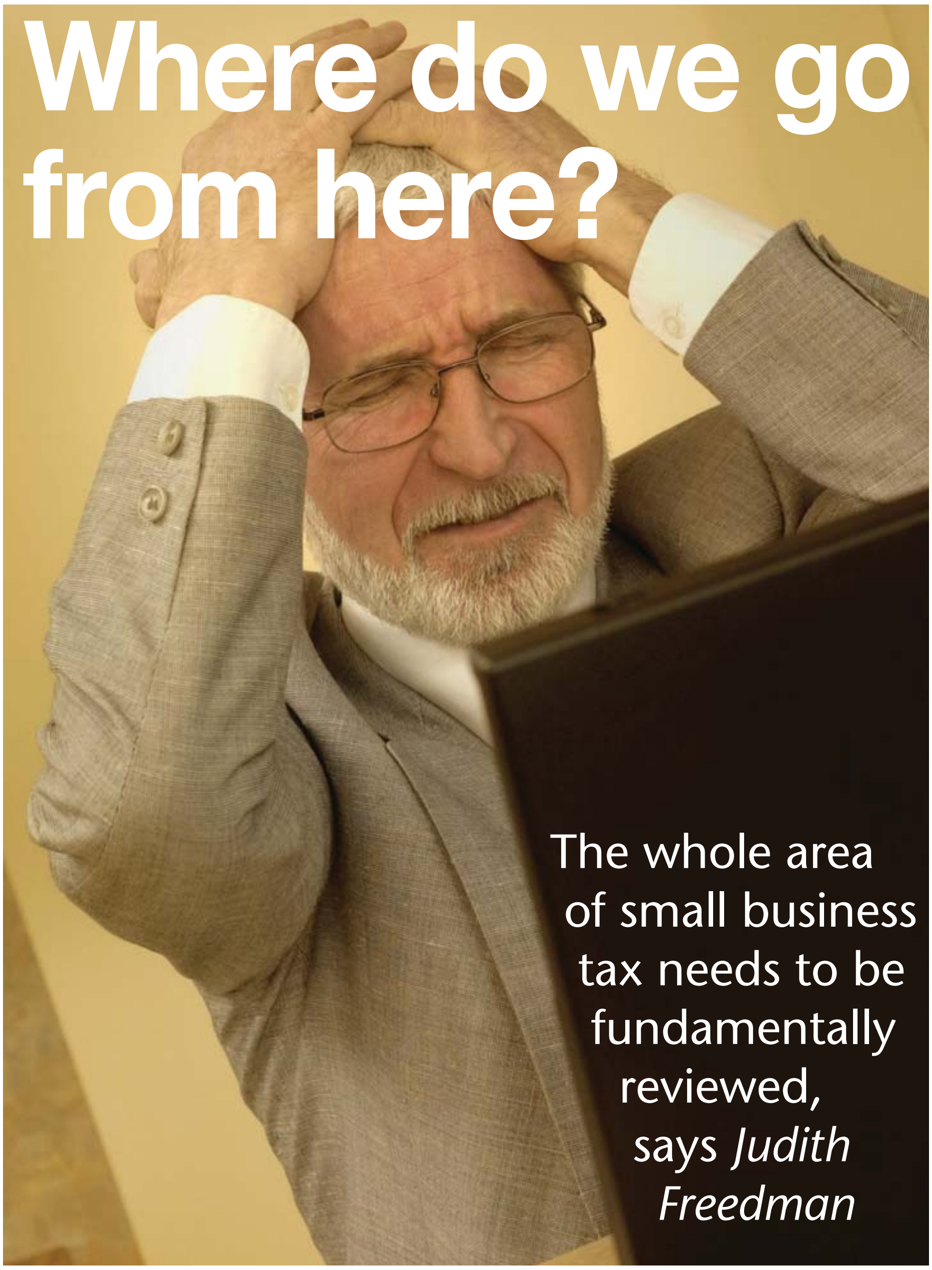
Where do we go from here?



The whole area of small business tax needs to be fundamentally reviewed, says *Judith Freedman*

Small businesses give rise to big tax issues. Recent tax history in the UK has shown how many problems can result from a failure to examine problems in the small business area as a whole, and from the reluctance to look at the root of the problem rather than applying patches to the symptoms. The saga includes the introduction and abandonment of the zero starting rate of corporation tax, the problems over IR35 and the subsequent managed service company legislation, and the income-splitting mess. Quick fixes, badly thought-through tax incentives and complex (arguably unworkable) legislation have created a mix that government, advisers and small businesses alike consider to be unfair to some and burdensome to many. The UK is not unique in finding that the taxation of small businesses is not a straightforward affair.

The CIOT has called for the government to carry out a fundamental review of how small businesses are taxed, to reflect the 21st century small business community (see *Tax Adviser*, April 2008, p 9). It reiterated this view in response to an Early Day Motion in the House of Commons, following the announcement in the 2008 Budget that income shifting legislation was to be deferred (http://www.tax.org.uk/showarticle.pl?id=6665). The EDM advocates a solution that 'minimizes risk of tax avoidance, creates a level playing field in which all in the sector can compete fairly and ensures that the right person is taxed on the reward they have earned at the right time and in ways which do not create artificial and inappropriate incentives to recategorise employment as self-employment, and the reward for labour effort expended as investment income'.

This is a wonderful aspiration, although easier said than done. The EDM suggests it might be achieved by introducing 'a suitable legal entity designed for use in the 21st century and not the 19th century as the limited company was'. Interesting though this idea is theoretically, in practice the limited company is here to stay, and the thrust of recent company law reform, in the guise of the 'think small first' policy behind the 2006 *Companies Act,* has been to make this legal form more, not less, suitable for very small firms. While the limited company is available to very small businesses (even one-person firms) and especially while it gives tax advantages, small business owners will quite reasonably take advantage of what it has to offer, and any alternative legal form, even if that were to be useful for other reasons, would not prove so popular.

The solution to the tax problems is to align the tax treatment of employees, the self-employed and owners of limited companies. This does not necessarily mean treating them in the same way, because there are differences between the types of income and gains they receive, so alignment proposals have to examine the problem holistically. Concentrating on reducing the differences at the employed/self-employed borderline could merely exacerbate the differential between incorporated and unincorporated firms, unless the issues are examined across the whole spectrum. So a broader review is needed, and it is encouraging that the tax and policy communities (including the Treasury Select Committee in its report on the 2008 Budget) seem to be receptive to the need for such a fundamental re-think.

In the 2006 *Hardman* lecture (http://www.icaew.com/index.cfm?route=138334), I proposed an examination of the Nordic approaches to small business taxation to see if any ideas could be gained from this. The suggestion created interest, but *Accountingweb* commented that 'it seems dangerous to allow academics to decide tax policy as they lack hands on experience'. Of course academics do not (and should not) *decide* tax policy, but what they should do is think about underlying problems and possible solutions. The changes we have seen over the last decade hardly suggest that reliance on piecemeal reform and ad hoc changes for practical reasons have resulted in a good experience for small businesses. We cannot start with a completely clean piece of paper, and practicalities are important, but thinking about what we are trying to tax, and why, might be a good starting point. This is what we have tried to do in a chapter on small business taxation written for the Institute for Fiscal Studies' *Mirrlees Review on Reforming the Tax System for the 21st Century.*

What is the problem?

- There is no general agreement about the definition of 'small businesses', and so the objectives of discussions on small business taxation can get confused. For the purposes of this article, I am referring to small owner-managed, family companies at the smallest end of the business sector, for which the tax incentive to select between employment, self-employment, partnership (general and limited liability) and incorporation is relevant. The focus here and in the *Mirrlees* study is on these structural issues.
- Small businesses within this category lie at the intersection between the personal and corporate tax systems, and so small business issues need to be taken into account in the design of both these systems.
- In any system where returns to labour are taxed at a higher rate than returns to capital, there will be opportunities for taxpayers to reduce their tax liability by converting income from labour into income from capital using the mechanism of incorporation, unless a method of countering this is found. In the UK this problem is exacerbated by National Insurance contributions (NICs), which are not payable on dividends and are levied at a higher level on employees than on the self-employed.
- Too often, small business taxation policy is muddied by attempts to provide tax incentives for enterprise. In the *Mirrlees* study we explain why we reject the case for blanket tax incentives for small businesses as such, although we accept that there may be exceptional cases of market failure or issues of compliance costs where specific reliefs are warranted and can be targeted effectively. Generally though, steps towards increasing simplicity and reducing distortions in the tax system for all taxpayers are more likely to increase efficiency and equity for all taxpayers, including small businesses, than are special small-business measures. In particular, the UK government's attempts in recent years to advantage incorporation in the belief that this will encourage entrepreneurship have not proved successful.

Developing a way forward

Experience in the UK and elsewhere suggests that measures that differentiate on the basis of definitions and legal form are likely to fail for practical reasons. IR35 is a prime example. The failure to detach the special rules from the problematic concept of employment has meant that the legislation is hard to enforce, probably raises little revenue, and yet creates compliance costs and concerns for far more taxpayers than are actually caught by the rules.

Total alignment of tax and NICs treatment across the spectrum is difficult to achieve in a straightforward manner because there are real differences between legal forms: a self-employed contractor does not have the same legal rights and obligations as an employee, and an unincorporated business owner becomes a shareholder and probably a director and an employee on incorporation, rather than a direct owner of the underlying business. Nevertheless, we argue that the aim should be to align effective tax rates for these groups after taking capital investment into account. Other differences, such as the possibility that employees have greater security than the self-employed, or holiday pay or other perks, clearly exist. Requiring the tax system to take account of this is, however, unrealistic and creates complexity rather than equity, especially since the differences will not be present in every case. The market should be left to deal with these differences. This would be a much better tool than the blunt instrument of the tax system.

Alignment of effective tax rates across different legal forms in the UK could be achieved either by adapting our existing system, or by adopting more radical reforms. If we were to retain a structure broadly along the lines of the current UK tax system, we could increase neutrality across the spectrum by aligning NIC rates for the employed and self-employed, while at the same time increasing the small companies' corporation tax rate, aiming to align it with the main corporation tax rate (thus raising the effective tax rate on dividend income). The government appears to be moving in the direction of this last objective. The differences in the benefits available to the employed and self-employed are not as great as the differences between the contributions.

These reforms do not, however, address the fact that in the UK, as in most 21st century tax systems, the aim is to tax the return to capital more lightly than the return to labour. This might sound counter-intuitive, but there are both theoretical justifications and practical reasons for this, which are discussed in the *Mirrlees Review*. Any viable proposal needs to recognise that this is likely to carry on being the case.

Various radical alternatives might deal with this. One solution, adapted from the Nordic approach, might be a system that would exempt the normal rate of return to capital from taxation at both the corporate and the personal levels, while providing a mechanism for taxing above-normal returns to capital and labour income at the same progressive rates regardless of whether they are described as dividends, capital gains or salary. This mechanism would take into account the corporation tax already paid, and would include NICs in the personal tax rate. Our proposal requires the introduction of a shareholder income tax with a rate of return allowance (RRA), and a corporation tax with an allowance for corporate equity (ACE) for all companies. If desired, returns to self-generated goodwill could be taken into account also alongside investment of physical capital, although this would be more complex. Such a system could be extended to unincorporated small businesses with capital investments, although record-keeping requirements are such that the RRA should probably be kept optional for these firms. In this way, alignment across legal forms could be achieved without prejudicing the tax system's capacity to distinguish coherently between normal returns to physical capital and labour income.

A major advantage of this approach, which fits with a broader proposal about corporation tax that the economists Griffith, Hines and Sorensen make in the *Mirrlees Review*, is that all businesses would obtain the benefit of a lower tax rate on returns to capital than on labour income. There would be no need for the kind of arbitrary definitions and difficult distinctions between different types of firm that have so hampered previous attempts at reform in this area.

It is true that this proposal does not completely deal with the problem of income splitting by the creation of a company or partnership, which would still be advantageous due to the availability of personal allowances and the effects of progressive income tax rates. The advantages would be reduced, however, since all income derived from a company or partnership above the normal rate of return would be taxed at labour income rates even if paid by way of dividend. The remaining advantage would be largely the result of the system of individual taxation, and, since a similar result can be achieved by splitting investment income, any change in this respect would require a review of that policy rather than changes to small business taxation.

No doubt these proposals will be criticised for being 'academic' – and they would certainly need to be worked through in detail – but it may be time to think radically, given that 'practical' amendments to the system have brought us to where we are now.

Judith Freedman is KPMG professor of taxation law at Oxford University and co-author with Claire Crawford of the small business chapter in the Institute for Fiscal Studies' Mirrlees Review *(http://www.ifs.org.uk/mirrleesreview/publications.php). This article draws on that chapter but does not represent the views of any organisation*