Taxing income from business

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Tax rates vary by income source

Overall top statutory marginal tax rates

- Employment
- Self-employment
- Dividends
- Capital gains (property & carried interest)
- Capital gains
- Capital gains (business assets)

Excluding employer NICs & corporation tax
Including corporation tax
Including employer NICs

Taxing income from business © Institute for Fiscal Studies
The effect of tax on investment incentives varies with:

- asset type
- source of finance
- investment horizon
- inflation rate
- combination of legal forms & vehicles involved

Investments can be penalised or subsidised. E.g:

- Disincentive to invest money in a company
- Subsidy to most debt-financed investments

Risk-taking is discouraged

- Relief for losses is less generous than taxation of gains/profits – government takes a bigger share of the upside than the downside
Problems with the current system

- **Unfairness** - people with same overall income can get very different tax bills

- **Economic inefficiency** – tax system reduces aggregate output and wellbeing by distorting work and investment decisions

- **Administrative burden and complexity** – boundaries cause problems
How to fix the problems

- Aim: ‘neutrality’, at least as the benchmark
- Two goals:
  1. ‘Tax all income the same’
  2. ‘Don’t discourage saving and investment’

Perceived tension: tax income from capital like labour income (1) or not at all (2)?
  - Setting tax rates as a compromise doesn’t achieve either aim
  - Get around this by fixing both tax rates and the tax base
How to fix the problems

- Aim: ‘neutrality’, at least as the benchmark

- Two goals:
  1. ‘Tax all income the same’

    Tax income from all sources under the same overall marginal rate schedule

  2. ‘Don’t discourage saving and investment’

    Give full deductions from the tax base (at corporate and personal levels) for amounts saved and invested

    Treat losses as nearly symmetrically to gains/profits as possible
Reforming the tax base

Basic idea:

- Don’t tax investments that are only just worthwhile
- Tax returns in excess of that in full

Two ways to achieve this:

1. Cash-flow tax: upfront deductions for amounts saved/invested
2. Deferred allowances: stream of annual allowances for a ‘normal’ rate of return to amounts saved/invested

Needed for both personal and corporate tax
Reforming the business tax base

1. Extend full expensing to all real investments

2. Reform treatment of business borrowing:
   - either tax the principal borrowed and deduct the principal repaid (as well as interest);
   - or restrict deductibility of interest payments (and taxation of interest income) to interest rates above the normal return

   (Alternative route: Allowance for Corporate Equity)
Reforming the shareholder tax base

Cash-flow approach:

▪ Give tax relief for share purchases (including in own company) and tax full proceeds from selling shares (as well as dividends)

Deferred-allowance approach:

▪ Give (say) 5% annual ‘rate of return allowance’ for amount invested
▪ Or can implement by indexing capital gains for an interest rate
  ▪ Indexing capital gains for inflation would be a good start
Losses

- Relief for losses should be as nearly as possible symmetrical to taxation of profits/gains
  - Taxing upside without cushioning downside penalises risk-taking

- Subject to avoiding creating new scope for abuse

- Consider changing the treatment of losses arising after April 202X to:
  - Allow carried-forward self-employment losses to be set against any income or capital gains (not just profits from the same trade)
  - Allow individuals and companies to offset capital losses against income (rather than capital gains) in more circumstances
  - Allow losses to be carried back further (e.g. up to five years)
  - Carry losses forward (and back) with interest
Winners and losers

Winners:

- Employees and employers
- Those investing & making modest return or risking a loss

Losers:

- Those getting large incomes from business/capital with relatively little investment
Solves many problems, not all

- This approach offers a significant prize
  - Considers whole system and solves many problems at once
  - Would create a more efficient and fairer tax system

- Doesn’t solve all problems. E.g:
  - Still an incentive to split income (e.g. between spouses)
  - Evasion opportunities would remain higher for business owners than employees
  - Still some disincentive to risk-taking
  - International issues
Going beyond neutrality

- May want to actively encourage certain activities where markets fail
  - Innovation
  - Venture capital

- Try to target the particular activity / market failure rather than broad-brush preferential tax rates based on legal form

- Consider whether tax rates or tax base more appropriate tool
  - R&D tax reliefs vs patent box
  - EIS & SEIS
Conclusion

- Ideal:
  - Align tax rates across all income sources…
  - …while reforming the tax base to avoid discouraging investment

- Various ways to take smaller steps in the right direction

- Not easy politically
  - Many losers – those getting unjustifiable tax advantages now

- But the status quo involves inefficiency, complexity and unjustifiable tax disadvantages for others