2006 it is too soon to assess it fully as yet. It is not without its own complexities and potential problems but it is worthy of further consideration and observation.

Encouraging incorporation through the tax system?

The discussion above assumes that neutrality as between different legal forms is desirable and that choice of legal form should not be tax driven. Chris Sanger⁵⁸ has argued that we should not rush to this conclusion though it is government policy. He argues for an incentive for incorporation because incorporated firms are more manageable and accountable, but he states that this is only the case if the incentive is at an appropriate level. The problem is, as we have seen with the nil rate starting rate and other less dramatic examples, that it is very hard to control the incentive level because of the possibility of conversion of labour income into capital described above. Sanger also cites the non-tax advantages of incorporation, but these are advantages that are often illusory, such as limited liability, which the very smallest firms rarely achieve since they are required to give personal guarantees, or unwanted by the micro-business which is at the heart of this matter, such as ability to raise finance, since most business owners at this level wish to retain control and not to grow by taking in outside investors.⁵⁹ If we wish to encourage incorporation through the tax system there should be a clear rationale and a relationship between the size of the incentive and the benefit to the economy. Since this is difficult to achieve, neutrality seems to be a better aim.

CONCLUSION

To return to my title, small businesses are **indefinable**, it is true, but mainly because we seek to use the word ‘small’ as a proxy for many other characteristics. Where the target is growth businesses, for example, we should focus on attributes of growth and not size. If this is impossible to predict in advance, which it may well be, then the tax system may not be the best route for delivery of incentives or benefits. Measures intended for small businesses should focus on problems truly associated with size, such as regressivity.

Is a solution **unachievable**? The problems are daunting, but we need to define the questions so that answers are achievable. I leave you with some key points to take into account when considering tax policy for small firms.

⁵⁸ Taxline March 2005

⁵⁹ See Freedman and Godwin, ‘Legal Form, Tax and the Micro-Business’ in Caley et al (eds) *Small Enterprise Development* (1992),

- Focus on ‘small’ in terms of size and not as a proxy for other characteristics.
- Structural issues need to be addressed in a holistic and not piecemeal way.
- We must not expect too much from the tax system- just to provide a fair tax on small businesses might be enough without attempting to shape policy through this means.
- Attempts to simplify can create complexities of their own.
- Design of business tax for large businesses must take account of the small business problem from the outset rather than relying on adjustments once large business taxation is dealt with.
- The ideal solution for the small business problem would be a flat rate tax and alignment of tax and national insurance with an extension of national insurance element to unearned income. This is not a realistic expectation. But we could bring our small business corporation rate up and our mainstream corporation tax rate down. Though of course that has cost implications- meeting somewhere in the middle might make sense.
- The trend towards lower taxes on income on capital is in tension with this ideal unless labour income is also to be taxed at low flat rates, which seems impractical, especially if social security payments are taken into account.
- One alternative is to adopt a system like the Norwegian one where income from owner-managed businesses is treated in part as labour income and taxed progressively. This reduces distortions between different forms of return from a business but increases the distinctions between income from labour and business activity and other forms of income. It also requires a degree of complexity in the operation of such systems. Arguably provision would need to be made for the returns to what we might call non-physical capital: entrepreneurial risk and self-created goodwill. Attempts to do this in Norway have shown that it is not straightforward to set the level for this allowance so as to obtain an appropriate tax rate. However some way forward along these lines would eliminate the emphasis in our system on the definition of employment which is highly problematic, especially in the context of IR 35. It would also deal with the settlements problem in a way which applied across the board rather than in an arbitrary and uncertain way only in some cases.

- It is worth addressing these bigger picture questions rather than merely changing things at the margins. The response to the removal of the nil rate was favourable and mature- it should not be supposed that small business taxpayers could not take a sensible structural change if it could be shown to benefit them in the long run.

We must not be so overwhelmed by the task that we do not even ask the questions. **If we define our objectives sensibly, a solution should be achievable.**

I am very grateful to the Tax Faculty for giving me the opportunity to discuss these issues and welcome the views of members as part of the process of writing the chapter on this topic for the Mirrlees Review (<http://www.ifs.org.uk/mirrleesreview>).

E-mails may be sent to judith.freedman@law.ox.ac.uk.