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26 January 2021

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# Taxing work and investment across legal forms: pathways to well-designed taxes

# What's in the report



1. How different legal forms and types of investment are taxed and the problems that are caused
2. Long-run ideal and options for achieving it
3. Ideas for steps in the right direction

# Business owner-managers

## Self-employment (unincorporated)

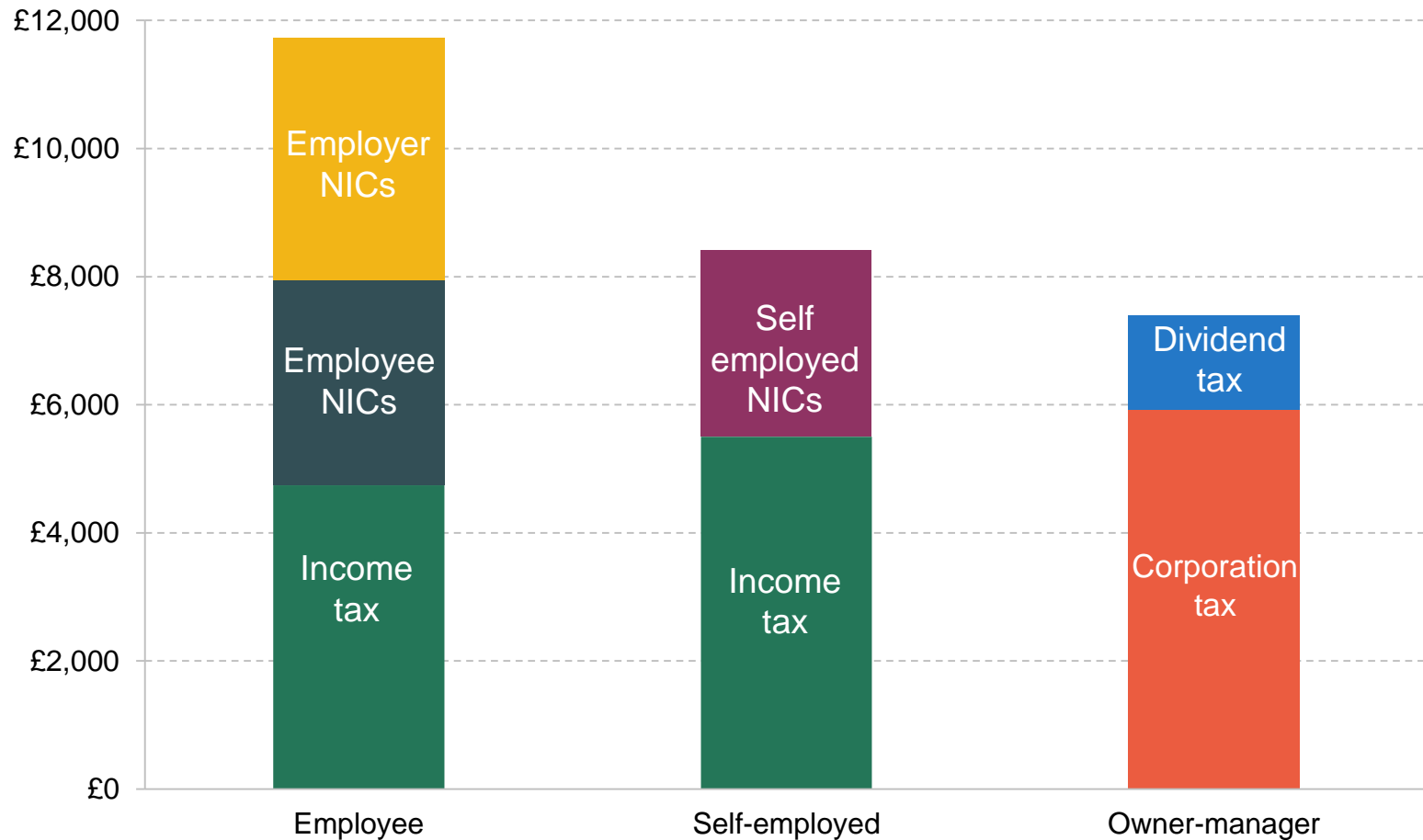
- ~5 million people with some self-employment income
  - ~3.7 million got over half of income from self-employment
- Up from ~4 million in 2000–01

## Company owner-manager (incorporated)

- ~2 million company owner-managers (1 or 2 directors)
- Up from ~0.9 million in 2000–01
  
- Share of business owner-managers with employees: down from 44% in 1975 to 15% in 2019

# Tax penalty on employment

Tax due on a job generating £40,000, 2020–21



Source and notes: Figure ES.1.

# 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 untaxed, discouraged, 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
  - Business income accrues disproportionately to the top 1%, but unfairness occurs across income distribution

# 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
  - Distortions to choices over legal form, type & timing of income, allocation of capital, risk-taking and many others

# 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 investments decisions
- **Administrative burden and complexity** – boundaries cause problems



# Rate differences aren't justified



- Claim: Lower NICs for self-employed reflect lower access to publicly-funded benefits
  - No: NICs advantage for self-employed far bigger than benefit differences
- Claim: Self-employed should get lower tax rates because they don't get employment rights
  - No: Employment rights are not a transfer from the government. They don't skew the labour market towards employment
- Claim: Lower rates incentivise entrepreneurship
  - Preferential rates for all business owners are poorly targeted



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**The long-run ideal**

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# 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 also 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 the corporate and personal levels) for amounts saved and invested*

*Make loss offsets as nearly symmetric as possible to taxation of profits/gains*

# How to fix the problems

- Basic recipe
  - *Tax income from all sources under the same overall marginal rate schedule*
  - *Give full deductions from the tax base (at the corporate and personal levels) for amounts saved and invested*
- Equivalent to saying:
  - *Don't tax 'normal rate of return'*
    - = return that makes someone just willing to invest
    - Achieves goal 2 (don't discourage saving and investment)
  - *Do tax excess (above normal) returns*
    - Tax excess returns all at same rate as labour income
    - Achieves goal 1 (tax all income the same)

# Solves many problems, not all

- 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
- But the 'big picture' solution offers a significant prize
  - Considers whole system and solves many problems at once
  - Would create a more efficient and fairer tax system
  - Solutions extend beyond small business context

# Winners and losers

- Any meaningful reform would create winners and losers
  
- Winners under the ‘full solution’:
  - Employees and employers
  - Business owners investing & making modest return or risking a loss
  
- Losers under the ‘full solution’:
  - Those getting large returns from relatively small investment
  - Those labelling labour income as capital income

# Reform after COVID-19

- Reform even more important
  - Better designed taxes do less economic damage
  - If raising revenue, removing preferential rates a natural start
  
- There have been difficulties helping the self-employed
  - SEISS is poorly targeted. Those eligible got very generous support; many not eligible
  
- COVID-19 doesn't alter the long-run solution
  - Keeping large tax breaks for all business owners in the long-run not justified as way to help those who are struggling in short-run





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# Unpacking the long-run ideal

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# What's coming up

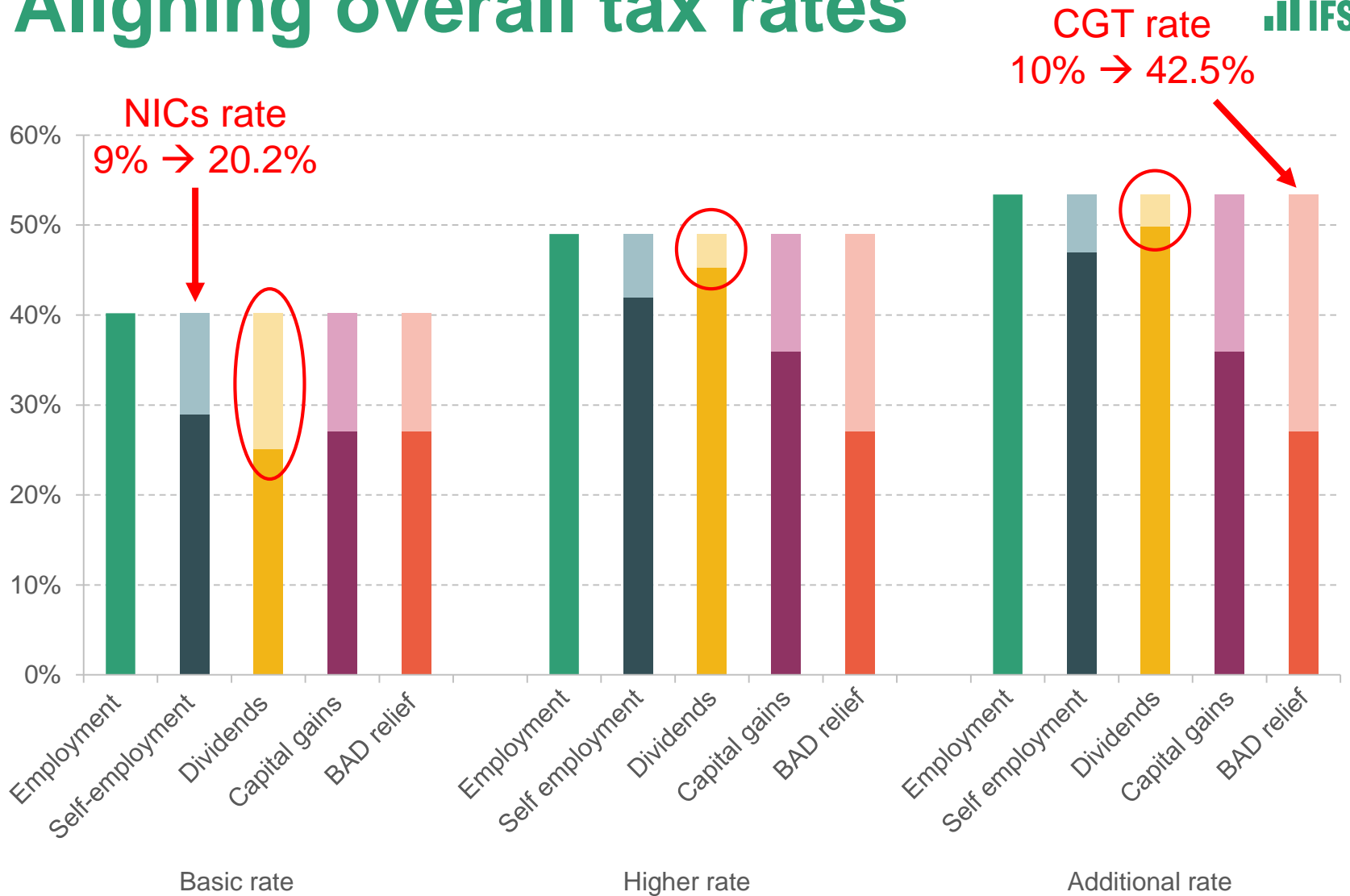


- What would the long-run ideal actually involve?
- Smaller steps in the right direction

# The long-run ideal

- Align overall tax rates across all sources of income
  
- Give full deductions for amounts saved/invested
  - Equivalently, don't tax the 'normal' return to savings/investments
  
- Treat losses as nearly symmetrically to gains/profits as possible
  
- ❖ *What do these mean in practice?*

# Aligning overall tax rates



Source: Figure 2.1.

# Reforming the tax base

Basic idea:

- Don't tax the 'normal' return to saving & investment
- Do tax 'excess' returns

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

# Approach 1: cash-flow taxation

- ❖ *Cash-flow personal tax – like income tax treatment of pensions*
- ❖ *Cash-flow corporation tax – like with 100% capital allowances*
  
- Immediate tax relief on money invested
- Tax all cash flowing from the business/asset
  
- Government in effect takes a compulsory stake in the investment
  - Provides (say) 40% of the outlay, takes 40% of the receipts
  - If tax rate constant, investments that are profitable before tax are profitable after tax
  - Government takes share of those pure profits (excess returns)
  - Each extra £1 of income is taxed in full like labour income

# To introduce cash-flow taxation



1. Give tax relief for share purchases (including in own company) and tax full proceeds from selling shares (as well as dividends)
2. Extend Annual Investment Allowance to all real investments
3. 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

# Approach 2: deferred allowances

- ❖ *Rate of Return Allowance and Allowance for Corporate Equity*
  - ❖ *RRA used for shareholder taxation in Norway*
  - ❖ *ACE used for corporate taxation in several countries*
- Based on current system
  - Taxing corporate profits and personal income & capital gains
- But with allowances for a ‘normal’ return on investments
  - Deduct (say) 5% of amount invested from taxable income each year
- If ‘normal’ return set correctly:
  - Stream of allowances has same value as 100% up-front deduction
  - Only investments that yield high returns are taxed – still profitable
  - Each extra £1 of income is taxed in full like labour income



# To introduce deferred allowances



1. Introduce RRA for share purchases
2. Introduce RRA for business assets of the self-employed
3. Introduce ACE for companies

- Relief for losses should be as nearly as possible symmetrical to taxation of profits/gain
  - Taxing upside without cushioning downside penalises risk-taking
  
- Giving tax refunds may be a step too far
  
- Instead, as far as possible:
  - Allow any loss to be offset against any income/gain in any year
  - If carried forward, add interest to maintain their present value



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# Example reform packages

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- Long-run ideal requires radical reform – difficult to achieve quickly
- Piecemeal reforms can be like playing ‘whack-a-mole’
- No single ‘right’ pathway to long-run ideal
- We designed 11 reform packages, combining components of the long-run ideal, which:
  - Move towards the long-run ideal
  - Are (arguably) improvements in their own right – illustrate and manage trade-offs associated with piecemeal reform

# Combining tax rate changes

- Steps towards aligning tax rates across different income sources

1.	Reduce employer NICs; increase employee and self-employed NICs
2.	Levy NICs (or equivalent tax) on dividends in exchange for reducing NICs rates
3.	Increase income tax (including on dividends) and CGT; reduce NICs
4.	Align tax rates on capital gains with those on capital income
5.	Remove big separate allowances for dividends and capital gains

Source: Table 5.1

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- All involve higher tax rates on income from business
- With no reform to tax base, worsen existing distortions to investment

Source: Table 5.1

# Combining rate and base changes

- Moving towards alignment while improving investment incentives

6.	Increase headline tax rates in return for broadening the Annual Investment Allowance
7.	Increase dividend tax & CGT rates and introduce a new investment vehicle offering cash-flow personal taxation of shares
8.	Increase headline tax rates and allow losses to be offset more flexibly
9.	Increase CGT & dividend tax rates and reintroduce inflation indexation

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# 7. Cash-flow taxation of shares

- Introduce new (optional) Personal Shareholding Account:
  - Contributions get income tax relief at investor's marginal rate
  - No personal tax on returns within the PSA
  - Amounts taken out of the PSA taxed at investor's marginal rate
  - Funds in PSA used to invest in new shares issued (including by investor's own company)
- Increase dividend tax & CGT rates, e.g. to standard income tax rates
- Would no longer discourage investing in a company

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# 8. Reforming loss relief

- Change the treatment of losses arising after April 202X:
  - 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
- Key challenge: what can be done without creating scope for abuse?
- Increase headline tax rates
- Would not discourage risk-taking as much

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# Combining reforms here with reforms elsewhere

- Changes to this part of the tax system could be combined with changes in related policy areas

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# Conclusion

- Long-run 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
- None of this will be easy
  - Many losers – those getting unjustifiable tax advantages now
- But the status quo involves inefficiency, complexity and unjustifiable tax disadvantages for others
  - Increasing tax rates with no other reform would make these problems worse
- A challenge: if not these reforms, then what?