Small companies, the self-employed and the tax system

a discussion paper

December 2004

HM TREASURY

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The Licensing Division
HMSO
St Clements House
2-16 Colegate
Norwich
NR3 1BQ
Fax: 01603 723000
E-mail: licensing@cabinet-office.x.gsi.gov.uk

HM Treasury contacts

This document can be accessed from the Treasury Internet site at:
www.hm-treasury.gov.uk

For further information on the Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: ceu.enquiries@hm-treasury.gov.uk

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1 INTRODUCTION

1.1 Globalisation and the growth of the knowledge-driven economy has led to increasing numbers of new businesses and growing flexibility in the nature of contractual arrangements in the UK. Around 500 new businesses are being created every day, and the number of small businesses in the UK is showing the fastest rate of growth since 1995.[1] The pace of new business start-ups appears to be accelerating and traditional relationships are changing. This is contributing to increased diversity in the small business sector.

1.2 The Government is keen to encourage the growth of small businesses, and since 1997 has taken steps to create the conditions to make the UK the best place in the world to start and grow a business. The Government believes that small businesses can play a pivotal role in its productivity agenda by building an enterprise economy. The Government also believes that small businesses can make a significant contribution towards delivering sustainable regeneration and higher living standards in the UK's disadvantaged communities.

1.3 Budget 2004 therefore set out the Government's determination to continue with a forward programme of targeted tax incentives, in support of its objectives for growth, enterprise and productivity. Furthermore, the creation of HM Revenue & Customs, from the integration of the Inland Revenue and HM Customs & Excise, will provide an opportunity to improve the coherence of the treatment of businesses.

1.4 Businesses can be operated through a number of legal structures in the UK. Small businesses tend to be structured as sole traders, partnerships or limited companies. The most appropriate legal structure for a business will be determined according to a wide range of commercial factors and should reflect the specific nature and characteristics of the business. The Government is keen to ensure that people who choose to set up in business have the flexibility to adopt the structure that will best suit their commercial requirements, quickly and efficiently.

1.5 Tax policy makers need to understand the impact of recent developments such as the growth of the knowledge-driven economy. Where appropriate, the tax system needs to respond to accommodate the increased diversity generated by changes at the small business level.

1.6 Both the personal[2] and corporation tax regimes are relevant to small businesses, depending on their legal structure. The interaction of these tax regimes as they apply to business income can have an impact on behaviour at the small business level. Most businesses also collect and pay value added tax (VAT), but this is not dependent on the legal structure adopted by the business. Adopting a company form offers certain commercial benefits, such as increased flexibility in access to external finance, but there are legal and regulatory obligations attached to the company form that mean it is not appropriate for all.

[1] See Small Business Service's statistics at http://www.sbs.gov.uk

[2] References to the personal tax regime in this document can be taken to include tax, tax credits and national insurance contributions, unless otherwise stated.

1.7 Legal structure can also have an impact on the administration and compliance obligations that are placed on businesses by the tax system. The structure of the corporation tax system, which applies from the smallest companies to major multinationals, offers benefits of consistency, yet it may have a disproportionate compliance impact on small, relatively straightforward incorporated businesses. The decision on whether to operate a business through a company will depend on a number of commercial factors and the perceived benefits, and this should not be influenced by underlying tensions in the tax system. The Government believes that the choice of legal form that a small business takes should reflect commercial rather than tax considerations.

1.8 While the Government is keen to ensure flexibility in access to the different commercial structures, it is critical that all who benefit from public services pay their fair share of tax. In Budget 2004, the Government expressed its concerns about the increasing numbers of self-employed individuals adopting the corporate legal form for tax reasons rather than as a step to growth, often as a result of marketed tax-avoidance schemes. The Chancellor therefore introduced a 19 per cent minimum rate of corporation tax where profits are distributed to individuals by way of dividends, in order to target low tax rates more accurately towards those small businesses that reinvest their profits for growth. The Government will continue to monitor this area to ensure that its objectives for the tax system continue to be met.

1.9 The purpose of this paper is to open up a discussion on the strategic issues raised by these recent developments that affect small businesses. The paper sets out the background that will inform Government thinking on the appropriate mechanisms for supporting growth, enterprise and productivity objectives, and on the targeting of incentives to ensure that commercial factors, and not tax considerations, determine the legal structures that are adopted by businesses.

1.10 The paper sets out the small business context, in terms of:

- the Government's economic objectives;
- the diversity of small businesses in the UK and the commercial environment they operate in; and
- the range of legal structures that small businesses adopt.

1.11 The paper then sets out the taxation regime for business income and gains – covering some of the issues raised by the interaction of the personal and corporation tax regimes and the tax requirements that businesses must comply with.

1.12 The creation of HM Revenue and Customs presents an opportunity to look at the way small businesses interact with the tax system more strategically. The Government believes that this paper provides the starting point for discussion with interested parties, focusing particularly on the strategic issues raised by the approach in the tax system towards self-employment and the remuneration of owner-managers of small incorporated and unincorporated businesses.

2 SMALL BUSINESS IN THE UK

The small business sector has grown significantly over recent years and today makes an important contribution to all sectors of the UK economy. The first part of this chapter discusses the pivotal role that small businesses play in delivering the Government's agendas on productivity and fairness in society. The second part considers changes in the size and diversity of the small business sector in response to recent developments in the business environment.

GOVERNMENT OBJECTIVES FOR THE SMALL BUSINESS SECTOR

2.1 The Government's economic objective is to raise the rate of sustainable growth and achieve rising prosperity and a better quality of life for all. Increasing the productivity of the economy and expanding economic and employment opportunities are central to achieving this objective.

2.2 Small businesses[1] make a significant contribution to all sectors of the UK economy both in terms of output and employment. At the start of 2003, small businesses employed 10 million people and they generated £0.86 trillion in turnover in 2003.[2] This represented 46.2 per cent and 38.3 per cent of total UK private sector employment and turnover respectively.

2.3 The Government's strategy to promote productivity growth comprises two key elements:

- locking in the platform of ***economic stability*** which has been established under the macroeconomic framework, and which is particularly important for small businesses; and
- putting in place a series of ***microeconomic reforms*** based around the five key 'drivers' of productivity growth: competition, enterprise, innovation, human capital (skills) and physical capital (investment).

2.4 *Enterprise Britain*, published by the Government in November 2002, set out the Government's vision for building a sustainable enterprise economy, fit for the challenges of the 21st century. Small businesses can play a pivotal role in achieving that vision.

Enterprise and competition

2.5 Small businesses underpin a competitive and productive economy. Competition provides a clear incentive for firms to innovate and to improve their efficiency. Since small businesses, particularly those with growth ambitions, can present a strong competitive challenge to incumbent firms, they can provide a stimulus to productivity growth.

[1] Throughout this paper we use the Small Business Service (SBS) definition of small businesses. The SBS defines a small business as an enterprise employing fewer than 50 people. The EU definition is much narrower. The EU defines a small business as an enterprise employing fewer than 50 people with an annual turnover and/or annual balance sheet not exceeding €10 million (approximately £6.5 million).

[2] See Small Business Service's statistics at http://www.sbs.gov.uk (the turnover figures do not include the financial intermediation sector).

Innovation **2.6** Although not all small businesses have the ambition to grow, evidence suggests that small businesses can play a key role in diffusing new ideas and technologies as they operate in 'innovation networks', providing specialist equipment and services to boost the innovative potential of larger firms. The economic benefits of innovative activities among small businesses are amplified when larger businesses replicate or incorporate the ideas and technologies into other products, processes and services.[3]

Strengthening communities **2.7** Successful small businesses also form part of the bedrock of local communities, contributing to economic prosperity and social cohesion. They can provide a significant contribution towards delivering sustainable regeneration and higher living standards in the UK's disadvantaged communities. Participation in enterprise also allows individuals to gain transferable new skills and experience that enhance their prospects for subsequent employment.

THE VARIETY OF SMALL BUSINESSES IN THE UK

Diversity of small businesses **2.8** More people are thinking about starting up their own business today than in 2002.[4] The individuals who set up and run small businesses are an extremely diverse group. They will normally be motivated to be in business to make money, but they can also be influenced by any number of a variety of factors, including:

- the prospect of more freedom at work;
- sustaining a going concern (often a family business);
- the potential rewards of high growth;
- making a contribution to the local community; and
- the challenge of putting ideas into practice.

2.9 The number of small businesses in the UK has grown over recent years. In 1997, there were nearly 3.7 million small businesses and this had increased by about 8 per cent to nearly 4 million by 2003.[5] The UK has the shortest start-up period for businesses of all the major EU countries – it generally takes one working day to set up an individual enterprise in the UK and seven for a private limited company.[6]

[3] See Acs, Z., Morck, R. and Yeung, B. (1999) "Productivity growth and firms size distribution" in Acs, Z., Carlsson, B. and Karlsson, C. (eds) "Entrepreneurship, small and medium sized enterprises and the macroeconomy" and Tether, B. (1999) Briefing Paper No 2: Small firms, innovation and employment creation in Britain and Europe, *Manchester Centre for Research on Innovation and Competition .*

[4] According to Global Entrepreneurship Monitor data, for 2003, 8 per cent of people were considering starting up in business over the next three years compared with 6.2 per cent in 2002.

[5] See Small Business Service's statistics at http://www.sbs.gov.uk

[6] See "Benchmarking the Administration of Business Start-Ups." Final report by the European Commission, January 2002. The study defines an individual enterprise as one in which "the owner has sole personal responsibility for all business liabilities. Moreover, liability is unlimited and extends to private assets." Details are at: http://europa.eu.int/comm/enterprise/entrepreneurship/support_measures/start-ups/bench_admin_business_start-up_final_2002.pdf

2.10 Much of the growth in small businesses can be attributed to an increase in the number of micro businesses.[7] Between 1997 and 2003, the number of micro businesses grew from 3.5 million to 3.8 million, representing a rise of around 9 per cent. According to the Small Business Service, at the start of 2003, micro businesses employed 6.8 million people and they generated £0.5 trillion in turnover in 2003, representing 31.5 per cent and 23.5 per cent of total UK private sector employment and turnover respectively.

Dynamic environment

2.11 In addition to the diverse composition and motivations of the small business population, the environment in which small businesses operate is dynamic, which in turn generates greater diversity. Businesses rarely operate in a static environment, and businesses of all kinds often develop through a number of different stages – the business 'life cycle'.

Business life cycle

2.12 Small businesses face different challenges and have different requirements as they develop and change over time. The life cycle of a business can be broken down into four distinct stages: start-up, early years, growth and exit.

2.13 Start-up refers to the creation of a business. This is a time when the owner is looking to raise the initial finance to establish the business. The legal form of the business will, to a large extent, be governed by the motives of the owner. Individuals aspiring to run a family business may prefer to do so as a sole trader or as a partnership, while those seeking to reap the potential rewards from high growth may decide that a small company is the most appropriate legal form.

2.14 In the early years, it is possible that the business may make a loss. This may be because it has yet to establish a presence in the market and generate the necessary cash flow to service its debt obligations.

2.15 Assuming that the business survives these first challenging years, it may reach a time when the owner aspires to expand the business. It is at this point that sole traders and partnerships may decide to incorporate their businesses in order to take advantage of the commercial benefits, such as risk management and increased flexibility to raise external finance, that help companies invest and grow.

2.16 After a period of time, the owner of the business may decide to exit from the business. This may be because the owner is looking to retire or because he or she wishes to use the funds for another venture. In such cases, it does not necessarily follow that the business is wound up. It may continue either through the transfer of ownership to another family member, or by the sale of the business to a third party.

Recent developments

2.17 The Government actively encourages diverse forms of employment, including self-employment, in support of a flexible labour market and an enterprising economy. Flexible work patterns have contributed to a changing labour market and business environment, including a growth in the number of small businesses that are managed by their owners. These recent developments have increased the size and diversity of the small business population, and will have had an impact on the dynamic environment in which small businesses operate.

[7] Throughout this paper we use the Small Business Service (SBS) definition of micro businesses – an enterprise employing fewer than 10 people. This definition includes enterprises with no employees. The EU definition is again much narrower. The EU defines a micro business as an enterprise employing fewer than 10 people with an annual turnover and/or annual balance sheet not exceeding €2 million (approximately £1.3million).

3 Legal Structures

This chapter sets out the commercial characteristics of the three legal structures that are generally adopted by small businesses, and explores the respective bases for tax treatment. It concludes by considering the factors that underpin the adoption of a legal structure by a business.

3.1 Entrepreneurs can structure their business affairs according to their own requirements and the particular circumstances of their business. The forms of legal structure that are most commonly adopted by small businesses are:

- sole trader;
- partnership; and
- limited company.

3.2 At the start of 2003, there were nearly 4 million small businesses in the UK private sector. This comprised some 2.5 million sole traders, 536,000 partnerships and 931,000 companies.[1] Most of these were micro businesses (3.8 million).

3.3 Many owners of small companies are both shareholders and actively involved in the management of the business as a director or employee of the company (owner-managers).

UNINCORPORATED BUSINESSES

Sole trader

3.4 Where a small business is owned and run by one individual, the simplest way to structure the business will often be to operate as a sole trader.

Commercial considerations

3.5 A sole trader has direct control over the running of the business. There is no legal division between the assets of the business and the individual, so the owner has direct access to any funds held in the business. However, there is also no legal division between the liabilities of the business and the individual, so the owner of the business retains unlimited liability (e.g. for any debts incurred by the business).

3.6 Sole traders generally finance their businesses through a mixture of debt finance (often bank debt secured on personal assets, such as the owner's home), and direct injections of personal funds into the business. There is no structured mechanism for raising external 'equity' finance (where the investor can participate in the profits of the business).

3.7 The sole trader form can be commercially unattractive for some businesses, such as those that need to make substantial capital investments, in particular where investment is funded from external sources. On the other hand, lower levels of regulation apply to sole traders because they are wholly accountable for all the debts of the business (i.e. they retain unlimited liability). The sole trader form is therefore commercially attractive for low risk or low growth businesses where limitation of liability and raising external finance are not significant considerations.

[1] See Small Business Service's statistics at http://www.sbs.gov.uk (figures for companies include public corporations and nationalised bodies).

Basis for taxation

3.8 Sole traders have direct access to funds kept in their business and are directly affected by any business losses. The tax treatment follows the status of the sole trader and therefore seeks to tax the profits of the business as income of the individual, and to give tax relief to the individual for any losses incurred by the business. The owner is therefore taxed on all profits irrespective of whether they are drawn out of the business by the owner. Sole traders pay flat rate Class 2 national insurance contributions (NICs) (currently £2.05 per week) and Class 4 NICs at 8 per cent on profits between £4,745 and £31,720 per year and at 1 per cent on profits above £31,720. The rate of Class 2 NICs was reduced and the rate of Class 4 NICs increased from 6 April 2000, to reduce the NICs cost for small businesses with low profits.

Partnership

3.9 Partnerships offer a mechanism for bringing more than one individual together to invest and participate in the business. Partnerships can be highly complex structures, involving corporate as well as individual partners and, since 2001, include limited liability partnerships.[2] Nonetheless, the majority of small partnerships are structured as partnerships of individuals, where all the partners have unlimited liability.

Commercial considerations

3.10 The partners share the risks, costs and responsibilities of being in the business. They are entitled to a share of the profits and gains of the business, and are allocated a share of any losses of the business, on the basis of a partnership agreement. In most cases, each partner will be involved in the management of the business and personally responsible for the debts of the business, with unlimited liability in the case of business failure. As with a sole trader, external borrowing will be the personal liability of the partners and will often be secured on their personal assets.

3.11 Aside from the ability to bring more than one individual together to invest and participate in the business, small business partnerships tend to have commercial implications that are similar to those that apply to the sole trader form.

Basis for taxation

3.12 Partnerships are ‘tax transparent’. This means that the tax treatment looks through the partnership itself, to the underlying allocation of profits, gains and losses between the various partners. No tax is levied on the profits or gains at the partnership level, and instead the partners are subject to tax, or entitled to relief, on their shares of profits, gains and losses as set out under the partnership agreement. The NICs arrangements are similar to those applied to sole traders.

COMPANIES

3.13 For some businesses, a limited liability company will be the most appropriate commercial vehicle.

Commercial considerations

3.14 A company is a legal entity with the ability to enter into contracts, to earn income and incur liabilities, and to own assets in its own name. There is a legal separation between the company and the owner(s) of the company. The owners will be shareholders, who may also be directors or employees of the company depending on the nature of their involvement in the business.

[2] The Limited Liability Partnership Act 2000 (LLP Act) introduced this new corporate business entity to Great Britain and took effect from 6 April 2001. It applies in England, Scotland and Wales but not Northern Ireland. LLPs have been developed to combine the organisational flexibility of partnerships with the benefit of limited liability for their members. In commercial law LLPs are regarded as ‘bodies corporate’ with legal personality separate from their members and are subject to aspects of company law. For example, the LLP is technically a corporate vehicle and has to file accounts and disclose certain financial information, but it is taxed as a partnership.

3.15 Adopting the company form can improve access to external risk finance. Equity finance in particular is only available in a company structure which provides a mechanism for raising share capital. Where external parties invest in share capital they have a claim to the profits and gains of the business by receiving dividends and they can also realise their share of any capital growth by selling their shares on to another party. Share capital allows investors to participate in the profits and capital growth of the business, without necessarily playing a role in the running of the business.

3.16 The limited liability afforded by the company form means that the shareholders' liability is restricted to their share capital, and they are not otherwise liable for the debts of the company in the event of business failure. However, directors of small companies, or businesses that are at an early stage of the business life cycle, will often be required by lenders to provide personal guarantees. As such, the distinction between the business and the owners/directors is seldom straightforward, and the benefit of limited liability can be diluted in practice.[3] Similarly, investors may associate business reputation with the personal standing of the owner-managers of small companies.

3.17 The advantage of limited liability status does bring with it certain obligations under company law. These obligations include corporate governance requirements, reporting requirements, legal parameters for the management of the business (such as arranging annual general meetings) and conditions on the extraction of profits from the business. These obligations are there to protect external investors, such as creditors (e.g. debt providers, trade suppliers) and shareholders who have no role in the day-to-day running of the business.

Basis for taxation

3.18 The fact that companies are separate legal entities is reflected in the tax treatment. The company is subject to corporation tax on any profits, and receives tax relief for losses at the company level. Shareholders are only taxed on income that is distributed to them by the company (usually in the form of dividends) as compared with the position for a sole trader, who is taxed on all profits whether or not they have been drawn out of the business. The potential for 'double taxation' is offset by the reduced net rate of tax applicable to dividends (after non-payable tax credits), reflecting the fact that tax has already been levied at the company level on the underlying profits.

3.19 Shareholders who are also directors of the company often have contracts of employment and are paid a salary by the company for the services they provide to the business. The normal rules of the personal tax regime apply to this type of income.

ADOPTING THE APPROPRIATE LEGAL FORM

3.20 Adopting an appropriate legal form is important for a business as it sets the structure within which the owners run their business. Each of the three legal structures that tend to be used by small businesses will be more (or less) appropriate depending on the specific circumstances and different characteristics of the businesses.

Change over the business life cycle

3.21 Businesses often make use of different legal structures at different times as they develop over the business life cycle. In practice, small firms may progress through more than one of these structures as they are set up and grow, for example by developing from a one-person concern into a company with several shareholders and employees. Each

[3] For more details of what the Government is doing to help small firms raise risk capital, see *Bridging the finance gap: next steps in improving access to growth capital for small businesses*, HM Treasury & SBS, December 2003. For debt finance, the Government has announced an implementation framework for the final report of the *Graham review of Small Firms Loan Guarantee: Recommendations*, October 2004.

of the different forms brings with it benefits and obligations and, as set out above, getting the structure right is an important consideration for anyone who is planning to set up their own business.

Flexibility

3.22 The Government encourages flexibility in the choice of legal form so that businesses can adopt the structure that is commercially appropriate and conducive to growth. Transition to the company form can be an important step in the development of a business, and can assist small businesses in realising their growth potential by providing flexibility in access to external finance, improving governance and managing risk.

Easing the path to incorporation

3.23 The Government is keen to ensure that the process of incorporation does not present a barrier, which discourages businesses that would otherwise benefit commercially by adopting a company structure. To this end, the Government has introduced a range of measures to simplify the process of setting up and running a company, e.g. online registration of new companies at a reduced fee and the increased threshold for an independent audit of the accounts at a turnover level of £5.6 million.

3.24 Balanced against this there are legal and regulatory obligations and practical considerations associated with each particular organisational structure. This means that an incorporated form is not appropriate for all.

Accessing funds

3.25 Owners of small businesses will have different options for accessing funds from their businesses, depending on the legal structure adopted by the business. Owners of unincorporated businesses have more flexibility to access funds held in their business than owners of incorporated businesses. Limited liability comes with certain obligations, which restrict the ability of owner-managers to make personal use of company funds, as a safeguard to protect the interests of external creditors and other investors. This can come as a surprise where an owner-manager has taken the decision to incorporate his or her business, but is the necessary effect of adopting a legal structure that has been designed to provide protection for external investors.

Tax-motivated incorporation

3.26 Evidence suggests that there is a range of factors that underpin any decision to incorporate a business.[4] The Government believes that the choice of legal form that a small business takes should reflect commercial rather than tax considerations. In Budget 2004, the Government expressed its concerns about the increasing numbers of self-employed individuals adopting the corporate legal form for tax reasons rather than as a step to growth, often as a result of marketed tax-avoidance schemes. The Chancellor therefore introduced a 19 per cent minimum rate of corporation tax where profits are distributed to individuals by way of dividends, in order to target low tax rates more accurately towards those small businesses that reinvest their profits for growth. The Government will continue to monitor this area to ensure that its objectives for the tax system continue to be met.

3.27 This discussion will help inform the Government's thinking on how tax incentives can be targeted to ensure that normal commercial decision-making is not influenced unduly by tax considerations and that businesses adopt legal structures that are appropriate to their commercial requirements.

[4] For example see Freeman, J. and Godwin, M. (1992), "Legal form, Tax and the Micro Business", in Caly, Chittenden, Chell and Mason (eds), "Small Enterprise: Policy and Practice in Action", Publishing Ltd 1992. In their study, 83 per cent of unincorporated businesses cited personal control as an important reason for not incorporating. Simplicity was identified as an important reason by more than 50 per cent of unincorporated businesses while tax and social security reasons were highlighted by 39 per cent. For companies, 64 per cent identified limited liability as an important reason for incorporating with 50 per cent citing the prestige/credibility of corporate status. Only 39 per cent of companies highlighted tax and social security reasons.

4 TAX TREATMENT OF BUSINESS INCOME

This chapter outlines the current tax treatment of small businesses. Using practical examples, the chapter illustrates interactions between the personal and corporation tax regimes at the small business level.

THE TAXATION FRAMEWORK

4.1 The personal and corporation tax regimes are relevant for the taxation of income and gains arising from businesses. The way that income and gains are taxed depends on the legal form adopted by the business and, in some circumstances, the nature of the reward that is taken by the owner(s) of the business. Most businesses also collect and pay VAT on the supplies of goods and services that they provide. However, the way that VAT is charged and paid does not depend on the legal form adopted by a business and it is not therefore considered further in this chapter.

Personal income

4.2 Personal income is subject to income tax and, where appropriate, NICs based on the nature of the commercial or contractual relationship that gives rise to the income. NICs are paid on income from employment and self-employment and build entitlement to certain social security benefits, in particular state pensions.

4.3 Where income from a business is directly attributable to an individual (e.g. profits arising to a sole trader or allocated to a partner in a partnership), income tax and, as appropriate, NICs are charged on that income, and income tax relief is allowed for losses against other taxable income of that individual.

4.4 This is consistent with the underlying relationship between the individual and the business – the individual has access to any profits and gains that they are entitled to, and the tax system therefore taxes the individual on those entitlements.

Company income

4.5 A business that is operated through a limited company has separate legal status from the individuals that own it. Owners of limited companies are not entitled to immediate access to any funds held in the company, but the company can control the form, amount and timing of any payments to the owners. The company can opt to pay owners a salary (if they are directors or employees) or distribute profits to the owners as dividends (if they are shareholders). When any profits are extracted by way of dividend payments or any other means the company must conform to company law requirements that serve to protect creditors.

4.6 The tax system follows the underlying relationship between the individual and the business. The profits and gains generated by the business are not taxed as personal income of the business owner, as the owner is not directly entitled to them, nor is the owner entitled to any loss relief against other taxable income as the owner is not directly affected by losses arising in the company.

4.7 The company itself is instead taxed on the profits and gains, reflecting the separate legal identity of the business. When profits are extracted by way of a dividend payment, the amounts are also taxed as the personal income of the individual. Through the lower net rate of tax on dividend income (after non-payable tax credits), the tax system reflects the fact that any taxation on a small company creates the potential for 'double taxation' (i.e. tax levied at the company and the individual level on the same underlying profits and gains).

4.8 The tax treatment of dividends, whether received by an individual who effectively controls the company and works for it as a director, or by unconnected shareholders, reflects the assumption that the dividends are a return on the shareholder's investment in the company (as distinct from earnings which are a reward for labour).

INTERACTIONS IN THE TAXATION OF SMALL BUSINESS INCOME

Differences in tax treatment

4.9 The differing treatment of companies and individuals reflects the fact that the tax system in the UK does not seek to tax "businesses" as such, but only those legal persons (individuals and companies) who are capable of earning income and owning assets. The tax system does not therefore require dividends to be apportioned between different forms of underlying investment. No NICs are payable on dividends, and shareholders are not entitled to employment rights or contributory benefits as a result of receiving dividends. Business income is therefore subject to a mixture of requirements under the personal and corporation tax regimes dependent on the circumstances of the business and its owners.

4.10 Although the tax treatments of personal income and company income are consistent with the underlying relationships between businesses and individuals, a range of different interactions can arise between the taxes at the small business level which can give rise, in some cases, to apparent anomalies. The interactions between the taxes can also have an impact on behaviour – as has been seen in the trend in tax-motivated incorporation. Yet the tax effect of the various legal structures is not as straightforward as common perceptions may suggest. The tax treatment under each legal structure will vary depending on the circumstances of the business.

Administration & compliance

4.11 In addition to differences in the way tax is calculated, the legal form that is adopted by a business will also have an impact on the administrative and compliance obligations that apply to the business.

4.12 Owners of unincorporated businesses are required to self-assess their income from the business on their personal tax return. The Inland Revenue accepts reduced tax calculations from self-employed persons with profits under £15,000 a year – the 'three-line-account'. Where businesses are incorporated, the company is required to self-assess profits on a corporation tax return separately from the returns prepared by its shareholders. The directors, employees and shareholders will also have to complete their own tax returns in the normal way. This is a necessary effect of the legal separation of the company as a distinct taxpaying entity and is one of the responsibilities that goes with company form.

4.13 The Government is keen to encourage flexibility in the choice of structure for small businesses. However, it is important to note that small businesses that incorporate are effectively opting in to a legal form where the benefits of incorporation – limited liability and the ability to raise external equity – need to be balanced with the obligations that are necessary to protect the creditors of the company above other capital providers. Offering a clear and fair approach to investors and creditors has made the limited liability company a popular business vehicle, while the speed and simplicity of the arrangements for forming a company in the UK is seen as one of the UK's competitive strengths. But the necessary minimum level of regulation that goes with this must apply to all companies, as a protection for external creditors to balance the limitation of liability, and this may make a limited company an unsuitable vehicle for some smaller businesses.

4.14 Similarly, although there are a number of specific features that apply a different treatment for smaller companies, there is no differentiation between small and large companies in the application of the essential features of the corporation tax regime. This regime covers all companies in the UK, from simple owner-managed entities, to FTSE100 enterprises with complex structures and transactions.

4.15 The treatment of incorporated businesses under the corporation tax system offers the benefits of consistency, familiarity and in most cases, simplicity to those, whether based in the UK or investing from overseas, who wish to use a UK company to do business. However such an approach may itself be a cause of tensions in the tax system that can have a disproportionate effect on some small businesses. For example, rules that are designed to prevent avoidance can add compliance and administrative costs to businesses. This also means that small, relatively straightforward businesses must understand and comply with rules that are also capable of being applied to more complex business structures. As a consequence these rules can affect or be perceived to affect some small businesses more than larger concerns. This must be balanced against the benefits provided by the company form where it is commercially appropriate for the business.

Impact on behaviour

4.16 The potential for the tax system to have an impact on behaviour is greatest where a small business is controlled by a small number of individuals. In these cases, the nature of the relationship between the business and its owner(s), as well as the mechanism that is used to reward the owner(s) for any work performed, can be subject to a tax bias (real or perceived). This can in turn mean that the tax system for some small businesses can carry a disproportionate influence on normal commercial decision-making.

4.17 In Budget 2004, the Government expressed its concerns about the increasing numbers of self-employed individuals adopting the corporate legal form for tax reasons rather than as a step to growth, often as a result of marketed tax-avoidance schemes. The Chancellor therefore introduced a 19 per cent minimum rate of corporation tax where profits are distributed to individuals by way of dividends, in order to target low tax rates more accurately towards those small businesses that reinvest their profits for growth. The Government will continue to monitor this area to ensure that its objectives for the tax system continue to be met. Adoption of legal form should be determined by the commercial circumstances of a business, and the Government is concerned to ensure that entrepreneurs are fully aware of the implications of adopting a specific legal structure.

4.18 The practical examples that are set out below illustrate some of the commercial and tax issues that can arise over the business life cycle. The issues raised in these examples suggest that there may be tensions between the perceived tax effects of the various legal structures and the way businesses adopt a given legal form.

PRACTICAL EXAMPLES

Setting up

4.19 As set out in Chapter 2, businesses are often loss-making during the start-up period. Box 4.1 shows the tax treatment of new, loss-making businesses under a range of commercial structures.

Box 4.1 Example of start-up businesses

Ah Chan, Becky and Charles have just set up identical one-person furniture design businesses.

Ah Chan set up his business as a self-employed sole trader. Becky has set up a company and plans to take part of her income as salary and part as dividends when the company starts to make a profit. Charles has also set up a company but plans to takes all his income as salary when the company is established.

Ah Chan

Ah Chan borrowed £100,000 from the bank when he started trading and contributed £15,000 from his own savings as the capital for the business. He made £1,500 in his first year before deducting interest of £6,000 on the loan.

As the loan is used wholly to finance the business, the interest on the loan is deductible in computing his taxable profits so Ah Chan makes a loss of £4,500. Ah Chan is able to claim that loss against other income in the current and preceding years which could be worth £1,800 to him if he is a higher rate taxpayer.

Although Ah Chan has no trading profits and so no liability to income tax or Class 4 NICs, he is still liable to Class 2 NICs of £106 although he can apply for exemption from paying Class 2 contributions as his profits are below £4,215.

Becky

Becky's company borrowed £100,000 from the bank when it started trading and issues fully paid shares to Becky for £15,000. The company makes £1,500 before deducting Becky's salary (£5,000) and employer's Class 1 NICs (£33) and the interest on the bank loan (£6,000).

The company's trading loss is £9,533. It is unable to set this loss against any income of Becky's (whether in the current or preceding years) and it must carry the loss forward to set against future profits to claim any relief.

The company is unable to pay Becky any dividend but she is taxed on her salary in the normal way and pays £28 in employee's Class 1 NICs and £26 in income tax on the £5,000.

Charles

Charles financed his company entirely using equity finance. He borrowed £100,000 from the bank and invested £115,000 in shares in the company. Since the company is a close company[1] and meets the other conditions for relief, Charles is able to obtain tax relief for the interest he pays on his loan. The company's profit is also £1,500 before Charles's salary (£18,269) and employer's Class 1 NICs (£1,731) are paid.

The company's trading loss is £18,500. It is unable to set this loss against any income of Charles's (whether in the current or previous years) and it must carry the loss forward to set against future profits to claim any relief.

The company is unable to pay Charles any dividend. Charles must pay employee's Class 1 NICs of £1,488 on £18,269 and income tax of £1,413 on £12,269 (his salary after deduction of loan interest relief of £6,000).

[1] A close company is defined under Schedule 414 of the Incomes and Corporation Taxes Act 1988 as one which is under the control of five or fewer participators, or all participators are directors.

4.20 In this example, the underlying economic activity of the three businesses is the same, but Becky and Charles have decided to incorporate - taking on the benefits, responsibilities and obligations that go with incorporation.

4.21 They are all making losses in their businesses, but only Ah Chan is able to receive the cash flow benefit of immediate relief for his losses by way of a repayment of some of the tax he paid under his previous employment. This tax treatment reflects the fact that Ah Chan, as a sole trader, is directly entitled to any profits and gains and directly affected by any losses that arise in his business. If Ah Chan were to continue in part-time employment during this early, challenging stage, the business losses could also be offset against any taxable income that Ah Chan earns under the part-time employment. As the owner of an unincorporated business, Ah Chan will also typically have greater flexibility in accessing funds held in his business to meet his costs of living during this period.

4.22 Becky and Charles's businesses are incorporated and therefore have separate legal status. They are not able to access tax relief against personal income for losses arising in their business. Any tax relief for the losses in Becky and Charles's businesses will be given at the company level as an offset against future taxable profits.

4.23 If Becky and Charles need funds to cover living costs during these early years, they will only be able to pay themselves by way of increased salary (which will increase the losses of the business) or by way of a dividend, which might, while losses are being generated, not be possible within the constraints of company law that are designed to protect creditors. They will be taxed under the normal personal tax rules on any salaries when they are paid, but the losses that will be generated in the company by the payment of their salaries will only receive relief in later years when the companies make profits.

Early years

4.24 Box 4.2 shows the tax treatment of the businesses as they move into a profit-making period.

Box 4.2 Example of businesses in early years

Ah Chan, Becky and Charles run identical one-person furniture design businesses. Ah Chan is a self-employed sole trader. Becky runs her business as a company and takes part of her income as salary and part as dividends. Charles has also set up a company and takes all his income as salary. The profits of each business before any remuneration for Ah Chan, Becky or Charles is £20,000.

Ah Chan

Ah Chan has stayed self-employed. He must pay Class 2 and Class 4 NICs and income tax on £20,000 regardless of the amount he draws from the business, leaving a net figure of £15,559 a year.

Becky

Becky is the managing director of her company. The company also makes £20,000 profit before Becky's salary (£5,000) and employer's Class 1 NICs (£33) are paid. The company pays corporation tax (£2,559) on the net profits after salary and employer's NICs have been deducted. The profits after tax are paid to Becky as dividends. Becky must pay employee's Class 1 NICs (£28) and income tax (£26) on her salary.

Becky takes home £4,946 a year as an employee of the company and receives £12,408 a year in dividends. She will be entitled to a tax credit that covers her income tax liability on those dividends so Becky's total take-home pay is £17,354.

Charles

Charles is the design director of his company. The company also makes £20,000 a year in profits before Charles's salary (£18,269) and employer's Class 1 NICs (£1,731) are paid. The company's taxable profits are nil and no corporation tax and dividends are paid. Charles must pay employee's Class 1 NICs (£1,488) and income tax (£2,733) on his salary.

Charles takes home £14,048 as an employee of the company.

4.25 The businesses have chosen different remuneration strategies, so the tax and NIC liabilities of all three differ.

4.26 Ah Chan pays more tax than Becky (although less than Charles) but enjoys the flexibility that comes with self-employment. He can continue as he is, take on new partners or take up an entirely new occupation – perhaps in employment – without having to deal with the necessary formalities that come with company regulation.

4.27 Becky's company is paying her partly in dividends, which can be seen as representing both a return for the labour she has provided to the business, and her return on any capital she may have invested in the business. She is able to enjoy the benefit of the overall lower effective rate of tax that applies to dividends.

4.28 Charles has chosen to give himself the position of a full salaried employee and as a result is taxed more heavily than either Ah Chan or Becky.

Growth

4.29 Box 4.3 illustrates what would happen if the businesses started to make substantial capital investments to upgrade their commercial activities.

Box 4.3 Example of growth businesses

Ah Chan, Becky and Charles have now been running highly successful furniture design businesses for many years. Ah Chan is still self-employed. Becky is the managing director of her company and takes most of her return as dividends. Charles is the design director of his company and takes his remuneration as salary. Each now wishes to make a substantial capital investment to expand the business.

Ah Chan

As a self-employed sole trader, Ah Chan is able to claim first year capital allowances against his trading profit and this will reduce the income tax (and the Class 4 NICs) which he has to pay. This means that he can claim the early relief offered under first year allowances at his marginal rate. If he has insufficient trading profits from his business to make full use of the capital allowances, he can set the trading loss against any other taxable income. He can decide how much of his profits to withdraw from his business as cash drawings and how much to leave in the business to finance his capital investment. If he takes out a further loan to finance the capital investment, the interest on that loan will also be deductible from his trading profits when calculating his tax liability. In practice, Ah Chan will have to make his decisions in the light of how much he is able to borrow and that will depend on a range of factors.

Becky

Becky's company will also be able to claim first year capital allowances against its trading profits and this will reduce its corporation tax liability. If the company does not have sufficient trading profits to make full use of the first year capital allowances, some of the cash flow benefit will be lost as the unused loss may only be available to be carried forward for use against profits in later years. The company can also decide how to finance the investment and how large a dividend to pay. Interest on any company borrowings to finance the capital investment will also be deductible in calculating taxable profits. In practice, decisions about dividends, capital investment and borrowing will also be influenced or constrained by the cash available to the company, its accounting profits, the provisions it makes for current and future tax and the amount of its profits available for distribution, taking into account past profits and the amounts distributed or retained.

Charles

Charles's company will also be able to claim first year capital allowances against its trading profits and it could be in essentially the same position as Becky's company. But if it continues to pay Charles a substantial salary, claiming the capital allowances is more likely to lead to a loss for tax purposes which the company might be unable to use and would have to carry forward for use against future profits. Interest on company borrowings to fund the capital investment would also reduce the tax profits of the company, or increase its losses. On the other hand, if Charles makes a further investment in shares in the company, he would (provided the company is still a close company and the other conditions for relief are still met) be able to claim against his personal income the interest on any borrowings to finance the purchase of those shares.

4.30 In this example, if Becky and Charles choose to fund the cost of investment from profits made in the businesses in earlier years, they may have benefited in those earlier years from the low rates of corporation tax where profits are retained for investment.

4.31 Alternatively, if they choose to raise new external finance to meet the cost of investment, the company structure they have adopted will help them to raise new finance for this purpose.

4.32 All three businesses will qualify for enhanced first year allowances on their capital investment, but if Becky and Charles's companies do not have sufficient profits to make use of all of the first year allowances available to them, they will instead carry forward the relief for use against future profits in the companies.

4.33 If Ah Chan's business has insufficient profits in the year to set against the first year capital allowance, he can set the surplus of the relief against other personal income as a sole trader, and gain an immediate cash flow benefit at his marginal rate of income tax.

Exit **4.34** Box 4.4 shows some of the issues that could arise if the owners of small businesses decide to exit from their business by selling it on to another party.

Box 4.4 Example of businesses in exit period

Ah Chan, Becky and Charles have now been running furniture design businesses for very many years and have decided to retire. Ah Chan is still self-employed. Becky and Charles are directors of their own companies.

Ah Chan

Ah Chan can either sell his business as a going concern or he can sell the assets of the business separately. The route he follows will depend on whether he can find a buyer for the business and what the buyer is prepared to pay for the goodwill. But in either case, Ah Chan will be liable to capital gains tax on the chargeable gains made. He will be able to take advantage of business asset taper relief (and indexation for assets acquired before April 1998) to reduce his capital gains tax liability.

Becky

Becky sells her shares in the company and will be liable to capital gains tax on the increase in their value from when she established the company (or made further investments in it). She will also be able to take advantage of business asset taper relief (and indexation for shares acquired before April 1998) to reduce her capital gains tax liability. There are no tax consequences for the company arising from Becky's decision to sell it.

Charles

Charles does not sell his company but the company sells its assets separately after it ceases trading. The company will be liable to corporation tax on any chargeable gains (less indexation) and other profits on the disposal of its assets.

Charles then winds up the company and takes out the proceeds (after the company's debts and the costs of the winding-up have been paid) as cash. This is a disposal of his shares in the company and he is liable for capital gains tax on any chargeable gains made. He will also be able to take advantage of business asset taper relief (and indexation for shares purchased before April 1998) to reduce his capital gains tax liability.

4.35 In this example, Ah Chan and Becky have been able to sell their businesses to the purchasers and to receive the sale proceeds with only a single tax charge arising.

4.36 The purchaser of Becky's business was willing to purchase the shares in her company, whereas the purchaser of Charles's business was not. Charles would have also been able to receive the sale price in his own hands if the purchaser had been willing to buy the company, and take on any historic liabilities (which might well have resulted in a lower price being paid). As it is, he will be obliged to liquidate his company or pay dividends in order to realise the cash proceeds. By contrast Ah Chan, as the owner of an unincorporated business, was able to have direct access to the proceeds from the sale of his business, without requiring the purchaser to take on the risk of any hidden liabilities.

Conclusions

4.37 As can be seen from the above examples, the interaction of the personal and corporation tax regimes can create different results for different legal forms, and behavioural responses can vary accordingly. In some cases these reflect genuine commercial differences but in others there may be a strong element of tax motivation.

4.38 The examples illustrate that the tax effects of the various legal structures are not necessarily straightforward, as they can vary depending on the specific circumstances of the business. The Government is concerned to ensure that entrepreneurs and their advisers are fully aware of the implications of adopting a specific legal structure.

4.39 The issues raised in these examples may suggest that there are underlying tensions in the tax system. In looking at these tensions the Government will want to ensure that the tax regimes strike the right balance between promoting enterprise and growth and ensuring that everyone pays a fair amount of tax and NICs.

4.40 The current system can offer real benefits to a growing company by enhancing the post-tax return on early year profits. At the same time, to a hard working individual who has chosen to remain self-employed, the rules can in some circumstances appear to be giving an unfair advantage to those who have adopted company form for purely tax reasons. The Government wants to ensure that incentives for growth and enterprise do not come to be seen as unfair to others or unduly costly to the Exchequer.

5 INVITATION FOR COMMENTS

5.1 The Government believes that small businesses can play a pivotal role in supporting its economic objectives, and is keen to ensure that individuals setting up in business have the flexibility to start and grow their businesses. The Government is determined to continue with a forward programme of targeted incentives, in support of its objectives for growth, enterprise and productivity. However, in some areas the pursuit of these objectives through the tax system may be constrained by the ability to match definitions for tax purposes with underlying characteristics.

5.2 The UK small business population is diverse, and recent global developments such as the growth of the knowledge-driven economy are likely to add to that diversity. The Government is committed to encouraging such diversity and the tax system needs to respond to these new developments. Trends in tax-motivated incorporation may suggest that there are structural tensions at the interface between the personal and corporation tax regimes that are particularly relevant at the small business level.

5.3 Strategic thinking on these issues needs to take place in the context of the Government's objective to promote a fair, efficient and integrated tax and benefit system with incentives to work, save and invest. The integration of the revenue departments will provide further opportunities to improve the coherence of the treatment of businesses.

5.4 The Government would therefore like to invite comments from interested parties to inform its thinking on the strategic development of the personal and corporation tax regimes as they relate to small businesses. In particular, the Government would welcome thoughts on the following issues arising from this paper:

- how the government can improve targeting of incentives for growth and enterprise – for instance by adjusting the balance of tax and non-tax incentives;
- whether the Government should consider segmenting owner-managers of companies from other company owners for tax purposes;
- how the trade offs between the different tax treatments for different types of business can be managed, including between meeting the objectives of minimising the economic costs of raising tax revenue, and of minimising compliance and administrative costs; and
- whether and to what extent businesses would value the benefits of certainty and simplicity over specific incentive structures.

5.5 All comments received may be made public unless specifically requested otherwise. In the case of comments received electronically, general confidentiality disclaimers that often appear at the end of e-mails will be disregarded for the purposes of publishing comments unless an explicit request otherwise is made in the body of the comment.

Contact details

5.6 Comments should be sent to:

SME Taxation Team
Room 2/36,
2nd Floor, HM Treasury,
1 Horse Guards Road,
London.
SW1A 2HQ

E-mail: smetaxation@hm-treasury.x.gsi.gov.uk

Fax: 020 7451 7672

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