# SMALL BUSINESS TAXATION

**A special study in selected issues undertaken for the Mirrlees Review**

**Claire Crawford, Institute for Fiscal Studies.**

**Judith Freedman, University of Oxford.**

**April 2007**

**CONFERENCE DRAFT: THIS PAPER REPRESENTS INCOMPLETE WORK IN PROGRESS AND IS NOT FOR QUOTATION WITHOUT PERMISSION.**

**We are grateful to Peter Birch Sorensen, Michael Devereux and Stuart Adam for their advice to date and welcome further comments from all. Please send comments to judith.freedman@law.ox.ac.uk**

# I. Introduction

*Objective of study*

This Review seeks to 'identify the characteristics of a good tax system for any open developed economy in the 21st century, to assess the extent to which the UK tax system conforms to these ideals, and to recommend how it might realistically be reformed in that direction.'

The taxation of small businesses cuts across a number of different topics in the Review- hence its status as a special subject. It could be seen as a key to the design of a good tax system or merely an irritant, getting in the way of such design because it does not conform to the same requirements as other forms of activity.

This special study for the Review argues that getting the taxation of small businesses right is an important element of the design of a good tax system. Though the study tackles small businesses, it does not follow that the issues are simple. Because they arise at the interface of personal and corporate taxes, the problems of tax design for small businesses raise questions of complexity that permeate many other areas of tax system design. The small business cannot be merely an afterthought: to leave it out is like leaving out one number from a Su Doku frame- it might be just the one figure that shows every other number to be unworkable. Due to this objective, the paper concentrates on structural issues related to the relationship (or lack of relationship) between legal form, entrepreneurship and the taxation of the very small business. It does not attempt to cover in detail all issues which might be of importance to small businesses, not least since many of these issues are discussed elsewhere in Review chapters.

In particular, the study focuses on the problem that the very small business owner usually has the capacity to choose between operating as an unincorporated firm, and thus being taxed as a self-employed person, or incorporating and thereby becoming subject to corporation tax and dividend taxation. This incorporation option has the capacity to alter the legal character of the income of the firm. In any system where there is a difference in the tax rates (including social security contributions) applicable to income from capital and income from labour this may create a distortion and interfere with intended incentives.

The differential tax treatment may follow the legal form (as in the UK) or the taxpayer may be given a choice of method of taxation to some extent regardless of legal form (as in the USA as a result of the S Corporation electionfor corporations and the check-the-box system for unincorporated firms).[1] In either case inefficiencies and lack of horizontal equity may occur. In one sense this is because legal form and economic substance differ, and in another because the legal act of incorporation often does *in fact* alter rights and relationships, thus impacting in a real way on taxable capacity and practicalities. Thus, for example, an unincorporated firm is not a separate legal entity which can make it difficult to differentiate between the personal and business assets of the owner, whilst an incorporated firm's owner may have limits on his ability to access

[1] These elections are described below in Section IV.

the assets of the corporation even if he holds a majority of the shares and certainly if there is another major shareholder.

There is further potential for distortion and lack of equity at the employee/self-employed boundary for similar reasons. Although the case law distinguishing these two categories is flexible and always developing, it may not always follow economic reality in every case, yet there are real economic and practical differences between the categories away from the boundary line, which lead to differences in tax treatment.

There is little in the *Meade report* dealing with this problem. It has become more significant in the UK over recent years due to changes in levels and relationships between personal and corporate tax rates and increases in social security contributions paid at differential levels for the employed and self-employed and not at all on corporate dividends. Increased diversity in working practices, moving away from the standard full time employment mode, and easing of corporate law regulatory burdens for incorporated firms have also added to this mix. These developments have led to increasing numbers of self-employed and incorporated firms, with incorporation offering opportunities to convert highly taxed labour income into less highly taxed corporate distributions. These issues are not unique to the UK and have real implications for the structure of personal and corporation taxes more generally.

*Outline of paper*

This paper outlines some key areas of potential difficulty and distortion for small business taxation and discusses the key elements to be taken into account when designing a tax system which takes account of small business issues. Part II deals with definitional issues and draws a picture of the small business sector in the UK; Part III addresses the significance of small businesses in the tax system and asks when, if at all, the tax system should favour small firms, concluding that the main possibilities are 1) to correct market failures by providing incentives and reliefs in limited circumstances and 2) to deal with the disproportionate nature of compliance costs on small business. The paper deals with these issues in brief only given that they are dealt with elsewhere in the review. Part IV focuses on the key structural issues and problems of distortion due to differences in treatment of the employed and self-employed at one end of the spectrum and the self-employed and the incorporated form at the other. This is illustrated by an analysis of the current state of the UK system. Part V looks at possible alternative approaches.

## II. A problem of definition

The term ‘small business’ conjures up a variety of types of entity, ranging from the one man service provider, who might be close to an employee in economic terms, to the company about to be launched on AIM. What is meant by ‘small’ will depend on the purpose of the definition and may actually relate to qualitative characteristics rather than size. The *Committee of Inquiry on Small Firms* (the Bolton Report) (Bolton 1971)

favoured a qualitative, or what it called an economic definition, albeit in tandem with statistical definitions looking at different measures for different sectors.

*Qualitative and quantitative definitions.*
The Bolton Report defined a small firm as one that has a relatively small share of its market; that is managed by its owners in a personalised way and not through the medium of a formalised management structure and is independent (that is it does not form part of a larger enterprise and the owner-managers are free from outside control in taking their principle decisions). As a short-hand description we might call these businesses owner-controlled rather than small but the use of the term ‘small’ for such firms is widespread and embedded. Due to its emphasis on structure this paper will focus on businesses which are small in this qualitative sense.

This definition has its limits in connection with practical purposes and therefore taxation and regulatory provisions. Objective and easily measurable criteria are often needed in legislation. Quantitatively, size may be measured by profit, turnover, balance sheet, number of employees, number of owners or some combination of all these measures **(see Appendix 1)**. Each measure will give a very different picture- for example quite large businesses in terms of number of employees may make low or negative profits. In terms of tax design, whether a business is owner managed and controlled may have greater relevance to how the business should be taxed than quantitative size as it affects the nature of income and the scope for recharacterisation of profits.

Size is also sometimes used as a proxy not only for owner control but also for other characteristics which governments may wish to target through the tax system, such as new firms, ‘entrepreneurship’, growth and job creation. Using size in this way can be highly inefficient in view of the large number of small firms which do not grow or create jobs and which never intended nor desired to do so. Therefore tax subsidies delivered by reference to size may carry a significant dead-weight cost by targeting too wide a group and even encouraging others to join this group in receipt of tax reliefs when there is no good commercial reason to do so.

*Legal form not an indicator of size, growth or entrepreneurialism*
It might be thought that there would be a clear gradation from the employee, who provides only labour in return for a wage and so is clearly not running a small business, through the unincorporated, self-employed firm to the incorporated firm in which the provision of ownership and of labour are separated. The true picture is much muddier. At the edges of the employment category are non-standard employees such as causal workers and those who are providing services to more than one organisation or client but who nevertheless share some of the characteristics of employees. For example they may provide no equipment but only services, they may take little risk and they may invest no capital in their activities. In the UK, and indeed in most jurisdictions, the law has difficulty in drawing the line between the employed and self-employed and relies heavily on fact based tests which may also be used in a similar or slightly different form for other legal purposes such as employment law and health and safety regulation (Freedman

2001). The European Commission reports that non-standard working and self-employment are increasing and together made up almost 40% of the EU-25 workforce in 2005 and this is forcing consideration of change in employment law as well as having tax implications (EC 2006).

Horizontal equity issues arise at both the employee/self-employed borderline and the incorporated/unincorporated boundary. Further there is an interaction between seeking to escape employment status and incorporation. An employee often has a tax and National Insurance (social security) incentive to arrange matters so that he can be reclassified as self-employed but may find this problematic due to the uncertainties of the case law dividing line between the two. He may therefore prefer to incorporate his business to strengthen his argument that he is not an employee of the person to whom he is providing services. He will be an employee of his own company but if this arrangement brings further tax advantages there will be an even greater incentive to do this.

Legal form, in particular incorporation, is also sometimes thought to have some bearing on size issues. As is clear from the statistics below, there is a correlation between size and incorporation but it is a poor test. Incorporation does not necessarily relate to qualitative characteristics such as ownership and control since single person firms may incorporate and there are some very large professional unincorporated partnerships. Nevertheless it is true to say that most businesses which contemplate growth and the raising of external finance will incorporate. It does not follow that incorporation encourages growth or can be associated with growth if there are also tax and other reasons which encourage incorporation. As will be shown, much of the recent growth in incorporations has been in the form of companies with no employees other than the owner himself and these companies will typically also have only one or two shareholders. The public company/ private company divide is also not necessarily associated with size- whilst most, but not all public companies are large, privately owned companies may also be very substantial indeed and we have many recent examples of this.

*Background statistics*

As discussed above, there are numerous ways of defining a "small" business. Since our aim in this paper is to address structural tax design issues, much of the focus will be on structural differences indirectly related to size rather than direct issues of size. Nevertheless it is helpful to have some background information on the "small" business sector in the UK. **Appendix 1** provides sources of the measures discussed herein.

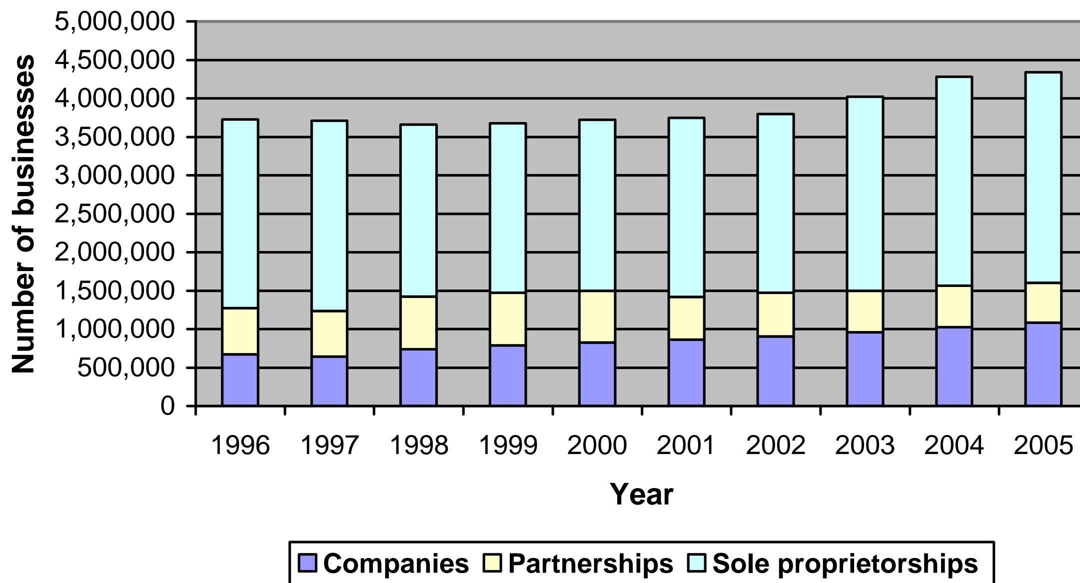
In 2005, there were an estimated 4.3 million private sector business enterprises in the UK, of which 99% were firms with fewer than 50 employees[2] and 96% were firms with

[2] This is one of the criteria – alongside having turnover of less than £5.6 million and a balance sheet total of not more than £2.8 million – used to define a small business in the Companies Act 1985. See **Appendix 1** for more details.

fewer than 10 employees (referred to as micro-businesses): these micro-businesses accounted for 32% of employment and 22% of turnover in the UK in 2005.[3]

Figure 1 shows how these firms were split according to legal form: note that partnerships and sole proprietorships are both unincorporated business types. From this figure, it is clear that the number of incorporated firms is increasing relative to the number of unincorporated firms (although this masks an increase in the number of sole proprietorships and a decrease in the number of partnerships). The number of self-employed (unincorporated) individuals has also been rising relative to the number of employees in the UK over recent years and, since mid-2002, has been growing faster than at any time since the late 1980s.[4] These patterns may partly be explained by tax and other legislative changes made in the UK over this period (considered in more detail in the structural section below), thus underlining the importance of tax design with reference to "small" businesses.

**Figure 1 - Number of businesses over time in the UK, by legal form**




Source: Small Business Service

In terms of other definitions of "small" businesses: the small companies' rate of corporation tax is paid by companies generating profits of up to £300,000 per year. In 2004-05, 92% of companies paid the small companies' rate or below, generating around

[3] Source: Small Business Service SME statistics.
[4] Source: Growth in self-employment in the UK www.statistics.gov.uk/articles/labour_market_trends/Growth_article.pdf. This article notes that flows into sole-directorships come mainly from the self-employed and not from employees and so argues that the increase in self-employment is not tax motivated. *This may require further consideration*.

£8 billion in tax revenue (22% of all corporation tax paid).[5] Further, of the 4.64 million individuals recorded as having some self-employment income in 2004-05, 4.55 million (98%) had self-employment income of less than £100,000[6] – well within the small companies' range.[7]

At the start of 2005, just over 1.8 million businesses in the UK were VAT registered. It is estimated that around one fifth of these had turnover below the VAT threshold at that time (£58,000), such that approximately two thirds of all UK businesses would have been classified as "small" on this measure.[8]

How do these definitions relate to legal form? Table 1 shows the number (and percentage) of each business type that would be classified as "small" under the definitions discussed above. As can be seen, a greater proportion of unincorporated than incorporated businesses had fewer than 10 employees, but the number of "small" companies (at least on this definition) remains significant, such that legal form does not provide a perfect proxy for size.

**Table 1 – Statistics on "small" businesses in the UK in 2005, by legal form**

| | All | Number (%) with fewer than 10 employees | Number (%) with no employees | Number (%) with profits less than £300,000 | Number (%) with turnover less than £64,000 |
|---|---|---|---|---|---|
| **Incorporated (companies)** | **1,084,705** | **934,240 (86)** | **418,950 (39)** | | |
| **Unincorporated** | **3,257,335** | **3,214,290 (99)** | **2,743,650 (84)** | | |
| Partnerships (including LLPs) | 515,555 | 487,110 (94) | 323,345 (63) | | |
| Sole proprietorships | 2,741,780 | 2,727,180 (99) | 2,420,305 (88) | | |
| **Total** | **4,342,040** | **4,148,530 (96)** | **3,162,600 (73)** | | |

Source: Small Business Service

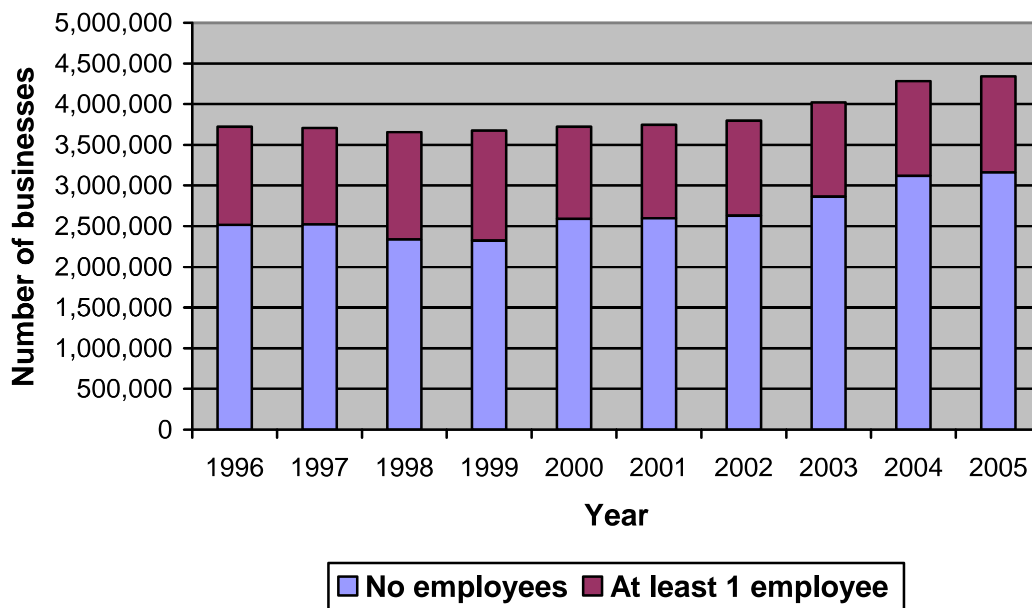
Given that our focus in this paper is on the interaction between the labour and capital income tax systems that arises from the opportunity for small businesses to reclassify their income, it is important to consider firms where this is most likely to be a possibility, that is where there is an identity between the owners and employees of the firm. This is most likely to be the case for businesses with no employees ("one-man" firms) and for micro-businesses (those with fewer than 10 employees).

[5] Authors' calculations from: www.hmrc.gov.uk/stats/corporate_tax/11-3-corporation-tax.pdf.
[6] Source: Authors' calculations from: www.hmrc.gov.uk/stats/income_distribution/table3-10.pdf.
[7] Unfortunately, it is not possible to derive the proportion of individuals with less than £300,000 of self-employment income from these statistics. (to check)
[8] Source: www.dtistats.net/smes/vat/VATStatsPressReleaseOct2006.pdf (plus some authors' calculations).

As Table 1 shows, in 2005, around 73% of private sector businesses in the UK had no employees (other than the self-employed owner-director or company director).[9] Figure 2 shows how this split has been changing over time, and highlights the fact that almost all of the increase in the number of businesses in the UK (at least since 1999) has come from those with no employees.[10] Much of this must reflect the increasing tax and National Insurance Contribution (NIC) incentive to move away from employment and towards self-employment or incorporation (discussed in more detail in the structural section below).

Although arguably less important than larger small businesses as 'engines of the economy', it is this group of owner-managed micro businesses that gives rise to the greatest structural problems, so it is this group that is at the centre of business tax design, and that will form the main focus of our paper.

**Figure 2 - Number of businesses over time in the UK, by number of employees**




Source: Small Business Service

---

[9] Source: Small Business Service SME statistics.

[10] 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.

## III Should tax systems favour small businesses?

*The importance of the small business sector and 'fairness'*

Small businesses punch above their weight in terms of turnover, profit and employment levels in policy debates in the UK. This may seem strange in that this is not likely to be a particularly well organized or resource rich lobby group.[11] Nevertheless recent campaigns in the UK (relating to IR35 and the settlements legislation discussed below, for example) have shown that groups representing small businesses can get themselves noticed even if they cannot achieve changes in the law.

One reason for this may be that small businesses are numerous, even if not having high turnovers and profits. Many taxpayers and voters are either running a small business, have done so at some time or have aspirations to do so. Others have connections with small businesses as customers, employees, and through family members. Many members of vocal profession are also, effectively, running small businesses and so they will represent themselves and their clients energetically. There is also a sense of 'fairness; surrounding the small business debate in the third sense refereed to in this Review by Banks, Diamond and Mirrlees, which they describe as the

'citizens' perceptions of fairness, which may or may not coincide with some philosophic measure, and which matter for both the political process and individual compliance'.[12]

This sense of fairness seems highly developed in the case of the small business community. This may be a repercussion of the way in which small businesses have been referred to in recent times by Ministers. As discussed below, those who have praised and encouraged them as part of the 'enterprise economy' have later accused some small business owners of reprehensible behaviour and tax avoidance when these owners have reacted to incentives in a rational way which has not, however, been in line with the original intentions of government. Since Ministers and Government documents often use the word 'fair' in this context, it is not surprising to find that business owners see issues in terms of 'fairness' also. References to 'fairness' in this paper have this meaning, rather than fairness in the sense of horizontal equity, unless otherwise indicated.

*Rationale for special tax treatment of small firms.*

There is a strong assumption in government, often to be found in the speeches of politicians, that small businesses should be provided with tax incentives and reliefs. The reasons for this are not always clear but relate to the definition of small being used. If it is new firms, growth or entrepreneurship that is being targeted there may be some justification for seeking to favour a particular group, but often there is slippage from rhetoric about entrepreneurship or similar to implementation through reliefs or incentives for *all* small businesses. This is inevitable due to the difficulty of targeting firms with

[11] See Alt, Preston and Sibieta, 'Political Economy ' in this Review.
[12] Banks, Diamond and Mirrlees, 'The base for direct taxation' in this Review, at p.40.

more elusive characteristics; nevertheless this is a process which can create considerable distortion in the tax system.

There are several arguments for tax measures favourable to small businesses.

First, there may be market failures that affect small firms, such as asymmetric information, for example on markets or products, monopoly power of large firms making entry into the market difficult or difficulties for small firms in raising finance. These may be used as a justification for general tax reliefs or for specific schemes to promote investment in small firms. These schemes, it is argued, will assist not only the firms themselves but the market more generally with spillover effects from the innovative activity of the smaller firms (e.g. Gordon, 1998).

Second, it may be important to counter the disadvantages of being small by special measures, as in the case of the burden of compliance costs on small business. Compliance cost work in various countries has established that tax and other burdens fall disproportionately on small businesses and this is widely accepted as being a problem that may legitimately be addressed by reliefs and exemptions and by removing certain reporting and disclosure requirements from small firms (e.g. Sandford, Godwin and Hardwick (1990); Chittenden, Kauser and Poutziouris (2003); Evans (2003); KPMG (2006)).

Third, losses bear more heavily on small businesses than on others. Tax is paid immediately on taxable profits, but relief for tax losses may have to wait until the business generates sufficient taxable profits to absorb past accumulated losses. This is less of a problem for mature firms, which are likely to be generating profits from existing business and can claim immediate relief for any loss on the new investment. This option is not open to new firms without existing taxable profits, so that there is discrimination against investment spending by new firms, or by small firms during a high-growth phase in which investment spending is high relative to current profits. The same is true for high-risk investments, where the different availability of loss reliefs and the risk of catastrophic failure are likely to favour investment by mature firms as compared with start-up firms (IFS 2000, chapter 8). This may point, for example, to a need to permit small corporations to have pass through treatment for tax purposes so that the owners can set their business losses against other sources of income.

Fourth, there may be an argument for ensuring that small businesses can be passed on to family members, preventing firm break-up and leading to reliefs from capital gains and inheritance taxes.

Finally, a general argument is frequently put forward that small businesses are important as an engine of the economy and for job creation purposes and that this in itself justifies tax favouring provisions.

The rationales outlined above are not, however, uncontentious. Even if they are accepted, there are many problems with ensuring that these objectives are satisfied through special

small business tax reliefs and incentives, or through structural reliefs related to legal form, rather than by more direct subsidies and other regulatory policies.

First, there is the issue of targeting. When politicians talk about small businesses, they generally give the figures for all small businesses in existence, yet those of importance to the economy in terms of likely growth and job creation make up a much smaller number. It is notoriously difficult to distinguish growth and non-growth businesses *ex ante*.[13] There is considerable academic debate about the extent to which small businesses are 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 Harrison (Harrison 1997) and David Storey (Storey 1994). 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."(Storey, 1995).[14] 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. (Curran et al 1993).

Reliefs aimed at all small businesses are available, inevitably, to non-growth firms, so called life style businesses and even business operations which governments aiming at growth and job creation would not consider to be 'genuine businesses' but rather 'disguised employees'. Indeed, the creation of reliefs and exemptions may result in the reorganisation of business activity in order to create 'small businesses' at least partly in order to obtain the tax advantages: an activity sometimes characterised by government as tax avoidance, as will be seen from the UK experience of the nil rate corporation tax discussed below.

Second, the provision of tax reliefs and exemptions for small businesses may be inefficient. It may distort the choice of business organisation, commercial decisions about forms of expenditure, timing and method of change and transfer into other hands. It may be that keeping a business in the family, or holding it until death, is not the best commercial choice, yet this may be the result of the tax system. Reliefs might even result in barriers to growth at the margins if restricted to businesses below certain thresholds. It is arguable that a simple and neutral system of business taxation could be more important to small businesses than many special provisions, which create a complexity of their own (Freedman 2006).

Third, tax incentives and reliefs to small business may result in economic inefficiency if they interfere with the market and result in the allocation of resources to small, less efficient, firms rather than to larger, more efficient, ones. Alternatively, they may not be effective at all.

---

[13] Attempts have been made to predict which firms will grow based on such factors as the characteristics of the owners. Even these have limited predictive value ex ante and they could certainly not provide the basis for differential tax regimes: See Storey (1994) at p 158.

[14] However, while most small firms do not grow themselves, threat of entry may force larger incumbents to increase productivity, indirectly generating growth.

The OECD (OECD 1994) has commented that, from a strict economic efficiency viewpoint, all special provisions for small businesses need to be justifiable in terms of market failure or malfunction. It recognizes, however, that there may be objectives beyond pure economic efficiency, such as income distribution, which might justify special tax and other provisions for small firms.

Apparent market inefficiencies may, however, be examples of the market getting it right. So, if small businesses lack finance in some circumstances there might be good efficiency reasons for this in the case of some activities or types of firm. Attempting to manage this through the tax system could have unintended consequences. Thus the OECD argues that tax measures are most likely to improve on the free market outcome in situations where the nature of the market failure is clear (such as inability of firms to raise funds for worthwhile projects with a good chance of success). In addition there needs to be evidence that the failure is significant, and a tax measure must be available that tackles the source of the inefficiency, has a significant effect on the behaviour in question and does not produce major distortions elsewhere. This will be quite a rare combination of circumstances.

The OECD recommends that countries must first decide what problems are faced by small businesses and then, if they consider the problems are sufficient to warrant government action, the relative merits of preserving a neutral tax system (in so far as one exists) and using direct expenditures to pursue small business policy objectives should be considered, since non-tax measures will often be better targeted than tax measures. In a later report (OECD 1997) it concludes 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. Beyond that, since there is no such thing as a tax on a small business per se there is not necessarily any reason to provide special relief through the tax system.

*Incentives and removal of barriers*

This study does not cover the issue of incentives in detail but questions whether there is a special small firm rationale for tax incentives. There certainly seems to be no reason to limit any incentives which are given to incorporated firms although that is the case, presumably for administrative and accounting reason, with R&D credit in the UK. As seen in the political economy chapter of this review, whilst the R&D credit was initially introduced for small companies it was soon extended to larger ones. If it is believed that there is a rationale for a tax incentive then it is generally hard to justify its restriction to small firms, especially where very few of them can actually benefit form the relief, as in the case of R&D and the evidence that R&D tax credits address the issue of growth is unclear. [15] 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.

---

[15] Abramovsky, Griffith and Harrison, (2006); PricewaterhouseCoopers (2006), *Enterprise in the UK: Impact of the UK tax regime for private companies*.

The recent announcement of help for small businesses to claim R&D would fall into that category but this is closer to a compliance cost rationale .[16]

Another area where small businesses are often given special assistance is in relation to transfers, particularly from one generation to another, which might result in closure of the business with consequent loss of employment and wealth generation.[17] These issues are not the focus of this paper but it is worth mentioning that the UK has a number of tax reliefs aimed at easing the transfer of businesses, particularly inheritance tax business relief. The basis for these reliefs on transfer is not entirely clear, however. For example, why is it assumed that the transfer of a business to the second generation is necessarily better than, say, the purchase of a business by a third party? The evidence from the small business literature suggests this is not necessarily the case. A better guiding principle would seem to be neutrality as between these different outcomes to allow the commercial considerations to govern but there may be political and social reasons why this is not acceptable.

Where incentives are given and are linked to size, there can be a danger that this becomes a barrier to growth in itself. The small companies' tax rate could be an example, where taxpayers can go to some lengths to stay within the threshold. This is another reason to delink incentives from size.

*Compliance costs*

Reductions in formalities for small firms which address the very real compliance cost issues seem more justifiable. As noted in the implementation chapter of this Review, the literature strongly supports the position that both compliance cost and the non-compliance rate are highly regressive (i.e., costs as a fraction of a measure of firm size decline with firm size, and non-compliance as a fraction of actual liability declines with firm size). Assistance with these compliance burdens could increase compliance. These issues are discussed extensively elsewhere in this Review but a few points should be noted here.

First, there is a need to avoid complexity in deregulation and the proliferation of thresholds which can be confusing and can themselves create barriers to growth. Not all supposed simplifications are helpful. For example, the low take up rate of some of the VAT simplification schemes illustrates this. The National Audit Office (NAO) reports (2006) 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.[18] The NAO

---

[16] HMRC Press Release 10 Nov. 2006 www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=241316&NewsAreaID=2&NavigatedFromDepartment=False

[17] European Commission Recommendation of 7 December 1994 on the transfer of small and medium-sized enterprises (94/1069/EC); European Commission Communication on Recommendation of 7 December 1994 on the transfer of small and medium sized enterprises (94/C 400/01).

[18] There are certain pitfalls and traps for the unwary, particularly in the flat rate scheme- for further discussion see Freedman, Hardman lecture, ICAEW.

comments that the ICAEW consider that the simplification schemes should not be used as a substitute for simplifying the whole tax system.

Secondly, there may be a very good administrative and compliance cost saving reason for some kind of exemption, for example the VAT registration threshold,[19] but this too may become a barrier to growth and moreover it may reduce the level playing field for those firms which do have to register. So the problem may not merely be one of revenue foregone but may be loss of efficiency in that competition is hindered and more efficient larger small firms are put at a disadvantage. There is also a problem of perceived unfairness amongst the small business community.

Thirdly, reduction of some requirements may not actually assist the small firms because the tax requirement bolsters a commercial need, for example to keep proper accounts. Recent arguments that small firms should be able to pay tax on a cash basis fall into this category. [20]Moving to cash accounting for the very smallest firms might be thought to reduce complexity but small business owners might be misled, because properly drawn accounts have an important management function. What is more the end result could be a good deal of anti-avoidance regulation which might make for more complexity rather than less in the long run.

## IV Structural issues: legal form, boundaries and distortions

*General principles*

The differences in tax treatment between the employed and self-employed on the one hand and the unincorporated and incorporated firm on the other, and the impact of this on decision making about legal form by small business owners, have been the subject of some academic discussion in the UK and elsewhere[21] although this does not appear to have been a major concern in the *Meade report*. To the extent that *Meade* was concerned with the relationship between corporate and personal tax it was in relation to an integrated treatment of dividend taxation (for which transparency was seen as the ideal, though not necessarily practical solution) rather than the relationship between income from labour and the return to capital which concerns us here.[22] The different concerns

---

http://denning.law.ox.ac.uk/tax/JF/14Hardmanlecture.doc

[19] See Indirect Taxes chapter in this Review.

[20] Truman (2006).

[21] On the UK see Freedman, and Chamberlain (1997), Freedman (2001), Chittenden and Sloan ( 2007). On the impact of differential tax rates in the USA see Mackie-Mason and Gordon (1997), Gordon (1998), Cullen and Gordon (2002) although the legal background and tax rates have changed considerably since these US papers were published. Sorensen (2007) has written about the way in which this issue is dealt with by the Nordic dual income tax systems.

[22] Meade (1978) p143. Meade stated that partnership treatment of shareholders would have the 'great advantage that the need for special legislation to treat close companies differently from other companies would disappear'. The most troublesome of that legislation, the apportionment rules, have in fact disappeared as personal tax rates have decreased in any event. Other close company provisions remain.

were in part a result of a different balance of tax rates and different work practice conditions thirty years ago, leading to different preoccupations.

In this context, there are two boundaries at which distortions can take place. The first is between employees and the self-employed. Whilst many workers have no choice other than employment, there is an increase in the number at the boundaries with self-employment and there may be scope to structure relationships to create self-employment rather than employment at this boundary. There will often be labour law incentives to do this for those to whom services are being provided and the tax system may also advantage the self-employed. The self employed in turn may have a choice about operating in unincorporated or incorporated form.

Most, if not all, legal jurisdictions offer business owners a choice of operating as incorporated and unincorporated businesses. Unincorporated businesses are typically sole traders and partnerships whilst incorporated firms are corporations which usually offer limited liability. Owners of unincorporated firms generally will not have limited liability and will not have a formal separation of their personal and business assets which can have implications for tax system design.

Incorporated companies will offer limited liability to their shareholders (although this can be illusory in the case of small firms without outside shareholders since creditors will often insist on personal guarantees). Corporations are the most appropriate vehicle for businesses wanting to raise outside finance because they bestow limited liability on the lender. Corporation law is often predicated on the separation of ownership and control and the need to protect all shareholders, especially minorities, and creditors. Thus incorporation can be costly and inappropriate for firms where there is no actual separation of ownership and control, especially if the legal protections are mandatory and involve burdensome compliance. Where the corporate regime is more flexible and some provisions may be escaped by agreement and election, this cost may not be so great. For the same reason (to protect shareholders and creditors) there will also be financial protections around the corporation in the form of accounting and audit requirements and possibly a reduction of flexibility in the way in which corporate funds can be utilized. In Europe, for example, this includes rules on capital maintenance.[23]

In both the UK and the USA there are now hybrid legal forms. In the USA, limited liability companies (LLCs) are unincorporated firms organized on a flexible partnership basis, but have limited liability in some measure. They are not to be confused with UK limited liability companies which are incorporated. In the UK, limited liability partnerships (LLPs) are also a hybrid: they are bodies corporate which exist as legal persons separate from their members and have limited liability in some measure but the internal governance follows partnership law as a default mode and have tax transparency. The creation of these hybrid forms has been tax motivated to a considerable degree. [24]
In the USA there are elections, discussed below, which delink tax treatment from legal form to some extent but this simply changes the nature of the boundaries- it does not

---

[23] For further discussion of these issues see Freedman (2000).
[24] See Freedman (2001); Limited Liability Partnerships Act 2000.

prevent tax planning from taking place around the different tax treatments – transparent partnership treatment ('pass-through') or corporate treatment. [25]

The boundaries may be illustrated (using the UK terminology which refers to social security contributions as national insurance contributions (NICs)), as in the following table.

| A | B | C |
| --- | --- | --- |
| Employee<br>Income tax on earnings plus NICs<br>(employees)+ (employers) | Self-employed/ sole trader/ partnership<br>………………<br>Income tax on profits plus self-employed NICs | Owner-managed company<br>Corporation tax on profits (mixed return on capital and labour and economic rents)<br>Income tax and NICS on earnings (flexible level chosen by owner-manager).<br>Dividend tax |

The first boundary is between the employed and the self-employed. The employee will be taxed on his wages and will often suffer deduction of tax at source. Both he and his employer will be liable for social security payments (national insurance contributions 'NICs' in the UK). His employer will withhold taxes, making evasion, avoidance and tax planning more difficult for an employee than for the self-employed.[26] Clearly this system will be popular with governments, potentially costly for employers and will limit the freedom of action of employees.

The second boundary is between the self-employed, paying income tax, and the incorporated firm paying corporation tax. The attraction of incorporation for a one person business owner is that he can convert his personal income into corporate income which can be sheltered in the company, taxed at corporate rates and distributed by way of dividend (with associated tax credits) instead of salary. By choosing a careful mix of salary payments and dividends he can achieve all the benefits of a full social security record and avoid the higher social security payments on part of his profits by distributing them as dividends. In other words he can recharacterise his income from labour so that it is treated in the same way as income from capital. Furthermore he may be able to take in

[25] See the discussion of S corporations and 'check- the box' below.
[26] See Implementation chapter in this Review

other family members as shareholders so that they can received dividends, which may be helpful due to the progressivity of the system, and he may also be able to pay other family members salaries within their personal allowances or at a lower tax rate than he would pay (income-splitting). This leads to anti-avoidance provisions and general rules on deductibility of expenditure which limit the ability of the business owner to achieve these ends as discussed below in the consideration of the UK system.

*The UK system as an example of the structural issue*

**Employment and self-employment**

In the UK the majority of workers are employees but there are increasing numbers of self-employed as shown above. For employees, a complex cumulative PAYE system operates and employees do not normally complete tax returns for themselves. For this reason deduction at source reduces the available expenses deductions for an employee to virtually nothing so that there is also an additional cost to being an employee in this respect (Freedman and Chamberlain 1997). The substantive rules on expense deduction for employees are notoriously rigid, more so than for the self-employed, partly to support the workings of the PAYE system and the desire to avoid employees having to complete tax returns. Further, the National Insurance Contributions for employees, especially when taken together with those paid by their employers, are considerably higher than those for the self-employed (note **Appendix II**: Class 1 payments are made by employers and employees and Class 2 and Class 4 payments by the self employed).[27]

Employment is defined by the case law, often influenced by cases from other areas of law and largely a question of fact. The case law has made some movement to recognize that the tests of control and provisions of equipment are now less important than they once were in defining employment but there are areas of uncertainty and difficulty, especially in cases where employment agencies are involved. (Freedman 2001). The test does not offer a clear dividing line.

**Incorporation**

Incorporation with limited liability in the UK has been becoming steadily simpler and less costly as a matter of government policy which is to 'think small first' and remove unnecessary regulation from small companies ( DTI (2005) chapter 4) So, for example, the statutory audit requirement has been gradually removed from small companies,[28] requirements about meetings have been relaxed and the 2006 Companies Act will introduce further reforms to simplify the use of the corporate form for small companies. These regulatory changes have contributed to increased popularity of the corporate form

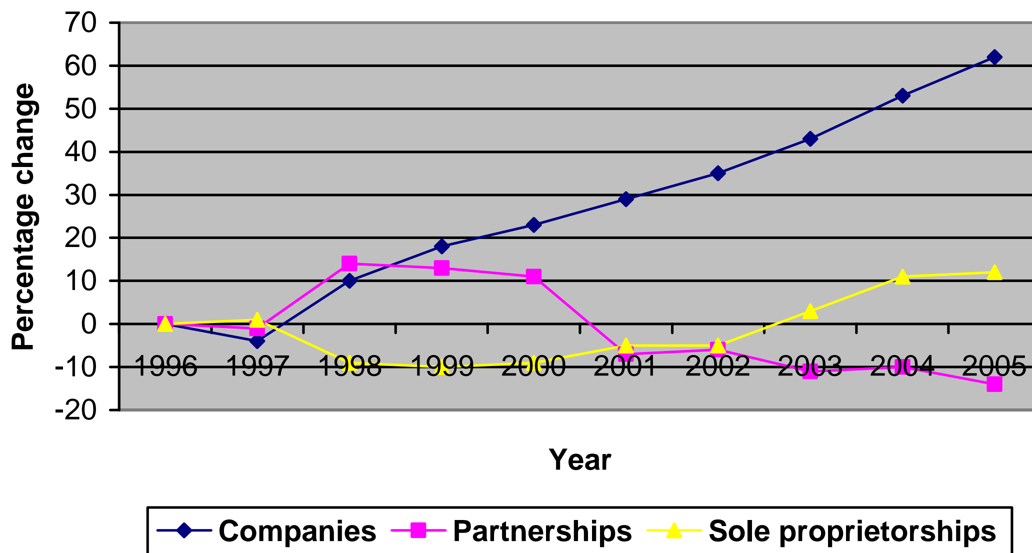
[27] The employed may have greater entitlement to some social security benefits than the self-employed but this does not account for the entire difference between the two levels of payment The 2007 Budget Financial Statement shows that the reduction in National Insurance contributions for the self-employed *beyond that attributable to reduced benefit eligibility* is £1.8 billion (Budget 2007 FSBR, *Table A3.1: Estimated costs of principal tax expenditures and structural reliefs).*

[28] Commencing with an announcement in 1993 of the introduction of a £90,000 turnover audit threshold (with reduction of burden up to £350,000), the threshold was raised to £350,000 in 1997, to £1 million in 2000 and to £5.6 million in 2004.

in the UK, which have been supported by the tax changes described below. From its earliest creation the limited liability company was available in the UK to the smallest firms, with no minimum capital requirement, and the ethos of easily available incorporation has been strengthened by these changes (Freedman 1994). In addition, in certain industries engagers will only deal with incorporated service suppliers- in practice because this will remove any tax problems from the engager to the service supplier and it will also assist the engager to show he is not an employer for employment law purposes (although not being decisive).

It is not always easy to disentangle the impact of taxation from that of regulatory and structural legal changes but the UK evidence from recent years appears to show sensitivity of small firms to the tax incentives created by these differences in treatment.[29] The combination of the regulatory changes described above together with tax changes (discussed further below) have resulted in a remarkable increase in incorporations, as can be seen in Figures 3 & 4.

**Figure 3 - Percentage change in the number of businesses over time in the UK, by legal form**




Source: Small Business Service

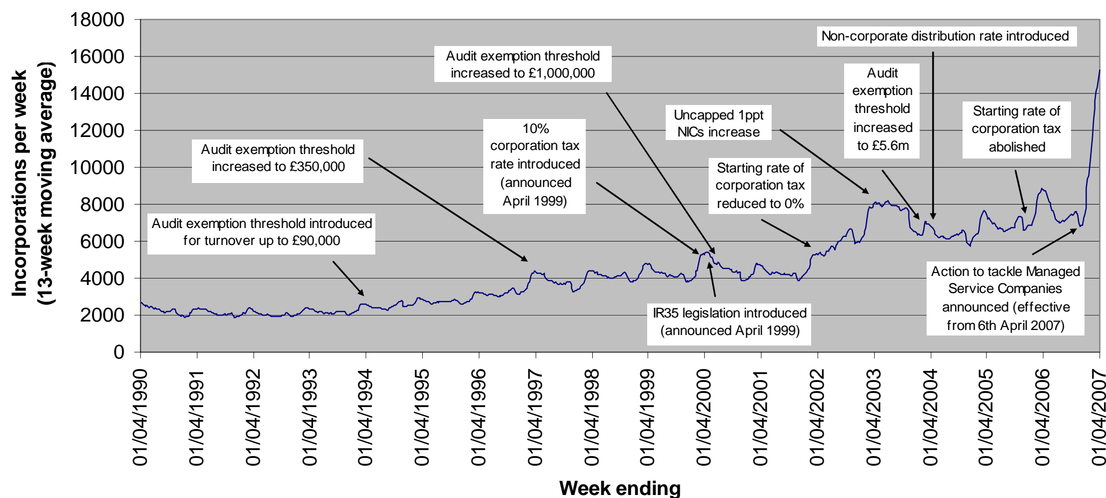
[29] In this discussion, references to tax changes include references to social security contributions which play a major role in this context.

Figure 3 shows the percentage change in the number of companies (incorporated firms), and in the number of partnerships (including LLPs) and sole proprietorships over the period 1996 to 2005.

The number of partnerships has been declining since 2001, perhaps because partnerships are more likely than one-person firms (sole proprietorships) to respond to pressure to incorporate. The Limited Liability Partnerships Act 2000 (effective 2001) permits the creation of LLPs which have pass-through status for tax purposes combined with limited liability. Some predicted that this would become a popular legal form for small firms[30] but so far the numbers being created seem so small as to be insignificant. The total number of LLPs registered in the year ending March 2006 was 17,449, with new registrations in 2005-6 being 6,570 compared with 372,000 new limited companies. It is possible that the 2007 Budget changes (discussed below) will increase interest in this legal form, and the cost of setting up an LLP is likely to reduce as experience of them is gained, but it should be noted that LLPs were not designed with small firms in mind.

The upward trend in the number of incorporations (at least since 1997) evident in Figure 3 is examined in more detail in Figure 4, which provides a 13-week moving average of the number of incorporations per week in Great Britain, from the week ending 1st April 1990 to the week ending 1st April 2007: it is annotated by reference to developments which appear to have affected the incorporation rate.

**Figure 4 - number of incorporations per week in Great Britain over time (13-week moving average, not seasonally adjusted)**




Until early 1994, the rate of incorporation was relatively stable, at around 2,000 new companies per week. Thereafter, there is an upward trend, rising to approximately 4,000 incorporations per week in early 2000. At this point, there is a relatively short-lived rise in the number of new companies being formed – to around 5,500 per week: this is around

[30] Morse (2004).

the time at which the audit exemption threshold was increased to £1 million and at which the 10% rate of corporation tax was announced[31] for companies with profits of £10,000 or less, known as the 'corporation tax starting rate'.[32] This starting rate was reduced to zero by the Finance Act 2002 and was finally removed after a very unhappy history by the Finance Act 2006.

Even before the introduction of this starting rate, one of the first issues small business owners faced when setting up was their choice of legal form as between a partnership or sole proprietorship and a company, but this change meant that tax was now even more relevant than before to this decision.[33] The potential for distortion following the introduction of the nil rate was pointed out by the Institute for Fiscal Studies[34] amongst others and highlighted in the Standing Committee Debates on the 2002 Finance Bill. Nevertheless the government persisted with this policy. Speaking in the House of Commons Standing Committee on introducing the measure, the Paymaster General explained the thinking.

> The measure recognises that businesses growing beyond a certain size will often be companies. We believe that cutting corporation tax is an effective way of targeting support at small and growing businesses'…. Surely small businesses will not look a gift horse in the mouth. We want to create growth and economic activity, and to sustain entrepreneurial activity.[35]

Small businesses took this message on board. Businesses of all kinds, entrepreneurial and not, began to use the relief in a perfectly rational and entirely predictable way, incorporating whether or not this was desirable for non-tax purposes in order to obtain the tax breaks. Incorporations rose from 222,000 in 2001 to nearly 397,000 in 2003.[36]

At this point Government became concerned about loss of revenue and the use of the relief for tax and national insurance advantages without any change of economic activity.[37] It therefore introduced a complex 'anti-avoidance' provision to counter the incentive effect of the nil rate band for all those distributing their profits, which most very small businesses needed to do simply to be able to pay their bills. Figure 4 shows that this rate was introduced during a period of slower growth in the number of incorporations per week, although this rate never fell back as far as its pre-nil rate level.

Despite the fact that it did suppress incorporations slightly, the non-corporate distribution rate,[38] was not completely successful and was also unduly complicated and the subject of

[31] Announced in 1999 and included in the Finance Act 2000.
[32] Income and Corporation Taxes Act 1988 s 13AA. For corporation tax rates see Appendix III.
[33] Freedman and Godwin (1992).
[34] Blow, Hawkins, Klemm, McCrae and Simpson(2002).
[35] House of Commons Standing Committee F 16 May 2002, cols. 114-115.
[36] DTI, *Companies in 2004-5*, Table A4.
[37] HMRC (2004), *Regulatory Impact Assessment Corporation Tax: The Non-Corporate Distribution Rate,* 6 April 2004.
[38] Finance Act 2004 s 28 and Schedule 3 (now Income and Corporation Taxes Act 1988 s13 AB and Schedule A2).

much adverse comment. Its repeal, together with that of the zero rate band, was announced in the pre Budget report in December 2005 as a measure to ‘better target tax incentives’. The Regulatory Impact Assessment for this change comments that

> [T]he benefits of existing incentives are being eroded by increasing numbers of new incorporations, who do not have growth ambitions, but are still able to take advantage of these incentives. The Government’s objective is to refocus growth incentives so that the support for and the benefits of reinvestment go to businesses with growth ambitions and it is concerned that any incentives should be perceived as fair. Use of incentives by people being encouraged to incorporate and reduce their tax and national insurance contributions erodes that fairness. [39]

The concern is not only about loss of revenue, but that incentives should be *perceived to be* fair. Loss of horizontal equity seems to be acceptable if those taking advantage of incentives are those within the Government’s intended objectives but not otherwise, even though the incentives apply also to those others who take advantage of them in a completely legal manner. These latter taxpayers have understandably had a different perception of ‘fairness’, although interestingly there was not a major outcry from small business over the removal of this relief.[40]

**IR 35**

Whilst these changes to corporation tax were taking place, there were other developments attempting to discourage the use of incorporation to escape classification as an employee and to engage in income splitting. In the 1999 Budget the Chancellor announced the introduction of personal service companies legislation (widely known as IR35) to take effect in April 2000. Essentially this legislation counteracts the recharacterisation of labour income into income from shares by treating it as if it were employment income but it does so only in certain cases.

Many micro-businesses provide services rather than goods and the individuals concerned may be hard to distinguish from employees on the traditional tests. Those to whom they provide their services do not wish to engage in the difficult question of whether they are employees — for tax, employment law and other legal reasons they wish them to be clearly providing only services. As a result they encourage or even require these businesses to incorporate. The person supplying the services becomes an employee of his own personal service company (‘PSC’). This opens up opportunities for extracting at least part of the remuneration for the services by way of dividend and so saving on NICs. Income splitting with other family members also becomes possible.

The difficulty here is that whilst some PSC owners are merely disguised employees, others may intend to create a growth company which will employ others and therefore be within the group the Government was aiming to incentivise through its starting rate of

---

[39] HM Treasury, *Regulatory Impact Assessment for Changes to the Corporation Tax Structure*, 16 March 2006.

[40] Indeed these changes had been proposed by several small business organisations, including the Forum for Private Business, which pointed out that the compliance cost of the anti-avoidance provision outweighed the savings from the nil rate- *The FSB's key recommendations within the pre-Budget report* (November 2004).

corporation tax. Initially, however, both types often start off by working only for one client and have some of the common law badges of employment and the Government saw the development of PSCs (which existed well before the nil rate complication described above but were encouraged by it) as a form of tax avoidance. Hence, special rules for taxing PSCs were imposed. In its original form, this legislation would have imposed a duty on those to whom services were being provided. This might have had a positive social effect in persuading such businesses to revert to straightforward employment, but the superior lobbying power of the businesses soon ensured that responsibility was transferred to the workers. This legislation then made less sense than originally intended, but it was introduced nevertheless and was accompanied by the introduction of the starting rate of corporate tax, presumably on the basis that all non-entrepreneurial small businesses would be caught by the PSC legislation. This reveals a misunderstanding, since not all non-growing micro-businesses have the characteristic that they are disguised employees. The rich pattern of different micro-business types was not recognised.

The IR 35 rules met with much discontent and litigation.[41] Though they sought to tackle a real problem of inequity as between employees and disguised employees, the way in which this was implemented and the disregard for employment law issues led to resentment and can mean that workers pay tax as employees but without any of the non-tax benefits. In addition, arguably some genuine entrepreneurial activity may be deterred.

The IR 35 legislation[42] subjects the earnings of PSCs and other entities (such as partnerships) to income tax and NICs as if the individual had earned them. The rules apply where a worker provides his or her services to a client who is a business (not, for example, to householders); the arrangements are made through an intermediary such as a company or partnership; and the worker would have been treated as an employee of the client for tax and NICs purposes had the arrangement been made between the worker and the client. Where these rules apply, the client continues to pay the intermediary gross and salary paid by the intermediary to the worker is subject to the PAYE and NIC rules in the usual way. But to the extent that the intermediary does not pay out its entire earnings as salary, the intermediary is treated as paying a salary to the worker on the last day of the tax year (or earlier, if relationship with the intermediary ceases before then). In addition, benefits in kind paid to the intermediary are taxed in the same way as employee benefits. Dividend tax relief is given to prevent double taxation, and a deduction is allowed for expenses of running the intermediary equal to 5% of the receipts from the engagements caught by the legislation. Any amounts spent by the intermediary, which could have been claimed as expenses against income tax had the worker been employed by the client and had paid them himself, can be deducted but only under the more restrictive employee deduction rules.

In determining whether the worker would have been an employee of the client had there been a direct relationship between them, the existing case law that seeks to distinguish

---

[41] *R (on application of Professional Contractors Group Ltd) v IRC* [2001] STC 629; *Jones v Garnett* [2005] EWCA Civ 1553 (CA).

[42] Now *Income Tax (Earnings and Pensions) Act 2003* (UK) part 2, chapter 8.

the employed from the self-employed is used but, as explained above, this case law can leave those involved in a state of uncertainty.

Although the IR35 legislation slowed down the rate of incorporation as its workings settled down and other developments occurred, incorporations picked up again from January 2002, as shown in Figure 4.

**Settlements provisions**

A feature of PSCs is that they facilitate income splitting. The income of one person can be shared with family members who become shareholders of his company and lower rates of tax can be paid by paying out salaries within the personal allowances of these family members or dividends in respect of their shares. The IR 35 legislation prevents this but where IR35 cannot be shown to apply, income splitting remains possible. To counter this, HMRC has resorted to using anti-avoidance provisions designed for settlements (the 'settlements provisions') and categorically not originally intended for this situation.[43] This has proved highly contentious and is being litigated in a test case, *Jones v Garnett*, also known by the name of the company as *Arctic Systems*.[44]

The use of the settlements provisions is widely thought to be misconceived. It does not seek to tackle the structural problem at its root and has created serious uncertainty for many small businesses and a general sense of persecution. The central feature creating this problem is the ability of micro-businesses to incorporate and thus transform income from labour into income from capital. If the aim is to tax a controlling company owner on a minimum deemed salary, or as if the entire profits of the company are to be treated as salary, this needs to be clearly stated and not derived from anti-avoidance legislation not designed for this purpose. Within a family context, where the regime is one of independent taxation of spouses, there are many conflicts of policy and practicalities. This is a question that needs addressing in a holistic way, looking at the rules on family taxation, small business taxation and capital transfers between spouses in the round but instead HMRC has addressed the issue as a self-contained operational matter. The result is complexity and uncertainty and a sense that the Government is antagonistic to small business which is unhelpful in terms of perceptions of fairness and in encouraging compliance.

**Managed service companies**

Figure 4 shows that over the first four months of 2007, the number of new companies being formed has rocketed, from approximately 7,000 per week in December 2006, to over 15,000 per week in April 2007. This dramatic change is thought to reflect a response to the announcement in December 2006 that the government would be introducing legislation to tackle Managed Service Companies (MSCs) (HMRC 2006).

---

[43] Formerly s 660A of part XV of the *Income and Corporation Taxes Act 1988* and now in ch 5 of pt 5 to *Income Tax (Trading and Other Income)* Act 2005.

[44] *Jones v Garnett* above. The case is to be heard by the House of Lords in the summer of 2007.

Managed Services Companies were themselves largely a reaction to the IR35 legislation, although arguably they also serve a useful function in assisting some small businesses with compliance tasks. They are mass marketed service companies provided by MSC providers to large numbers of individuals. They use composite companies, with several unrelated worker shareholders in each, or PSCs with only one worker per company structure. The workers are not generally directors and the worker is not involved in running the company. In theory the IR35 rules apply to these arrangements but these rules are hard to police when dealing with individuals and even more so in the case of the MSCs. The new legislation to be introduced in the Finance Bill 2007 will deem income received by individuals providing their services through MSCs to be employment income if it is not already treated as such. There will be extensive enforcement powers operative against those running the MSCs. This is acknowledged to have resulted in underpayment to HMRC. The additional registrations may have resulted from taxpayers being advised to set up their own PSCs to escape this new legislation although it is not clear that it will help them to avoid the operation of the legislation if they continue to use the services of an MSC. This may be a short term increase but it does suggest a very clear impact of the tax system on choices about legal form.

Once again the Government has chosen to tackle this problem not by changing the underlying structure but by deeming income to be employment income rather than dividend income, but only in particular cases. This requires selection and enforcement, may give rise to uncertainty and almost certainly some small business owners will feel oppressed by this legislation. They also complain that they could end up paying tax as employees but without the benefits of employment. The original proposal to place the onus for tax payment on those to whom the services are being provided (the engagers) would have been preferable from this point of view. It is interesting to note that under the new Construction Industry Scheme which came into force in April 2007, the onus is on contractors to check the employment status of sub-contractors. This may be thought practical within one sector in which the main engagers are large and there is union pressure for compliance though even here the implementation date had to be deferred for a year to ensure that the industry was ready. It would be more difficult across the board and even in the construction industry has created a considerable reaction.

The Chartered Institute of Taxation has commented in responding to the consultation on MSCs, that faced with the more radical alternatives of either imposing NICs on dividends for all small businesses or imposing the tax on the engagers, the approach taken by the Government to this problem is

‘the more proportionate and balanced one, seeking to deal, as it does, with the immediate issue rather than introducing a more fundamental change that would affect a much greater number of workers and engagers’.(CIOT 2007).

Nevertheless it is a piecemeal change which is likely to meet further attempts at circumnavigation.

**Tax driven legal form and the Budget 2007**

Despite all the above attempts to reduce the incentives and opportunities for tax driven choice of legal form, distortions remain. Table 2 shows the amount of tax and National Insurance Contributions (NICs) paid by an employed[45], a self-employed and an incorporated individual whose business makes either £25,000 or £75,000 profits per annum.

**Table 2 Tax and NICs to be paid in the UK, by legal form (2007-08 tax system)**

| | £25,000 profits per annum | | | £75,000 profits per annum | | |
|---|---|---|---|---|---|---|
| | Employed | Self-employed | Incorporated | Employed | Self-employed | Incorporated |
| Salary | £22,756.03 | £25,000 | £5,225 | £67,082.27 | £75,000 | £5,225 |
| Income tax | £3,589.23 | £4,082.90 | | £18,247.31 | £21,414.40 | |
| ***NICs*** | | | | | | |
| Class 1 employee | £1,928.41 | | | £3,580.07 | | |
| Class 1 employer | £2,243.97 | | | £7,917.73 | | |
| Class 2 | | £114.40 | | | £114.40 | |
| Class 4 | | £1,582.00 | | | £2,770.80 | |
| Corporation tax | | | £3,757.25 | | | £13,257.25 |
| Dividend tax | | | | | | £4,173.19 |
| **Total tax** | £7,761.61 | £5,779.30 | £3,757.25 | £29,745.11 | £24,299.60 | £17,430.44 |
| **Net receipts** | £17,238.39 | £19,220.70 | £21,242.75 | £45,254.89 | £50,700.40 | £57,569.56 |
| **Increase in net receipts compared to employed** | | **£1,982.31** | **£4,004.36** | | **£5,445.51** | **£12,314.67** |

Notes to Table 2:
1) All rates and allowances are in 2007-08 terms.
2) The tax calculations for the employed individual take into account both employer and employee National Insurance Contributions (NICs), i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).
3) It is assumed that the incorporated individual pays themselves a salary equal to the personal allowance (roughly equivalent to an 18 hour week on the national minimum wage), with the remainder of the profits from the business extracted in the form of dividend payments, on which corporation tax and dividend tax must be paid.

[45] Note that the tax calculations for the employed individual take into account both employer and employee National Insurance Contributions (NICs), i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).

These figures provide clear evidence of a tax incentive to be self-employed rather than employed (especially when taking into account other tax advantages not apparent from this chart related to expense deductibility), and to incorporate and classify profits from the business as returns to capital rather than to labour rather than being either employed or self-employed. This makes it largely unsurprising that the number of incorporations per week in the UK has been growing over time, as shown in Figure 4 above. If anything this table underestimates the differences because it does not show the advantages to be gained by the self-employed and incorporated firms in terms of the expense deductibility rules.

In addition to the changes to MSCs, the 2007 Budget has made an attempt to deal with this structural problem by raising the small companies' corporation tax rate as shown in **Appendix III**. The increase in corporation tax for the majority of corporations is accompanied by a decrease in the mainstream corporation tax rate and in the basic rate of personal tax. As shown in Table 3 below and in **Appendix IV,** this has the effect of reducing the incentive to engage in tax driven incorporation. This appears to offer a solution of a kind to the current UK problem of apparent tax driven incorporation but a radical cut in corporation tax rates generally to below the personal tax rate, if contemplated by this Review, would of course undermine this solution.

Table 3 shows the effect of the Budget change of an increase in the small companies' rate of corporation tax coupled with other changes: the 10% tax rate on labour income is to be abolished, with the basic rate reduced to 20% (from 22%) from April 2008; in addition, the higher rate tax threshold and upper earnings/profits limits will be increased and aligned in April 2009.

**Table 3 Tax and NICs to be paid in the UK, by legal form (potential 2009-10 system)**

| | £25,000 profits per annum | | | £75,000 profits per annum | | |
|---|---|---|---|---|---|---|
| | Employed | Self-employed | Incorporated | Employed | Self-employed | Incorporated |
| Salary | £22,756.03 | £25,000.00 | £5,225.00 | £67,082.27 | £75,000.00 | £5,225.00 |
| Income tax | £3,506.21 | £3,955.00 | | £17,677.91 | £20,845.00 | |
| ***NICs*** | | | | | | |
| Class 1 employee | £1,928.41 | | | £4,151.07 | | |
| Class 1 employer | £2,243.97 | | | £7,917.73 | | |
| Class 2 | | £114.40 | | | £114.40 | |
| Class 4 | | £1,582.00 | | | £3,170.50 | |
| Corporation tax | | | £4,350.50 | | | £15,350.50 |
| Dividend tax | | | | | | £3,468.63 |
| **Total tax** | £7,678.59 | £5,651.40 | £4,350.50 | £29,746.71 | £24,129.90 | £18,819.13 |
| **Net receipts** | £17,321.41 | £19,348.60 | £20,649.50 | £45,253.29 | £50,870.10 | £56,180.88 |
| **Increase in net receipts compared to employed** | | **£2,027.19** | **£3,328.09** | | **£5,616.81** | **£10,927.59** |

Notes to Table 3:
1) All rates and allowances are in 2007-08 terms. The higher rate income tax threshold is due to increase more than in line with inflation at the time that the income tax and NI thresholds are aligned under Budget 2007 reforms: this rise has been taken into account, but the new figure used remains in 2007-08 prices (i.e. the new 2009-10 threshold has been deflated).
2) The tax calculations for the employed individual take into account both employer and employee National Insurance Contributions (NICs), i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).
3) It is assumed that the incorporated individual pays themselves a salary equal to the personal allowance (roughly equivalent to an 18 hour week on the national minimum wage), with the remainder of the profits from the business extracted in the form of dividend payments, on which corporation tax and dividend tax must be paid.

Table 3 makes clear that while the tax (and NICs) incentive to incorporate is reduced by changes made in Budget 2007 (an incorporated individual making profits of £25,000, for example, has net receipts that are only £3,328.09 higher than for an employed individual after the Budget, compared with £4,004.36 beforehand), the increase in net receipts for self-employed compared to employed individuals actually *increases* with these changes. This highlights the need to consider both boundaries (employed vs. self-employed, and self-employed vs. incorporated) when making changes to the tax system.[46]

To compensate for the changes in tax rates for small companies the 2007 Budget introduced a new annual investment allowance for the first £50,000 of expenditure on

[46] The impact of these changes on marginal and average tax rates throughout the income distribution is shown in **Appendix IV.**

plant and machinery from 2008-09. This will be available to incorporated and unincorporated firms. The intention is to encourage entrepreneurship without distortion and to this limited extent a cash flow treatment is introduced. The difficulty is that not all firms which consider themselves to be genuine will make capital investments in order to benefit from this. Services and consultancy businesses might not do so, yet they may be genuinely entrepreneurial and create wealth and employment in due course. In addition the higher tax rates are permanent whilst the advantage of the new allowances is a cash flow advantage only. [illustrate from red book] It is also inevitable that any such incentive will further increase the advantages of being self-employed rather than an employee so that this new allowance may exert more pressure at this boundary, but it would not be possible to derive any attempted incentive to enterprise which would not do this. The details of this relief are not yet known and its usefulness may depend on whether it can be implemented in a straightforward way and without too many restrictions.

## V Alternative approaches.

*Aligning tax rates*

There is a fundamental tension between the current international pressure to reduce rates of tax on income from capital to a rate lower than that on employment income, and the distortion which might be created by an imbalance between the taxation of incorporated and unincorporated firms. In the UK the special lower rate of tax for small corporations **(see Appendix III)** created this problem even though the mainstream corporation tax rate is higher than the basic (but not the higher rates) of income tax. To address the latter problem, the ideal from a small business point of view would be to align rates of tax (including National Insurance) across all types of income, in whatever form received. This is inconsistent with current trends towards radical reductions in corporation tax rates and would also be problematic in relation to any corporate tax system in which the return to capital was not taxed, as suggested by Meade.

Within the current system of income taxation and corporation tax on profits, the approach now being adopted in the UK of trying to remove the tax advantage of incorporation and to provide incentives to small businesses to invest in non-discriminatory ways may seem a reasonable approach to removing distortion, although it does nothing to reduce the incentive to fall into the category of self-employment rather than employment. Because incorporating may, in effect, assist taxpayers to escape employment, there will still be an incentive to incorporate for those service providers who can develop that option. In the same way, bringing the taxation of the employed and self-employed closer together but failing to alter the way in which a small company's income is taxed could result in increased distortion at the unincorporated/self-employed borderline, thus exacerbating the problem. It is therefore necessary to bear in mind the whole spectrum of employment and small business activity when considering tax design. The other problem with the method employed in the Budget is that it moves the small companies' tax rate to a figure above the basic rate of personal tax. This is a complex way of achieving the desired result and

one that is not easily understood by the small business community though it has some logic. The small companies' rate really made logical sense only when we had an imputation system and it was aligned with the basic rate of taxation, a rationale now long past. There is no real rationale for not aligning the mainstream corporation tax rate and small companies' rate completely although this would almost certainly be unacceptable to the small business community at this stage. The results of aligning at 26% can be seen in **Appendix IV** below.

The reason for this complexity in terms of rates is in part the need to build in the NICs differential without integrating income tax and NICs, which would be the simplest move (but one that is unlikely to be politically acceptable). Any move to reduce corporation tax across the board radically would encounter the problem that to do so beyond the personal rate of tax would once again increase the incentive of the self-employed and the disguised employee to incorporate.

*Utilizing the incentive effects of differences in tax rates*

A contrasting approach is to take the view that imbalances of corporate and personal tax rates might be a positive advantage. Advantaging incorporation through the tax system might be an encouragement to risk taking and entrepreneurship. For example Gordon (1998) argues that where there are high personal rates and lower corporate rates, entrepreneurship is encouraged because of the flexibility to choose high personal tax rates when the firm has losses and lower corporate tax rates where it has profits. This of course assumes that providing incentives to entrepreneurship is considered to be a valid role for the tax system, which we have questioned above. Even if we were to accept that encouragement of entrepreneurialism should be an objective of the tax system, however, this argument relies upon the assumption that the resulting incorporation will be entrepreneurial. Gordon himself recognizes the possibility that this will not always be the case and we have now seen the UK evidence to suggest that favouring incorporation could result in significant distortions in favour of non-entrepreneurial incorporators. One suggestion that Gordon has to counter this effect is that the marginal rates of corporation tax faced by a new firm should increase and then decline with income with an initial corporate tax rate above and the top corporate tax rate well below the top personal tax rates to try and limit the extent to which non-entrepreneurial businesses will incorporate.

Regardless of the arguments about encouraging risk taking, some commentators argue that encouragement of incorporation is desirable in itself as a means of encouraging proper account keeping and similar business methods. (Sanger 2005). Incorporation does, however, have legal implications which may not always be understood by its users.

These ideas of favouring incorporation through the tax system appear to have influenced UK tax policy in recent years but the practical results, as described above, have proved costly in terms of non-entrepreneurs incorporating. Any serious entrepreneur is unlikely to be deterred from his activity by the fact that there is no tax incentive to incorporate since he will incorporate in any event for legal and commercial reasons. The fact of

incorporation in itself is unlikely to turn a risk averse person into a risk taker since he will still have a great deal to lose in terms of personal assets regardless of any slight tax advantage: indeed a real risk taker may wish to remain unincorporated in order to share initial losses with the Government. [47] Thus the rationale for favouring those engaged in activities in incorporated form per se through the tax system can be hard to discern and the distortions introduced vis a vis the employed and self-employed are a problem. .

*Differentiate tax treatment from legal form*

In the USA, in contrast to the UK, the pressure has generally been to obtain unincorporated tax treatment rather than corporation tax treatment due to the double taxation of corporate income and the different relationship between corporate and individual tax rates. Various elections are available which mean that tax treatment does not necessarily follow legal form.

A US corporation with no more than 100 shareholders and satisfying certain other conditions may elect to be taxed on a partnership or 'pass through' basis as an S corporation. The S corporation is not a separate legal form of business organisation but a corporation which has made a tax election to be treated in this way. A sole proprietor or limited liability company (LLC) (which is unincorporated, in the USA, unlike the UK limited liability company) may be treated in the same way as a partnership for tax purposes or may elect to be treated as a corporation.[48] Since 1997, under the check-the box regulations,[49] US entities other than corporations may elect to be treated for tax purposes either as a corporation or on a pass through basis. This gives most small businesses a choice of tax treatment regardless of legal form, but it does not provide a solution to the problem of distinctions in tax treatment and the potential for recharacterisation of income- on the contrary it increases the opportunities for tax planning, but this is not linked to legal form in a simple way. It should be noted that the legal differences between corporations and unincorporated firms are also not identical in the US and the UK, since US corporate law is more mandatory and less flexible than the UK form of incorporation.

The reduction of the dividend tax in the US [50] does not so far seem to have reduced the popularity of the pass through treatment for small firms, it still being advantageous to pay personal tax rates in many cases, especially if the intention is to distribute all or most of the income in any event. This pass through basis would not, of course, be practical for most large companies and the tax is payable whether or not there is a distribution which means that only owners with control are likely to be attracted by such treatment. In the

---

[47] Domar & Musgrave (1944) cited in Cullen & Gordon (2002) argue that high marginal tax rates make risky projects relatively more attractive because risk can be shared with the government (through the ability to deduct losses from other personal income).

[48] In this way an LLC can also elect via corporation status for S corporation status. Treas. Reg § 301.7701-3(a)

[49] Treasury Decision 8697

[50] Job Growth and Taxpayer Relief Reconciliation Act of 2003. However the statistics are only available until 2004 [TO BE CHECKED WITH SUBSEQUENT FIGURES WHEN AVAILABLE]

UK pass through treatment would not normally be an attractive option even after the Budget changes, the exception being if there were losses. Whilst some have argued for this flexibility for small corporations, and for unincorporated firms to be able to opt for corporation tax treatment, this seems to introduce complexity for small firms that would be of little help to most of them. Alignment of treatment for all firms seems more desirable than more choices which would no doubt be hedged about by anti-avoidance measures.

It might seem that the result of pass through treatment in the United States would be that those electing for this would be treated as if all the corporate income was earned income rather than a dividend. This is so in the case of active members of an LLC but, surprisingly, it is not a result fully achieved by the USA S corporation pass through system. Unlike US sole proprietorships, partnerships and LLCs, S corporations have the ability to pay only a small salary to an active shareholder, paying out the rest to be taxed on a flow through basis. The definition of earnings from self-employment for the purposes of self-employment taxes does not include such flow through payments. This thus saves employment taxes and associated social security and Medicare payments (Winchester 2006) There is a requirement that S Corporations should pay reasonable compensation to shareholder employees but this does not seem to impose any real control on single shareholder corporations if they are not paying distributions. This ability to turn labour income into dividend income, in exactly the same way as is possible in the UK through incorporation, seems likely to account for some of the popularity of the S corporation tax treatment. Other benefits include the avoidance of a double level of taxation on dividends and on capital gains and pass through treatment of losses which can then be set against other profits of the shareholders.

A US Treasury department study in 2005 (US Treasury (2005); Winchester (2006)) suggests that all majority S corporation shareholders should be subject to employment taxes on their entire share of ordinary operating gains. The number of single-shareholder S corporations grew by 65% between 1994 and 2001 and the Treasury report describes the S corporation form of ownership as a 'multibillion dollar employment tax shelter for single-owner businesses'. In 2000, nearly 80% of all S corporations were either owned by a single shareholder (69.4%) or majority owned by a single shareholder (9.5%) (treating husband and wife as a single shareholder). The report estimated that the loss of employment taxes was $5.7 billion in 2000 due to the ability of these S corporation owners to minimize their employment taxes. The proposal in the report has not yet been implemented. What this does show is that in the US system also there is an issue about the conversion of employment income into income from capital and that it could in part be this that is driving the popularity of the S corporation and not pure entrepreneurialism. Whilst the problem is dealt with in LLCs by differentiating inactive and active owners (only the latter pay self- employment taxes), the corporate legal structure presumably makes this more difficult to achieve through regulation for S corporations (Fritz 1998).

*Nordic Dual Income Taxation Treatment*

If there is to be a differential between the taxation of income from capital and the income from labour, with the latter being taxed at a higher rate, as in the dual income tax systems, then one way to address this is to treat all or part of the income of unincorporated firms and closely held corporations as labour income, regardless of whether it is paid out by way of salary or not. In effect, this is the approach of the UK IR35 and MSC provisions but these apply only in limited circumstances. Some Nordic countries have rules which achieve this more widely and in a more even handed way in the case of closely held companies (Sorensen (2005); Sorensen (2007)). Norway goes further with a shareholder income tax which applies to all domestic shareholders.

The Nordic system of dual income tax levies a tax on 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. 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. (Sorensen 2005). In this way, this new business tax design for large business necessitated the development of a solution for small business.

Because these corporate systems give incorporated business owners a lower tax rate on the return to capital than on the rest of their profits, a similar system has been introduced for unincorporated firms Given that it is not possible to observe the working hours of the self-employed,[51] 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 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 may be non-active shareholders in the picture. In Sweden, for example, the progressive labour income tax above an imputed after tax return is imposed only on dividends accruing to active shareholders who carry out a certain amount of work in their own closely held companies. The option of treating active and non-active shareholders differently was originally used in Norway but latterly rejected (because of the difficulties of definition). Instead a shareholder income tax with a rate of return allowance (RRA) is now used for shares owned by personal taxpayers resident in Norway. This system exempts shareholder income below an imputed normal rate of return – the RRA.[52] 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

[51] Assessing a 'market wage' is a problem we have in the UK system – see *Jones v Garnett*, above.

[52] This differs from an allowance for corporate equity (ACE) which would be given at corporate level: the RAA is given at shareholder level.

the top marginal rate of tax on labour. Only distributed dividends are so taxed (so this is not pass through treatment and is less draconian than IR 35) and if the income distributed falls short of the RRA in one year the unutilized RAA may be carried forward and deducted in a later year. The undistributed profits are eventually taxed at the labour income rate on a sale of the shares but there may be a cash flow advantage over unincorporated firms which cannot shelter undistributed income in this way. However, since unincorporated firms do not have a clear distinction between business and personal assets this may be difficult to counteract.

The Norwegian system is more radical than other Nordic systems and applies to all domestic shareholders. This paper refers only to the advantages in dealing with the problem of the differential between labour income and income from capital but consideration of the introduction of any such system, particularly if it were not limited to small corporations, would need to be in the context of the corporation tax system as a whole

One problem with such a system using an imputed return to capital is that is that this system recognizes only monetary or physical investment. One complaint in the UK already is that entrepreneurialism of service companies and consultancies is insufficiently recognised. Some would argue that it should also allow for the return to self-generated goodwill and to recognize the risk taken by the self-employed and corporate owners above risks taken by employees, especially as these may also be taxed if reflected by capital gains at some point. Recognition could be given in various ways; for example there could be a cap on the amount of income to be treated as labour income above a certain amount, or based on a percentage of the wage bill in relation to other employees to take account of the value of providing employment. 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 extent to which this is a problem depends on the extent to which it is thought important to attempt to encourage entrepreneurship and risk taking as opposed to investment through the tax system and to compensate for the loss of the security of employment and the allowances to be given could be set accordingly.[53]

*Other alternatives*
*This section needs to consider proposals made in main Mirrlees chapters – after the conference*

Different structural difficulties would arise under an expenditure or consumption tax affecting unincorporated firms, the precise nature being dependent upon the approach adopted. A change in the tax base would not remove the differences between legal forms nor the fact that a company has a legal personality and that its shareholders may not have the same rights over its income and assets as do the owners of an unincorporated business. In addition, in designing any radically new form of business taxation, it would

[53] Though employment does not necessarily offer security in changing work conditions and, where it does so, this might well be reflected in lower wages.

need to be observed that unincorporated businesses, in the UK, at least do not have legal personality. This means that business assets and business expenditure may not be clearly separated from the personal. This is a problem under our existing income and corporation tax system but could be greater under an expenditure tax where there was a need to distinguish between business and personal consumption. Under an expenditure tax the base for taxation would be shifted from the profit of the business to the net amount withdrawn from the business during the year by the proprietor for his own consumption. In practice, given the difficulties of measurement, this would come close to taxation of profits subject to a full deduction for any reinvestment of profits. It may be that the new annual investment allowance will bring some small businesses close to this in the UK following the 2007 Budget. But it remains to be seen how this will be made operational and whether it can remain as simple as the concept appears to be.

The introduction of a corporate tax system which taxed only economic rent and not the return to capital at all would require even greater adjustment than the dual income tax to align rates for those working through companies with unincorporated workers and employees.

## V Conclusions

Small businesses and organizational form were not major preoccupations of the Meade Committee. Nevertheless, in current conditions, these are issues which require attention in any radical review of the tax system. They describe a difficult point at which personal and corporate taxes interact. In addition, small business taxation, the need to encourage ‘enterprise’ and the need to achieve ‘fairness’ in this area are a frequent focus of Government attention and these issues have a political and popular weight which may go beyond their economic significance.

Those designing corporate tax systems will (reasonably enough in view of the revenues involved), often consider primarily large multi-national companies. As pointed out by Auerbach and Devereux, however, we might wish to treat domestic companies very differently and small companies differently from large ones because what we are trying to tax and why might be different in each case. In the case of a small, domestic company, it may be important to tax the entire income of the company including the normal return to capital in order to ensure equality of treatment with other forms of investment. Moreover there may be a need to achieve equality of taxation with other forms of labour income to the extent that the corporate income in practice arises from the provision of labour. This seems to call for treatment which in some way evens out tax rates to produce an efficient, non-distorting system and also one that is perceived to be ‘fair’ by business owners operating in different modes.

This view is underscored by the need to view employees, the self-employed and the small company owner as part of one continuum rather than undertaking completely different economic activities. There are economic differences between the groups but there are difficult distinctions between them at the margins and very great differences in treatment

will offend horizontal equity, efficiency and the broader sense of fairness of taxpayers. This could result in inefficiencies, tax driven decision making and enforcement and compliance difficulties.

An alternative view is that differential tax rates should be used to encourage entrepreneurship. This might seem to point to the advantages of having a lower corporate tax rate than personal tax rate. This view relies, however, on a belief that the tax system is a suitable tool for the encouragement of entrepreneurship and secondly that the encouragement of incorporation is equivalent to the encouragement of entrepreneurship. This paper has questioned these assumptions.

For those who support the provision of tax incentives, a system of elections such as that in the USA under which taxpayers can choose their tax treatment regardless of organizational form might seem attractive. In the UK, however, incorporation is simple to obtain and inexpensive to maintain for those who require it, so corporate tax treatment is easily obtained. It could become the case that corporate tax treatment becomes undesirable, where there are losses, for example, or due to the double layer of tax on capital gains, but to allow an election for pass through tax treatment in these circumstances, whilst achieving flexibility, would also be likely to give rise to opportunities for avoidance which would require extensive anti-avoidance provisions and therefore more complexity. Should the tax rate on corporations become substantially higher than personal taxes or should we move to a system of complete double taxation of dividends, there might be a stronger argument for this. It is in these conditions that the S corporation has developed in the USA, but even so the S corporation might not be so popular now if it was not for fact that its profits escaped self-employment taxes.

The most recent changes to the UK system attempt to remove the incentive to incorporate from those who have no commercial need to do so and to tax some, but not all, of those who incorporate at the employment income rate. However, the piecemeal way in which the issues have been dealt with have left us with a complex array of anti-avoidance provisions, a confusing and non-transparent system and every possibility that further anti-avoidance provisions will be required. At the same time, small business feels beleaguered and that they have paid the price for the mainstream corporation tax reduction in an increase levied on them. Whilst the rate changes can be supported logically, the manner in which reform in this area has been implemented has not given rise to good relations with the small business community. A reform based on a holistic overview and treating all businesses in the same way rather than picking out some on the basis of draconian legislation based on unsatisfactory case law classifications of employment could save a great deal of time and effort in administration and compliance costs. Appeals to ‘fairness’ by politicians can backfire if taxpayers do not feel this is reciprocated by fair treatment of them by Government. Taxpayers who respond to structural incentives in the tax system and are then penalized for their rational responses will become less, rather than more, compliant. A structural solution which looks at small businesses across the board rather than introducing ‘anti-avoidance’ provisions for specific cases is needed to give a stable taxing basis for entrepreneurs and others alike and to encourage compliance.

More generally, the use of the tax system to provide tax incentives and reliefs for small businesses is questioned. It is argued that it should not be assumed that this is justifiable unless a clear and specific rationale can be shown such as market failure or disproportionate burdens. Even then care should be taken in designing these reliefs and incentives. The creation of options, elections and thresholds can lead to cost and complexity for small businesses which might outweigh the value of the reliefs. The most valuable measures will be those which counteract the disproportionate nature of compliance costs by providing practical assistance or relief from burdens for the very smallest firms, whilst at the same time encouraging rather than undermining business like methods.

**Bibliography** **(incomplete and unsorted)**

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*.

*Accounting Web*- 19th October 2006, 'What do you think? Cash accounting for small businesses' – 10 October 2006;

Bannock, *The Economics and Management of Small Business*, (2005) Routledge 42.

Benneyworth, 'Watch out- Flat rate VAT disaster!' *AccountingWeb* 27 Nov. 2006;

Blow,L. , M. Hawkins, A. Klemm, J. McCrae and H. Simpson (2002) *IFS Budget 2002: Business Taxation Measures* IFS Briefing Note No. 24 (London: IFS).

J.E. Bolton (Chairman) (1971) Report of the Committee of Inquiry on Small Firms Cmnd 4811 HMSO.

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

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

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

Chittenden, Kauser and Poutziouris, 'Tax Regulation and Small Business in the USA, UK, Australia and New Zealand' in *(2003) 21 International Small Business Journal 93.*

Chittenden and Sloan 'Quantifying Inequity in the Taxation of Individuals and Small Firms' [2007] *British Tax Review* 58.

CIOT (2007) *Tackling Managed Service Companies*

CIOT and ATTA, (2005) *Small Companies, the Self-employed and the Tax System* (2005) http://www.tax.org.uk/attach.pl/3449/2762/SmallCosandSelfEmployed%20finalsub010405.pdf;

CIOT and ATTA, (2005a) *Working Towards a New Relationship: Priorities for Reducing the Administrative Burdens of the Tax System on Small Businesses*.

Cullen, J. & R. Gordon (2002), Taxes and Entrepreneurial Activity: Theory and Evidence for the US, NBER Working Paper 9015

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.

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

Dirkis, M. 'Tax change or tax reform: Business tax reform evaluated' 2006 (publication forthcoming; supplied to author by M. Dirkis).

DTI, *Companies in 2004-5*, (2005) (London: TSO).

DTI (2005) Company Law Reform (White Paper) (London, TSO).

Domar and Musgrave 1944 cited in Cullen and Gordon (2002)

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

European Commission, *Green Paper, Modernising labour law to meet the challenges of the 21st Century* (2006) Brussels COM(2006) 708 final.
Fritz (1998) Flowthrough Entities and the Self-Employment Tax 17 Va Tax Rev 811

Freedman, 'Small Businesses and the Corporate Form: Burden or Privilege?' [1994] *Modern Law Review* 555.

Freedman, *Employed or Self-employed?* TLRC Discussion Paper (IFS, 2001) http://www.ifs.org.uk/comms/dp1.pdf

Freedman, J. 'Limited Liability: Large Company Theory and Small Firms', [2000] *Modern Law Review* 317.

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).

Freedman, 'One Size Fits All - Small Business and Competitive Legal Forms' (2003) 3(1) *The Journal of Corporate Law Studies* 123.

Freedman, J. (2004) Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms? in McCahery, Raaijmakers and Vermulen (eds) *The Governance of Close Corporations and Partnerships* (OUP).

Freedman, 'Why taxing the micro-business is not simple — a cautionary tale from the 'Old World', 2006 JATTA Vol 2, No 1, 58
http://www.atax.unsw.edu.au/atta/jatta/jattavol2no1/5_Freedman_JATTA_vol2_no1.pdf

Freedman and Chamberlain (1997) , 'Horizontal Equity and the Taxation of Employed and Self-Employed Workers' *Fiscal Studies* Vol 18,

Freedman "Legal Form, Tax and the Micro Business", (with Godwin) in Caley, Chell, Chittenden, Mason (eds.), (1992) *Small Enterprise Development* (Paul Chapman Publishing Ltd.)

Freedman "Incorporating the Micro Business: Perceptions and Misperceptions", (with Godwin) in Hughes and Storey (eds.), (1994) *Finance and the Small Firm*, (Routledge).

Goolsbee, A. (1988), "Taxes, organisational form and the deadweight loss of the corporate income tax", Journal of Public Economics, Vol. 69, No. 1, p. 143.

Gordon, R. (1998), Can High Personal Tax Rates Encourage Entrepreneurial Activity?, IMF Staff Papers, Vol. 45, No. 1, p. 49.

Harrison *Lean & Mean* (1997) Guilford Press.

HMRC, *Spreading the Cost of VAT for clients* http://www.hmrc.gov.uk/news/annual-accounting-note.htm
https://www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=263096&NewsAreaID=2&NavigatedFromDepartment=False

HMRC (2004*) Regulatory Impact Assessment Corporation Tax: The Non-Corporate Distribution Rate,* 6 April .

HM Treasury Discussion Paper, (2004a) *Small companies, the self-employed and the tax system*
http://www.hm-treasury.gov.uk/media/8EB/69/pbr04small_companies_228.pdf

HMRC (2006) *Regulatory Impact Assessment for Changes to the Corporation Tax Structure* March , http://www.hmrc.gov.uk/ria/ria-corporation-tax.pdf

HMRC and HMT (2006) *Tackling Managed Service Companies*.

ICAEW, TAXREP 22/05, *Small Companies, the Self-Employed and the Tax System*. http://www.icaew.co.uk/index.cfm?route=116030.

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

IFS (2000) Green Budget (IFS).

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

Kay and King, *The British Tax System* (5th ed., OUP 1990) p. 153.

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

MacKie-Mason, J. & R. Gordon (1997), "How much do taxes discourage incorporation?", Journal of Finance, Vl. 52, No. 2, p 477.

Meade, J. E. (Committee Chair), *The Structure and Reform of Direct Taxation*, (IFS, 1978), Ch 12 p. 227.

Morse, G, 'Partnership Law Reform in the UK' in McCahery, Raaijmakers and Vermulen (eds) *The Governance of Close Corporations and Partnerships* (OUP).

Murphy, R. 'The case against cash accounting', http://www.taxresearch.org.uk/Blog

National Audit Office report *HMRC Helping newly registered businesses meet their tax obligations* (HC 98 Session 2006-7, December 6 2006)

OECD, (1994) *Taxation and Small Businesses* (Paris: OECD)

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

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

Redston, 'Small Business in the Eye of the Storm' [2004] *British Tax Review* 566.

Sanger, C. (2005) Taxline (ICAEW).

Sandford, Godwin and Hardwick *Administrative and Compliance Costs of Taxation*, (Bath: Fiscal Publications, 1990)

Small Business Service SME Statistics for the UK 2005. http://www.sbs.gov.uk/SBS_Gov_files/researchandstats/SMEstats2005pr.pdf

Sorensen, 'Neutral taxation of Shareholder Income', *International Tax and Public Finance* (2005) 12, 777-801.

Sorensen, (2007) *The Nordic Dual Income Tax: Principles and Practices* (Report prepared for the Canadian Department of Finance, copy provided by author)

St John Price, 'Pros and cons of the VAT Flat Rate Scheme' *AccountingWeb* 1 Dec. 2006.

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

Storey, *Understanding the Small Business Sector* (1994) Routledge.

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

Truman, 'What's in a name?', *Taxation* 23 Nov. 2006.

US Treasury Study (2005) *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single Shareholder S Corporations,* Reference no. 2005-30-080.

Winchester, R. (2006) 'Working for Free: It Ought to be Against the (Tax) Law', Mississipi Law Journal Vol 76. p. 227

## Appendix 1 Measures of business size for different purposes

**UK Corporation Tax**

**Section 13 Income and Corporation Taxes Act 1988 section 13**

**Small companies' rate-** where profits do not exceed £300,000 in an accounting period with marginal relief between £300,000 and £1,500,000 (provisions exist to prevent splitting between associated companies)

**Section 414 Income and Corporation Taxes Act 1988**: a close company is one which is under the control of five or fewer participators or of participators who are directors.

**UK VAT**

**Registration threshold** from 1 April 2007 - £64,000 annual turnover

**Ability to use simplified systems-** annual accounting and cash accounting £1,350,000 annual taxable turnover.
(Flat rate scheme has more limited availability)

**UK Company Law and Accounting**

**Companies Act 1985 (small companies accounts regime; audit exemption)**

A company is 'small' if it satisfies two of the following

- A turnover of not more than £5.6 million
- A balance sheet total of not more than £2.8 million
- Note more than 50 employees.

**Audit exemption for small companies** -1993 exemption introduced for turnover less than £90,000 (with reduction of burden up to £350,000); 1997 threshold raised to £350,000;
2000 raised to £1 million; Jan 2004 raised to £5.6 million as above.

**UK Small Business Service**
Small business defined as having 0-49 employees

**Observatory of European SMEs**
Micro enterprise 0-9 employees
Small enterprise 10-49 employees

## Appendix II

UK National Insurance Contributions

| **£ per year (unless stated)** | **2007-08** |
| --- | --- |
| Lower earnings limit, primary Class 1 | £87 |
| Upper earnings limit, primary Class 1 | £670 |
| Employees' primary Class 1 rate between primary threshold and upper earnings limit | 11% |
| Employees' primary Class 1 rate above upper earnings limit | 1% |
| Employees' contracted-out rebate | 1.6% |
| Employers' secondary Class 1 rate above secondary threshold | 12.8% |
| Employers' contracted-out rebate, salary-related schemes | 3.7% |
| Employers' contracted-out rebate, money-purchase schemes | 1.4% |
| Class 2 rate (per week) | £2.20 |
| Class 4 lower profits limit | +£5,225 per year |
| Class 4 upper profits limit | £34,840 per year |
| Class 4 rate between lower profits limit and upper profits limit | 8% |
| Class 4 rate above upper profits limit | 1% |

**Source HMRC**

## Appendix III

UK Corporation tax rates

| Financial Year | Rate of Tax | Small Companies | Starting rate |
|---|---|---|---|
| 1982 | 52% | 38% | |
| 1983 | 50% | 30% | |
| 1984 | 45% | 30% | |
| 1985 | 40% | 30% | |
| 1986 | 35% | 27% | |
| 1988/89 | 35% | 25% | |
| 1990 | 34% | 25% | |
| 1991-5 | 33% | 25% | |
| 1996 | 33% | 24% | |
| 1997-8 | 31% | 21% | |
| 1999 | 30% | 20% | |
| 2000-1 | 30% | 20% | 10% |
| 2002-5 | 30% | 19% | 0% |
| 2006 | 30% | 19% | Abolished |
| 2007 | 30% | 20% | |
| 2008 | 28% | 21% | |
| 2009 | 28% | 22% | |

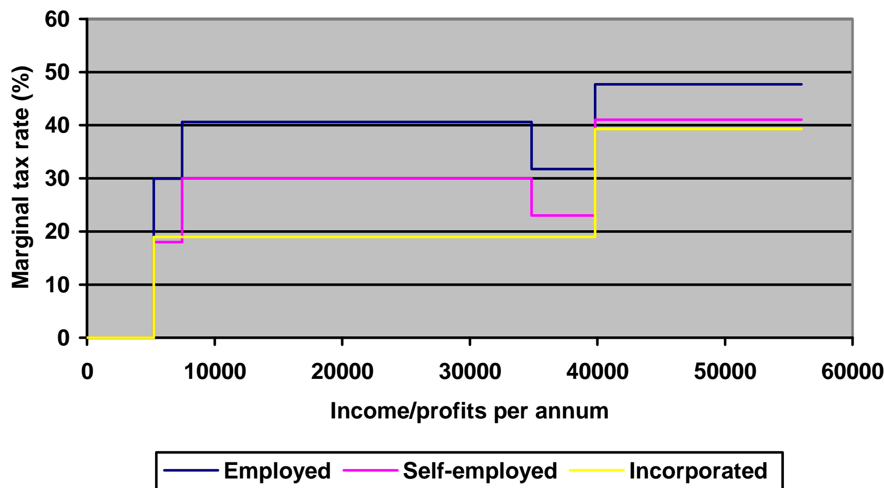
**Basic rate of tax until 2008= 22% going down to 20% and thus below the small companies rate in 2008.**

## Appendix IV

Given that small businesses effectively face a choice over the legal form they adopt, it is worth considering how the 2007-08 UK tax system influences that decision. For simplicity, we consider here the position of a "one-man" business, with the individual concerned able to choose between employment, self-employment and incorporation.[54]

Figure IV.1 shows the marginal tax schedule that this individual would face under each of these three scenarios. We see here that an employed individual[55] always faces a marginal tax rate that is at least as high as that for either the self-employed individual, or the incorporated individual (who extracts most of their profits in the form of dividend payments). Furthermore, with the exception of the range over which income is taxed at the 10% rate under the labour income tax schedule (£5,225 to £7,455), the marginal tax rate of the self-employed individual is at least as high as that of the incorporated individual.[56]

**Figure IV.1 2007-08 UK marginal tax rates**




Notes to Figure IV.1:
1) All rates and allowances are in 2007-08 terms.

---

[54] Here, we assume that the individual chooses to pay themselves a salary equal to the personal allowance (roughly equivalent to an 18 hour week on the national minimum wage), with the remainder of the profits from the business extracted in the form of dividend payments.

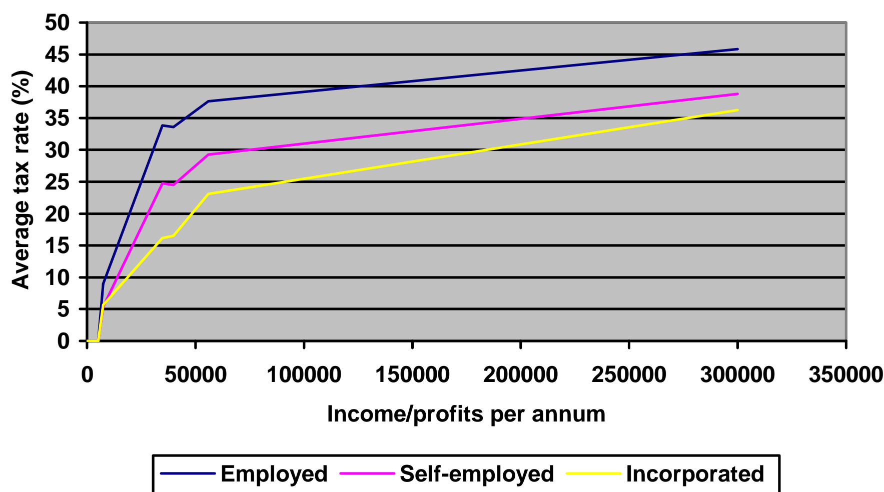
[55] Note that the marginal tax rates for an employed individual take into account both employer and employee National Insurance Contributions (NICs), i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).

[56] We repeated these calculations with the incorporated individual paying himself a salary equivalent to a 35 hour week at the national minimum wage (£9,737 in 2007-08): this is because it is unclear exactly how minimum wage legislation is applied to such individuals. Under this scenario, a business earning profits of up £9,737 would choose to be unincorporated – the incorporated individual now faces the same marginal tax schedule as the employed individual over this range – while a business earning profits above this level would, on the basis of these incentives, still choose to be incorporated.

2) The calculations for the employed individual take into account both employer and employee National Insurance Contributions (NICs), i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).
3) The self-employed individual makes Class 2 and Class 4 National Insurance Contributions, which, together, are lower than the Class 1 contributions that employees make.
4) We assume here that the incorporated individual pays themselves a salary equal to the personal allowance (roughly equivalent to an 18 hour week on the national minimum wage), with the remaining profits extracted in the form of dividend payments, on which corporation tax and dividend tax must both be paid.

Figure IV.2 shows how these marginal tax rate schedules translate into average tax rates. As one would expect, the average tax rate is highest for employed individuals and lowest for incorporated individuals, with the self-employed falling somewhere in between: this is true across all profit levels between £0 and £300,000 (the range over which the small companies' corporation tax rate is paid[57]), despite the fact that there is some catch-up (see discussion below).

**Figure IV.2 2007-08 UK average tax rates**




See notes to Figure IV.1.

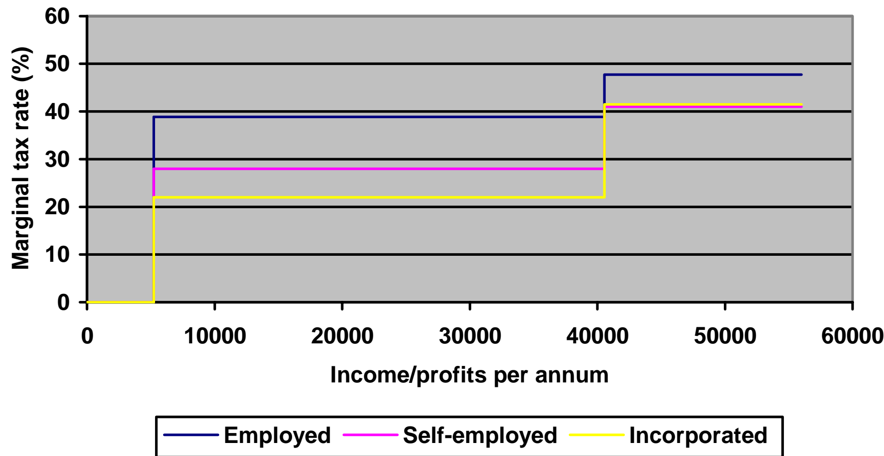
Figures IV.3 and IV.4 show the marginal and average tax rates respectively once changes made in Budget 2007 (an increase in the small companies' rate and a decrease in the basic rate of labour income tax, together with the removal of the 10% tax bracket) have come into effect (in 2009-10). The removal of the 10% income tax band, together with the alignment of the higher rate threshold with the upper earnings/profits limit removes the kinks seen in the 2007-08 marginal tax rate schedule for employed and self-employed individuals, making their marginal incentives clearer (see Figure IV.3).

In terms of a comparison across legal form, over the basic rate range, the picture remains broadly similar to that described above, although the difference in marginal tax rates faced by the three groups is now significantly smaller. Above the higher rate threshold,

[57] We did not consider incomes beyond £300,000, as this provides one definition of a "small" business that is used in the UK tax system.

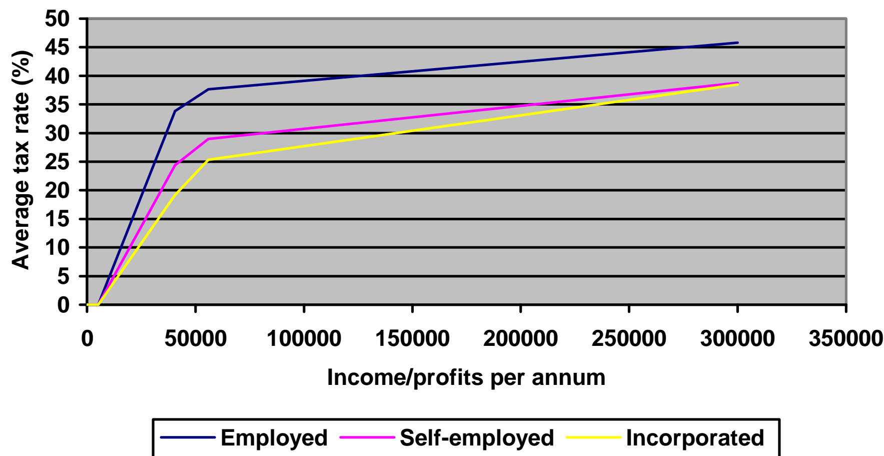
incorporated individuals now face slightly higher marginal tax rates than self-employed individuals: from Figure IV.4, it is clear that these changes mean that the average tax rates for these groups now equalise over the range of income on which the small companies' corporation tax rate is paid (unlike the 2007-08 system).

**Figure IV.3 Proposed marginal tax rates in the UK in 2009-10**




Notes to Figure IV.4:
1) All rates and allowances are in 2007-08 terms. The higher rate income tax threshold is due to increase more than in line with inflation at the time that the income tax and NI thresholds are aligned under Budget 2007 reforms: this rise has been taken into account, but the new figure used remains in 2007-08 prices (i.e. the new 2009-10 threshold has been deflated).
2) See also Notes to Figure IV.1.

**Figure IV.4 Proposed average tax rates in the UK in 2009-10**

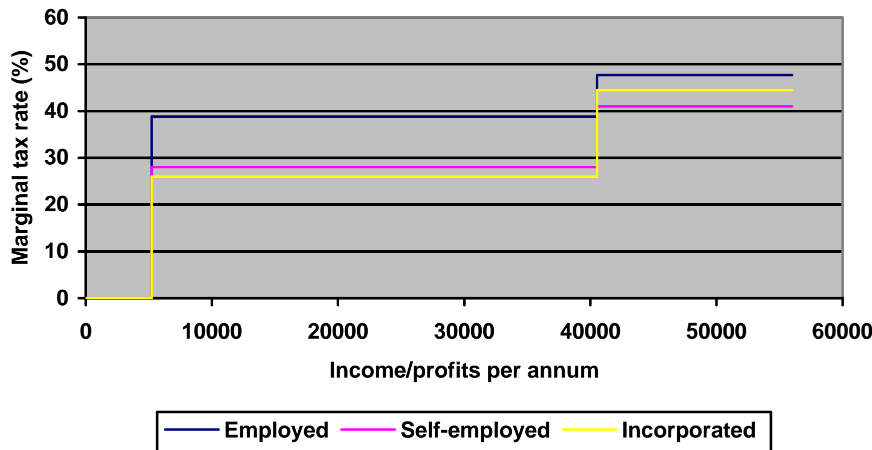



See Notes to Figure IV.4.

At the same time as increasing the small companies' rate of corporation tax from 19% to 22%, the Chancellor also announced a reduction in the main rate of corporation tax from 30% to 28% in April 2008. In Figures IV.5 and IV.6, and Table IV.1, we consider what the implications would be of having a single rate of corporation tax at 26% (a further move in the same direction): clearly, this simply shifts upwards the marginal and average tax rate schedules for incorporated individuals, with the schedules for employed and self-employed individuals remaining unchanged.

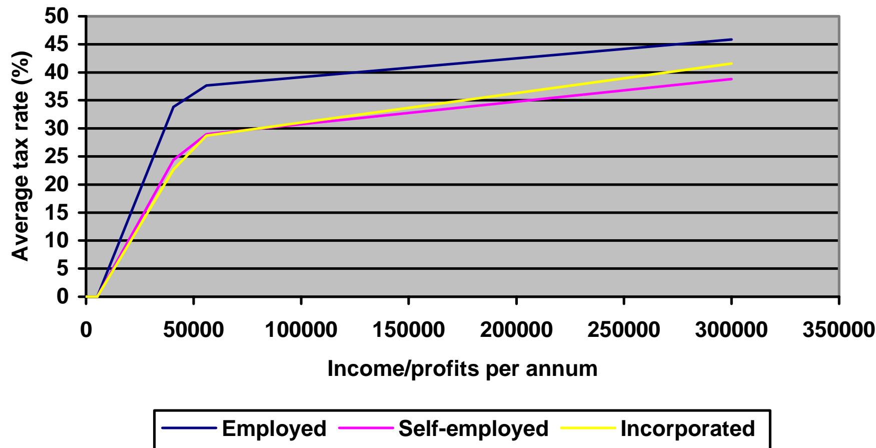
Figure IV.5 clearly demonstrates that a single corporation tax rate of 26% would virtually eliminate the incentive to incorporate over the basic rate income range, while incorporated individuals would actually face a significantly higher marginal tax rate than self-employed individuals above the higher rate threshold. This causes the average tax rate schedule for incorporated individuals to cross that for self-employed individuals at an income of approximately £75,000. This means that for small businesses earning above this threshold, tax incentives alone would now encourage them to be self-employed rather than incorporated – the opposite of what a life-cycle model of small business might suggest was sensible.

**Figure IV.5 Marginal tax rates in the UK assuming a single corporation tax rate of 26%**




Notes to Figure IV.5:
1) The potential scenario involving the single corporation tax rate of 26% takes the Budget 2007 reforms as given, such that only the calculations for the incorporated individual have changed.
2) See also Notes to Figure IV.4.

**Figure IV.6 Average tax rates in the UK assuming a single corporation tax rate of 26%**




See Notes to Figure IV.5.

**Table IV.1 Tax and NICs to be paid in the UK, by legal form (single corporation tax rate of 26%)**

| | £25,000 profits per annum | | | £75,000 profits per annum | | |
|---|---|---|---|---|---|---|
| | Employed | Self-employed | Incorporated | Employed | Self-employed | Incorporated |
| Salary | £22,756.03 | £25,000 | £5,225.00 | £67,082.27 | £25,000.00 | £5,225.00 |
| Income tax | £3,506.21 | £3,955.00 | | £17,677.91 | £20,845.00 | |
| ***NICs*** | | | | | | |
| Class 1 employee | £1,928.41 | | | £4,151.07 | | |
| Class 1 employer | £2,243.97 | | | £7,917.73 | | |
| Class 2 | | £114.40 | | | £114.40 | |
| Class 4 | | £1,582.00 | | | £3,170.50 | |
| Corporation tax | | | £5,141.50 | | | £18,141.50 |
| Dividend tax | | | | | | £2,770.88 |
| **Total tax** | £7,678.59 | £5,651.40 | £5,141.50 | £29,746.71 | £24,129.90 | £20,912.38 |
| **Net receipts** | £17,321.41 | £19,348.60 | £19,858.50 | £45,253.29 | £50,870.10 | £54,087.63 |
| Increase in net receipts compared to employed | | £2,027.19 | £2,537.09 | | £5,616.81 | £8,834.34 |

Notes to Table IV.1:
1) All rates and allowances are in 2007-08 terms. The higher rate income tax threshold is due to increase more than in line with inflation at the time that the income tax and NI thresholds are aligned under Budget 2007 reforms: this rise has been taken into account, but the new figure used remains in 2007-08 prices (i.e. the new 2009-10 threshold has been deflated).
2) The potential scenario involving the single corporation tax rate of 26% takes the Budget 2007 reforms as given, such that only the calculations for the incorporated individual have changed.
3) The tax calculations for the employed individual take into account both employer and employee National Insurance Contributions (NICs), i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).
4) It is assumed that the incorporated individual pays themselves a salary equal to the personal allowance (roughly equivalent to an 18 hour week on the national minimum wage), with the remainder of the profits from the business extracted in the form of dividend payments, on which corporation tax and dividend tax must both be paid.