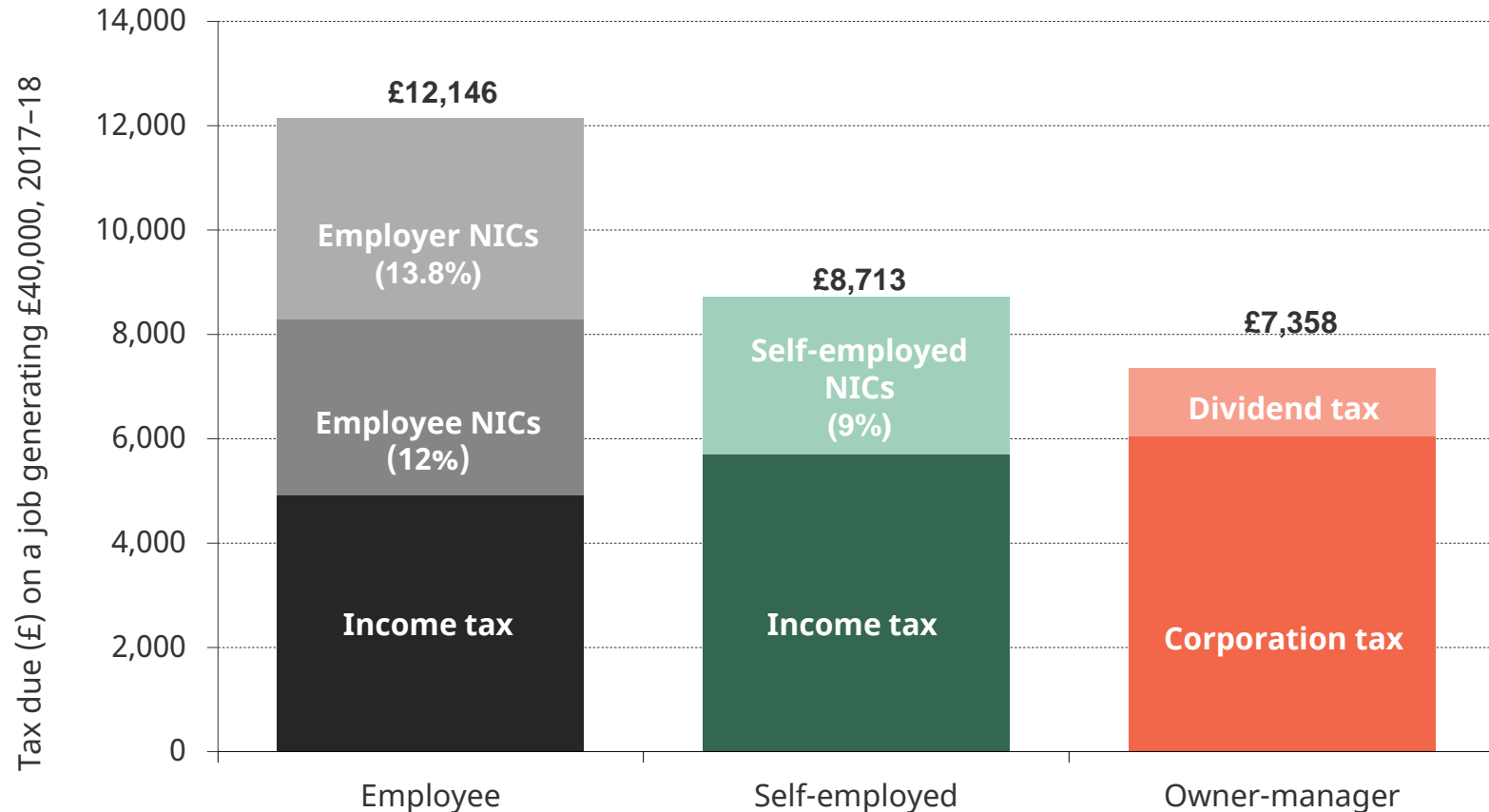


How do small business owners respond to the tax system?

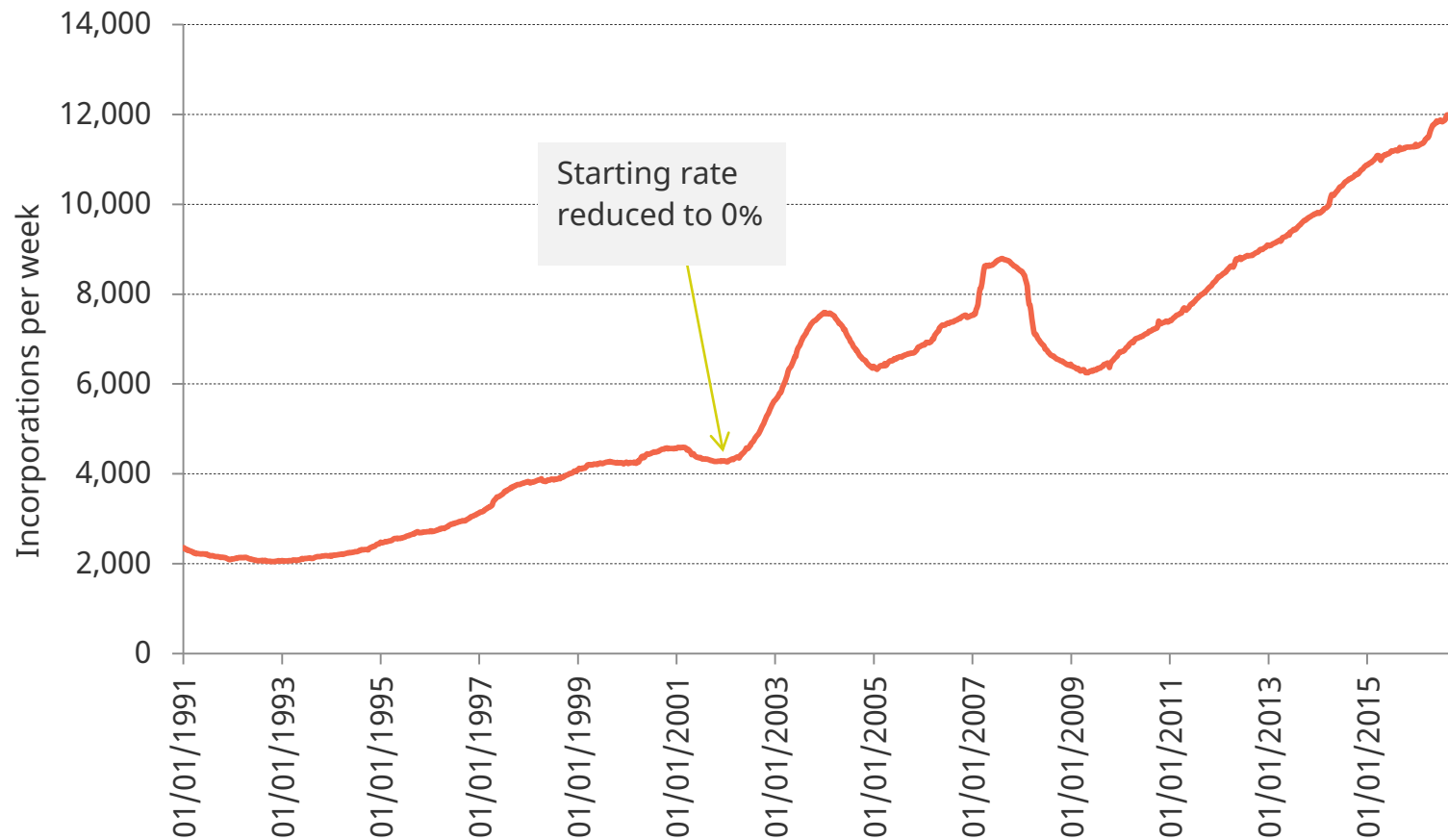
Kate Smith

The tax system favours business ownership



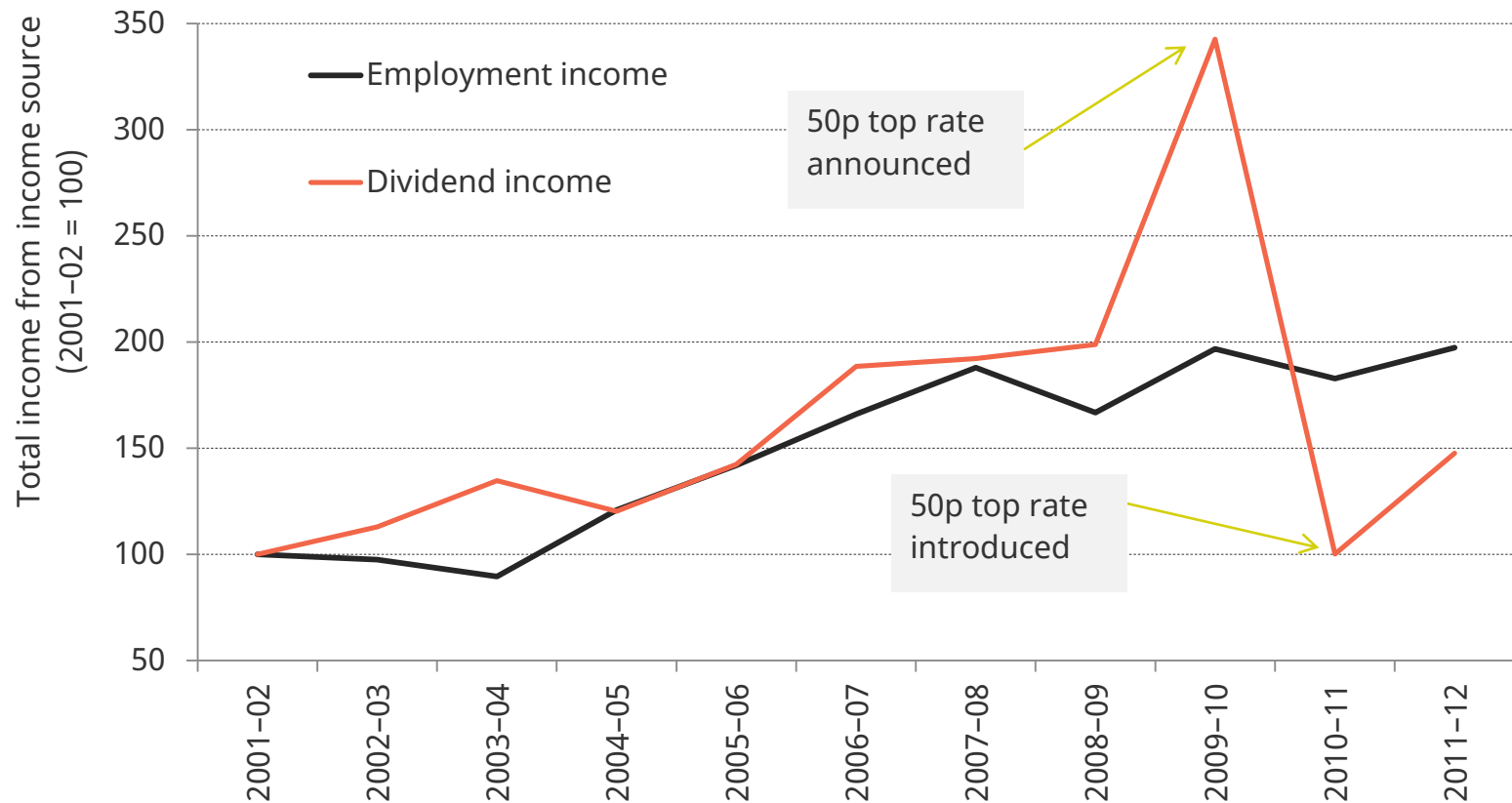
Notes: Income tax is slightly higher for the self-employed than for employees in this chart only because the latter are charged income tax on income *net* of Employer NICs.

People move between organisational forms



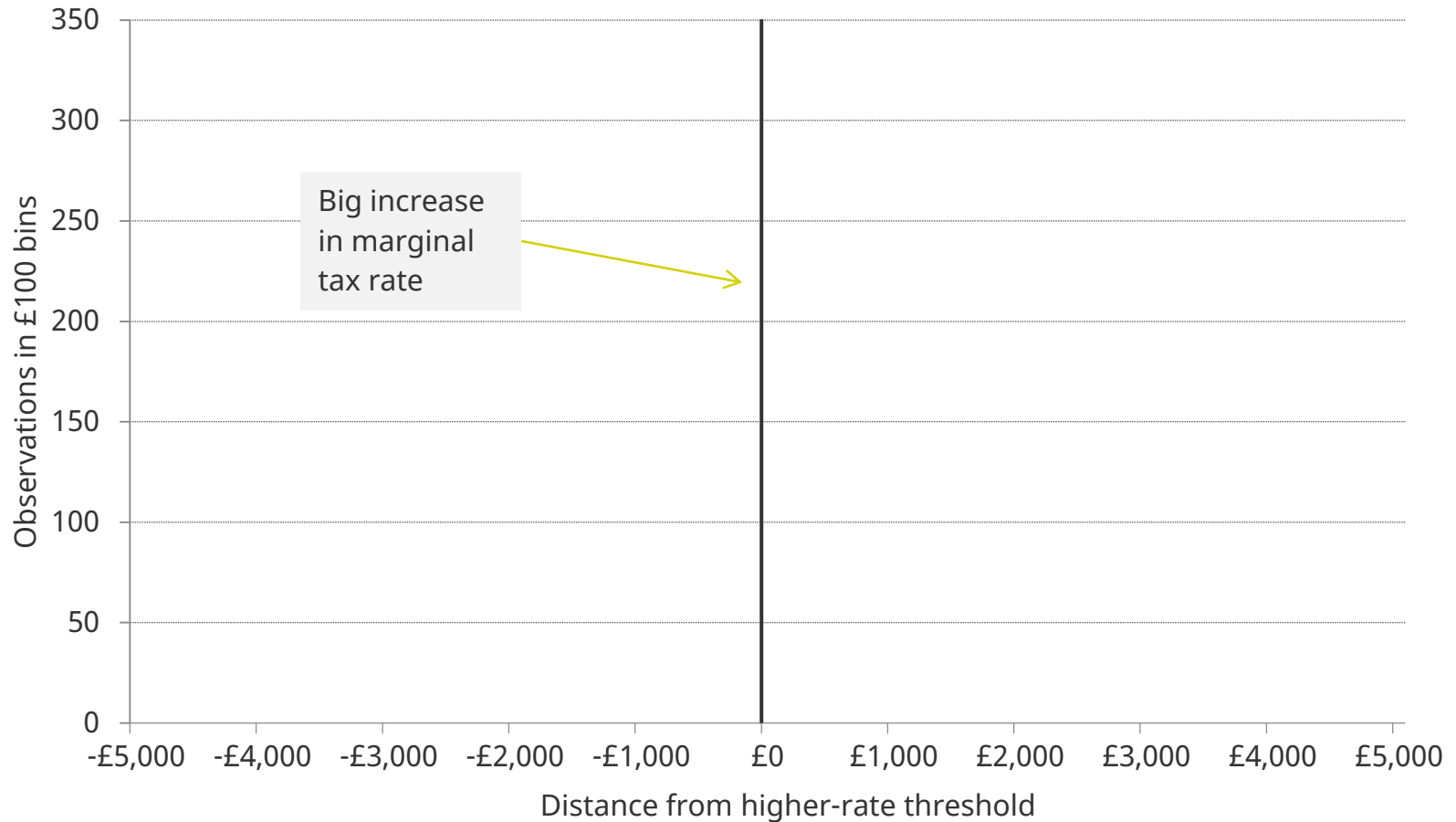
Source: Figure 7.6 in Chapter 7 "Tax, legal form and the gig economy", *The IFS Green Budget*, February 2017 .

People shift income when the tax system changes



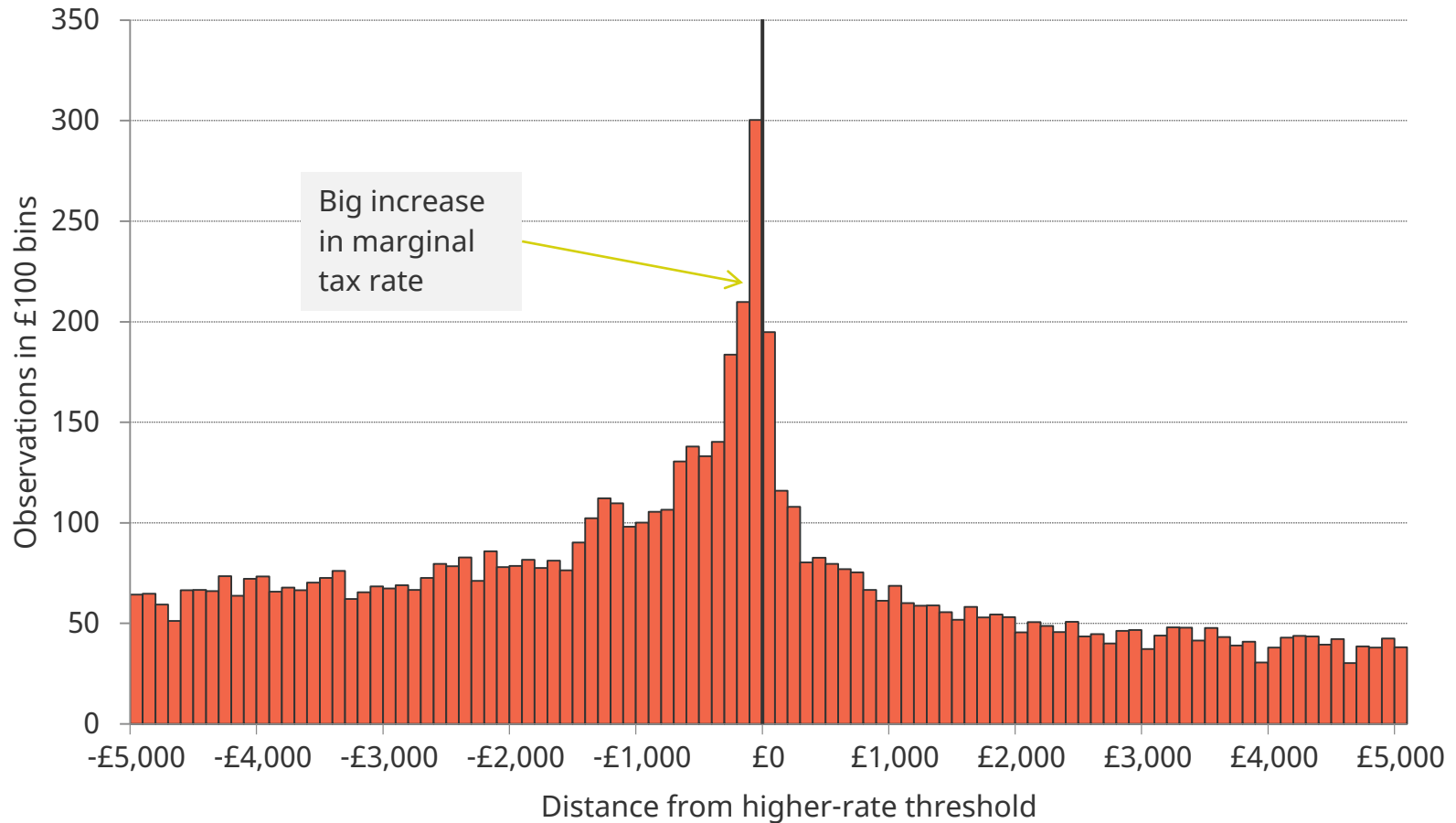
Notes: More individuals had to file tax returns in 2010-11, leading to slightly understated income falls in that year.

Owner managers bunch at kinks in the tax schedule



Notes: Distance from higher-rate threshold measured in 2007–08 prices. Distribution shown for company owner-managers, 2003–4 to 2007–8.

Owner managers bunch at kinks in the tax schedule



Notes: Distance from higher-rate threshold measured in 2007-08 prices. Distribution shown for company owner-managers, 2003-4 to 2007-8.

Company owner-managers have a lot of flexibility over when to withdraw income

Individuals with incomes that fluctuate around a kink point have an incentive to smooth taxable income over time

- By bunching at the kink point they can ensure they don't pay the higher rate of tax in 'good years'

Individuals with average incomes above the higher rate threshold have an incentive to retain profits until company liquidation

- Entrepreneur's Relief: lower capital gains tax rate paid on business income taken out on liquidation

Adjustment of real activity is not the only way to bunch

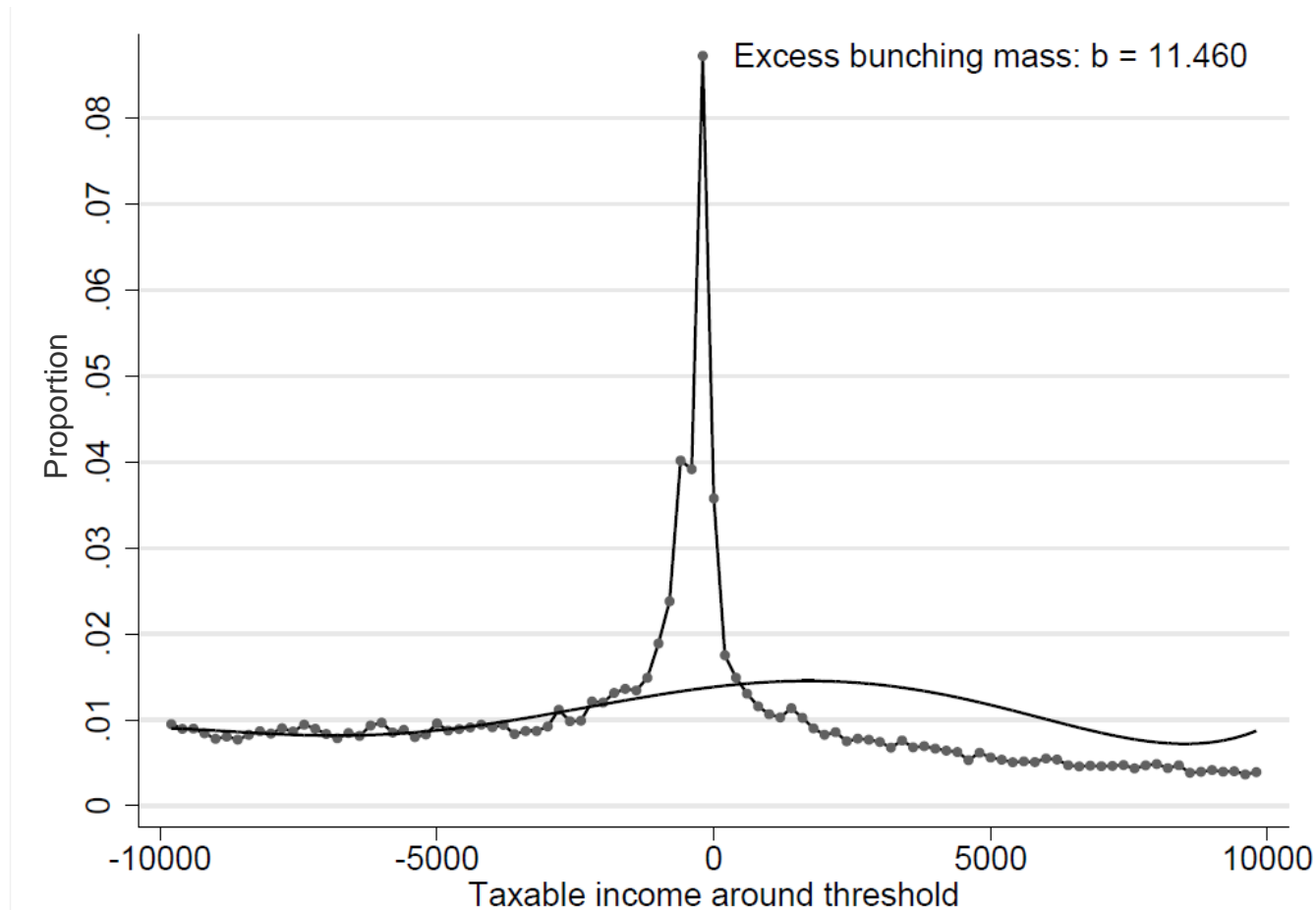
New linked tax records crucial to get fuller picture of owner-managers' behaviour

New link between personal tax records of the owner-manager and the corporate tax records of the company

- Observe: company profit (total income), and timing and size of taxable income withdrawals by owner-manager

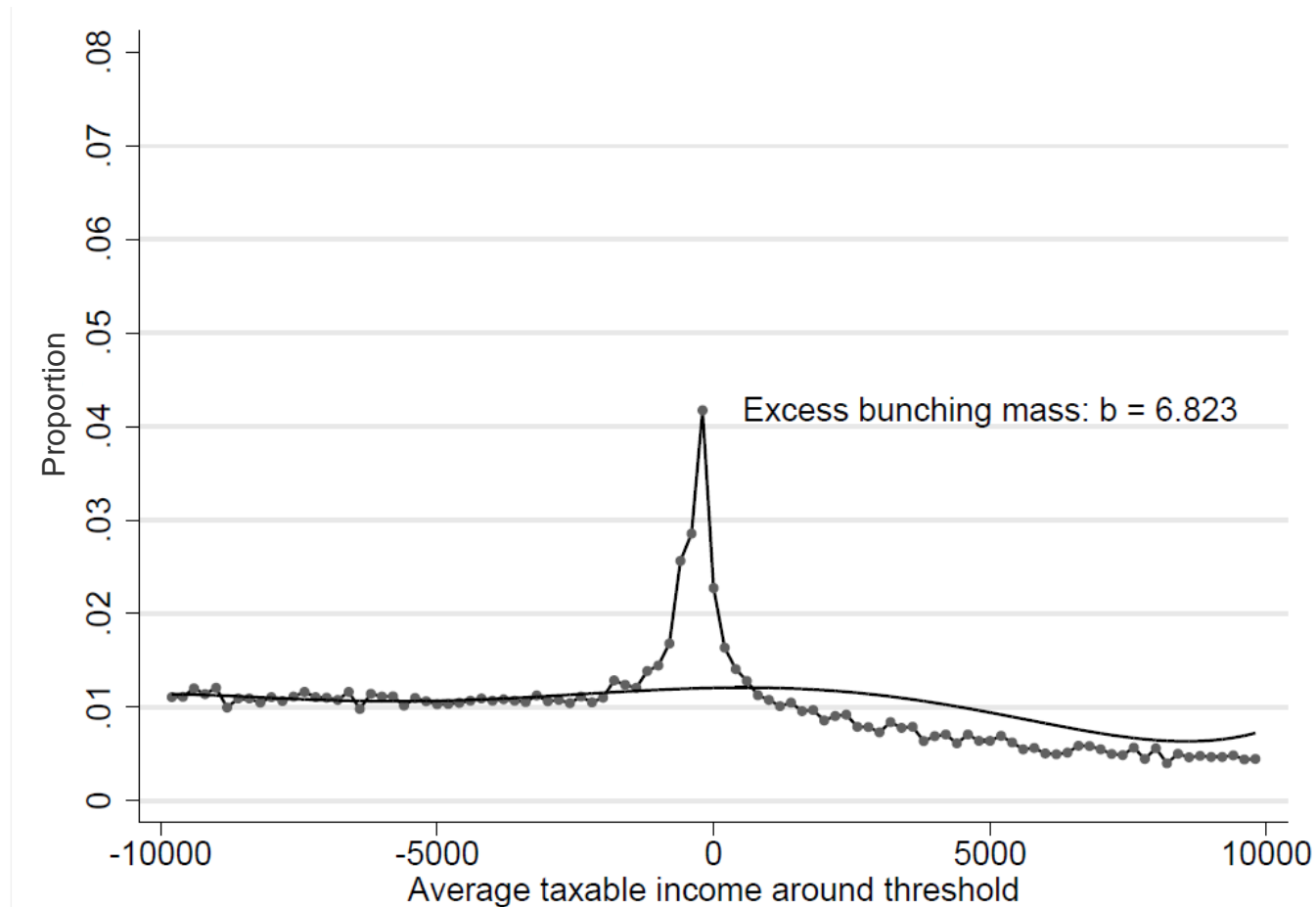
Allows us to understand how much of responsiveness is driven by income shifting or adjustments to 'real business activity'

Bunching in annual taxable income - all responders



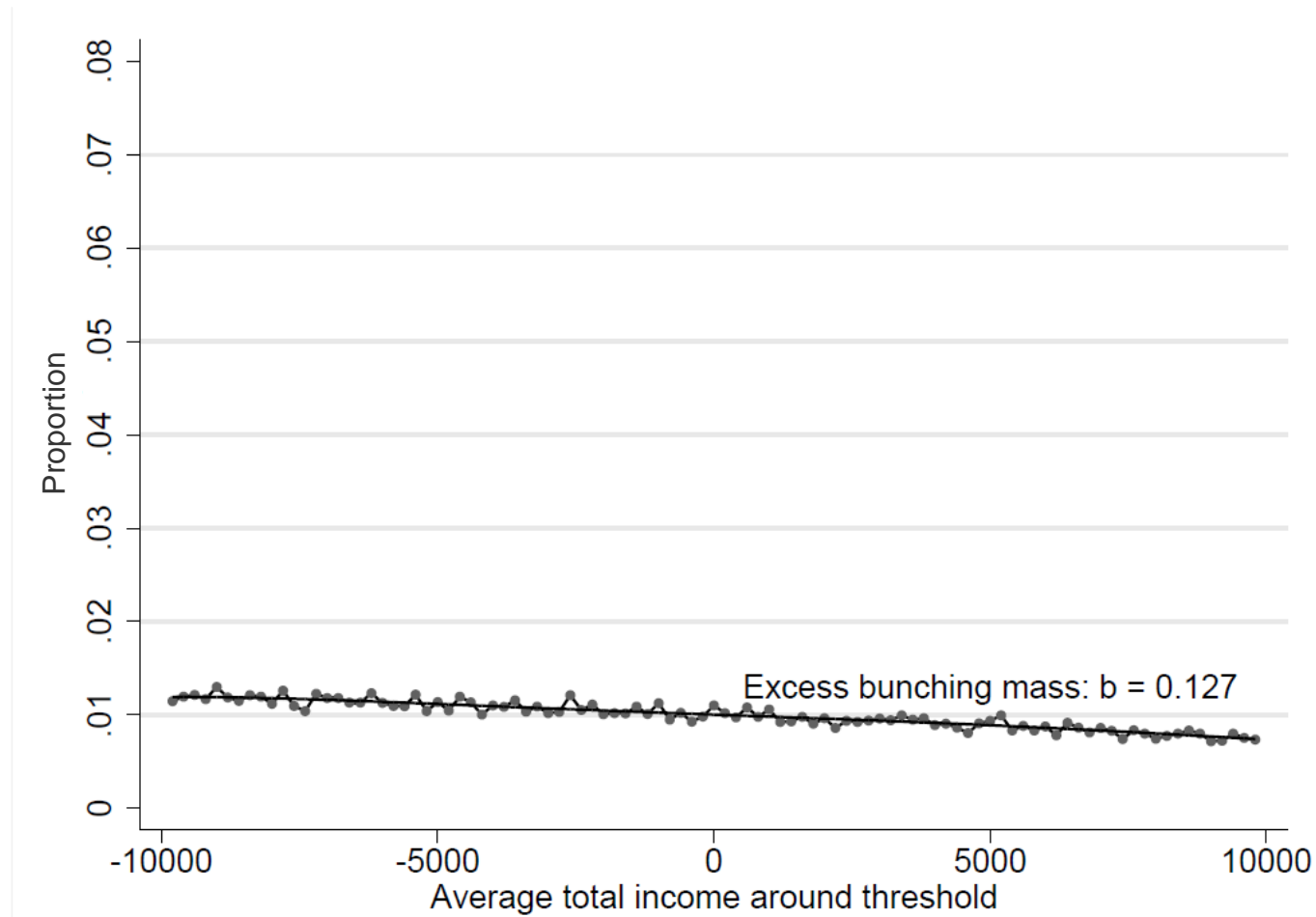
Notes: Authors' calculations using HMRC administrative tax records. Bin width is £100. Counterfactual density estimated using higher order polynomial.

Bunching in average taxable income – takes out short term income shifters



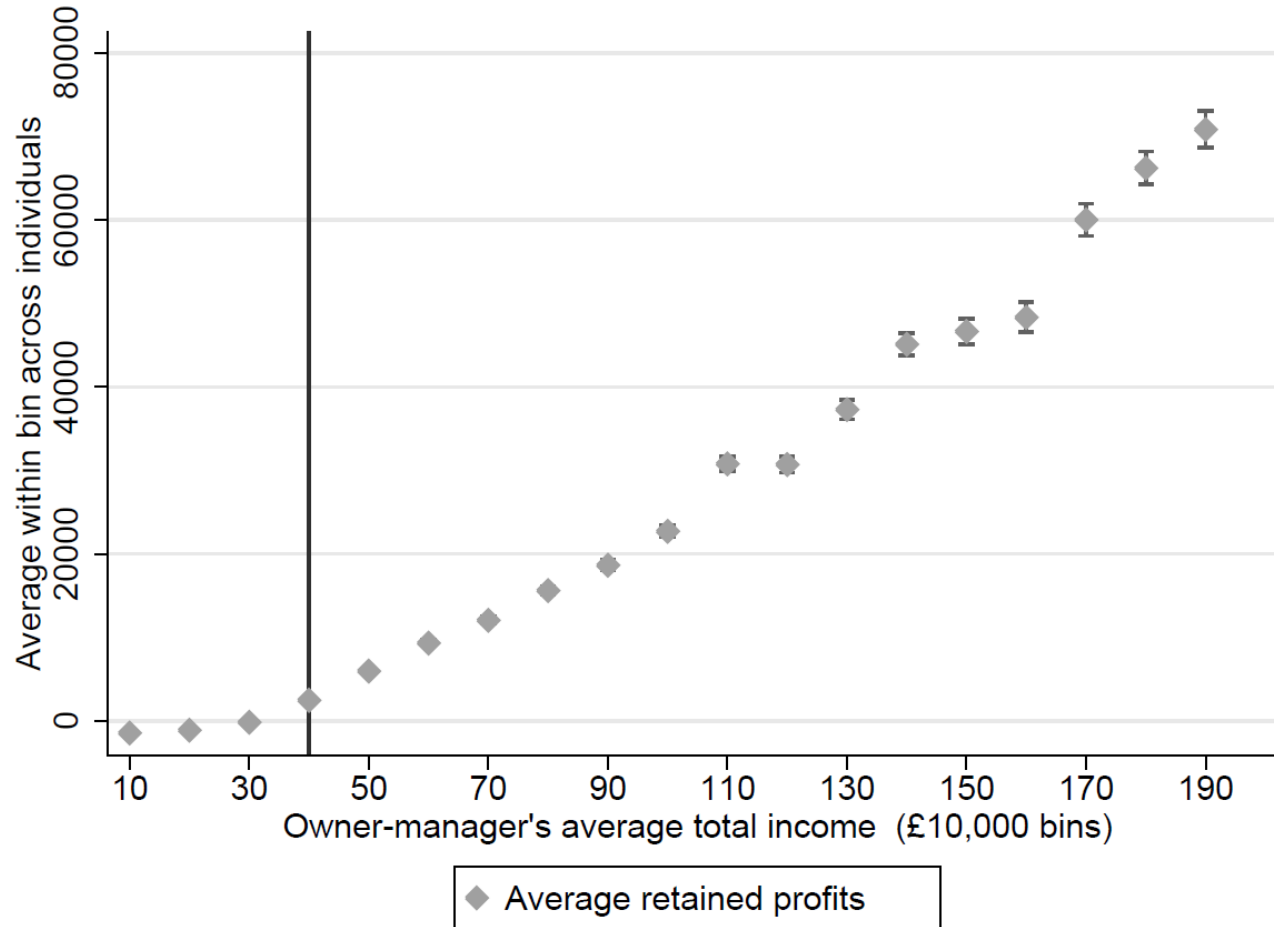
Notes: Authors' calculations using HMRC administrative tax records. Bin width is £100. Counterfactual density estimated using higher order polynomial.

Bunching in average total income – takes out longer term income shifters



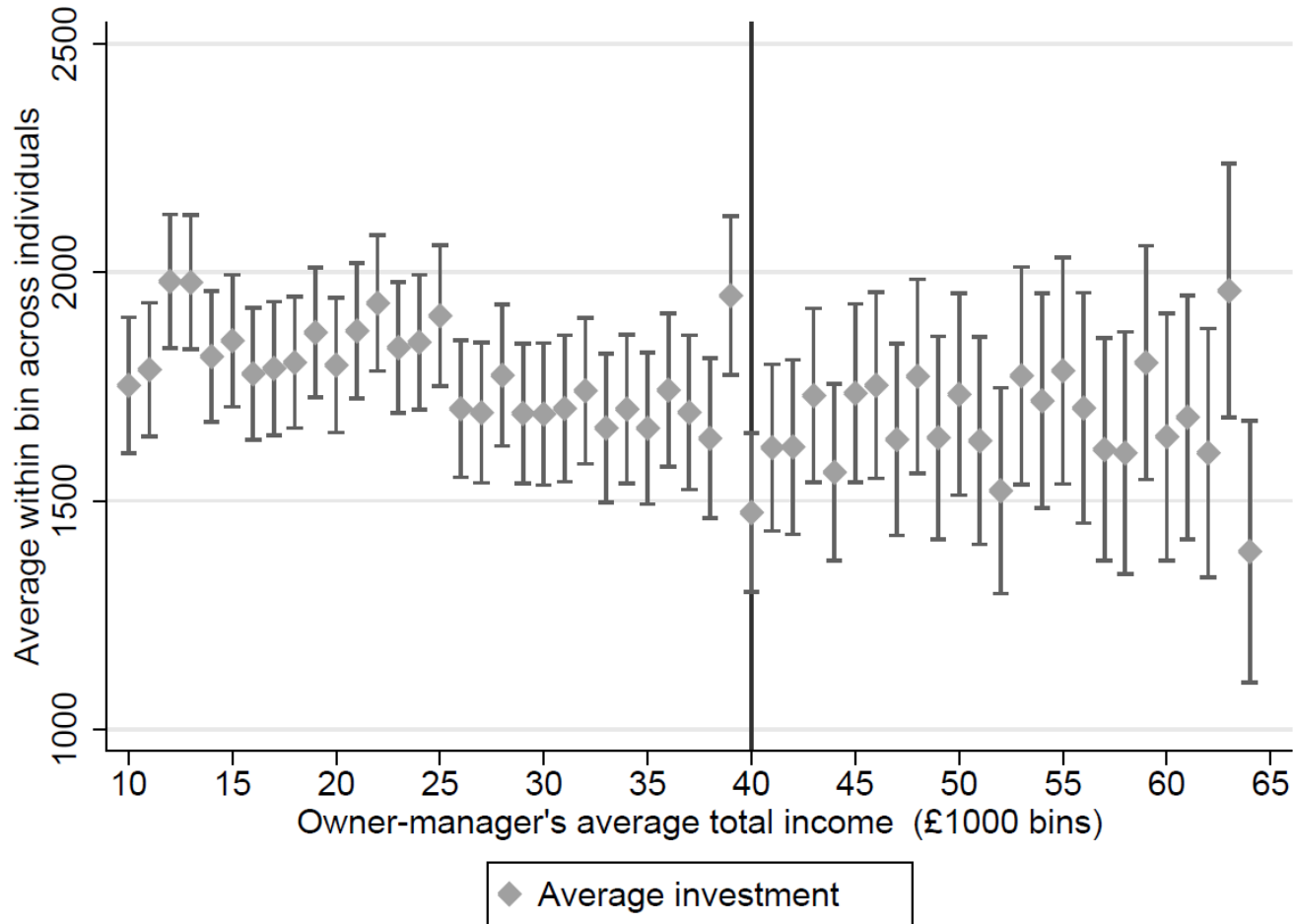
Notes: Authors' calculations using HMRC administrative tax records. Bin width is £100. Counterfactual density estimated using higher order polynomial.

Retained profits are important, particularly for higher income owner-managers



Notes: Authors' calculations using HMRC administrative tax records. Average retained profits constructed across years observed for each owner-manager.

No evidence that investment is higher for those retaining profits above threshold



Notes: Authors' calculations using HMRC administrative tax records. Average investment constructed across years observed for each owner-manager.

Conclusion – responses matter

Business owners are very responsive to the tax system

- They have flexibility over how and when to take their income
- And use this to respond to changes in the tax rates they face
- We find intertemporal income shifting explains bunching at thresholds

Understanding *how* these individuals respond is crucial

- Short term shifting: gives individuals with volatile income ability to smooth
- Longer term shifting:
 - Distorts choices and reduces government revenues
 - We find no evidence that retained profits are linked to higher investment