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]
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

![Graph showing the number of newly-incorporated companies by profit level from 2002 to 2008. The x-axis represents the financial year, and the y-axis represents the number of companies. The graph has two lines: one for companies with profit £50k and another for companies with profit > £50k. The line for profit £50k shows a peak in 2004, while the line for profit > £50k remains relatively flat throughout the years.]
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?