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Taxing income from business

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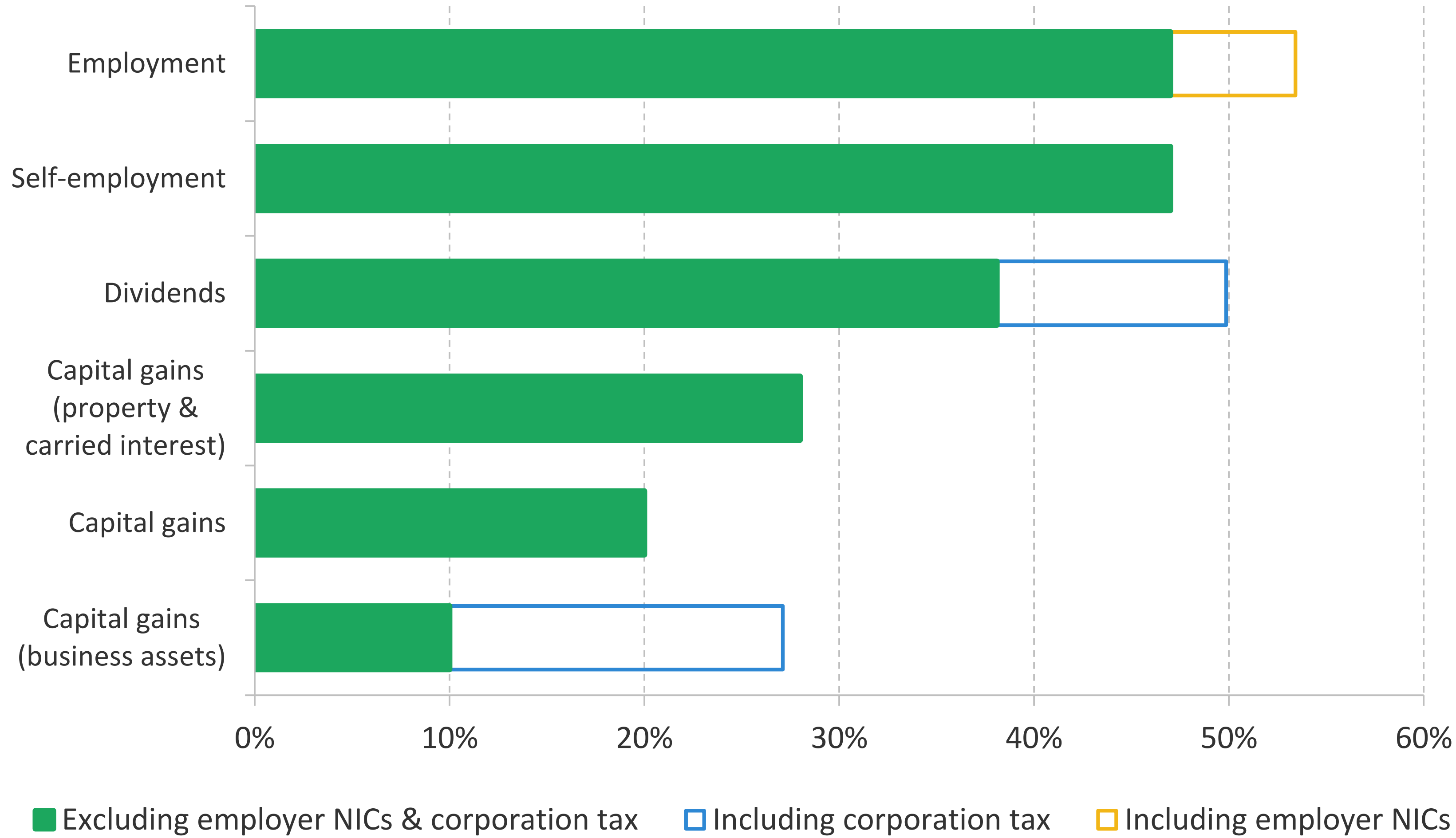
Tax rates vary by income source

Overall **top statutory marginal tax rates**



Investment incentives a mess

- 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:
   - *<u>either</u>* tax the principal borrowed and deduct the principal repaid (as well as interest);
   - *<u>or</u>* 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