includes changes to the capital loss regimes (individuals and corporates); loss relief for partners; further tweakings of the structured finance regime introduced in the Finance Act 2006, section 774A–G; double taxation relief (DTR) planning (likely to be of less relevance if the United Kingdom moves to an exemption regime for corporates with 10 per cent plus interests in subsidiaries overseas); measures to combat Intra-Community Missing Trader (ITMC) fraud (the modified reverse charge regime); and previously announced changes to the stamp duty land tax (SDLT) legislation.

The Act contains two particularly controversial measures. The first is intended to ensure that those subject to the disclosure regimes do comply with their obligations. The challenge is whether HMRC will insist on knowing about schemes that do not have tax avoidance as their raison d'etre and so over-burden advisers and the Anti-Avoidance Group with unnecessary disclosures, at a time when even Ministers are starting to admit that regulatory burdens have to be reduced. Even more controversially, the attempt to restrict claims for overpaid tax to six years following the decision in *Deutsche Morgan Grenfell Group plc v HMRC*[1] is bound to invite further litigation on the ability of a sovereign government to over-turn rights vested in litigants, however unmeritorious the claims may be perceived to be.

Yet some things rarely change: some good, penetrating questions were asked—in between the party political manoeuvring—and occasionally meaningful answers were provided, and some illumination was provided by the government ministers orchestrating the Bill through the House. The case for a more technical approach to the passage of tax legislation was not weakened by the enactment of FA 2007. Will the bringing together of statements on spending on tax, with the likely acceleration of the pre-budget report to mid October 2007, provide an opportunity for Alistair Darling, the new Chancellor, to modernise how we make tax law in the United Kingdom? If so, FA 2007, apart from having been the last of Gordon Brown's legacy, may mark the end of an era.

G.R. LT

Small companies again—section 3

SECTION 3 of the Finance Act 2007 (FA 2007) is a short section, but it is part of a long saga. There are real difficulties in taxing small corporations, but in recent years the UK government has made it appear even more difficult than it needs to be. Often, as with the misconceived zero starting rate,[1] this has been because of a failure to think through reforms in a holistic way and a desire to appeal to the "enterprise" lobby, without considering carefully who will benefit from any given reforms. In 2007, however, we see a reform that does seem to be part of a plan. It may be a step in the right direction, even though it does not have any immediate appeal to the small business community or, prima facie, any very obvious logic. To the small business community, this change may seem like a penalty on small companies to pay for a reduction in the rate of tax on large companies. A detailed examination of the figures, however, does reveal some logic behind the move.

[1] [2007] STC 1.

LT Corporation tax; Limitations; Overpayments; Tax avoidance

[1] A. Redston, "Small companies' tax rate" [2006] BTR 495; J. Freedman, "Small business taxation—the indefinable in pursuit of the unachievable?" 14th Hardman memorial lecture, (2006): *http://denning.law.ox.ac.uk/tax/JF/14Hardmanlecture.doc*

Table I Corporation and basic income tax rates in the United Kingdom: 1982–2009

Financial Year	**Basic rate** of income tax in April commencing that year	**Rate of** Corporation Tax	**Small** Companies' rate	**Starting** rate (CT)
1982	30%	52%	38%	
1983	30%	50%	30%	
1984	30%	45%	30%	
1985	30%	40%	30%	
1986	29%	35%	29%	
1987	27%	35%	27%	
1988–89	25%	35%	25%	
1990	25%	34%	25%	
1991–95	25%	33%	25%	
1996	24%	33%	24%	
1997–98	23%	31%	21%	
1999	23%	30%	20%	
2000–01	22%	30%	20%	10%
2002–05	22%	30%	19%	0%
2006	22%	30%	19%	Abolished
2007	22%	30%	20%	
2008	20%	28%	21%	
2009		28%	22%	

Section 3 increases the small companies' rate of corporation tax to 20 per cent for the financial year 2007.[2] This is a rise of one percentage point from the previous 19 per cent rate which had applied since 2002. It was announced in the Budget that this direction would be continued, with subsequent rises to 21 per cent in 2008 and 22 per cent in 2009. The marginal rate of tax applying to profits between £300,000 and £1.5 million is adjusted from 11/400 to 1/40, thus reducing a little the growth disincentives created by the system of marginal small companies' relief, although not removing it entirely. At the same time, the basic rate of income tax will come down from 22 per cent to 20 per cent in

[2] Ring fence profits (as defined in ICTA 1988, s.502) are excluded from this change. This note will not discuss this exclusion any further.

2008, so that this is not an attempt at alignment of basic income tax and small companies' corporation tax rates. The rate of tax applicable to dividends will remain the same.[3]

As can be seen from Table I above, the small companies' rate shadowed the basic rate of income taxation between 1983 and 1996. This was a logical scheme under an imputation system but it began to break down, firstly because of the use of lower corporation taxes intended to promote enterprise, in 1997, and then, further, when imputation was effectively abandoned in 1999. As the linkage between the rates has now been discarded completely and deliberately, that rationale for a small companies' rate has been removed. The combination of this development and the decrease in the mainstream corporation tax rate to 28 per cent does raise the question of whether the ultimate aim is to remove the small companies' rate altogether, which of course would make sense with a low rate of corporation tax in place.[4]

Why has the small companies' rate been increased now? This seems to be an attempt to reduce the well known tax advantages of incorporation inherent in the 2006–07 tax system. There is also an interaction with the problem of the tax incentive to escape employee status. Thus the operation of the small companies' rate change must be seen as part of the package of measures introduced by Budget 2007 affecting income tax rates and National Insurance Contribution (NICs), as well as the change to the small companies' rate.

Table II and Figure A below show the pre-FA 2007 position. Table II shows the amount of tax and NICs paid by an employed individual, a self-employed individual and an individual who chooses to incorporate, at the £25,000 and £75,000 level of earnings or profits.

In Table II (and in Figure A):

(1) 2006–07 rates and allowances are used.
(2) The tax calculations for the employed individual take into account both employer and employee 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 individual choosing to incorporate pays himself 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 (where appropriate) must be paid.

These figures provide clear evidence of a tax incentive (worth £5,435 for an individual with earnings or profits of £75,000) to be self-employed rather than employed. There is an even greater tax incentive to incorporate and use dividends rather than salary to extract profits, with tax savings of £12,095.99 compared to being an employee of the client firm or firms, and savings of £6,660.99[5] compared to being self-employed.[6]

Figure A (on p.440) illustrates these advantages over a range of incomes (rather than at two points in the distribution), by showing the average tax schedule faced by the above

[3] Budget Note 1, March 20, 2007; Budget Note 4, March 20, 2007.

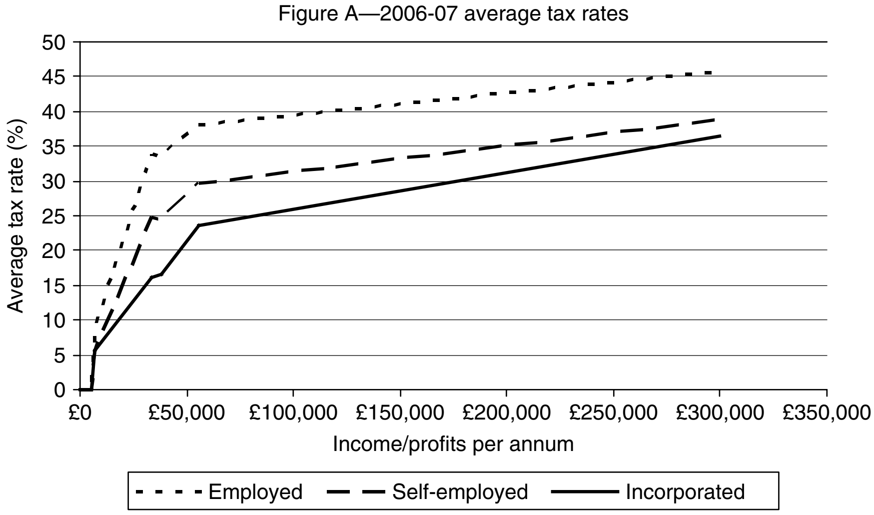
[4] This was suggested by the Tax Reform Commission set up by the Shadow Chancellor, George Osborne MP, *Tax Matters: Reforming the Tax System* October 2006. The Commission, however, would not have raised the small companies' rate until the main corporation tax rate had been lowered to 20 per cent.

[5] £12,095.99–£5,435.00.

[6] If anything, these figures underestimate the incentive to be self-employed or incorporated (rather than employed), because they do not take into account expense deductibility rules.

Table II Tax and National Insurance Contributions (NICs), 2006–07 tax system

	£25,000 earnings/profits per annum			**£75,000 earnings/profits per annum**		
	Employed	Self-employed	Incorporated	Employed	Self-employed	Incorporated
Salary	£22,737.06	£25,000.00	£5,035.00	£67,063.30	£75,000.00	£5,035.00
Income tax	£3,636.45	£4,134.30		£18,559.32	£21,734.00	
NICs						
Class 1 employee	£1,944.71			£3,477.48		
Class 1 employer	£2,262.94			£7,936.70		
Class 2		£109.50			£109.50	
Class 4		£1,597.20			£2,695.00	
Corporation tax			£3,793.35			£13,293.35
Dividend tax						£4,584.16
Total tax	£7,844.10	£5,841.00	£3,793.35	£29,973.50	£24,538.50	£17,877.51
Net receipts	£17,155.90	£19,159.00	£21,206.65	£45,026.50	£50,461.50	£57,122.49
Increase in net receipts compared to employed		**£2,003.10**	**£4,050.75**		**£5,435.00**	**£12,095.99**



individuals. As one would expect—given the differences in net receipts evident in Table II—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' rate is paid), although there is some catch-up as earnings/profits increase.

Table III below illustrates the same tax and NICs calculations for an employed individual, a self-employed individual and an individual who chooses to incorporate in 2009–10, once all the changes announced in the 2007 Budget have been introduced.

In Table III (and in Figure B):

(1) 2006–07 rates and allowances are used. By 2009–10, the upper earnings/profits limit for NICs will have been aligned with the higher rate threshold for income tax, and both will have been increased by £800 per year above the rate of inflation in April 2009. These changes are taken into account in these calculations (but the adjusted allowance is not inflated).
(2) The tax calculations for the employed individual take into account both employer and employee 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 individual choosing to incorporate pays himself 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 (where appropriate) must be paid.

Table III below makes clear that the tax (and NICs) incentive to incorporate is reduced—but by no means eliminated—by these changes. For example, an incorporated individual making profits of £75,000 has net receipts that are £10,706.35 higher than for an employed individual with earnings of that amount in 2009–10, compared with £12,095.99 in 2006–07.

Table III Tax and National Insurance Contributions (NICs), 2009–10 tax system

	£25,000 earnings/profits per annum			**£75,000 earnings/profits per annum**		
	Employed	Self-employed	Incorporated	Employed	Self-employed	Incorporated
Salary	£22,737.06	£25,000.00	£5,035.00	£67,063.30	£75,000.00	£5,035.00
Income tax	£3,540.41	£3,993.00		£17,991.32	£21,166.00	
NICs						
Class 1 employee	£1,944.71			£4,030.05		
Class 1 employer	£2,262.94			£7,936.70		
Class 2		£109.50			£109.50	
Class 4		£1,597.20			£3,086.65	
Corporation tax			£4,392.30			£15,392.30
Dividend tax						£3,859.43
Total tax	£7,748.06	£5,699.70	£4,392.30	£29,958.07	£24,362.15	£19,251.73
Net receipts	£17,251.94	£19,300.30	£20,607.70	£45,041.93	£50,637.85	£55,748.28
Increase in net receipts compared to employed		**£2,048.36**	**£3,355.76**		**£5,595.92**	**£10,706.35**

Figure B—2009–10 average tax rates

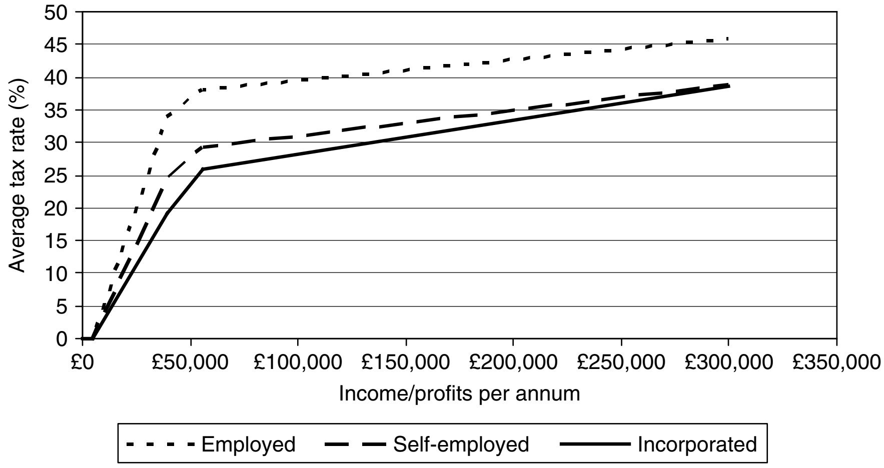


Figure B above shows the average tax rate schedules for the same individuals in 2009–10. As the small companies' rate increase affects the marginal tax rate faced by individuals above the higher rate threshold—while the reduction in income tax does not—incorporated individuals now face slightly *higher* marginal tax rates than self-employed individuals above the higher tax threshold: this translates into an equalisation of the average tax rates over the range of income on which the small companies' rate is paid (with both remaining below the average tax rate for the employed individual).

As partial compensation for the increase in the small companies' rate, the new annual investment allowance (AIA)—to be introduced from 2008–09—will give immediate relief for the first £50,000 of expenditure on plant and machinery—and for both incorporated and unincorporated firms.[7] By reforming small business incentives in this way, the government appears to be refining its targeting procedure—towards businesses (of whatever legal form) that make investments in physical capital.

Even if one can justify assisting small businesses through the tax system (and this is not accepted by all), there seems to be no reason to favour one legal form of organisation above another for tax purposes. Whether this new bias towards firms that require expenditure on equipment as opposed to those which merely provide services makes any more sense is a matter for discussion, but arguably it will encourage investment. In any event, the AIA will give only a relatively small timing advantage. Nevertheless, together, the changes introduced in FA 2007 make sense in terms of a move towards greater neutrality between the self-employed and those who incorporate. They should assist small business owners to make decisions about legal form on commercial rather than tax grounds, although, as seen above, an incentive to incorporate for tax reasons still remains in 2007–08 and beyond.

[7] See the consultation document, HM Treasury, "Business tax reform: capital allowances changes", July 2007.

Rather more fundamental reforms would be needed to remove this incentive altogether, if indeed that was the aim.[8]

CLAIRE CRAWFORD* AND J.F.**

Gambling—section 8 and Schedule 1

DEVOTEES of new taxes need only read as far as section 8 of the Finance Act 2007 to find that a new way of plucking the goose has been invented. This section gives us remote gaming duty. Schedule 1 of the Act provides some details requiring insertions into the Betting and Gaming Duties Act 1981. You will also need a copy of the Gambling Act 2005 if you wish to read some of the definitions of the terms employed.

"Remote gaming" means gaming by the use of the internet, telephone, television and radio. Clearly, the draughtsman did not want to find that his impost lagged behind technological developments so remote gaming is said also to encompass the use of "any other kind of electronic or other technology for facilitating communication". Whether these words derive from an abundance of caution or an insight into the future is not clear.

The rate of charge is 15 per cent of P's remote gaming profits for an accounting period. P is the person who provides facilities for remote gaming. The charge is imposed if the facilities are provided in reliance on a remote operating licence, i.e. a licence conferred by the Gambling Commission. Alternatively, at least one piece of remote gambling equipment used in the provision of the facilities must be situated in the United Kingdom (whether or not the facilities are provided for use wholly or partly in the United Kingdom).

Provisions governing the review of certain decisions and appeals to the VAT and Duties Tribunals, pursuant to the Finance Act 1994, are to be found towards the end of Schedule 1. A Finance Act which did not add to the workload of the tribunals would be most unusual.

T.L.

Environmental tax changes—sections 10–24

Increase in rates of fuel duty, vehicle excise duty, air passenger duty, aggregates levy and landfill tax—sections 10–15

SECTION 10 amends the Hydrocarbon Oil Duties Act 1979 with effect from October 1, 2007 to increase the rates of fuel duty. Rebates of duty on heavy oil, unleaded petrol and furnace oil are increased to reflect the new rates of duty.

[8] More fundamental reform options will be discussed in the chapter currently being prepared by the writers of this note as a contribution to the Mirrlees Review being conducted by the Institute for Fiscal Studies: see *www.ifs.org.uk/mirrleesreview/*

* IFS.

** The writers would like to thank Alastair Muriel of the IFS for his assistance in checking the figures in this note.

LT Company incorporation; Corporation tax; Income tax; National insurance contributions; Small businesses

LT Distance contracts; Gaming duty; Tax rates