

# SMALL BUSINESS TAXATION

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# **SMALL BUSINESS TAXATION**

## **A special study of the structural issues surrounding the taxation of business profits of owner managed firms<sup>1</sup>**

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### **Abstract**

This chapter considers the taxation of small, owner-managed businesses. It focuses on the difficulties created by treating employees, unincorporated and incorporated businesses differently for tax and social security purposes. The authors reject blanket tax incentives for small firms and differentiation between legal forms and concentrate on issues arising from opportunities created on incorporation for the conversion of income from labour into income from capital (taxed at a lower rate). Experience in the UK and elsewhere suggests that an approach that relies on defining a sub-category of small businesses will not produce a satisfactory solution. The chapter therefore examines methods of aligning the effective tax treatment of different legal forms: in particular it considers the advantages of combining a Rate of Return Allowance with an Allowance for Corporate Equity, so as to tax income above the normal return to capital at the same rate whether it is described as dividend, capital gain or salary.

### **Key words**

Small business taxation, labour income taxation, social security, taxation of income from capital, incorporation, corporation tax, choice of legal form, rate of return allowance, allowance for corporate equity

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## Executive Summary

This chapter considers how small, owner-managed businesses are currently taxed and how this might be improved. Our focus is on the difficulties created by taxing different legal forms of business in different ways. Differences in tax treatment across a spectrum from employees to the self-employed (unincorporated firms) and on to companies (incorporated firms) create opportunities for taxpayers to reduce their tax liability and their social security contributions (NICs) by converting income from labour into income from capital.

‘Small business’ has many different meanings in different contexts. Whilst we do not attempt to cover every issue that could be considered to fall under the heading ‘small business’ taxation, we do deal with some topics that provide essential background to the main structural issues discussed. We explain why we reject the case for blanket tax incentives for small businesses as such, although we accept that there may be exceptional cases of market failure or issues of compliance costs where specific reliefs are warranted and can be targeted effectively. Otherwise, for both efficiency and equity reasons, steps towards increasing simplicity and reducing distortions in the tax system generally are likely to be of more help to all (including small businesses) than are special measures.

The structural issues we address are a problem in many jurisdictions, but have been brought to the fore in the UK in recent years by the introduction, reduction and subsequent withdrawal of a ‘starting rate’ of corporation tax, and by the different and increasing rates of NICs levied on the employed and the self-employed. These developments have highlighted the tax advantages available through self-employment and, more importantly, incorporation. For many taxpayers there is no choice other than to be an employee. For larger businesses wishing to raise external capital, incorporation is generally essential for commercial reasons. Thus the incentive to select between employment, self-employment and incorporation is relevant only for owner-managed businesses at the smallest end of the business sector. Nevertheless, the distortions in the system affect many. Not only do large numbers of employees feel unfairly treated but attempts to counteract these incentives can lead to anti-avoidance provisions targeted at the self-employed and owner-managers of small companies which increase costs and cause difficulties beyond the group at which they are aimed. Moreover, they impact on the design of the entire corporate tax system.

It is important to consider the entire spectrum of legal forms when considering reforms: simply treating the self-employed more like employees, for example, could increase the difference in treatment between incorporated and unincorporated businesses. Total alignment of tax and NICs treatment across the spectrum is difficult to achieve in a straightforward manner because there are real differences between legal forms: a self-employed contractor does not have the same legal rights and obligations as an employee, and an unincorporated business owner becomes a shareholder and probably a director and an employee on incorporation, rather than a direct owner of the underlying business. Nevertheless, we argue that the aim should be to align effective tax rates for these groups after taking into account capital investment. Attempts by the UK government in recent

years to advantage incorporation in the belief that this will encourage entrepreneurship have not proved to be a success. We maintain that the tax system should not discriminate between legal forms and proceed on this basis.

One suggestion frequently made as a step towards equal tax treatment of owner-managed businesses is that some sub-category of incorporated firms should be treated as if they were unincorporated for tax purposes, but this does not solve the problem at the employee/self-employed boundary. Moreover, it would only address the differences at the incorporated/unincorporated boundary if such treatment were to be mandatory, which would give rise to the problem of defining the firms to which this compulsion should apply. We review the definitional difficulties encountered in a number of jurisdictions (including the UK, Norway and Sweden), and, on this evidence, conclude that it is unlikely that a general, workable and non-arbitrary definition could be devised. We therefore reject approaches that seek to treat particular types of firm differently from others in favour of reforms that can be applied to all firms, and move on to consider a number of potential solutions that adopt this approach.

Alignment of effective tax rates across different legal forms in the UK could be achieved either by adapting our existing system, or by adopting more radical reforms. If we were to retain a structure broadly along the lines of the current UK tax system, we could increase neutrality across the spectrum by aligning NICs rates for the employed and self-employed, whilst at the same time increasing the small companies' corporation tax rate even to the point of aligning it with the main corporation tax rate (thus raising the effective tax rate on dividend income). This latter move appears to be in tune with the direction of current UK government thinking.

Neither of these reforms completely addresses the fact that, for the reasons discussed in this chapter and elsewhere in this book, it is often argued that the return to capital should be more lightly taxed than the return to labour. Various radical alternatives could be adopted in order to deal with this. We consider one solution to be the combination of a shareholder income tax with a rate of return allowance (RRA), and a corporation tax with an allowance for corporate equity (ACE). Such a system would exempt the normal rate of return to capital from taxation at both the corporate and the personal levels, while providing a mechanism for taxing above normal returns to capital and labour income at the same progressive rates, regardless of whether they are described as dividends, capital gains or salary.

Thus, while it remains the case that alignment or equalisation of the effective tax rates applied to different legal forms is necessary to tax small owner-managed businesses in a sensible way, this can be achieved without prejudicing the capacity of the tax system to distinguish coherently between normal returns to physical capital and labour income. Furthermore, the approach we propose has the advantage that it does not require the use of arbitrary definitions and difficult distinctions between different types of firm.

## **I. Introduction**

This chapter addresses a focused set of structural issues concerning the way in which small, owner-managed businesses are taxed. This may sound limited, but in fact these issues are highly complex and pervade the design of the entire tax system. They affect the interaction between taxation of income from labour and that of income from capital. They are at the interface between the taxation of incorporated and unincorporated firms and also go to the heart of the relationship between personal and business taxation. These issues therefore have great significance for many of the areas examined by this Review, because it is impossible to design a sensible personal or corporate tax system without taking them into account. This is the reason for this special study.

This focus means that this chapter will not attempt to cover every issue that could be considered to fall under the heading 'small business taxation'. Some topics which are key to an understanding of small business issues and provide important background to the structural focus of our chapter are dealt with in the Note to this chapter. 'Small business' has many different meanings in different contexts. Our chapter focuses on structural issues surrounding the taxation of business activity across a spectrum that starts with employment and then moves through self-employment (either sole proprietorships or partnerships, that is, unincorporated businesses), to small, owner-managed companies (incorporated businesses). This focus delineates our scope for the purposes of this chapter.

### **1. The key structural question**

Across the spectrum of activity described above, the practicalities and substance of taxation vary significantly. At one end of the spectrum there are standard, full time, permanent employees who appear to require very different tax treatment from incorporated businesses with a number of shareholders at the other end. Nevertheless, there are boundaries within this spectrum. On either side of these boundaries, between the employed and the self-employed, and between the incorporated and unincorporated business, there are activities which may be, or may seem, very similar economically but are based on different legal relationships, rights and obligations. One solution might be to treat employees through to companies across this whole small business spectrum in exactly the same way for tax purposes, taxing them on the same receipts and at the same rate, but this is not achievable in a completely straightforward way for two reasons. First, differences in legal form have real practical consequences. Receipts vary in nature: an employee's wage cannot be equated with the receipts of a business and so business receipts will require the application of rules from which to derive a profit figure. Even once profit has been calculated, the existence of a company may mean that receipts can be paid out either as wages or as dividends, with different legal implications. Aligning overall rates of tax on income across this spectrum may require analysis of the tax levied at both corporate and personal levels. Secondly, there is a trend towards taxation of labour income at a higher rate than that levied on income from capital that leads away from neutrality between the taxation of different types of business. It may be that the requirements of small business taxation weigh against this trend, but, as discussed in Griffith, Hines & Sorensen (2008) in this book, there are theoretical and pragmatic

arguments to support a differential. If a differential is to be maintained between the tax rates on income from capital and income from labour, however, it follows that there will be an incentive to attempt to convert labour income into income from capital.

One of the consequences of incorporation of a business, however small, is the scope it offers for conversion of labour income (earnings from employment or self-employment) into income from capital (dividends or capital gains). This can alter the tax consequences with no change in economic activity. To the extent that this is considered undesirable, this is sometimes dealt with by special tax rules that partially counteract the legal characterization, for example, by treating incorporated firms as if they were unincorporated, or by deeming all corporate income to be earned income. These provisions may bring their own difficulties, however, especially in relation to when they should be applied.

Some observers question the simple dichotomy between labour income on the one hand and income from capital on the other. Whilst income from employment is clearly labour income, income from self-employment and that derived through an incorporated business may be a mixture of labour income, income from capital and – possibly – a return to risk-taking or ‘entrepreneurship’. Apart from the fact that risk and entrepreneurship are not easily measurable, it is not entirely clear whether income representing a reward for these factors should be taxed as a return to capital or in the same way as labour income (or in some other way). There are issues of equity and also of the creation of incentives for risk taking. There are pragmatic and political questions which mean that the tax treatment of this type of return will not necessarily be identical with that of either labour income or income from capital.

In order to accommodate the structural problems described above, any proposed new system in which capital income is to be taxed at a lower rate than labour income needs to ensure that the way in which this is achieved cannot be exploited by recharacterising labour income as capital income. The mechanism for determining the nature of the return needs to be built into the system and applicable to all firms in order to make it equitable and practical.

There is little discussion in the *Meade report* (Meade, 1978) of these problems. They have become more significant in the UK over recent years due to changes in levels and relationships between personal and corporate tax rates, and increases in social security contributions (National Insurance Contributions (‘NICs’)) which are paid at differential levels for the employed and self-employed and not at all on corporate dividends or capital gains. Increased diversity in working practices and easing of corporate law regulatory burdens for incorporated firms have also added to this mix. These developments, together with at times low or even nil corporation tax rates, have led to increasing numbers of self-employed and incorporated firms. Incorporation offers opportunities to convert highly taxed labour income into less highly taxed corporate income which, on distribution, carries a tax credit and is free from NICs. Profits retained in the company may be sheltered from higher tax rates and re-invested, eventually leading to a capital gain on the sale or liquidation of the company rather than income tax at the top rate.

These issues are not unique to the UK<sup>2</sup> and have real implications for the structure of personal and corporation taxes more generally and so to the fundamental design questions studied in this Review.

## 2. Outline of paper

For the reasons given, the focus of this paper is on issues relating to the integration of corporation tax and income tax which links it to some of the questions of tax system design dealt with in other chapters. Following this introduction (Part I), Part II of this paper deals with definitional issues and discusses the nature of the small business sector. Part III analyses the different types of business organisation which exist in law. It describes the structural tax issues which arise as a result of the differences in rules for different legal forms of business, with special reference to the difficulties currently experienced in the UK system. Part IV discusses the various alternative options that have been put forward and comments on the extent to which the structural issues would be solved or alleviated by these proposals. Part V concludes.

The Note to the chapter makes reference to important issues which have arisen in debates forming part of this Review. It addresses the question of when, if at all, the tax system should favour small firms. Whilst it is not our aim to discuss the details of different types of support and incentives for small firms, this question is relevant to the structural issues which are our focus because rules which give rise to non-neutralities are often justified on the ground that small businesses, or particular sub-categories of them, require special incentives. We therefore analyse this justification in order to consider the structural issue fully. Issues relating to capital gains tax and inheritance tax are referred to briefly in this context, as are compliance cost issues. Some of these questions are also dealt with extensively elsewhere in this Review, but we examine them in the Note in so far as they are relevant to our key focus.

## II. **Definitions and nature of sector**

### 1. A problematic definition

The term ‘small business’ is used in many different ways. To some it may call to mind a one person service provider or unincorporated self-employed contractor; to others the term might refer to a company listed on the Alternative Investment Market rather than the London Stock Exchange. What is meant by ‘small’ is relative and will depend on the purpose of the definition. It may relate to qualitative characteristics rather than size. The *Committee of Inquiry on Small Firms* (Bolton, 1971) favoured a qualitative, or what it called an economic definition, albeit in tandem with statistical definitions looking at different measures for different sectors. As explained above, this chapter focuses on structural issues, but these need to be set in the context of a review of the make-up of the business population in order to understand their significance.

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<sup>2</sup> Although the difference between rates of social security for the employed and the self-employed may be more extreme in the UK than in some other systems.

## 2. Qualitative and quantitative definitions

Our structural focus might lead us to try to define firms that are small in some qualitative sense for tax purposes: independent firms that are managed by their owners in a personalised way. They could have a significant turnover or profit levels and still fall within this definition, so we might properly call these businesses owner-managed rather than small; however, the use of the term ‘small’ for such firms is widespread and embedded.

This definition is of limited value for practical and therefore taxation purposes. Objective and easily measurable criteria are often needed in legislation. Quantitatively, size may be measured by profit, turnover, balance sheet, number of employees, number of owners or some combination of these, as can be seen in the various examples in **Appendix I**. Each measure will give a very different picture – for example, quite large businesses in terms of number of employees may make low or negative profits. In terms of tax design, whether a business is owner-managed and controlled may have greater relevance to how the business should be taxed than quantitative size, as owner control affects the nature of income and scope for choice in the characterisation of payments out of a corporation.

There is a long history in both UK company law and tax law of trying to define special types of small company, with little success.<sup>3</sup> Attempts to define a sub-category of owner-managed companies have always resulted in highly complex definitions which have been difficult to apply. Whilst prima facie an owner-managed company may seem to be a very different entity from a large listed company, it is very difficult to capture the exact point at which the tax or company law treatment should change in a way that is not open to manipulation, not least because it is so difficult to define the concept of control, which may be obtained through voting rights but also in other ways. It is equally difficult to separate out passive investors from those working in the company, since whilst this is obvious in many cases, in others it will change from time to time and shareholders may be engaged in working for the company in a whole variety of ways and for varying periods and portions of time. The distinction between companies listed on a recognised stock exchange and those which are not is occasionally used for tax purposes<sup>4</sup>, but this only distinguishes a small percentage of companies from the majority and so will not be particularly helpful in tackling the structural problem discussed in this chapter.

The legal definition of a ‘close company’ for tax purposes in the UK (which is not to be confused with the use of that term in the economic literature) is one which attempts to achieve this kind of qualitative nature, but involves several complex sub-definitions (see Appendix I) and is not straightforward to apply. For this reason, some of the ‘solutions’

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<sup>3</sup> For example, the Companies Act 1947 introduced a definition of exempt private companies which was described by the Jenkins Committee (Board of Trade, 1962) as producing ‘hideous complications and capricious results’ and the category was abandoned in the Companies Act 1967.

<sup>4</sup> For example, Section 691 Income Tax Act 2007 (anti-avoidance provision not applying to listed companies). The UK companies’ legislation distinguishes public companies, which may offer their shares to the public, and private companies, which may not, but the public/private divide is not necessarily associated with size. Whilst most, but not all, public companies are large, privately owned companies may also be very substantial.

to the small business taxation problem – in which ‘small’ businesses would be treated differently to ‘large’ businesses (from a tax perspective) – which appear prima facie attractive are likely to be unworkable in practice.

### 3. ‘Small’ as a proxy for other characteristics

Confusingly, the term ‘small business’ is sometimes used as a proxy for other characteristics which governments may wish to target through the tax system, such as new firms, ‘entrepreneurship’, growth and job creation. Using size as a means of targeting these groups is inaccurate because size does not relate directly to these characteristics.

Despite the rhetoric sometimes found in the small business literature and in political references to small businesses to the effect that they are the ‘engine of the economy’, there is considerable academic debate about the extent to which small businesses are significant to job creation or growth. Whilst some are, many are not. As the figures below show, many are (and remain) very small indeed and are what might be termed ‘non-entrepreneurial life style businesses’. Distinguishing ex ante between those that will create employment and growth and those that will not is notoriously difficult, and even then there is no evidence that the provision of tax incentives would make much difference to the chances of growth.<sup>5</sup>

In the Note to this chapter we explain our view that the tax system should only be used to provide assistance to the small business sector in limited circumstances, in particular if and when assistance can be clearly targeted to meet a specific market failure. We comment on the difficulties in achieving this, which are in part related to the definitional issues discussed in this section. Here we merely seek to point out that it is a mistake to equate ‘small businesses’ with any particular economic or social characteristics when devising tax policy.

### 4. Make up of the ‘small business’ sector

The majority of businesses in the UK and in other economies are ‘small’ by any measure.

#### 4.1. Employment

In 2006, there were an estimated 4.5 million private sector businesses<sup>6</sup> in the UK, of which over 99% were firms with fewer than 50 employees and 96% were firms with fewer than 10 employees (referred to as micro-businesses).<sup>7</sup> Most businesses in the UK have no employees (other than the owner in the case of incorporated firms). The number of businesses with no employees increased from just over 2.5 million (68%) in 1996, to over 3 million (73%) in 2006. By contrast, the number of businesses with at least one employee did not rise at all between 1996 and 2006, falling as a percentage of the total

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<sup>5</sup> Attempts have been made to predict which firms will grow based on such factors as the characteristics of the owners. Even these have limited predictive value ex ante and they could certainly not provide the basis for differential tax regimes (see Storey (1994) at p158).

<sup>6</sup> This includes all legal forms, i.e. incorporated and unincorporated businesses.

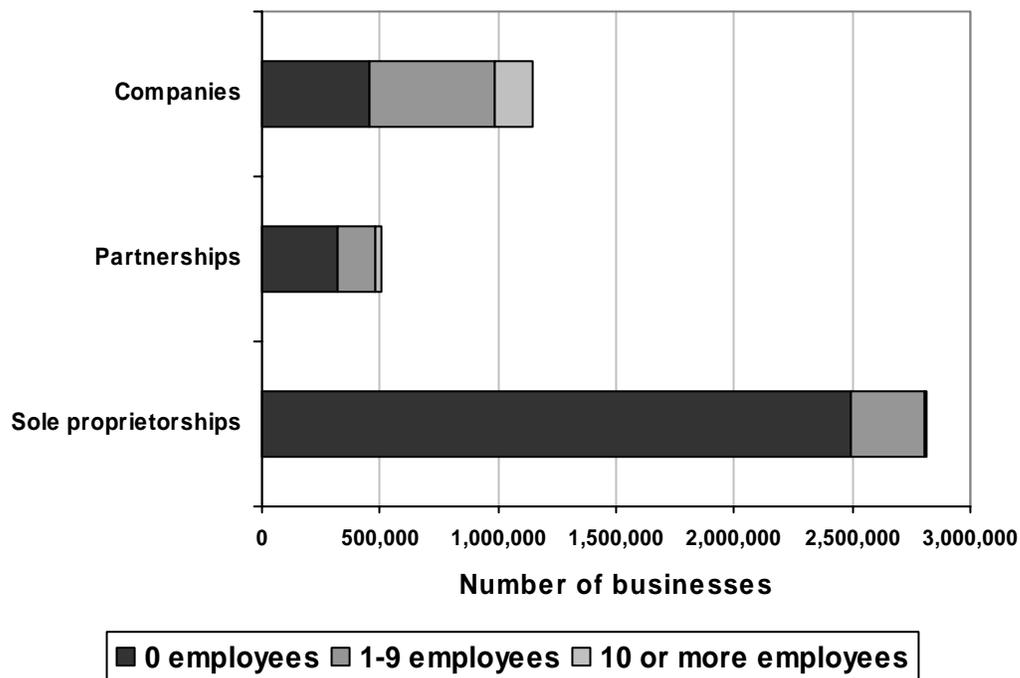
<sup>7</sup> Micro-businesses accounted for 33% of employment and 23% of turnover in 2006.

from 32% in 1996 to 27% in 2006 (see Section III for details).<sup>8</sup> Thus a disproportionate amount of the increase in the number of businesses in recent years has been of businesses with no employees: this has relevance to our later discussion of the way in which the tax system appears to affect behaviour.

#### 4.2. Other size related categories<sup>9</sup>

The number of employees is not the only test which reveals how very small most businesses in the UK are. Almost 91% of companies paid the small companies' rate of corporation tax (or less<sup>10</sup>) in 2005-06.<sup>11</sup> Further, approximately two-thirds of all businesses were not required to register for Value-Added Tax (VAT) in 2006 – indicating that approximately two-thirds of all businesses had annual turnover of less than £60,000 (the registration threshold in 2005-06).<sup>12</sup> Finally, two-thirds of companies registered with Companies' House were audit exempt in 2005-06 (that is, their annual turnover was less than £5.6 million).<sup>13</sup>

**Figure 1 Number of businesses in the UK in 2006, by number of employees and legal form**



Notes: authors' calculations from DBERR SME Statistics, 2006

<sup>8</sup> Source: DBERR SME statistics 2006, accessed via: <http://stats.berr.gov.uk/ed/sme/smestats2006.xls>.

<sup>9</sup> For further information on size related criteria, see Appendix I.

<sup>10</sup> A lower rate was also available to companies whose profits were less than £10,000 pa at this time (see Appendices I and II).

<sup>11</sup> Authors' calculations from: [www.hmrc.gov.uk/stats/corporate\\_tax/11-3-corporation-tax.pdf](http://www.hmrc.gov.uk/stats/corporate_tax/11-3-corporation-tax.pdf). Note however that a very large company could make profits within this range.

<sup>12</sup> Authors' calculations from: <http://stats.berr.gov.uk/ed/vat/VATStatsPressReleaseNov2007.pdf>.

<sup>13</sup> Source: [www.companieshouse.gov.uk/about/miscellaneous/DTIReport20056.pdf](http://www.companieshouse.gov.uk/about/miscellaneous/DTIReport20056.pdf).

#### 4.3. Legal Form

Legal form or structure (discussed in Section III) is not a reliable measure of size or of qualitative characteristics per se. Figure 1 shows the number of businesses in the UK in 2006, by number of employees and legal form. This illustrates that while sole proprietorships and partnerships are less likely to have employees than companies, it is still the case that 39% of companies do not have any employees at all (aside from the owner-manager) and 86% have fewer than 10 employees.<sup>14</sup> So a reduced corporation tax rate for small companies does not necessarily target businesses providing employment.

### **III. Structural Issues: legal form, boundaries and distortions (with special reference to the UK)**

As outlined in the introduction, the approach taken in this paper requires us to examine the legal forms of organisation used by small businesses, and to consider the link between legal form, the nature of the economic activity involved and the consequent tax implications. We argue that the ideal would be that the legal form of a business should make no difference to its tax treatment (that is, we would achieve complete neutrality) but this cannot always be achieved in a straightforward way. Further consideration of the legal position may make this clear.

#### 1. Two boundaries

There are two boundaries at which tax distortions can take place, as described in Table 1 below. The first is between the incorporated and unincorporated firm, and the second between the employed and self-employed.<sup>15</sup> To complicate matters further, the worker's choice may be between employment and incorporation, rather than between employment and self-employed status. Horizontal equity<sup>16</sup> issues arise at each borderline and across the piece. Reducing the distortion at one boundary could make it worse at the other and so the whole spectrum must be considered as one issue in any proposals for reform. Thus, whilst bringing the tax treatment of the employed and self-employed closer together might be one solution at that end of the spectrum, if this meant that the difference between the unincorporated and incorporated firm increased, it might not be advisable; further, it might not even solve the problem at the boundary being tackled, since movement can take place between all three categories.

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<sup>14</sup> Around 89% of sole proprietorships and 63% of partnerships have no employees. The category 'with no employees' comprises sole proprietorships and partnerships comprising only the self-employed owner-manager(s), and companies comprising only one employee-director (see <http://stats.berr.gov.uk/ed/sme/sme-stats2006-meth.pdf> for more details).

<sup>15</sup> Self-employed workers are all unincorporated businesses in tax terms, although they may not be considered to be businesses in economic terms. For the purposes of this paper, self-employed workers and unincorporated businesses are synonymous unless otherwise stated.

<sup>16</sup> Horizontal equity means that people with a similar ability to pay taxes should pay the same amount.

**Table 1 Some differences in tax treatment between employees, the self-employed and owner-managers of companies in the UK<sup>17</sup>**

Employee	Self-employed (sole proprietorship or partnership)	Owner-manager of company
<p>Income tax on wages (return on labour)</p> <p>Social security contributions on wages (employee and employer)</p>	<p>Income tax on profits (mixed return on labour, capital and economic rents)</p> <p>Lower social security contributions than employees</p> <p>Capital gains tax on sale of business assets</p>	<p>Corporation tax on income profits and capital gains paid by company (mixed return on labour, capital and economic rents)</p> <p>Tax on dividends (credit for corporation tax plus additional payment by higher rate taxpayer at personal level)</p> <p>Income tax and social security contributions on wages as employees (but flexible level chosen by owner-manager)</p> <p>Capital gains tax paid by shareholders on sale of shares</p>

2. Overview of legal form

The majority of small firms in the UK trade in one of three main forms: as sole traders, as partnerships<sup>18</sup> (both types of unincorporated firm), or as companies limited by shares (limited liability companies).<sup>19</sup> In addition, a new form, limited liability partnerships (LLPs) were introduced in the UK in 2001 (see Freedman (2004) for more details). LLPs are in some senses closer to companies than partnerships, but for the most part, they are taxed as partnerships. These forms are the key legal structures to be found in other jurisdictions, although there are important variations across systems. Although most large firms will be incorporated, it does not follow that most incorporated firms are large. Legal status is not a proxy for size. In addition, incorporation does not necessarily relate to qualitative characteristics such as separation of ownership and control, since single person firms may incorporate and there are some large unincorporated partnerships.<sup>20</sup> Nevertheless it is true to say that most businesses which contemplate growth and the raising of external finance will incorporate. Incorporation does not encourage growth so much as anticipate or even follow on from growth. As will be shown, much of the recent increase in the number of incorporations has been in the form of companies with no

<sup>17</sup> This Table is only designed to provide an indication of differences in tax treatment. Further details can be found in Appendix III.

<sup>18</sup> Partnerships may be general or limited. Limited partnerships are unincorporated but registered and one partner must have unlimited liability, although that partner may itself be a limited liability company.

<sup>19</sup> UK limited liability companies should not be confused with US limited liability companies (LLCs), which are unincorporated and organised on a flexible partnership basis.

<sup>20</sup> Although many professional partnerships are now LLPs.

employees other than the owner-manager himself and these companies will typically also have only one or two shareholders.

### 2.1. Unincorporated firms

In the UK, sole traders are not regulated by any special legal provisions regarding legal form<sup>21</sup> and the business has no separate legal personality. In particular, the business and personal assets of a sole trader do not need to be kept separate (although accounts are required for tax purposes for profits over a de minimis level). This has serious implications for any tax rules that require detailed records of assets belonging to the business and strict separation of business and personal assets. This is not merely a practical detail. The sole trader has personal liability for all debts and activities of his business so that his own assets and those of the business are mixed as a matter of law and it is conceptually difficult to treat them differently.

Similar rules apply to general partnerships. These may be governed by purely oral or by written agreements and can arise quite informally. The relationships between the partners are governed by the Partnership Act 1890, which also lays down some mandatory provisions regulating the relationship between the partners and outsiders. General partners remain liable to the full extent of their personal assets and these may well be mixed with their business assets.<sup>22</sup>

Limited liability partnerships (LLPs) are a hybrid form which combine transparent partnership treatment for tax purposes with a corporate form and have a measure of limited liability like companies. They are required to be registered and were introduced to cater for the needs of professional firms. There has been some speculation that they might be utilised by small traders but they have not yet become popular for this purpose, not being designed with this in mind, and because, to date, they have not been attractive to most ordinary small businesses from a tax point of view. If the benefits of incorporation were to be eroded by higher corporation tax for small companies, this could change.<sup>23</sup> Hybrid forms are also important in the USA, which has limited liability partnerships and limited liability companies (LLCs). The creation of these US hybrid forms by state legislatures was tax motivated to a considerable degree (Carney, 1995).

### 2.2. Incorporated firms

In contrast to unincorporated firms, UK limited liability companies must be registered in order to have legal existence and they are governed by a complex and detailed piece of legislation.<sup>24</sup> The company has legal personality, that is, it is a legal entity distinct from

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<sup>21</sup> Apart from the minimalist Business Names Act 1985 which governs the use of business names.

<sup>22</sup> Limited partnerships must be registered but there are very few of these: only 14,400 at the end of March 2007 (see [www.companieshouse.gov.uk/about/pdf/companiesRegActivities2006\\_2007.pdf](http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2006_2007.pdf)).

<sup>23</sup> The total number of LLPs registered in the year ending March 2006 was 17,449, with new registrations in 2005-06 being 6,570 compared with 372,000 new limited companies. By the end of March 2007, there were 24,500 LLPs, showing a steady but relatively small increase (see [www.companieshouse.gov.uk/about/pdf/companiesRegActivities2006\\_2007.pdf](http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2006_2007.pdf)). See also footnote 62 below and text thereto.

<sup>24</sup> The Companies Act 1985, currently in the process of gradually being replaced entirely by the Companies Act 2006.

its shareholders. In law it is capable of enjoying rights and of being subject to duties which are not the same as those enjoyed or borne by its shareholders, even if there is only one shareholder.<sup>25</sup> The shareholders are owners of the shares and not the underlying assets of the business. Although called limited liability *companies*, it is actually the liability of the shareholder that is limited rather than that of the company, which is liable to the full extent of its assets. The legislation governs the relationship between the shareholders, directors and creditors. The underlying scheme assumes separation of ownership and control and the need to monitor management.

It has been suggested that ‘the corporation is primarily a method of solving problems encountered in raising substantial amounts of capital’ (Posner, 1986). This may be correct in terms of economic theory, and firms which need substantial capital clearly need to incorporate, but the reality is that a company may be, and frequently is, a one person firm with very little (if any) capital. Most companies are very small indeed and have few shareholders.

In the UK, from the time of the 1855 Limited Liability Bill, Parliament was keen to make the corporate legal form widely accessible and there was no minimum capital requirement - as there is in some jurisdictions - so that the very smallest one person businesses used the corporate form from its inception (Freedman, 1994). Furthermore, incorporation with limited liability in the UK has become steadily simpler and less costly as a matter of government policy which is to ‘think small first’ and remove unnecessary regulation from small companies (DTI, 2005). So, for example, the statutory audit requirement has been gradually removed from companies with profits below certain levels (see Appendix I), requirements about meetings have been relaxed and the 2006 Companies Act introduces further reforms (DBERR, 2007). The ethos of easily available incorporation has been strengthened by these changes (Freedman, 1994), which, supported by the tax changes described below, have contributed to increased popularity of the corporate form in the UK in recent years.

Nevertheless, incorporation can be inappropriate for firms where there is no actual separation of ownership and control, especially if the legal protections are mandatory and involve burdensome compliance, which in some jurisdictions can be very costly. Even under the relatively relaxed UK regime, there are financial protections around the corporation in the form of accounting requirements and reductions of flexibility in the way in which corporate funds can be utilised in order to protect shareholders and these may be unnecessary for a one person company. There may be costs of incorporation which may sometimes be hidden – arising only, for example, on the break up of a business relationship, where it may be more difficult for a shareholder to extricate himself from a company than it would have been for a partner to end a commercial partnership. Despite the drawbacks, very small businesses which intend to remain owner-managed may have commercial reasons to use the corporate form: they may wish to obtain limited liability (although this can be illusory in the case of small firms without outside shareholders since creditors will often insist on personal guarantees) and they may require corporate form for status or other business practice reasons (Freedman &

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<sup>25</sup> For further explanation of corporate personality, see Davies (2003) at p27.

Godwin, 1992). Corporate form may also facilitate borrowing by making the provision of security easier because floating charges<sup>26</sup> are available to corporate and not individual borrowers (Davies, 2003).

### 2.3. Employed and self-employed boundary

Certain types of employee, at the margins, may be engaged in activities economically very similar to those of self-employed contractors. The different legal status of each of these relationships creates important differences between the rights and duties in each case, however. In the UK, subject to any special legislative provisions, the nature of the relationship will be decided on the basis of the contractual rights and liabilities between the worker and the person or body to which he is supplying services. The boundary is defined in law through a series of decided cases based on certain characteristics or 'badges' of employment status. These badges include such matters as the degree of control over the worker, the level of risk he undertakes, the amount of equipment he provides and whether he is integrated into the business in any way. Each factor varies in importance depending on the circumstances.<sup>27</sup> The case law has made some movement to recognise that the tests of control and provisions of equipment are now less important than they once were in defining employment. The test does not offer a clear dividing line, however, and is very fact based (Freedman (2001); Redston (2002)). This limits the amount of guidance provided by the court decisions. While this keeps the law flexible and ensures that it can develop with changing conditions, it also makes it uncertain and difficult to administer and comply with. Whilst in many cases it is obvious that a person is an employee or self-employed, so that there is no room for argument, at the margins the law offers some opportunities for (perfectly legal) arrangement of the contractual duties so that the relationship falls on one or other side of the employment status boundary.

The advantage often lies with arranging affairs so as to avoid creating an employment relationship. Employment is costly for the employer both in terms of the NICs he must pay, and because of the obligations imposed by employment law. His compliance costs may also be increased. The employee is also subject to NICs, at a rate which is substantially higher than for the self-employed without the benefits available to employees being commensurately higher (see Appendix III and Adam, Browne & Heady (2008)).<sup>28</sup> The employee suffers deduction of tax at source under the Pay-As-You-Earn (PAYE) system (see Shaw, Slemrod & Whiting (2008) for details). This cumulative

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<sup>26</sup> A floating charge is a form of borrowing secured on the assets of the company without being fixed on any one asset, so that assets can be dealt in despite the existence of the charge unless and until it is converted into a fixed charge as a result of a default.

<sup>27</sup> For a full discussion of the case law, see Chapter 3 of Freedman (2001).

<sup>28</sup> The employed may have greater entitlement to some social security benefits than the self-employed. In particular, employees have state second pension rights that the self-employed do not enjoy. Many employees "contract out" of these pension rights in exchange for a rebate on their NICs and those of their employers; however, even for contracted out employees, there is still a significant difference between the rate of NICs they and their employers pay, and that which is paid by the self-employed, which other relatively small differences in benefit entitlement do not account for. Table A3.1 of Budget (2007) shows that the reduction in NICs for the self-employed *beyond that attributable to reduced benefit eligibility* was £1.8 billion in 2006-07. See Appendix III for more details.

withholding tax reduces opportunities for evasion, but also makes tax planning more difficult for an employee than for the self-employed. The UK system has very restrictive rights to deduct expenses for employees, partly because the cumulative PAYE system attempts to operate to a high degree of accuracy, with most employees not completing a tax return (Freedman & Chamberlain (1997)). To make this feasible, the system keeps the availability of tax deductions for employees to a minimum by requiring them to satisfy a strict test of being *incurred wholly, exclusively and necessarily in the performance of the duties of the employment*.<sup>29</sup> A self-employed person has to show only that the expenses are *incurred wholly and exclusively for the purposes of the trade*.<sup>30</sup> There are also significant differences between the employed and self-employed in the rules for travel expenses.<sup>31</sup> In view of these tax and other issues there is an incentive for those engaging workers to treat them as self-employed contractors where that is feasible. For the worker there may also be tax savings in self-employment and higher payments for work done to compensate for the lack of job security and other benefits. This is balanced by a loss of employee benefits, pensions in particular, and employment rights. In some cases the decision to operate as a self-employed contractor rather than an employee may be that of the worker, but there are certain industries – notably IT and publishing – where the clients insist on self-employed status, leaving the worker very little choice (Harvey (1995); Stanworth & Stanworth (1997); Boyle (1994); Freedman & Godwin (1992)).<sup>32</sup>

#### 2.4. Pressure on the self-employed to incorporate – personal service companies

Where a person decides to set up a business, he/she may go on to consider incorporation, perhaps without going through the self-employed stage at all. This will convert the worker back into an employee, but as an employee of his own company he will have the ability to control how much he receives through (tax-disadvantaged) wages and how much by way of dividends. His choice of legal form may be to obtain limited liability or one of the other commercial benefits described above, or for tax reasons or a mixture of the two. For this reason the boundaries of employment/self-employment and self-employment/incorporation must be studied together: consideration of alignment at one boundary must take into account the impact on the other.

It will often be the person or business to whom or which the services are being provided (the client) that will insist that the worker supplies his services through a company. For the client this incorporation route has the advantage of shifting the onus of proving status to Her Majesty's Revenue & Customs (HMRC) to the worker. Not all incorporations by single taxpayers are at the behest of the client, of course. Within the UK system as it

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<sup>29</sup> Section 336 Income Tax (Earnings and Pensions) Act 2003 (ITEPA).

<sup>30</sup> Section 34 Income Tax (Trading and Other Income) Act 2005 (ITTOIA).

<sup>31</sup> Broadly, costs of travel from home to work are not deductible; from one workplace to another they are. It may be easier for a self-employed person to claim that their home is their work base. The rules for employees are strict but have been relaxed to some extent legislatively in ss 337-342 ITEPA.

<sup>32</sup> Movement from employment to other modes of working is not only tax motivated. , Changing work patterns are driven by a number of economic factors (Atkinson & Storey, 1993). Non-standard working and self-employment are increasing and together made up almost 40% of the EU-25 workforce in 2005 (European Commission, 2006). This is forcing consideration of change in employment law as well as highlighting the problem of tax differentials.

currently stands, the taxpayer may achieve significant tax advantages by being incorporated, as well as some commercial advantages in some circumstances. Nevertheless, various anti-avoidance tax provisions have been introduced to try to prevent workers supplying services from using incorporation to convert labour income into capital income. These provisions (notably the personal service company (PSC) legislation) are intended to apply where the taxpayers involved are economically closer to employees than to unincorporated businesses, but the definitional difficulties have made these attempts contentious and complex and, until 2007 at least, not very effective.

### 3. How the tax system may affect choice of legal form

#### 3.1. General issues

The relative effective tax rates paid on income earned in the corporate and non-corporate sectors often favour one legal form over another. Which form is favoured will depend on all the circumstances of the taxpayer, particularly in a system which has a progressive personal income tax, and the structure of the tax system.

Thus, in the USA, there has been a tax penalty on incorporation for those intending to distribute profits as a result of the classical system of dividend taxation which taxes dividends both at the corporate level (via corporation tax) and at the personal level (via income tax). This was tackled in 1958 by way of Subchapter S to the Internal Revenue Code which permits partnership or pass-through treatment for US corporations satisfying certain conditions ('S' Corps).<sup>33</sup> Thus many US firms may now choose incorporation without tax penalty and, in practice, the S Corp may have some tax advantages over unincorporated structures: for example, despite the pass-through treatment, the majority of the S Corp's profits escape various employment, social security and healthcare payments and taxes, so the S Corp offers an opportunity to escape both labour taxes and the double taxation of corporate dividends. This led to an estimated loss of \$5.7 billion employment taxes in 2000 (US Treasury (2005); Winchester (2006); Keatinge (2007)). Indeed, this Treasury report describes the S Corp form as 'a multibillion dollar employment tax shelter for single owner businesses'. It is significant that in 2000, nearly 80% of all S Corps were either owned by a single shareholder or majority owned by a single shareholder. Since 1997, under the check-the box regulations<sup>34</sup>, US entities other than corporations may elect to be treated for tax purposes either as a corporation or on a pass-through basis. The LLC hybrid form can also give limited liability with partnership tax treatment. These developments give many US businesses a choice of tax treatment regardless of legal form, but they also increase the opportunities for tax planning. Indeed, the growth in popularity of S Corps described by Auerbach, Devereux & Simpson (2008) may be partially explained by these tax advantages.

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<sup>33</sup> Sub-chapter S treatment can be chosen by companies with up to 100 shareholders. A series of other complex provisions must also be satisfied: for example, the only shareholders permitted are individuals, estates and certain exempt organisations and trusts. In practice, the S Corp need not be small in financial terms, nor in market or geographic scope (McNulty, 1992). The tax election makes no difference to the corporate status of the firm for the purposes of corporation law.

<sup>34</sup> Treasury Decision 8697.

In the UK, by contrast, the imputation system and now the system of tax credits has over recent years attempted to integrate the corporate and personal tax systems to some extent, so that the problem is often the reverse of that in the US: there is a tax advantage for many in incorporating so they would not generally elect for pass-through treatment even if it were to be available (which it is not).<sup>35</sup> The US literature therefore has to be applied to the UK situation with care.

Indeed, much of the literature on the impact of tax considerations (in particular, the difference between the effective tax rates paid on income earned in the corporate and non-corporate sectors) on choice of legal form is US based and mixed. MacKie-Mason & Gordon (1997) consider that non-tax factors are likely to dominate tax factors in the choice of legal form by businesses. Goolsbee (2004) is critical of this and other earlier time-series studies and uses cross-sectional data for US states and industries to suggest that the impact of the difference between the effective tax rates paid on income earned in the corporate and non-corporate sectors on the degree of incorporation might be larger than previously estimated. A recent paper by De Mooij & Nicodeme (2007) using European wide data supports this, finding that the tax gap between personal and corporate tax rates does exert a significant positive effect on the degree of incorporation.

Of course, it is difficult to transfer these results to a different legal system where the other legal factors may carry greater or lesser weight. In particular, the existence of the Subchapter S election further complicates the US picture. The true position is that the impact of taxation on choice of legal form no doubt depends on the precise balance of all the circumstances and factors (Freedman & Godwin (1992)). As we shall show, however, the recent increase in incorporation levels in the UK following the reduction of corporate tax rates supports the suggestion that the impact of taxation on legal form is strong. It is fundamental to the arguments in this chapter that we believe the tax system should not distort decisions about the best choice of legal form from a commercial point of view. Some commentators have suggested that it could be advantageous to encourage incorporation through the tax system as a means of promoting proper account keeping and similar business methods, both as a benefit for the firms themselves and for the revenue authorities (Sanger, 2005). Given the existence of audit exemptions for small companies and the informal way in which many are run, it is not entirely clear that incorporation does assist the revenue authorities very greatly in this way, although registration of the existence of the business may be helpful. VAT registration is probably more useful to the revenue authorities than incorporation per se, except that the UK has a high registration threshold relative to other jurisdictions (see Note and Shaw et al 2008). Well-designed requirements to produce accounts for tax purposes would be as helpful as the accounting requirements for small companies, as well as being more relevant. The advantages to the revenue authorities and businesses alike achieved by the requirements of incorporation are unlikely to be as great as those which could be obtained more directly by requirements relating specifically to tax returns.

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<sup>35</sup> There would be some circumstances in which pass-through treatment would be advantageous, of course, notably where there were losses (which could be deducted against higher personal taxes).

### 3.2. The incentive to incorporate in the UK

We have already explained that NICs bear more heavily on the employed than on the self-employed in the UK.<sup>36</sup> There is also a tax and NICs (collectively referred to as ‘tax’ hereafter unless the context makes the contrary clear) advantage in incorporation, which technically results in the taxpayer becoming an employee of his own company but gives tax advantages. Clearly most taxpayers are employees and have little choice about this but there is a group for which there appears to be some flexibility and who are increasingly choosing self-employment or incorporation.

The main tax advantages of incorporation as compared with employment and self-employment are threefold. First, corporate tax rates are lower than income tax rates, especially where the small companies’ rate applies (and when the corporation tax starting rate used to apply) (see Appendices I and II for details). This means that shareholders of owner-managed companies may shelter income for investment by the company, having paid only corporation tax on it at a lower rate than income tax. Eventually they will have to pay higher rate income tax if they take any gains as dividends, but if they sell or liquidate the company they may be able to convert some part of their income to a capital gain, which is generally taxed at lower rates.<sup>37</sup> Second, incorporation provides an opportunity to convert income from labour into income from capital, which enables shareholders to take income from the company in the form of dividends or capital gains not subject to NICs. Third, incorporation may offer the opportunity to an owner to split shareholdings with other family members so that the whole of the income is taxed at a lower rate than would be the case if it was all received by one shareholder.<sup>38</sup> This is considered objectionable by HMRC where the business of the company is essentially to supply the services of one of the shareholders, whilst the other or others do substantially less or no work for the company. We refer to this division of income across individuals as ‘income splitting’.

To give an example of the interaction between these factors, in the case of a one person company, the lowest possible tax rate combined with benefits entitlement is achieved by the company paying the single owner-manager a low salary (equivalent to their personal allowance (tax free threshold)). The company then either retains profits which are taxed only at the small companies’ corporation tax rate, or pays them out by way of dividends, which are not subject to NICs and which also carry a credit for corporation tax paid. For example, in 2009-10, applying this method means that an incorporated owner-manager whose business makes £25,000 gross annual profits pays only 17.3% (£4,313) of this in tax, compared with 27.7% for an employee and 22.4% for a self-employed individual earning the same amount (see Appendix III for details). To improve their tax position

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<sup>36</sup> The Labour Force Survey reports that the number of individuals running their own business (including, under their definition, both the self-employed and some owner-managers of companies) has been increasing at a faster rate than the number of employees in the UK in recent years. Between 1998 and 2006, the number classifying themselves as self-employed in the UK increased by 10%, from 3.4 million in 1998 to 3.7 million in 2006; this can be compared with a rise of 8% (from 23 million in 1998 to 25 million in 2006) in the number of employees over the same period.

<sup>37</sup> For the most part, the companies on which this chapter focuses will not have this option since they will need to pay out much of the corporate income for living purposes.

<sup>38</sup> Of course the situation is rarely as simple as this.

further, the owner-manager could also give shares in his company to other family members.

These three advantages are subject to highly contentious anti-avoidance provisions. The UK Government has attempted to prevent the conversion of labour income into dividend income by legislation which targets personal service companies (PSCs) and managed service companies (MSCs). Income splitting has been attacked by the use of anti-avoidance legislation aimed at settlements and new legislation is now under consideration, as discussed below. The Government argues that a considerable amount of revenue is at stake, but that there are also fairness issues.<sup>39</sup>

Special provisions to tax the income of certain types of PSC<sup>40</sup> as if it were employment income were introduced in 2000 (at the same time as the low starting rate of corporation tax, presumably in partial recognition of the fact that the low rate might exacerbate distortions) and instantly met with much discontent.<sup>41</sup> The rules aim to look through the existence of the corporation for tax purposes. They apply where a worker provides his services to a client through a PSC, and where the worker would have been treated as an employee of the client for tax and NICs purposes had the arrangement been made directly between the worker and the client. The application of these rules depends, therefore, on a finding that there would have been a contract of employment between the client and the individual undertaking the work had there not been a PSC involved. This places heavy reliance on the finding of a legal relationship of employment on which the law can be very unclear in borderline cases.

Where these rules apply, the client pays the PSC gross. Salary paid by the PSC to the worker is subject to the PAYE and NICs rules in the usual way. In addition, to the extent that the PSC does not pay out its entire earnings as salary, the PSC is treated as paying a salary of this sum also to the worker. Benefits in kind paid to the PSC are taxed in the same way as employee benefits and the restrictive employee deduction rules are applied to expenses. Relief is given to prevent double taxation, and a small deduction is allowed for expenses of running the PSC.

The impact of the tax liabilities is on the individual worker and not the client, however, so that there has been no reduction of the incentive to large businesses to insist that those providing services to them incorporate. Initially the legislation was designed to put some

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<sup>39</sup> The introduction of legislation to deal with PSCs was expected to increase NICs revenue by £220m per year from 2002 (Inland Revenue, 1999). The introduction of legislation to deal with MSCs was expected to yield £350m in 2007-08, £450m in 2008-09 and £250m in 2009-10 (HMRC, 2007). The introduction of legislation to deal with income splitting (now delayed) was expected to yield revenue of £25m in 2008-09, £260m in 2009-10 and £200m annually thereafter (HMT/HMRC, 2007).

<sup>40</sup> In fact the rules also apply to intermediaries which are partnerships but for the purposes of this chapter we shall refer to all intermediaries as PSCs. The rules are sometimes called the 'IR35' rules after the press release that announced them (see now ITEPA Part 2 Chapter 8).

<sup>41</sup> Including an unsuccessful judicial review: *R (on application of Professional Contractors Group Ltd) v IRC* [2001] STC 629. For a detailed discussion of IR35, see Redston (2002).

of the onus onto the clients and this might have altered behaviour but, following business complaints, the liability was placed on the PSC itself.<sup>42</sup>

Thus it is that some workers find themselves in a situation in which they must incorporate in order to obtain work, or are starting up with only one client with a view to development, but, in these circumstances, are vulnerable to this complex anti-avoidance legislation. Arguably, the involvement of the problematic employee status test in the determination of whether IR35 applies has made the legislation unworkable, unenforceable and uncertain in its application (Tiley & Collison (2007), p492; Lee (2007), p142; Gretton (2008)).<sup>43</sup> Taxpayers covered by this provision also pay tax as employees but without the benefits of employment. This could be the worst possible outcome, since it remains a trap for the unwary and increases compliance costs and encourages costly structuring to avoid the legislation but is unlikely to raise very much revenue.

The lack of success of the PSC legislation led to the managed service company (MSC) legislation in the Finance Act 2007 (see HMRC (2006); Lagerberg (2007)). The MSC legislation does not rely on the problematic definition of employee. It overrides the PSC provisions, but the latter remain on the statute book in case there are situations where the MSC legislation does not apply and it does. The MSC legislation was introduced to deal with specialised intermediaries (MSC providers) who were offering mass marketed packaged service companies to large numbers of individuals. From April 2007, PAYE is payable and most provisions relating to taxation of employment income are applied to a deemed employment payment by an MSC to the worker. A MSC is defined broadly as one whose business consists wholly or mainly of providing the services of an individual to other persons, the payments for which are mostly paid to the individual or his associates (note that this does not refer to the concept of an employee, unlike the PSC legislation.) Further, the way in which the payments are made would result in the individual or associates receiving more than if they had been payments of employment income (once tax and NICs are taken into account) and an MSC service provider is involved with the company. There are elaborations of these definitions in the legislation.

The existence of a provider giving straightforward legal or accountancy advice is not intended to convert a PSC into an MSC but there has been some discussion of this and the full extent of the provisions remains to be tested (Lagerberg, 2007). The mischief being addressed directly by this test is that small business owners were being encouraged by MSC providers to incorporate to take advantage of the incentives within the tax system, but the legislation still tackles the symptom and not the cause of the problem, despite moving away from the problem of defining employment. Opportunities were open to MSC providers only because of the structure of the tax system and this has not changed.

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<sup>42</sup> Contrast the Construction Industry Scheme in force from April 2007, where the onus is on contractors to check the employment status of sub-contractors – but in this sector the main engagers are large and there is union pressure for compliance. Even here implementation had to be deferred to ensure that the industry was ready.

<sup>43</sup> The Professional Contractors Group (a lobbying trade group) claim that of the 1,431 IR35 tax investigations known to that body, tax was found to be owing in only four cases in 2007 (see: [www.pcg.org.uk/cms/index.php?option=com\\_content&task=view&id=3183&Itemid=427](http://www.pcg.org.uk/cms/index.php?option=com_content&task=view&id=3183&Itemid=427)).

To target those who have set up companies because they have had this idea presented to them as part of a mass marketed package, whilst leaving the more sophisticated unchallenged, makes little sense in terms of tax policy. It will not necessarily treat taxpayers equitably across the board and it may penalise those who most need advice and assistance.

A key problem with both the PSC and MSC legislation is that it applies only to certain categories of companies, which then have to be defined. This adds to the burdens of all small businesses, penalise taxpayers who simply utilise incentives built into the tax system through differential rates, and potentially inhibits genuine entrepreneurialism. If it is desired to tax income from incorporated firms as labour income, then it would be preferable to achieve this through structural changes to the tax system that avoid definitional problems. This may mean that we need to align rates of tax on labour income and capital income across the board rather than in particular cases only. Some argue against this on the basis that lower tax rates should be used as a reward for the loss of the benefits of employment. We reject this and argue that if business owners do take greater risks and have less security than employees, which will be so in some cases but not all, then that should be reflected by the market in the prices charged for their services rather than by the tax system.

As explained above, incorporation also facilitates income splitting for tax purposes. The income of one person can be shared with family members (who become shareholders of the company) and lower rates of tax can be achieved by paying out salaries within the personal allowances of these family members or dividends in respect of their shares. This raises objections from HMRC where the profits of the company arise mainly from the work of one family member but are nevertheless split with others. Of course, there may be practical difficulties in determining the relative contributions. To counter what it perceives as an abuse, HMRC has attempted to use anti-avoidance provisions (the 'settlements provisions') under which it can assess dividends as income of the settlor in some circumstances (the settlor in these cases being the family member providing most of the work).<sup>44</sup> This has proved highly contentious and HMRC has been largely unsuccessful in litigation in the case of *Jones v Garnett (Arctic Systems)*.<sup>45</sup> The House of Lords came to their decision on the facts of this particular case, which leaves many questions unresolved.<sup>46</sup> It was immediately followed by an announcement of the intention to legislate against such 'income splitting'<sup>47</sup> and a consultation document on the topic (HMT/HMRC, 2007). The negative reaction to these proposals has resulted in their deferral but with a stated intention of legislating in 2009 (Budget (2008), para 4.69).

The proposals in the consultation document would require the parties and ultimately the courts to evaluate whether income has been foregone by one individual in favour of another. The proposed test is complex and fact dependent, leading to justified criticisms

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<sup>44</sup> Formerly s 660A of part XV of the *Income and Corporation Taxes Act 1988* and now in Chapter 5 of Part 5 to *Income Tax (Trading and Other Income) Act 2005*.

<sup>45</sup> [2007] UKHL 35.

<sup>46</sup> For a comprehensive discussion of the issues in the case, see Gammie (2007); Loutzenhiser (2007).

<sup>47</sup> *Jones v Garnett: Ministerial statement* (26<sup>th</sup> July 2007).

that it would be heavy in compliance and administration costs and yet would probably raise little revenue. Extra-statutory guidance is looked to as the solution but this is unsatisfactory. The tests involve looking at the market value of work done but, as pointed out by Redston (2007), raise very difficult questions of the value of each person's work, balancing value against volume of work done, balancing work done with capital contributions, and accounting for changes in the fact patterns over time.<sup>48</sup>

There are many interacting issues to consider here. This is a question that needs addressing in a holistic way, looking at the rules on family taxation, small business taxation and capital transfers between spouses in the round. An outright gift of other types of income bearing property may generally be made to a spouse, so that investment income may be split in this way. The Government's objection is to splitting what is perceived to be the equivalent of labour income, but where the equity lies depends upon whether the comparator is truly labour income or investment income. The fundamental issue is once again that income from labour is being recharacterised as income from capital.<sup>49</sup> A system which treated all the income from companies in the same way as labour income (unless it represented a return to capital) would remove part of, although not all, the advantage of income splitting, since some of the advantage lies in being able to use the personal allowances and lower personal income tax bands. To deal with this, it would be necessary to consider the nature of independent taxation of spouses and civil partners and the role of their personal allowances. It would be possible to make their allowances and even their lower rate bands transferable to their partner, but this would bring other problems. It is not clear that it is appropriate to try to prevent the use of these allowances through a complex business tax measure which is guaranteed to alienate small business owners.

### 3.3. The incentive to incorporate in the UK – changing tax rates and statistical evidence<sup>50</sup>

Small business owners have, quite rationally, taken advantage of the potential benefits to incorporation described above. Government has at times increased these benefits, with the intention of providing incentives for entrepreneurship, which it has associated with incorporation. So, for example, the Paymaster General stated in 2002 that the Government:

‘recognises that businesses growing beyond a certain size will often be companies. We believe that cutting corporation tax is an effective way of targeting support at small and growing businesses . . . Surely small businesses will not look a gift horse in the mouth. We want to create growth and economic activity, and to sustain entrepreneurial activity.’<sup>51</sup>

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<sup>48</sup> It is understood that similar tests operate in other jurisdictions such as the USA, Netherlands and Sweden, but that there are operational difficulties in all these and that such a test is likely to be of value only in extreme cases.

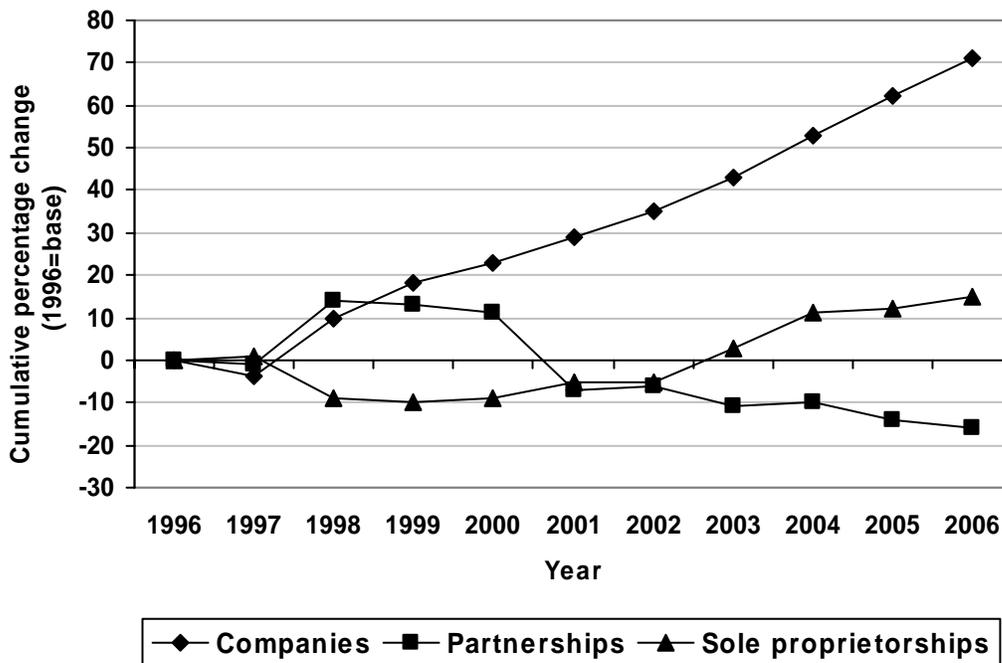
<sup>49</sup> Redston (2007) argues that it is not right to compare the small businessman and the employee in tax terms. ‘One could just as easily argue that [small business proprietors] should have paid holidays and fixed working hours. With respect, these conditions have nothing to do with the tax system, whereas rates of tax clearly do.’

<sup>50</sup> For a more detailed discussion of these developments, see Freedman (2006) and Freedman (2007).

<sup>51</sup> House of Commons Standing Committee F16 May 2002, cols. 114-115.

For example, the tax advantages of incorporation were increased in 2000 when a 10% rate of corporation tax was introduced<sup>52</sup> for companies with profits of £10,000 or less (the ‘corporation tax starting rate’). These advantages reached their height in 2003-04 when the starting rate of corporation tax was 0%.<sup>53</sup> In this year, an incorporated owner-manager whose business made £25,000 gross profits would have paid only 9% of this in tax. The potential for distortion was recognised by many at the time (see, for example, Blow et al, 2002) and, not surprisingly, incorporations did indeed increase (see Figure 2 below).

**Figure 2 Cumulative percentage changes in the number of businesses in the UK from 1996 to 2006, by legal form**



Notes: authors’ calculations from DBERR SME Statistics, 1996 to 2006<sup>54</sup>

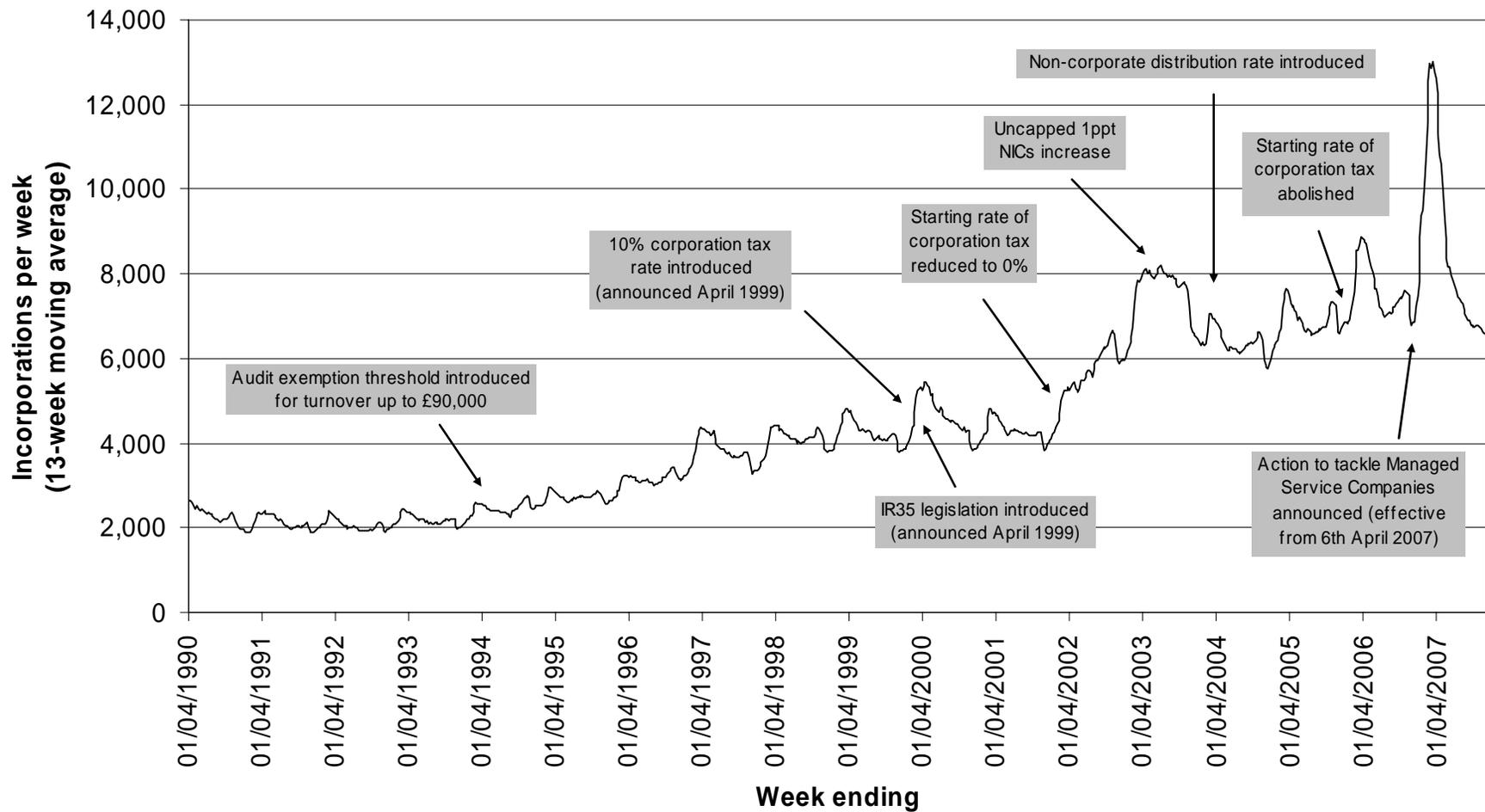
This upward trend in the number of incorporations (at least since 1997) is examined in more detail in Figure 3, which is annotated by reference to some developments which may have affected the incorporation rate.

<sup>52</sup> Announced in 1999 and included in the Finance Act 2000.

<sup>53</sup> The rate was reduced to 0% in 2002-03, but a 1 percentage point increase in the NICs rate for employees and the self-employed above the higher rate threshold was introduced in 2003-04, such that this was the year in which the advantage was greatest.

<sup>54</sup> Accessed via: <http://stats.berr.gov.uk/ed/sme/>

**Figure 3 Number of incorporations per week in Great Britain (13-week moving average, not seasonally adjusted)**

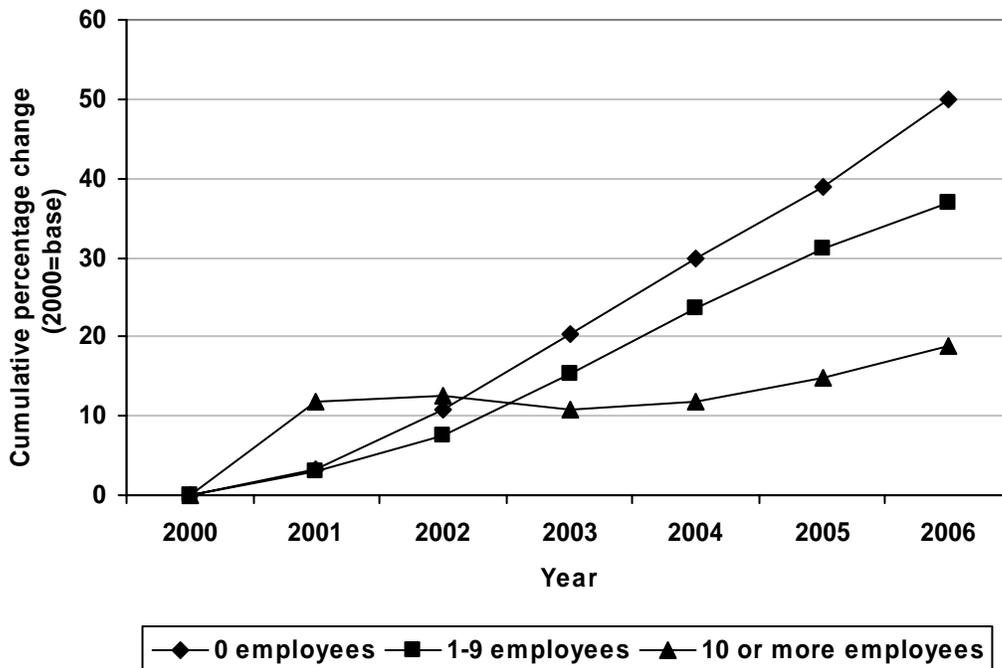


Notes: authors' calculations from statistics provided to the authors by Companies House, 1990 to 2007

Figure 3 shows that the reduction of the starting rate of corporation tax (from 10% to 0%) in April 2002 was followed by a period of growth in the number of incorporations per week, from just over 5,000 in April 2002 to just over 8,000 in April 2003. This increase is dwarfed by the increase in the first four months of 2007, however, when the number of new companies being formed rocketed from just under 7,000 per week in December 2006 to just under 13,000 per week in April 2007. This dramatic change seems to have been a response to the announcement in December 2006 that the government would be introducing legislation to tackle MSCs in April 2007, since it was thought for a time that forming individual companies rather than using umbrella vehicles would escape the new provisions. This may have been a short term increase, but it does suggest a very clear impact of the tax and legislative system on choice of legal form.

Of course, if the observed increase in incorporations was primarily a response to tax and other legislative changes, then we might expect there to be higher growth in the number of companies with relatively few employees than in the number of companies with relatively more employees. Figure 4 shows the cumulative percentage changes in the number of companies with 0, 1 to 9, or more than 10 employees in the UK between 2000 and 2006. As anticipated, the rate of growth has been greatest for companies with no employees – increasing by approximately 50% (from just over 300,000 in 2000 to just over 450,000 in 2006).

**Figure 4 Cumulative percentage changes in the number of companies in the UK from 2000 to 2006, by number of employees**



Notes: authors' calculations from DBERR SME Statistics, 2000 to 2006<sup>55</sup>

<sup>55</sup> Accessed via: <http://stats.berr.gov.uk/ed/sme/>. Note that it is not possible to make comparisons with earlier periods because the definition of companies with no employees changed in 2000.

Government complained that the increase in incorporations was due to ‘self-employed individuals adopting the corporate legal form where the change is made for tax reasons rather than as a step to growth’ (HMRC, 2004). This was the inevitable result of the policy pursued: small businesses did not ‘look a gift horse in the mouth’. Whilst businesses that intend to grow are likely to incorporate in order to raise external finance and to obtain limited liability, it does not follow that encouraging incorporation through the tax system will necessarily encourage growth. Rather, non-entrepreneurial and life-style businesses will quite reasonably utilise the advantages of incorporation so created. Finally the encouragement of incorporation in this way was accepted by Government to be misconceived. Following some complex and unpopular changes in 2004 designed to reduce the advantage of the 0% rate<sup>56</sup>, both this legislation and the corporation tax starting rate were removed in 2006.<sup>57</sup> These changes were announced as a measure to ‘better target tax incentives’ (Pre-Budget Report, 2005) and to:

‘refocus growth incentives so that the support for and the benefits of reinvestment go to businesses with growth ambitions and it is concerned that any incentives should be perceived as fair. Use of incentives by people being encouraged to incorporate and reduce their tax and national insurance contributions erodes that fairness’<sup>58</sup>

Thus Government was concerned not only about loss of revenue, but that incentives should be *perceived to be* fair. This is despite the fact that the incentives are used by the unintended recipients in a completely legal manner. Small business owners have a different perception of ‘fairness’, although interestingly there was no major outcry from small business over the removal of this relief, no doubt because the anti-avoidance measures associated with it had deprived it of some of its value and were very complex.<sup>59</sup> The objective of targeting growth companies through a tax relief available to all companies below a particular size threshold was always likely to fail and this has now been recognised by Government. Nevertheless, incorporation still brings tax advantages.

The 2007 Budget made an attempt to deal with these continuing advantages, proposing to raise the small companies’ corporation tax rate from 19% in 2006-07 to 22% in 2009-10. This increase in corporation tax for the majority of corporations was accompanied by a decrease in the mainstream corporation tax rate and in the basic rate of income tax (and an elimination of the starting rate of income tax). As shown in **Appendix III**, this has the effect of reducing the tax advantage associated with incorporation. This appears to offer an improvement to the current UK situation of apparent tax-driven incorporation, but a

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<sup>56</sup> Essentially this was legislation to tax dividends paid out of this non-taxed corporate income through the so called ‘non-corporate distribution rate’, expected to yield £10m in 2004-05, £340m in 2005-06 and £490m in 2006-07 (HMRC, 2004).

<sup>57</sup> Income tax rates remained broadly constant over this period.

<sup>58</sup> HMT (2006). It was estimated that there were 720,000 companies with profits of less than £50,000 pa at that time, equivalent to 63% of all companies (although this tells us nothing about which companies would be winners or losers from the change).

<sup>59</sup> This is an example of complex deregulation (explained in the Note to this chapter). Indeed these changes had been proposed by several small business organisations, including the Forum for Private Business, which pointed out that the compliance cost of the anti-avoidance provision outweighed the savings from the nil rate and ACCA – see ‘Abolition of nil rate discussed’ ([www.bytestart.co.uk/content/news/1\\_12/abolition-of-nil-rate-cor.shtml](http://www.bytestart.co.uk/content/news/1_12/abolition-of-nil-rate-cor.shtml))

radical cut in corporation tax rates generally to below the basic income tax rate, as is favoured by some as a reaction to the general downward trend in corporation tax rates internationally, would of course undermine this.

#### 4. Conclusion on UK experience to date

The above figures indicate that the impact of the UK tax system on choice of legal form has been significant. This is important, because it may distort commercial decisions; more fundamentally, it reveals a lack of equity in the tax system, since taxpayers with similar accretions to their economic power are taxed differently. This problem has been exacerbated in the UK by attempts to promote incorporation in an endeavor to encourage growth. Predictably, this has been ineffective and has caused further problems.

The Government has now declared its intention to encourage ‘all businesses who invest to grow’ without distortion<sup>60</sup> by introducing an annual investment allowance for the first £50,000 of expenditure on plant and machinery from 2008-09. In part this is to compensate for the loss of the starting rate of corporation tax, but it will be available to both incorporated and unincorporated firms. This is a move away from a size or legal form linked incentive towards one targeted at the activity to be encouraged, which is positive, and to a limited extent it introduces a cash flow treatment for very small firms.<sup>61</sup> It is inevitable that any such incentive will further increase the advantages of being self-employed or incorporated over employment by a third party, so that this new allowance may exert more pressure to leave employment, but it would not be possible to derive any attempted incentive to enterprise which would not do this. The usefulness of this relief depends in part on straightforward implementation, but the proposals contain anti-avoidance provisions and there is a risk that these will increase.<sup>62</sup>

The UK experience lends strong support to the argument that the tax system should not seek to favour one legal form over the other. Where the tax system does favour one form, structural solutions (such as rate changes) need to be sought for creating parity, rather than provisions which rely on definitions of sub-categories of businesses which will be difficult to apply and enforce.

## **IV. Options for Reform**

### 1. Objectives of reform

As discussed in Section III, in the UK, differential tax and NICs treatment of individuals across the spectrum of employment and small business activity generally creates an incentive to be self-employed rather than an employee, and incorporated rather than self-

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<sup>60</sup> Budget (2007) – Press Notice 1.

<sup>61</sup> A flow of funds tax was also proposed for “small” businesses by the President’s Panel (2005). However, their proposal raises issues of definition that are not involved with the UK’s less extensive provision.

<sup>62</sup> The point was made by business in the consultation process that complexity of anti-avoidance provisions needed to be avoided and Government claims that it has used a ‘light touch’, will, however, keep under review to ensure the safeguards in place are proving effective in maintaining the balance between simplicity and control of abuse (HMT/HMRC, 2007a).

employed. For many there is no choice other than to be employed, but for a significant group at the margins, it is possible to structure their affairs in alternative ways. The tax incentive to incorporate arises primarily as a result of the opportunities to convert highly taxed labour income into less highly taxed capital income by incorporating. For reasons explained above and in the Note to this chapter, our starting point is that the tax system should be neutral as to the choice of legal form, which should be made on the basis of commercial factors. Tax differentials do influence choice of legal form and will not always target ‘entrepreneurial’ businesses efficiently; furthermore, they create costs for business and revenue authorities. When taxpayers quite rationally take advantage of these differentials, revenue authorities often fail to go to the heart of the structural issues and instead react with complex provisions which attempt, often unsuccessfully, to confine the tax advantages to a sub-category. This in turn gives rise to dissatisfaction amongst taxpayers whose co-operation is important for the purposes of administration and for political reasons.

We do not believe that entrepreneurship should or can be encouraged by advantaging incorporation through the tax system. Nor do we consider that the solution to creating a structurally neutral system lies in producing special provisions for ‘small’ businesses: the difficulties of arriving at a non-arbitrary and enforceable definition of those ‘small’ businesses to which the tax system would be neutral with respect to legal form seem insurmountable. We therefore consider only briefly those options that rely on such definitions, before moving on to discuss in more detail reforms that would equate effective tax rates on income from the corporate and non-corporate sectors *for all businesses*.

## 2. Specific provisions for ‘small’ businesses

In this section, we discuss a number of ways in which it might be attempted to reduce inequalities between effective tax rates applied to ‘small’ incorporated and unincorporated businesses, using a variety of definitions of ‘small’.

### 2.1. Deterring or preventing incorporation

One way to tackle the small business taxation problem might be to prevent or inhibit ‘small’ businesses (however defined) from incorporating (for example, by way of an increased minimum capital requirement, as suggested by Murphy (2007)). This would mean that many very ‘small’ businesses would remain unincorporated and so be taxed under the personal tax system, thus eliminating opportunities for re-characterisation of income. Alongside the difficulties of arriving at a suitable level of minimum capital requirement, such an approach is unlikely to be politically acceptable in the UK.<sup>63</sup>

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<sup>63</sup> Indeed, following the decision of the European Court of Justice in *Centros* (C-212/97) that private companies operating in other Member States could incorporate in the UK to avoid having minimum capital, other countries (e.g. the Netherlands) are abolishing their own minimum capital requirements. The associated suggestion by Murphy (2007) that small businesses should be encouraged to use the LLP legal form falls into the same category: whilst there is a tax advantage to incorporation it is unlikely that there will be sufficient advantages to the use of an LLP to make this attractive.

## 2.2. Mandatory pass-through treatment

Another route to alignment for ‘small’ businesses would be to tax certain incorporated firms as if they were unincorporated and to make such pass-through treatment mandatory in these cases. This would not achieve alignment across the board without first aligning the NICs treatment of employed and self-employed persons by integrating NICs and income tax.<sup>64</sup> Following this, all or part of the income of owner-managed companies would need to be treated as labour income, regardless of whether it was paid out by way of salary or not. This would essentially align tax rates on labour and capital income for this group. Very roughly, this is the approach of the UK PSC and MSC provisions, except that since NICs are not currently aligned for employees and the self-employed, the treatment of income of the PSC or MSC as employment income makes the owners worse off than if they had operated through unincorporated firms. Furthermore, these provisions only apply to some, not all, owner-managed companies, and determining to which companies they should apply has been fraught with difficulty. Mandatory pass-through treatment thus does not seem to us to provide a viable solution to the small business taxation problem because of the need for difficult and potentially arbitrary or manipulable definitions. Furthermore, the effect of such legislation is to tax all profits of owner-managed companies as labour income, regardless of the investment of physical capital.

## 2.3. Optional pass-through treatment

Some commentators have argued for the *option* of pass-through or partnership treatment to be made available to owner-managed companies in the UK, as it is in the US (by making a Subchapter S ‘S-Corp’ election). As discussed above, the popularity of this legal form in the US is the result of aspects of the US tax system which differ from the UK as well as the ability to escape some labour and social security taxes. Far from increasing alignment between legal forms, it provides greater opportunities for obtaining tax advantages by using one form rather than another. Under a system with a lower corporate tax rate than income tax rate, and especially one with a tax credit system for dividends (as in the UK), pass-through treatment would normally only be an attractive option for companies if they were loss making. Businesses in the UK can already opt to set up as a LLP (which essentially combines limited liability with the ability to set off business losses against other personal income), although the numbers doing so are small, suggesting no great demand for such treatment and thus for a pass-through option.

## 2.4. The Nordic approach

The Nordic countries face similar difficulties with the taxation of small businesses to those found in the UK as a result of their dual income tax system – which combines a relatively low, flat rate of tax on capital income with progressive taxation of labour income. To deal with this problem, many have (at least at some point in time) adopted special rules for the treatment of the income of what have been defined as ‘active’ shareholders. These systems differ from simply treating all of the income of such shareholders as labour income (as under the UK PSC and MSC provisions) by making an allowance for the investment of physical capital in a business. In Sweden, for example,

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<sup>64</sup> See below and Adam & Loutzenhiser (2007) for a more detailed discussion of these issues.

distributions from closely held corporations<sup>65</sup> are taxed at a reduced rate up to an imputed return on the acquisition price of the shares; above this return, they are taxed at the same rate as labour income.<sup>66</sup>

Although this seems more acceptable than treating all of the income of owner-managed companies as labour income, the same issues of definition arise: whatever classification of owner-managed businesses (or active shareholders) is chosen, it is likely to be somewhat arbitrary, creating horizontal inequity for very similar companies falling either side of the boundary.<sup>67</sup> Furthermore, there is a trade-off between the simplicity (in terms of implementation and adherence) of a clearly stated boundary between those to whom the rules apply and those to whom they do not, and the ability of small businesses to practice tax avoidance by moving to the most advantageous side of that boundary.

### 2.5. Summary

The definitional problems of these kinds of approaches have been clearly demonstrated in practice, by the problems experienced with defining PSCs and MSCs in the UK, and by reactions to the Nordic systems. For example, in Norway, there was a reduction in the percentage of companies to which its system of subjecting income to mandatory division into components of income from capital and income from labour applied, from 55% in 1992 to 32% in 2000, as taxpayers began to learn about the definition of ‘active’ shareholder (Sorensen, 2007). Small business owners (or their advisors) have reacted rationally to what are somewhat arbitrary classifications by seeking out the most tax-favoured position available to them, suggesting that whatever rules are in place will not eliminate the problem of tax-motivated incorporation entirely. In dealing with the issue of the taxation of owner managed companies, therefore, it seems to us that the best solution will be one that does not rely on defining sub-categories of company or types of shareholder.

### 3. Alignment for all businesses

In this section, we first consider how alignment of effective tax rates could be achieved by making changes within the current structure of the UK tax system, before moving on to suggest ways in which this could be improved upon through more radical reforms.

#### 3.1 Changes broadly retaining the current UK income and corporation tax systems

To the extent that it is proposed to retain a tax on the normal return to capital – that is, the minimum return required for an investment to be worth undertaking – it seems likely that it will be argued that this should be relatively low in relation to the rate on labour income. There are various reasons for this, mostly pragmatic rather than ‘high theory’, but the idea has wide support (see Griffith, Hines & Sorensen (2008)). In so far as the reasons relate to issues surrounding foreign investment and international mobility of capital, these

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<sup>65</sup> Defined for this purpose as companies with one or ‘a few’ active owners, but the definition of active is itself problematic. In Sweden, for example, an active shareholder is one whose activity ‘has a significant influence on the income generated by the company’, with case law relied upon to delineate active shareholders further (Sorensen, 2008).

<sup>66</sup> Norway also adopted a similar approach between 1992 and 2006 (see Lindhe, Soderston & Oberg (2002) and Sorensen (2007) for more details).

<sup>67</sup> Of course, this is also a problem under the current system.

are not relevant to most owner-managed domestic businesses of the kind we are discussing here (particularly those without any real capital investment). If, however, the arguments in favour of maintaining a tax differential are accepted for general reasons, then the problem of distortion in the case of small businesses will remain.

Our preferred approach to tackling this issue – alignment of effective tax rates across all legal forms – requires us to adopt the contrary view: that is, that income from capital should, as a matter of equity, be taxed at the same rate as income from labour.<sup>68</sup> Indeed, this is the direction in which the UK government appears to be moving. Changes announced in Budget 2007 have certainly lessened the distortions to choice of legal form created in recent years, as shown in Appendix III.<sup>69</sup> The distinction between income tax and NICs, however, means that the small companies' rate now lies above the basic rate – a somewhat complicated way of achieving the desired result, and one that is not easily understood by the small business community (though it has some logic). Furthermore, there is a continued need for the complex, costly and unpopular PSC and MSC legislation, because the tax differentials have not been eliminated entirely. These difficulties could be at least partially ameliorated through the integration of income tax and NICs – which would be a bold and desirable move, but which we recognise may be politically difficult at the present time (see Adam & Loutzenhiser (2007) for more details).<sup>70</sup>

A less radical approach would be to align the rate of NICs paid by the self-employed with that paid by employees. Such a move would eliminate some of the NICs differential between employees and the self-employed but importantly would exclude employer contributions. Moreover, the self-employed would still be subject to more favourable rules governing expenses claims than the former unless changes could be made in that respect also (see Freedman & Chamberlain, 1997).<sup>71</sup> These changes alone will, however, do nothing to reduce the tax advantage associated with being incorporated rather than employed<sup>72</sup> (and, indeed, will increase the tax incentive relative to being self-employed), highlighting the importance of considering the whole spectrum of employment and small business activity in tax design.

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<sup>68</sup> Indeed, some would take the view that income from capital should be *more* heavily taxed than that from labour, as was the case in the past with the investment income surcharge, but practical considerations would make this difficult even if it was desirable.

<sup>69</sup> In fact, the tax incentives evident in the proposed 2009-10 system look broadly similar to those found in 1996-97. See Crawford (2008) for more details.

<sup>70</sup> This means that NICs would be subsumed into income tax, such that a higher composite rate would apply to all labour income – whether for employees or the self-employed – and dividend income (although the credit for corporation tax already paid on dividend income would remain in place). There are some complications in deciding which NICs rate (contracted in or contracted out – and, if the latter, salary-related or money purchase scheme) would be most appropriate for the purposes of integration. See Appendix III for more details.

<sup>71</sup> It is difficult to quantify this particular tax advantage. Further, this is a problem that applies across all of the alternative approaches discussed in this chapter. It might not be possible to make major changes to the employee expenses rules without an increase in the number of employees filing tax returns or even a universal tax return - see Shaw, Slemrod & Whiting (2008).

<sup>72</sup> This approach does not create a single composite income tax rate, such that the taxation of dividend income remains unchanged.

The distortions evident at the boundary between incorporation and (self-)employment could be reduced through the alignment of the small companies' rate of corporation tax (22% from 2009-10) with the mainstream rate of corporation tax rate (28% from 2008-09). The result of aligning the small companies' rate and the main rate of corporation tax at 26%, and of equating the NICs rate of the self-employed with that of employees (the incremental approach), can be seen in Appendix IV.<sup>73</sup> These figures show that such an approach would eliminate most (but not all) of the tax incentive to incorporate. Clearly this would have a cost to those currently paying the small companies' rate, but this would balance the potential NICs savings through paying dividends rather than salary. As discussed in the Note, there is no clear economic rationale for a distortion in the tax system in favour of those with low profits. Although this approach might reduce effective tax rate differentials between incorporated and unincorporated businesses, it might not be seen as acceptable because it would involve taxing returns to capital at the same rate as labour income (inclusive of NICs). In the next section, we move on to consider alternative reforms in which alignment of effective rates can be achieved without taxing the normal return to capital.

### 3.2 Changes moving away from the current UK income and corporation tax systems

This section discusses reforms that move away from the current UK income and corporation tax systems. Much will depend on the detailed implementation of any such reform and so our overriding point is that in any consideration of these new approaches, thought should be given to the structural issues we have described.

#### 3.2.1 A shareholder income tax with a rate of return allowance?

Norway (as mentioned above) has a dual income tax system (in which the corporation tax rate is equal to the capital income tax rate, which, in turn, is equal to the lowest labour income tax rate). There is also a higher (progressive) labour tax rate. To combat the incentive this produces to convert labour income into capital income, Norway adopted a residents' shareholder income tax with a rate of return allowance (RRA) in 2006. This enables it to align the effective tax rate on part of the income of a corporation with that of labour income, whilst leaving normal returns to physical capital taxed at a lower rate, whether or not they are distributed. This meets concerns that the taxation of the whole of the distributed profits of a company as if they were labour income does not recognise the investment of shareholders, and also permits a lower effective tax rate on the normal return to capital than on labour income, which may be attractive for non-small business reasons.

The RRA exempts all shareholder income (including both dividends and realised capital gains, which are treated identically) below an imputed normal rate of return on the share basis (the RRA) at the personal level, as this income has already been subject to corporation tax (at a rate corresponding to the capital income tax rate) and should

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<sup>73</sup> That is, we abolish Class 2 and Class 4 NICs, and move the self-employed onto the employees' Class 1 contribution schedule. For the purposes of these calculations, we use the "contracted out" rate for employees (see Appendix III for details). The differences between the employed and the self-employed would be reduced still further through the integration of income tax and NICs.

therefore not be taxed further.<sup>74</sup> The share basis in any given year is defined as the sum of the original share cost plus all unutilised RRAs from previous years: this is equivalent to carrying forward retained profits (postponed capital gains tax liabilities) with a normal return, to ensure that only capital gains in excess of the normal return are subject to taxation at the higher labour income rate.

Above the RRA, income is taxed at the capital income tax rate – which, in combination with the corporation tax rate (which has already been paid on this income), corresponds to the top marginal rate of taxation on labour income. In Norway, this top marginal rate excludes social security contributions (of 6%), but in a UK version, we would recommend that alignment should occur at a rate that takes into account both income tax and NICs – which could best be accomplished through integration. This is important because it is this equivalence that eliminates the ability of small business owners to convert highly taxed labour income into less highly taxed capital income.

Under the Norwegian system (and the one we recommend for the UK), this is equivalent to the tax treatment of unincorporated businesses - for which an imputed return to business assets<sup>75</sup> is taxed at the capital income tax rate, with the remainder taxed at the labour income tax rate - because the corporate and capital income tax rates are the same under the dual income tax system (and would also need to be equal under any UK version of the shareholder income tax that was adopted). Such an approach must be optional for unincorporated firms, however, as it requires detailed book-keeping; those who do not wish to maintain such detailed records may instead opt to have the whole of their income taxed as labour income (as under the current UK system).

Of course, the equivalence of the combined corporate and capital income tax rates with the top marginal rate on labour income means that there will be a tax incentive to remain unincorporated for businesses whose profits do not exceed the higher rate threshold. This could be overcome, possibly with some additional complexity, by taxing capital income (including both dividend income and realised capital gains) above the RRA according to the same progressive tax schedule as that used for labour income. This could be achieved for the dividend income of domestic taxpayers, for example, either with a credit for corporation tax already paid and a correspondingly higher tax rate applied to grossed up dividends (as under the current system), or without a credit (and a correspondingly lower rate of tax applied to cash dividends). The administrative workings of this would depend on the relative tax rates, but clearly as much as possible would need to be done through

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<sup>74</sup> If losses are fully deductible (which is necessary to ensure the neutrality of the shareholder income tax with respect to investment and financing decisions), then there is no need to include a risk premium in the RRA. See Sorensen (2007) for a more detailed discussion of the implementation issues surrounding the shareholder income tax.

<sup>75</sup> The imputed return to business assets can be calculated either on a ‘net assets’ basis or a ‘gross assets’ basis, each of which has advantages and disadvantages: while the net assets method is preferable because it does not distort marginal investment decisions, the gross assets method is preferable because it is less prone to tax arbitrage. See Sorensen (2007) for a more detailed discussion of these issues.

withholding, as now, with adjustments for higher rate taxpayers who complete self-assessment forms in any event.<sup>76</sup>

The appeal of the Norwegian shareholder income tax for the taxation of small businesses is that it provides a mechanism for dealing with the fact that different types of income are taxed at different rates, and that it uses investment of physical capital (rather than legal form) as the basis for reducing the tax burden. Furthermore, it applies to all shareholders, thus circumventing the need to define ‘active’ shareholders or owner-managed companies or some other category of businesses to which special tax treatment would apply. It does not eliminate the ability of incorporated owner-managers to ‘split’ their income with family and friends in order to minimise their tax burden, although the fact that they will be paying the labour income tax rate on all income may reduce the advantages. Since income splitting is the product of a progressive, independent tax system, rather than of the choice of tax rates applicable to different legal forms, we would not expect to be able to deal with it in this way.

A (potential) problem is that only returns to physical assets are taxed at the capital income (equivalently corporation) tax rate. One complaint in the UK already is that the entrepreneurialism of service companies and consultancies is insufficiently recognised, and that returns to entrepreneurialism, risk, ideas and ‘self-generated goodwill’<sup>77</sup> should also be taxed at a lower rate than labour income. This could be achieved, for example, via a cap on the amount of income subject to taxation at the labour income tax rate (with any income beyond this cap taxed at a lower rate, that is, the tax rate on capital income only).<sup>78</sup> Alternatively, these types of inputs could be valued and treated in the same way as tangible capital investments. On the other hand, there is also an argument that the rewards for ‘effort’ in whatever form (be they bonuses awarded by employers, the above-normal returns made from an individual’s investment portfolio, or the higher profits made by self-employed persons or persons providing their services through companies) should be taxed equally (and, possibly, at a different rate to the normal return on investment in physical capital). We believe that, as a matter of general principle, returns to forms of input other than capital should be considered to be rewarded by the market and should not be given any special treatment by the tax system. If, however, a government wishes to recognise such input by favourable treatment for pragmatic or policy reasons then this could be done, though not without complexity and opportunities for manipulation, as seen in other jurisdictions.

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<sup>76</sup> In Norway, deduction of the RRA (at corporate level) is permitted for all shareholders resident within the EEA (and not just domestic shareholders) before any withholding taxes on dividends are imposed. This is necessary to comply with European legislation, and would also be necessary were such a system to be adopted in the UK.

<sup>77</sup> Such as the name of the business, customer lists, etc. This is only a problem with self-created intangibles, since the value of acquired intangible assets is included in the basis value (acquisition price) of the shares and hence in the base for calculating the RRA.

<sup>78</sup> In Norway, there was previously a system for taking into account self-generated goodwill; however, it was quickly abandoned, after it was found that almost 80% of ‘active’ shareholders were reporting *negative* labour income for tax purposes (Sorensen, 2005).

Another issue is that the RRA could result in a distortion in favour of holding non-business assets (over business assets) – unless above-normal returns to non-business assets are taxed at the labour income tax rate as well – because distortions to choice of legal form are eliminated via the double taxation of distributions from incorporated and unincorporated businesses.

### 3.2.2 Combining the RRA with an allowance for corporate equity?

The current UK tax system, like many others around the world, is one in which the normal return to capital is taxed, with consequent implications for the level of investment.<sup>79</sup> Companies' choice of financing methods may also be distorted, as a result of the differential treatment of debt and equity for tax purposes: while interest payments on loans (made to the company) are not subject to corporation tax, dividends (the return to equity) are.<sup>80</sup> This has led many commentators and others writing in this Review to argue for a removal of these distortions.<sup>81</sup>

Whilst the introduction of a shareholder income tax (along the lines described above) would exempt the normal return to capital (invested in the corporate sector) from taxation at the personal level, it would do nothing to eliminate the distortions outlined above: this would require a separate solution.

Many commentators have argued for the introduction of an Allowance for Corporate Equity (ACE). Under an ACE system, companies would be given an allowance – reflecting the opportunity cost of equity finance – to be deducted from taxable profits (in the same way that interest payments currently are). This allowance would be calculated by multiplying cumulative past injections of new equity and past retentions of profits by some appropriate interest rate<sup>82</sup>, representing the return that could have been obtained had these funds been invested elsewhere (see Bond, Devereux & Gammie (1996), Devereux & Freeman (1991) and IFS Capital Taxes Group (1994) for more details). The equivalent for unincorporated businesses would be along the lines of the system currently used in Norway (above), except that the imputed return to physical assets would not be taxed at all here (it is taxed at the capital income tax rate in Norway).

We suggest that the combination of an ACE with an RRA-based shareholder income tax would eliminate the distortions to choice of legal form (as outlined above). It would also remove the incentive to choose debt-financing over equity-financing. Further, the normal return to capital would be exempt from taxation at both the business and the personal levels, thus reducing distortions to investment choices. This has the same benefits (and

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<sup>79</sup> To give the same post-tax return, the gross return required for an investment to be worth undertaking is higher than if there were no tax, making some investments that would have been profitable without the imposition of the tax not worth undertaking thereafter.

<sup>80</sup> This is further complicated by the availability of hybrid financial instruments, blurring the distinction between debt and equity (for tax purposes).

<sup>81</sup> For a more detailed discussion of these issues, see Auerbach, Devereux & Simpson (2008) and Griffith, Hines & Sorensen (2008).

<sup>82</sup> For example, this might be the risk-free interest rate on government bonds.

difficulties) for owner-managed firms as for others, although many of these businesses have no equity finance and are unlikely to do so whatever the tax regime.<sup>83</sup>

## V. Conclusions

The central small business taxation problem we have examined in this chapter is the structural one of lack of neutrality between different legal forms of doing business. In practice this is a problem only for owner-managed businesses at the smallest or micro end of the business sector, but this is an important group. Not only does it make a contribution to the economy but the small business community is vociferous and forceful when it comes to tax policy, and it can punch above its weight and create a sense of distrust in the tax system even if the actual number of people affected by a change is relatively small. In terms of being able to achieve sensible tax reform, this means that the concerns of the community need to be addressed, not necessarily by the tax response they have requested, but at least by a reasoned underlying policy rationale. Moreover the issue of how to tax small businesses has an impact on the structure of both personal and business taxation more generally. In order to investigate this problem thoroughly, we have considered the whole spectrum of activity through from employment via self-employment to incorporation.

In most systems there are tax differences between these various forms of doing business. Total alignment has been difficult to achieve straightforwardly because there are real legal differences between these methods of doing business, albeit that economically they may appear very similar. While some commentators argue that tax advantages for incorporation are desirable in order to encourage entrepreneurship, we reject this notion. We explain why we consider that neutrality between legal forms is desirable and proceed on that basis.

In the Note to the chapter we also explain why we do not accept the case for blanket tax incentives for small businesses as such, although there may be exceptional cases where some targeted reliefs are warranted. We suggest that small, or in fact any, businesses should be provided with tax incentives only where there is a clear case for targeted assistance to meet a market failure, but that otherwise, simplicity and an overall tax structure free from distortions and allowing decisions to be made on commercial grounds will be the most desirable approach for both efficiency and equity reasons.

If we were to retain a system broadly along the lines of the current UK tax system, the obvious key to increasing neutrality between the employed, self-employed and incorporated firms would be to align effective tax rates applicable to income from the

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<sup>83</sup> A similar overall result to an ACE plus a shareholder income tax might be achieved via a cash flow corporation tax plus a personal expenditure tax, although there are operational differences. Under this combination the rate of return to capital would be exempt at both the business and personal levels. Much would depend on the detailed implementation of such a combination: in particular, a mechanism would be needed to provide for alignment of rates for sums above the rate of return, in the same way as under an ACE plus shareholder income tax system.

corporate and non-corporate sectors as far as possible. Alignment would be aided considerably by the integration of income tax and NICs to create a composite rate on labour income, which would eliminate the most significant tax differences between employees and the self-employed, although we accept that this has political difficulties. At the other end of the spectrum, a simple route towards reduction of the tax incentive to incorporate would be the removal of the small companies' corporation tax rate, a relief for which we see little economic justification. This move would appear to be in tune with the direction of current UK government thinking. It would bring the cumulative corporation tax and dividend income tax rates into approximate line with labour income tax rates. The removal of the small companies' rate could be seen as an attack on entrepreneurship in the current climate and would have to be fully explained as part of a wider efficiency and simplification package. An accompanying reduction in the main corporation tax rate would assist although, as always where there are losers, acceptance by the small business community would not be immediate.

One suggestion frequently made is that a sub-category of small incorporated firms should be treated as if they were unincorporated for tax purposes. This does not solve the problem of the employee/self-employed boundary. It only solves the incorporated/unincorporated boundary problem if it is mandatory, since otherwise corporate or non-corporate tax treatment can be chosen for purely tax reasons. Mandatory non-corporate tax treatment could, however, give rise to the problem of defining the firms to which this compulsion should apply. We have reviewed the difficulties encountered in trying to do this in the UK in the case of a sub-category of owner managed companies. We consider it unlikely that a workable and non-arbitrary definition could be devised for general application and so reject the treatment of particular types of firm differently from others.

Under the radical alternatives discussed in this chapter, there is a mechanism for exempting the normal rate of return to capital from taxation at either the corporate or the personal level, or both. It remains the case that alignment or equalisation of tax rates across legal forms is necessary to achieve a sensible system for taxing small owner-managed businesses but, under these systems, this can be achieved whilst at the same time recognising that, for the reasons discussed in this chapter and elsewhere in this book, the return to capital should be more lightly taxed than the return to labour. This has the major advantage of distinguishing between returns to capital and labour income in a coherent way that does not require the use of arbitrary definitions and difficult distinctions between different types of firm. Thus it is not necessary to tax owner-managed companies, or companies in which all the shareholders are 'active' differently from others where some are passive. These are notoriously difficult definitions to devise and a system which does not require them is vastly superior to one that does. We recognise that for small firms, the issue is that these systems recognise actual capital invested but not the contribution of ideas, risk-taking and other forms of entrepreneurship and suggest (without recommending) ways in which that could be dealt with if required as a political matter.<sup>84</sup>

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<sup>84</sup> Many of the owner-managed firms we discuss in our paper have little or no capital investments so this is an issue of importance to them.

We recommend consideration of a combined RRA and ACE: a system that will facilitate the taxation of normal returns to capital at a lower rate of tax than labour income, whilst providing a mechanism for taxing above normal returns at the labour income rate, whether they are described as dividends, capital gains or salary.

## VI. Should tax systems favour small businesses? A Note to the Chapter.

There is a strong assumption in government (often found in the speeches of politicians) and more generally in the business community, that small businesses should be provided with tax incentives and reliefs. The reasons for this preference relate to the sense in which the concept of small business is being used. As we saw in Section II, the range of ways in which this definition is used deprives it of any real general meaning. Even if it makes sense to target new firms or growth or entrepreneurship in some circumstances, targeting *size per se* is likely to lack rationale and therefore effectiveness. Politicians and policy makers too easily slip from rhetoric about entrepreneurship or growth to proposals about reliefs or incentives for *all* small businesses. This may be inevitable, due to the difficulty of targeting firms with more elusive characteristics; nevertheless this is a process that can create distortion in the tax system without necessarily being of clear economic benefit.

Proponents of tax measures favourable to small businesses, or to some small businesses, put forward several possible rationales for their view. Broadly, these include: i) the need to counteract market failures; ii) the desirability of countering inherent disadvantages of being small such as the regressivity of compliance costs<sup>85</sup> and the asymmetry of taxable profits and losses; iii) the need to ensure that small businesses can survive family and other events which might threaten to break them up. Overriding all these is the argument that small businesses are important to the economy in creating wealth, stimulating competition and creating jobs, and that this in itself justifies tax favourable provisions.

There are two distinct issues here. First, are claims for the importance of the small business sector justified? It is not our objective here to decide upon this, but merely to note that there are issues surrounding the question. The second, and more important, question is: even if we accept the importance of the small business sector, as we do (to some extent), does it necessarily follow that it requires financial support, or that the tax system is an appropriate way to provide any such support as is appropriate? In particular, is it possible to target tax reliefs so as to support the possible rationales set out above? This note discusses these points to the extent needed to provide context for our structural review. Many of the distortions (though not all) present in tax systems as they relate to small businesses are the result of tax preferences. It is important, therefore, to consider the justification for such preferences. We argue that there are only limited circumstances in which small businesses and their owners should be advantaged through the tax system.

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<sup>85</sup> Regressivity of compliance costs is well established in the literature. The term here is used in the same sense as in Meade (1978) Appendix 22.1,

## 1. Significance of the small business sector

There is a large literature on this issue of which we can take only brief note in the space available. The small business sector is important in so far as it creates jobs, generates wealth and contributes to innovation. Small firms provide work for their owners, at least, and contribute to local economies. They carry out functions that it would not be economic for large firms to carry out and some of them have ‘spillover’ (external) effects which help to develop markets (Bannock, 2005). These attributes of small firms need to be recognised but not overstated.

Some of the earlier work purporting to show the importance of small businesses for job creation, specifically the work of Birch (1979), has been severely criticized (see Harrison (1997); Storey (1994); Davis, Haltiwanger & Schuh (1996); de Rugy (2005)). The matter is not settled, but it is clear that only a minority of small firms generate jobs. Professor Storey has shown that ‘most small firms do not grow and a handy rule of thumb is that over a decade 4% of small businesses create 50% of the jobs in small firms. The typical small firm is unlikely to survive for a decade and will create few additional jobs beyond those with which it started’ (Storey, 1995). It is also the case that some small businesses are poor employers and may be inefficient (Curran et al (1993); Storey (1994); Harrison (1997)), although workers may also find compensating factors in a small business environment (Curran et al, 1993). Small firms have many functions in society and the job creation debate may to some extent miss the point (Bannock, 2005), but, to the extent that job creation by small firms is used to justify tax preferences, it is worthwhile pointing out that the issue is not beyond doubt.

We illustrated in Section II that small firms, under the various definitions used, are numerous, but the businesses with which we are most concerned when discussing structural issues must be viewed in the context of their economic contribution. For example, in 2005-06, while almost all companies (91%) paid the small companies’ rate or below, they generated only 13% of all corporation tax paid.<sup>86</sup>

We do not deny the importance of parts of the small firm sector but it is clear that it is heterogeneous and not susceptible to generalisations. There is a serious issue of targeting. When advocates of small business reliefs propose special measures they generally give the figures for all small businesses in existence, yet those of importance to the economy in terms of likely growth and job creation make up a much smaller number. Focusing such measures on size will not necessarily encourage growth of firms that do not intend to grow and which will be able to take the benefit of a relief without any need to grow. Reliefs aimed at all small businesses are available, inevitably, to so called life-style businesses and to the type of small business which some suggest are not ‘genuine businesses’ but rather ‘disguised employees’. The creation of poorly targeted reliefs and exemptions may result in the reorganisation of business activity in order to create ‘small businesses’ at least partly in order to obtain the tax advantages. The introduction of such reliefs may thus result in tax driven behaviour which is entirely rational but which policy makers may subsequently castigate as tax avoidance, as in the case of incorporation to

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<sup>86</sup> Authors’ calculations from: [www.hmrc.gov.uk/stats/corporate\\_tax/11-3-corporation-tax.pdf](http://www.hmrc.gov.uk/stats/corporate_tax/11-3-corporation-tax.pdf).

obtain the benefit of the UK nil rate band for all small companies (see Section III for more details).

In any event, even if the sector is very important as a whole, the conventional wisdom that small business is the engine of the economy and the fountainhead of job creation is not, in itself, a justification for tax preferences targeted at size as opposed to other attributes (Holtz-Eakin (2000); Slemrod (2004); de Ruyg (2005)). For example, it has been argued that new firms may increase total factor productivity in the industry because they are potential market entrants (Aghion et al (2004); Disney et al (2003)) but whilst this might be an argument for encouraging *new* entrants, or at least not setting up barriers to them, it is not necessarily an argument for providing relief to *small* firms per se as opposed to a group of firms with some other characteristic, such as innovation. For the sake of efficiency, some small firms need to fail. As Holtz-Eakin has pointed out, it is hard to know whether levels of business failure are the 'right' levels, and even harder to determine which firms to target for success or failure (Holtz-Eakin, 2000).

We now turn to the areas in which it has been argued that there is a justification for providing tax reliefs for small firms.

## 2. Possible rationales for tax preferences for small firms

The OECD (OECD, 1994) has commented that, from a strict economic efficiency viewpoint, all special provisions for small businesses need to be justifiable in terms of market failure or malfunction. It recognises that there may be objectives beyond pure economic efficiency, such as income distribution, which might justify special tax and other provisions for small firms. Even where there does appear to be a rationale for assisting small firms or some class of them, however, there are many problems with ensuring that the objectives of the relief are satisfied through business tax reliefs and incentives based on size of firm, or through structural reliefs related to legal form, rather than by more direct subsidies and other regulatory policies. There may be problems at European Community level with giving subsidies, which can amount to prohibited state aid, but targeted tax reliefs will face similar difficulties, whilst more general tax reliefs will not be well targeted.<sup>87</sup>

The OECD recommends that countries must first decide what problems are faced by small businesses and then, if they consider the problems are sufficient to warrant government action, they should consider the relative merits of preserving a neutral tax system (in so far as one exists) and using direct expenditures to pursue small business policy objectives, since non-tax measures will often be better targeted than tax measures. In a later report (OECD, 1997) it concludes that the tax system has a potential role in limiting the cost disadvantages faced by small businesses in complying with tax

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<sup>87</sup> Specific tax relief is as much subject to EU state aid rules as a subsidy (Article 87(1) of the EC Treaty (2006)). Tax relief which is not specific, such as a general reduction in capital gains tax, is not state aid, even if it would favour some sectors above others. A Commission notice (European Commission, 1998) discusses the criteria for deciding what tax measures amount to state aid. Essentially, the test is whether the measure derives generally from the basic or guiding principles of the tax system in the Member State concerned (Case 173/73 *Italy v Commission* [1974] ECR 709).

legislation, encouraging the creation of *new* small businesses and ensuring the continuation of small businesses when control passes from the founder of the firm to another person. Beyond that, the OECD concludes that since there is no such thing as a specific tax imposed on small businesses per se, as opposed to taxes on wider target groups, it is not necessarily helpful to attempt to provide special relief for small firms through the tax system.

Balanced against the possible role for small business reliefs, the following potential difficulties must be considered. In addition to the problem of targeting, referred to above, the provision of tax reliefs and exemptions for small businesses may be inefficient. They may distort the choice of business organisation, commercial decisions about forms of expenditure, timing and method of change and transfer into other hands. In addition, they may result in economic inefficiency if they interfere with the market and result in the allocation of resources to small, less efficient, firms rather than to larger, more efficient, ones. Reliefs might even result in barriers to growth at the margins if restricted to businesses below certain thresholds. Small business reliefs often create complexity in the system, especially when coupled with anti-avoidance provisions. For this reason a simple and neutral system of business taxation might be preferred, even by small businesses, to a more complex system that seeks to favour some small firms (Freedman, 2006).

The possible rationales are now examined in more depth.

## 2.1 Market failures

There may be market failures that affect some small firms, such as asymmetric information – for example, on markets or products – monopoly power of large firms making entry into the market difficult, or difficulties for small firms in raising finance. These may be used as a justification for general tax reliefs or for specific schemes to promote investment in small firms. These schemes, it is argued, will assist not only the firms themselves but the market more generally with spillover effects from the innovative activity of the smaller firms (Gordon (1998); Aghion et al (2004); Disney et al (2003)).

Apparent market inefficiencies may, however, actually be examples of the market getting it right. If small businesses lack finance in some circumstances this might be because they do not have a good product or idea. Similarly, if the market rewards are not sufficiently high to compensate for undertaking risky activities, they may not be worth undertaking (see Adam (2008) at p226). Attempting to fine tune firm financing through the tax system could have unintended consequences. Thus, the OECD argues that tax measures are most likely to improve on the free market outcome in situations where the nature of the market failure is clear, but, of course, judging whether there is a market failure is the central difficulty that has to be addressed. It might be thought that the market is at least as likely to make sound judgments about the likelihood of the success of small business as are politicians. In addition, there needs to be evidence that the failure is significant, and a tax measure must be available that tackles the source of the inefficiency, has a significant effect on the behaviour in question and does not produce major distortions elsewhere. This will be quite a rare combination of circumstances.

Although capital market failures are often cited as a problem for small firms, it seems that in the UK there is no evidence of any general failure, although there may be particular problems for early stage businesses to attract small amounts of risk capital (Bank of England, 2004). 79% of small businesses seeking finance are successful on their first attempt to raise external finance (IES, 2005). The principal finance gap is for new and start-up businesses rather than small businesses (Graham Review, 2004). As a result of these findings, there has been an attempt to target tax assistance in raising external finance to those firms which do experience a problem, through the Enterprise Investment Scheme, Venture Capital Trusts and the Corporate Venturing Scheme.<sup>88</sup> These seek to meet the perceived 'equity gap' for unquoted trading companies<sup>89</sup>, although there has been discussion about how well targeted they are, and the jury is still out on their effectiveness (see Boyns et al (2003); Cowling et al (2008)). Non-tax-based assistance is given through the Small Firms Loan Guarantee, which has been remodeled following the Graham review to focus on firms within their first five years of business rather than small firms generally. This is consistent with the position taken here that the focus should not be on size but on other characteristics.<sup>90</sup>

In the UK, the abolition of taper relief from capital gains tax on business assets (available since 1998, when indexation and retirement relief were abolished) was announced in Pre-Budget Report (2007). This was greeted with strong protests from the business lobby, including small businesses, despite the fact that the removal of the relief was accompanied by the introduction of a generally applicable relatively low rate of capital gains tax. The government has reacted by proposing a new entrepreneurs' relief (see HMRC, 2008). This is not confined to small businesses as such, but is clearly directed towards them, given its limits and conditions. There is little or no evidence that this new relief is justifiable by any need to address a market failure.<sup>91</sup> The IFS has shown that the business cycle is far more important in determining the number of new VAT registrations than the introduction of capital gains tax reliefs (Adam, 2008). The new relief will introduce complexities and inequities, while the same low rate for all *without exception* (originally proposed) would have been more efficient, more equitable and much simpler.

One area often cited as being in need of intervention through tax incentives is investment in R&D. In the UK, the R&D credit was initially introduced for SMEs (small and medium-sized enterprises) in the Finance Act 2000 but was soon extended to all companies in the Finance Act 2002, although the relief is still more generous for SMEs.<sup>92</sup> The availability of a cash credit to SMEs and not to large companies may be justified on the basis that smaller companies have fewer possibilities for balancing costs against profits from other activities, but the larger amount of relief available to small companies is less easy to explain in the absence of evidence of greater credit constraints or spillover benefits in these cases. The evidence as to whether the UK R&D tax credits address the

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<sup>88</sup> See [www.hmrc.gov.uk/manuals/vcmmanual/index.htm](http://www.hmrc.gov.uk/manuals/vcmmanual/index.htm).

<sup>89</sup> See [www.hmrc.gov.uk/manuals/vcmmanual/vcm10020.htm](http://www.hmrc.gov.uk/manuals/vcmmanual/vcm10020.htm); HMT (2003).

<sup>90</sup> For a similar point from a US perspective see de Rugy (2005).

<sup>91</sup> Although it was in part at least a response to criticism that the change of rate affected taxpayers retrospectively.

<sup>92</sup> This measure does not extend to unincorporated SMEs, presumably for administrative and accounting reasons, since there is no principled justification for this.

real limitations on innovation seems to be equivocal (Abramovsky, Griffith & Harrison (2006); PWC (2006)). The extension of the relief to large companies is an example of the provision of reliefs for small companies fuelling demands by larger businesses. It is often the case that reliefs introduced for small companies result in pressure for extension to larger companies (what Alt, Preston & Sibieta (2008) call 'policy creep'). Such pressure is not surprising if there is no very clear rationale for limiting the relief according to size. Furthermore, the fact that the relief is more generous to SMEs may mean that just as a business expands and needs most help its credit reduces (Alt et al (2008)). This also illustrates one way in which small business tax reliefs might create barriers rather than removing them.

If such reliefs are to exist for all businesses, then the additional help required by smaller firms may lie in the need for assistance in accessing the schemes (Derregia & Chittenden, 2006). This relates directly to the size of the firm because smaller firms are less likely to have staff with specialist expertise and time to understand and prepare claims subject to complex requirements. Indeed, concern about take-up by SMEs of the R&D credit led to the announcement in 2006 of additional assistance for small businesses to make claims (HMRC, 2006a). This is closer to a compliance cost rationale, discussed below.

## 2.2 Inherent size disadvantages

A strong rationale for providing tax reliefs to small firms is that they are important in countering the inherent disadvantages of being small. The primary case is in relation to the regressivity of compliance costs.

### 2.2.1 Compliance costs

Compliance cost work in various countries has established that the costs of complying with tax and other regulatory burdens fall disproportionately on small businesses which have fewer staff and less expertise and time to devote to understanding and applying such regulation, the necessary information gathering being a fixed cost (Meade (1978); Sandford, Godwin & Hardwick (1990); Chittenden, Kauser & Poutziouris (2003); Evans (2003); KPMG (2006); and see Shaw, Slemrod & Whiting (2008) for a further discussion of the literature). Economies of scale and methods of organisation utilised by larger firms are not available to smaller firms. This is widely accepted as being a problem that may legitimately be addressed by reliefs and exemptions, and by removing certain reporting and disclosure requirements from small firms (OECD, 1997).

Slemrod, however, argues that greater non-compliance on average by small businesses (than employees) may offset their regressive compliance cost burden (Slemrod, 2004). Such evidence as exists in the UK points to sole traders and partnerships being the groups with the highest levels of non-compliance (as compared with employees and also with directors of companies).<sup>93</sup> There are clearly greater opportunities for non-compliance by

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<sup>93</sup> See NAO (2003), Table 7. Although the text to this table refers to non-compliance, the figures on which it is based are the percentage of cases generating additional tax yield upon a random enquiry. There was generally little evidence of negligence or fraud, so that these cases may have been the result of accidental understatement of profits as opposed to deliberate non-compliance. See also HMRC (2007a). The different

the self-employed than there are for employees and others with income from which tax is deducted at source. This might mean that some parts of the small business sector are paying a lower overall rate of tax than other taxpayers as a result of non-compliance. This might support the view given above that tax preferences for small businesses are not warranted, but it does not mean that policy makers should not seek to give relief from compliance costs where it is possible to do so without creating further problems, because there is unlikely to be a correlation between the tax savings of those prepared to reduce their taxes through non-compliance and those who suffer most through the regressivity of compliance costs (Gentry, 2004). Overall there should be a benefit to society through increased efficiency and greater revenue collection if compliance is encouraged by making it less costly. If this simplification also makes enforcement easier and so reduces opportunities for non-compliance, or encourages voluntary compliance, this will be an added bonus.

#### 2.2.1.1 Trade off between compliance cost and evasion – the VAT threshold

Some attempts to reduce compliance and administrative costs may increase opportunities for evasion. An example of this might be the VAT registration threshold, which is set higher in the UK than anywhere else in the OECD. This creates opportunities for evasion by making it easier to artificially stay below the threshold (through receipt of cash payments, for example)<sup>94</sup> but may also reduce other forms of evasion which rely on VAT registration, such as carousel fraud (Crawford, Keen & Smith, 2008).

There are some good administrative and compliance cost saving reasons for a high registration threshold (Warren (1993)<sup>95</sup>; Crawford, Keen & Smith (2008)), but the effect of too high a level may be a disincentive to grow beyond the level of the threshold and/or encouragement of methods of evasion used to stay below the threshold level. Chittenden, Kauser & Pouziouris (2003) reported that the Small Business Research Trust (in 1998) found that, overall, 15.3% of VAT-registered firms expressed the view that the registration threshold was a significant problem for them, and that 18% of non-registered businesses stated that they intentionally avoided growth so that their turnover remained below the VAT-registration limit. Moreover a high threshold may cause more significant disparities between firms which do have to register and those which do not and can create a sense of unfairness. Thus there may be a loss of efficiency in that competition is hindered and more efficient larger small firms are put at a disadvantage. This is a matter which has been stated to cause concern by some small business groups (HM Customs & Excise, 1999). There is clearly a trade off between these issues and the administrative and compliance cost considerations.

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levels of compliance amongst different groups are largely the result of different opportunities for non-compliance amongst these groups.

<sup>94</sup> See The Sunday Telegraph ‘Middle Class Criminals cost millions in taxes’ (24<sup>th</sup> February 2008): [www.telegraph.co.uk/news/main.jhtml?xml=/news/2008/02/24/nclass124.xml](http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2008/02/24/nclass124.xml).

<sup>95</sup> The threshold was increased in 1977 to decrease the number of registered traders and thus administrative costs (Warren, 1993).

### 2.2.1.2 Complex deregulation – VAT schemes for small businesses

Attempts to reduce compliance costs may also inadvertently increase them because the reliefs themselves introduce complexities (Freedman, 2006). The proliferation of thresholds below which special treatment is available can be confusing and some reliefs can require a considerable amount of advice and calculation before it can be decided whether they are advantageous.

These problems may be illustrated by some of the VAT simplification schemes which currently have a low rate of take up and different thresholds.<sup>96</sup> A flat rate scheme was introduced in 2002 (available in 2007-08 to businesses with a turnover of £150,000 or less (excluding VAT) or £187,500 (including VAT)). Under this scheme, VAT is paid on a percentage of turnover. This is intended to reduce accounting work for individual transactions, although proper business records are still needed for the purposes of taxation on income, so it is questionable how much time is saved. The scheme is meant to be revenue neutral but is likely to be utilised only where there is a likelihood of saving and therefore might involve time consuming comparisons (Benneyworth (2006); St John Price (2006)). Businesses with a turnover of up to £1,350,000 (excluding VAT) may also opt for cash accounting (avoiding bad debt problems) and annual accounting (to smooth their cash flow).<sup>97</sup>

The National Audit Office (NAO) reports that take-up rates for VAT schemes are low: 22% for the cash accounting scheme, 16% for the flat rate accounting scheme and 1% for the annual accounting scheme (NAO, 2006).<sup>98</sup> The NAO report remarks that the ICAEW (Institute of Chartered Accountants in England and Wales) consider that the simplification schemes should not be used as a substitute for simplifying the whole tax system. In similar a vein the CIOT (Chartered Institute of Taxation) has commented that some of its members consider that:

‘Stability is more important than more simplification schemes and simplification of the system is more beneficial than more schemes to counteract the complexity.’<sup>99</sup>

These schemes are targeted at real needs and so are better than some, but they are examples of complex deregulation<sup>100</sup>, with a variety of thresholds, some of which are not easily ascertainable in advance for firms, and with detailed anti-avoidance provisions. Businesses may need professional advice before they can be sure that they should use the schemes and, as the reliefs apply only to VAT and not income or corporation tax, they do not reduce the need for record keeping more generally. Indeed, on one view, reduction of

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<sup>96</sup> These schemes are described at:

[http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?\\_nfpb=true&\\_pageLabel=pageVAT\\_InfoGuides&propertyType=document&id=HMCE\\_CL\\_001208](http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_InfoGuides&propertyType=document&id=HMCE_CL_001208).

<sup>97</sup> The schemes are available until turnover reaches £1,600,000.

<sup>98</sup> There are certain pitfalls and traps for the unwary, particularly in the flat rate scheme – see Freedman (2007) for further discussion.

<sup>99</sup> See CIOT & ATT (2005) at p10. However, there were clearly different views on the Committee since they also state the alternative view that the VAT cash accounting scheme could be extended to direct taxation to make it more popular.

<sup>100</sup> A concept explained further in Freedman (2003a); see also Dean (2005).

record keeping requirements may not actually assist the small firms because the tax requirement bolsters a commercial need, for example, to keep proper accounts. Some, such as Truman (2006), have argued for a move to cash accounting for income tax for the very smallest firms to reduce complexity, but small business owners might not find this helpful ultimately, because properly drawn accounts have an important management function.<sup>101</sup> Moreover, the end result could be a good deal of anti-avoidance regulation which might make for more complexity rather than less in the long run.

### 2.2.2 Asymmetry of profits and losses

It is arguable that losses bear more heavily on small businesses than on others. Tax is paid immediately on taxable profits, but relief for tax losses may have to wait until the business generates sufficient taxable profits to absorb past accumulated losses. This is less of a problem for mature firms, which are likely to be generating profits from existing business and so can claim immediate relief for any loss on the new investment against other profits. This option is not open to new firms without existing taxable profits, so that there is discrimination against investment spending by new firms, or by small firms during a high-growth phase in which investment spending is high relative to current profits. This may suggest that rules should be devised to permit some corporations to have some level of pass-through treatment for tax purposes so that the owners can set their business losses against other sources of income. The arguments here seem stronger in the case of new corporations than those which are simply small. In the case of high-risk investments, the fact that loss relief is of more use to firms where there are other investments against which to set the relief is likely to favour investment by mature firms as compared with start-up firms (see Chennells, Dilnot & Emmerson, (2000), Chapter 8).

### 2.3 Keeping the small business intact

Another potential rationale that is in fact frequently adopted by governments is that used to justify special assistance to small businesses in relation to transfers, particularly from one generation of a family to another. It is argued that retirement or death might lead to the break up of a business and therefore closure with consequent loss of employment and wealth generation (European Commission, 1994). On this view, not only should there be relief available on the death of a business owner but he should be encouraged to part with his business whilst alive in order to keep it intact and secure a sensible succession.

European Commission (1994) takes it as given that there are advantages of intergenerational succession but provides no evidence (Bjuggren & Sund, 2002).

The UK has a number of tax reliefs aimed at easing the sale or transfer of businesses. In addition there is a general capital gains tax uplift on death for all property and this is accompanied by business property relief on certain business assets and 100% exemption from inheritance tax.<sup>102</sup> As discussed above, during the lifetime of the business owner

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<sup>101</sup> The 2008 Budget announced a review of smaller company accounts for tax purposes, but if anything seems to suggest a move away from cash flow towards commercial accounting, whilst recognising that this might exacerbate the already growing differences between technical tax rules applying to unincorporated firms and small companies ([www.hm-treasury.gov.uk/media/A/5/bud\\_bud08\\_taxsimplication\\_267.pdf](http://www.hm-treasury.gov.uk/media/A/5/bud_bud08_taxsimplication_267.pdf)).

<sup>102</sup> For the details of this relief, see [www.hmrc.gov.uk/manuals/ihmanual/IHTM25022.htm](http://www.hmrc.gov.uk/manuals/ihmanual/IHTM25022.htm); see also Boadway, Chamberlain & Emmerson (2008) for a discussion of this issue. They put the cost of business property relief alone at £350m pa.

capital gains tax may (from 6<sup>th</sup> April 2008) be removed or reduced by entrepreneurship relief, which reduces the rate of capital gains tax on some sales of businesses or sales of business assets following the cessation of a business.

The basis for these reliefs on transfer is not clear. First, as Boadway et al (2008) point out, the effects of the reliefs can be arbitrary, with 100% relief available for those who meet the inheritance tax provisions, for example, and none at all for those who do not. Second, the nature of the conditions means that the reliefs are utilised for tax planning purposes and the primary aim of holding the relevant asset may not always be a purely business objective. Third, the relief is available even if the business is not being maintained as a going concern by the person or persons inheriting it, so that it does not meet the test of being well targeted if the objective is to encourage continuity. It would be possible to provide relief as a deferral only whilst the business continues if the aim is to prevent break-up<sup>103</sup>, though it is not at all clear that this would be desirable since sometimes the continuity of the business in the most commercially efficient way will be best achieved by a sale to an outsider.

Transfer of a business to the second generation is not necessarily better than the purchase of a business by a third party. Some have argued that intergenerational succession is efficient because it preserves the benefits of knowledge idiosyncrasy (inherited knowledge) as well as being part of a transaction cost reducing social network (Bjuggren & Sund, 2002). This may be outweighed, however, by the inefficiency of having family disputes and poorly planned succession. Business owners frequently do not plan succession effectively and may even be reluctant to relinquish control (Handler, 1994). Children are often not interested in succession or, if they are interested, they are not the best managers. For example, Bloom & Van Reenen (2006) find that family-owned firms in which the position of the CEO is filled by the eldest male child are particularly poorly managed, with consequent implications for firm performance.<sup>104</sup> In light of the mixed evidence in this area, the best approach would seem to be not to give a tax preference to the passing on of businesses on death as opposed to lifetime sales, to allow the commercial considerations to govern.

There may be political and social reasons for favouring transfers within families and thus politicians may ultimately decide to support these through the tax system, but there does not seem to be any very clear economic rationale for doing so; indeed the result of giving reliefs from capital taxes to small businesses seems likely to be distortion and demands for further reliefs.

### 3. Political economy considerations

The introduction of special reliefs for small businesses is often based on strong political considerations. Business lobby groups are vociferous and, although the small business community is less powerful than large businesses economically, experience suggests that it can be very vociferous and often will be championed by the media. The result can be

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<sup>103</sup> Boadway et al (2008) point out that this could distort decisions and create compliance costs. It might, however, prevent people from buying and holding business assets purely as a tax planning device.

<sup>104</sup> This is supported in a publicly-traded firm context by Perez-Gonzalez (2005).

the introduction of reliefs which then become entrenched into the system and hard to remove even if found to be unhelpful, although the experience with the abolition of the nil rate of tax in the UK does show that business will broadly support simplifying measures where the reliefs have become very complex. Reliefs initially introduced for small businesses can result in pressure to extend them to all businesses, as described by Alt et al (2008). Thus, while it is not suggested that small business lobby groups should be ignored completely, in the long run a clear policy based system that can be explained to taxpayers and shown to be equitable and simple to operate may be more successful politically than one which responds to lobbyists and creates complexity, resulting anti-avoidance provisions and confusion amongst users about the objectives of the system.

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## Appendix 1 Legal size related definitions

### UK CORPORATION TAX

#### **Small companies' relief - Income and Corporation Taxes Act 1988 Section 13:**

A special rate of corporation tax applies where profits do not exceed £300,000 in an accounting period, with marginal relief between £300,000 and £1,500,000 (provisions exist to prevent splitting between associated companies). For the rates see Appendix II.

**Small companies starting rate:** This special rate applied between 2000-01 and 2005-06 to companies whose profits did not exceed £10,000, with marginal relief between £10,000 and £50,000.

#### **Close companies - Income and Corporation Taxes Act 1988 Section 414- 417:**

A close company is one which is under the control of five or fewer participators or of participators who are directors. Due to wide definitions of 'participator', 'associates', 'associated company' and 'control', companies with a large number of shareholders may be close companies. Accordingly it is necessary to remove certain quoted companies from this definition by a statutory exception.

#### **Enhanced allowance for R&D expenditure**

The definition follows the text of a Commission Recommendation 2003/36 (FA 2000, Sch 20, para 2(1)) (see [www.hmrc.gov.uk/manuals/cirdmanual/cird91400.htm](http://www.hmrc.gov.uk/manuals/cirdmanual/cird91400.htm) from which this summary is taken).

Recommendation 2003/361/EC defines enterprises as micro, small or medium by reference to various ceilings relating to staff headcount, annual turnover and balance sheet totals. To fall within a particular category an enterprise **must** meet the 'staff headcount' test and **at least one of** the 'turnover' or 'balance sheet total' tests.

#### **Ceilings within recommendation 2003/361/EC**

<b>Enterprise category</b>	<b>Staff Headcount</b>	<b>Turnover</b>	<b>Balance Sheet total</b>
Medium sized	< 250	not exceeding €50m	not exceeding €43m
Small	< 50	not exceeding €10m	not exceeding €10m
Micro	< 10	not exceeding €2m	not exceeding €2m

If the accounting period is not equal to one year, the figures are annualised. These ceilings are not necessarily calculated solely by reference to the enterprise itself. Where an enterprise is not autonomous it may be necessary to take account of the headcount, turnover and balance sheet totals of other enterprises to which it has connections.

## **UK VAT**

**Registration threshold** from 1 April 2007 - £64,000 annual turnover

**Eligibility for simplified systems** – annual accounting and cash accounting: £1,350,000 annual taxable turnover. Flat rate scheme turnover under £150,000 (excluding VAT) or £187,500 (including VAT).

## **COMPANIES ACT 2006**

A company is 'small' if it satisfies two of the following:

- A turnover of not more than £5.6 million;
- A balance sheet total of not more than £2.8 million;
- Not more than 50 employees.

## **AUDIT EXEMPTION FOR SMALL COMPANIES**

1993 exemption introduced for turnover less than £90,000 (with reduction of burden up to £350,000).

1997 threshold raised to £350,000.

2000 threshold raised to £1 million.

2004 threshold raised to £5.6 million.

## Appendix II

### Corporation and basic income tax rates in the UK, 1982-2009

<u>Financial Year starting</u>	<u>Basic rate of income tax in April commencing that year</u>	<u>Rate of Corporation Tax</u>	<u>Small Companies' rate</u>	<u>Starting rate (CT)</u>
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% <sup>105</sup>
2006	22%	30%	19%	Abolished
2007	22%	30%	20%	
2008	20%	28%	21%	
2009	20%	28%	22%	

<sup>105</sup> In 2004-05 and 2005-06, the 0% rate only applied to retained profits and those distributed to corporate shareholders. Other distributed profits were subject to the non-corporate distribution rate of 19%.

## Appendix III Calculations of tax incentive to incorporate

Given that small businesses face a choice over the legal form that they adopt, it is worth considering how the UK tax system influences that decision. In this Appendix, we first present the situation in 2009-10 (based on announcements made in Budget 2007), before showing how these incentives have changed over the period 1996-97 to 2009-10. For simplicity, we consider the position of a ‘one-man’ business making either £25,000 or £75,000 per annum – with the individual concerned able to choose between employment, self-employment and incorporation.<sup>106</sup>

### 2009-10

**Income tax:** Income tax operates via a system of allowances and bands of income that are taxed at different rates. Individuals have a personal allowance, which is deducted from income to give taxable income. In 2009-10, income tax is charged at 20% (basic rate) on the first £36,600 of taxable income and 40% (higher rate) on all taxable income above £36,600.<sup>107</sup>

**National Insurance:** National Insurance Contributions (NICs) entitle individuals to certain “contributory” state benefits (see Golding (2006) for details). Employees pay Class 1 NICs of 11% on earnings between the primary threshold (roughly equivalent to the personal allowance for income tax) and the upper earnings limit (equivalent to the higher rate income tax threshold), and 1% on earnings above this limit. If the employee “contracts out” of the State Second Pension (S2P), the 11% rate is reduced by 1.6% (to 9.4%) to reflect their reduced S2P entitlement.

Employers pay Class 1 NICs of 12.8% for each employee who earns above the secondary threshold (equivalent to the primary threshold). Where the employee has “contracted out” of S2P, the employer’s NICs rate below the upper earnings limit is reduced by 3.7% (to 9.1%) if the employee is enrolled in a salary-related pension scheme.<sup>108</sup>

Self-employed individuals pay two different types of NICs: Class 2 contributions are paid at a flat rate of £2.30 per week, and Class 4 contributions are paid at a rate of 8% between the lower profits limit (roughly equivalent to the personal allowance) and the upper profits limit (equal to the higher rate threshold), and a rate of 1% for profits above this limit. The payment of Class 2 and 4 NICs does not entitle the individual to S2P. The other differences between the employed and self-employed (mainly that the self-employed are not entitled to contribution based jobseeker’s allowance) are less significant than the S2P difference.

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<sup>106</sup> Here, we assume that the incorporated individual chooses to pay themselves 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. We do not consider the possibility of extracting profits in the form of capital gains.

<sup>107</sup> All bands and allowances are given in 2008-09 terms.

<sup>108</sup> There is a different rebate rate if the employee is enrolled in a money purchase scheme, but this rate is related to age, with younger employees receiving a smaller rebate than older employees.

**Corporation tax:** There is a small companies' rate of corporation tax (of 22%), which is paid on all profits below £300,000 per year.

**Dividend tax:** Dividend income is taxed at a rate of 10% up to the higher rate threshold for income tax and at 32.5% above this threshold. However, this is offset by a dividend tax credit – to reduce the distortion arising from the double taxation of dividends (once at the corporate level and once at the personal level) – which reduces the effective tax rates to 0% and 25% respectively.

**Calculation of tax incentives across legal forms**

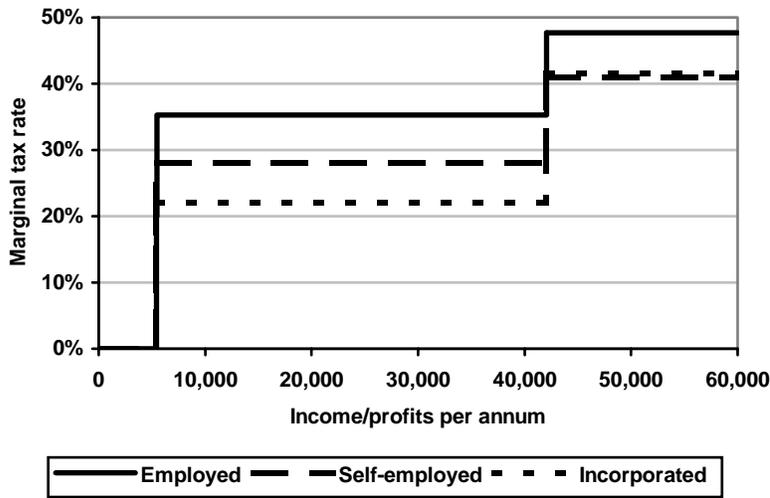
**Table III.I Tax and NICs to be paid in the UK in 2009-10, by legal form**

	£25,000 income/profits per annum			£75,000 income/profits per annum		
	Employed	Self-employed	Incorporated	Employed	Self-employed	Incorporated
Salary	£23,413.23	£25,000.00	£5,435.00	£68,351.66	£75,000.00	£5,435.00
Income tax	£3,595.65	£3,913.00		£17,846.66	£20,506.00	
<i>NICs</i>						
Class 1 employee	£1,685.83			£3,699.44		
Class 1 employer	£1,632.02			£6,695.14		
Class 2		£114.80			£114.80	
Class 4		£1,563.69			£3,256.14	
Corporation tax			£4,312.91			£15,312.91
Dividend tax						£3,054.27
<b>Total tax and NI</b>	<b>£6,913.50</b>	<b>£5,591.49</b>	<b>£4,312.91</b>	<b>£28,241.24</b>	<b>£23,876.94</b>	<b>£18,367.19</b>
Net receipts	£18,086.50	£19,408.51	£20,687.09	£46,758.76	£51,123.06	£56,632.81
<b>Total tax and NI as a % of gross income/profits</b>	<b>27.7%</b>	<b>22.4%</b>	<b>17.3%</b>	<b>37.7%</b>	<b>31.8%</b>	<b>24.5%</b>
<b>Increase in net receipts compared to employed</b>		<b>£1,322.01</b>	<b>£2,600.58</b>		<b>£4,364.30</b>	<b>£9,874.05</b>

Notes to Table III.I:

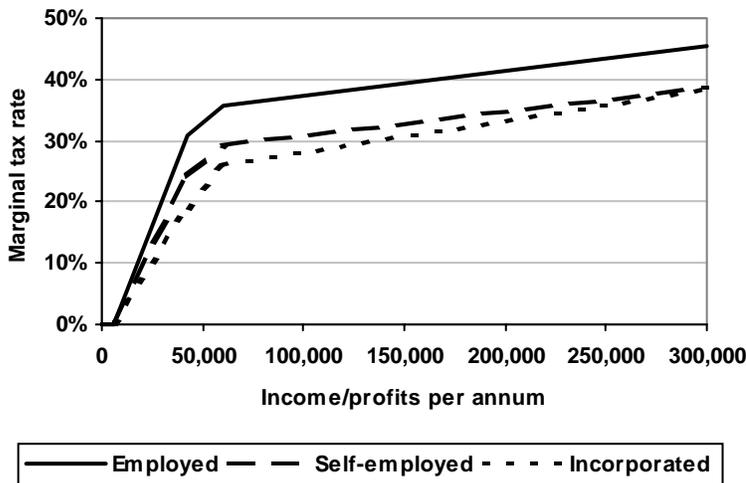
- 1) All rates and allowances are in 2008-09 terms. The higher rate income tax threshold is due to increase more than in line with inflation in 2009-10: this rise has been taken into account, but the new figure used remains in 2008-09 prices (i.e. the new 2009-10 threshold has been deflated).
- 2) The 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). We use “contracted out” NICs rates in these calculations – with the employers’ rate being the one relevant to salary-related pension schemes. This gives a better comparison than the “contracted in” rate which carries an entitlement to S2P. Other entitlement differences are smaller.
- 3) It is assumed that the incorporated individual pays themselves 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 must be paid.

**Figure III.I 2009-10 marginal tax rates, by legal form**



See Notes to Table III.I.

**Figure III.II 2009-10 average tax rates, by legal form**



See Notes to Table III.I.

**1996-97 to 2009-10**

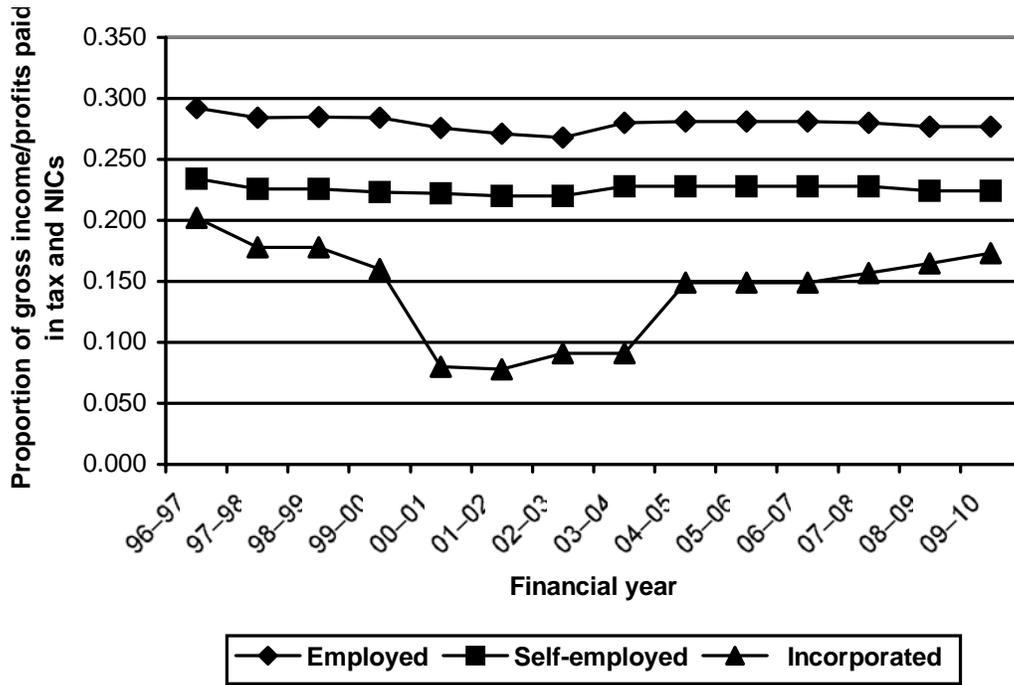
Table III.II illustrates how the proportion of gross income/profits paid out in tax and NICs paid by an employed, a self-employed and an incorporated individual whose business makes either £25,000 or £75,000 per year has changed over time in the UK. Figure III.III illustrates the same figures graphically for a business making £25,000 gross income/profits per year.

**Table III.II Total tax and NICs to be paid in the UK over time, by legal form**

	£25,000 profits per annum			£75,000 profits per annum		
	Employed	Self-employed	Incorporated	Employed	Self-employed	Incorporated
1996-97	29.2%	23.4%	20.2%	37.1%	31.6%	26.6%
1997-98	28.4%	22.6%	17.8%	36.5%	31.1%	24.3%
1998-99	28.5%	22.6%	17.8%	36.6%	31.1%	24.3%
1999-00	28.4%	22.3%	16.0%	37.2%	31.0%	23.4%
2000-01	27.6%	22.2%	8.0%	36.9%	31.1%	23.3%
2001-02	27.1%	22.0%	7.8%	36.8%	31.1%	23.3%
2002-03	26.8%	22.0%	9.1%	36.6%	31.1%	23.2%
2003-04	28.0%	22.8%	9.1%	37.9%	32.0%	23.2%
2004-05	28.1%	22.8%	14.9%	38.0%	32.1%	21.4%
2005-06	28.1%	22.8%	14.9%	37.9%	32.1%	21.4%
2006-07	28.1%	22.8%	14.9%	37.9%	32.1%	22.6%
2007-08	28.0%	22.8%	15.7%	37.9%	32.1%	23.3%
2008-09	27.7%	22.4%	16.5%	37.5%	31.7%	23.8%
2009-10	27.7%	22.4%	17.3%	37.7%	31.8%	24.5%
<b>Incremental approach</b>	<b>27.7%</b>	<b>23.0%</b>	<b>20.4%</b>	<b>37.7%</b>	<b>32.4%</b>	<b>27.3%</b>

See Notes to Table III.I. We discuss the incremental approach in Appendix IV below.

**Figure III.III** Total tax and NICs as a percentage of gross income/profits for a business making £25,000 p.a. in the UK over time, by legal form



See Notes to Table III.I.

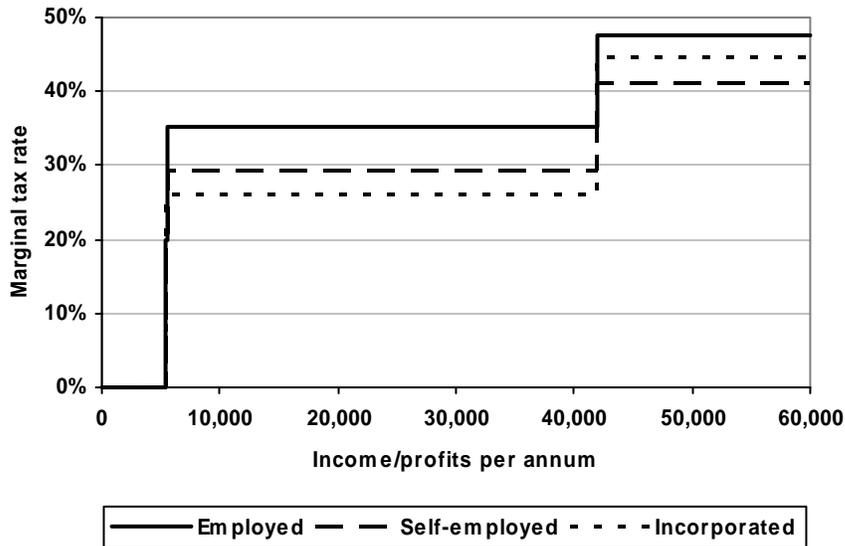
## Appendix IV Proposed incremental approach

We take the 2009-10 tax system (described in Appendix III above) as our base, and make the following changes:

**National Insurance:** Class 2 and Class 4 contributions are essentially abolished, with self-employed individuals now charged Class 1 employee contributions.

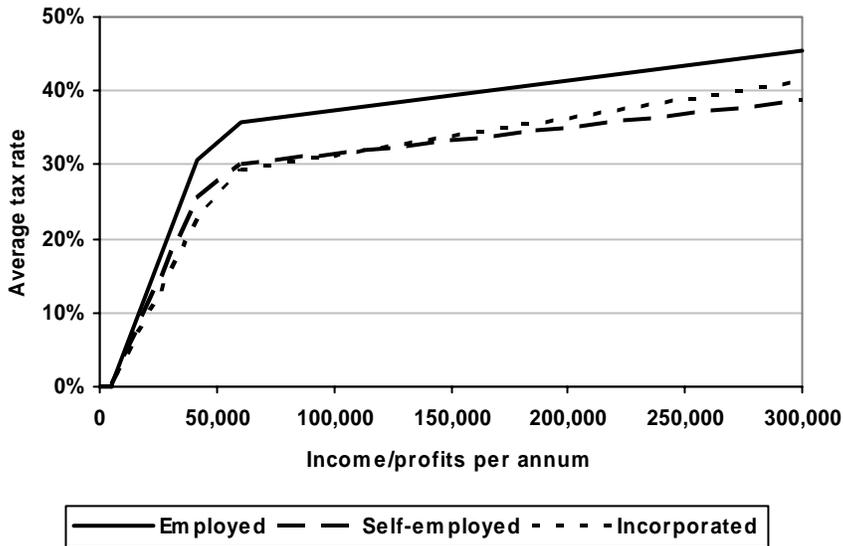
**Corporation tax:** A single rate of corporation tax is imposed at a rate of 26%.

**Figure IV.1 Marginal tax rates under incremental approach, by legal form**



See Notes to Table III.1.

**Figure IV.2 Average tax rates under incremental approach, by legal form**



See Notes to Table III.I.

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