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Small Business Taxation: U.K. issues—A Case Study on Tax and Organizational Form

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Introduction

- Lawyer
- Wrote Mirrlees chapter with economist
- Have previously undertaken empirical research on organizational form of small business
- Focus here on tax distortions that can result from different organizational forms and the difficulties of achieving tax neutrality
- Most of the chapter very much in line with Mr. Keen’s presentation

Significance of Small Business Taxation

- Small Business Taxation—
  - Cannot be ignored in corporate tax design
  - Or as part of personal tax design
  - And interface between them must receive attention in tax system design.
- Mirrlees' small business chapter deals with structural issues, plus use of the tax system for special small business measures
- Concludes that special measures should be used only to counteract market failure or to deal with special administrative burdens on small business
- Seeks to align tax on unincorporated and incorporated firms

Definitional Problems

- Reference to ‘small business’ popular amongst politicians, but…
- Definition depends on the question
- Focus here on structural issues
  - i.e. Are ownership and management separated?
  - Is income from labor from capital?
- Incorporation identified with separation, but not a necessary condition or a result of incorporation—hence, disguised labor income

Legal Form

- Spectrum from employee through self-employed to incorporated
- Straightforward alignment not so simple—real features of the legal forms
- But differences in treatment create incentives to distort behavior and lack of equity
- Incentive to be self-employed rather than employee (mostly due to social security)

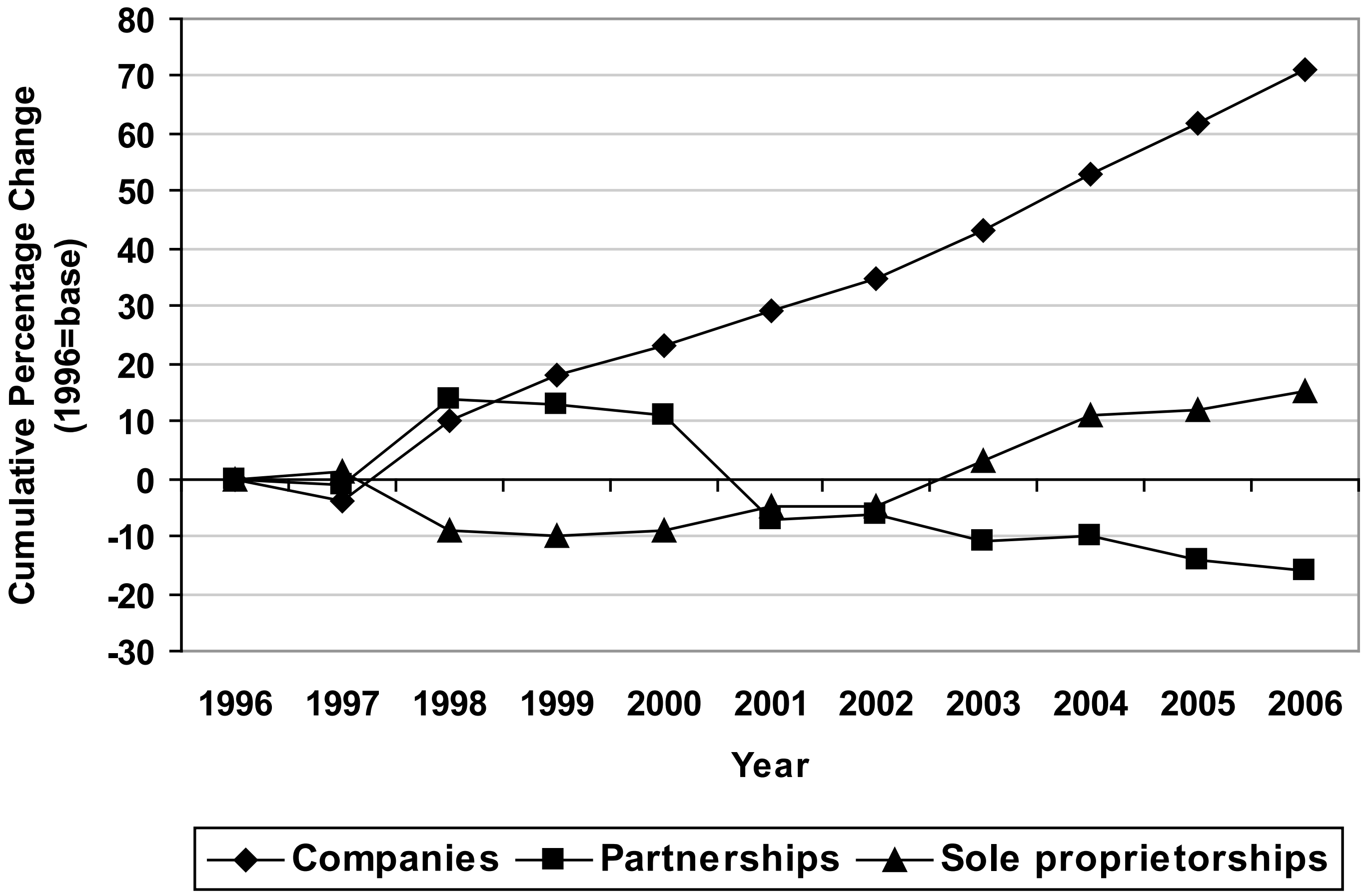
Differential Rates

- Where corporate tax rates are reducing below income tax rates—incentive to incorporate to shelter income
- Especially if profits can be extracted by way of dividends (carrying tax credit) rather than wages to save social security contributions (as in U.K.)
- Contrast U.S. with higher CT and classical corporation tax system; many elect out of corporation tax

U.K. Case Study – Tax-driven Incorporation

- Politicians decide encouraging incorporation = encouraging growing business (based on false logic)
- Reduced rate of CT for profits between £0 and £10k. 10 percent in 2001/02, reduced to zero for the next four years, abolished in 2006/07
- At all times, small profits rate (lower than main corporation tax) on profit between £0 and £300,000 with tapering marginal relief for profits between £300,000 and £1,500,000

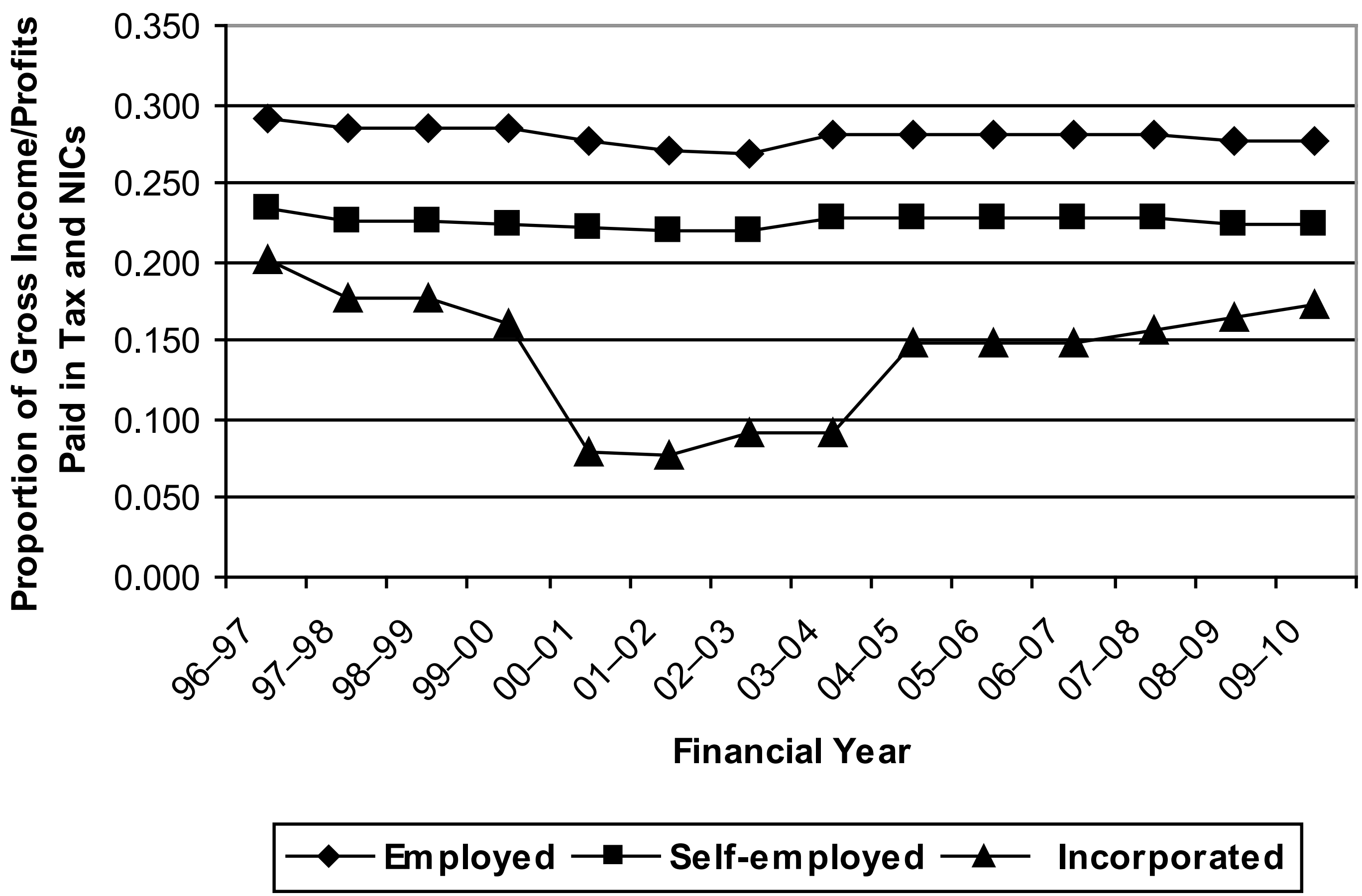
Figure 2. Cumulative Percentage Changes in the Number of Businesses in the U.K. from 1996 to 2006, by Legal Form



Note: Authors' calculations from DBERR SME Statistics, 1996 to 2006[1]

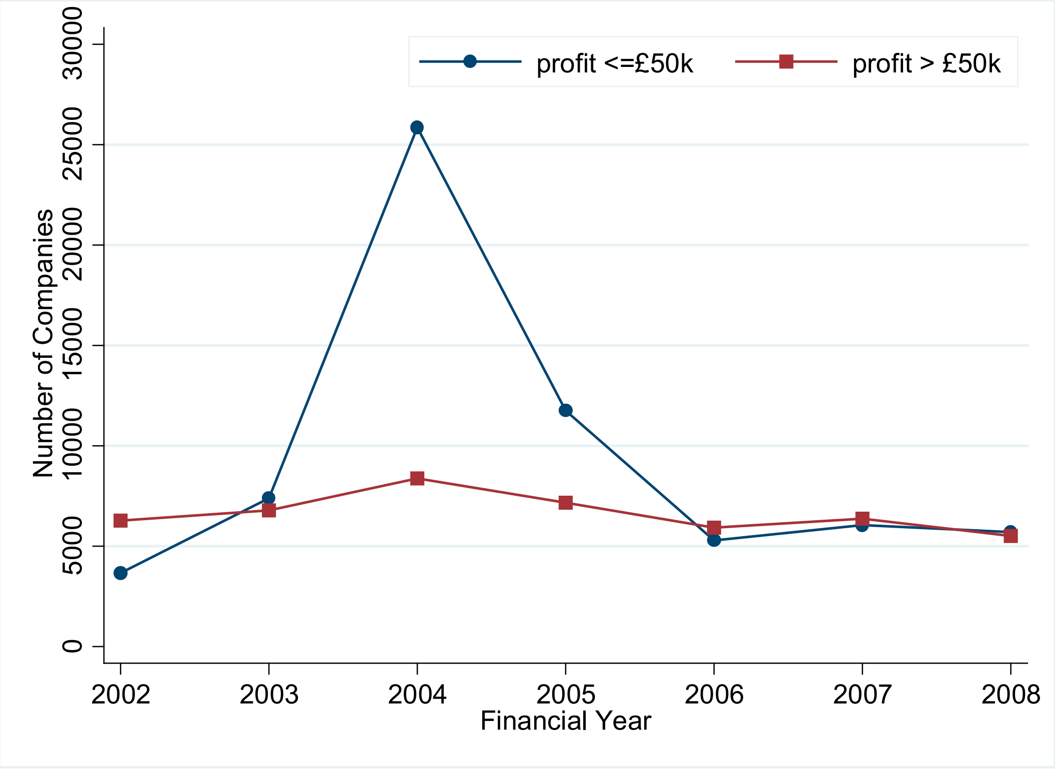
[1] Accessed via: http://stats.berr.gov.uk/ed/sme/

Figure 3. Total Tax and NICs as a Percentage of Gross Income/Profits for a Business Making £25,000 per annum in the U.K. Over Time, by Legal Form



Devereux, Liu, and Loretz (2012)

- Newly-incorporated companies by profit level



Lessons

- Size linked with legal form is an inappropriate target for special relief
- Cost with little gain
- Better to target specific activities or particular market failure- e.g., now annual investment allowance
- Reducing corporate tax rate generally (as in U.K.—to 20% in 2015) must consider impact on taxation of individuals—mechanism needed for alignment with:
  - Income tax
  - Capital gains tax
  - Social security contributions

BUT

- Arguments for lower rates of tax on income from capital than on labor—
    - Mobility
    - Administrative
- Distortion created by taxing normal rate of return from corporate sector—Allowance for Corporate Equity (ACE) or Meade's cash flow tax

Mirrlees' Alternative

- Exempt normal rate of return at corporate level through ACE
- At shareholder level through Rate of Return Allowance (RRA)
- Tax above normal returns to capital and labor income at the same rate (including social security)—progressive if desired for domestic shareholders
- One-person companies with no investment (for example) should thus be taxed at the same rate as employees with no need for arbitrary definitions

Difficulties

- What is capital base for purposes of RRA and ACE?
- Open to manipulation
- Narrows tax base, so high rate of tax on remaining base is necessary
- Will not compensate for perceived risks of self-employed (but does not try to)
- Reduces, but does not solve income splitting

A Note on Thresholds and Special Income Tax Treatment—e.g.,

- U.K. to introduce cash accounting with limited interest deduction for unincorporated firms with turnover up to VAT threshold
- Limitation on deduction of interest not logical, since annual investment allowance permits all small firms 100% deduction for plant and machinery, anyway, with no limit on interest deduction

Concerns with Cash Accounting

- Encouragement of manipulation?
- Removal of requirement to make up accruals accounts may not assist business
- Barrier to growth?
- Is it a simplification? Pages of anti-avoidance provisions, transition from one regime to the other, etc.
- Different considerations in different types of economy?