



The Association of Taxation Technicians



THE
CHARTERED
INSTITUTE OF
TAXATION

Small companies, the self-employed and the tax system

A joint response from the Chartered Institute of Taxation and the Association of Taxation Technicians

The Chartered Institute of Taxation (CIOT) and the Association of Taxation Technicians (ATT) are pleased to respond to the discussion paper 'Small companies, the self-employed and the tax system' issued with the Pre-Budget Report (PBR) in December 2004. This response also incorporates comments on related Government statements which led to the discussion paper (for ease of reference these are all reproduced at Appendix 1).

Introduction and Overview

1 Broadly, we welcome the small business discussion paper, and agree that it sets out the taxation and National Insurance (NI) regime for business income and gains (para 1.11). However, we believe there are a number of issues which also need to be brought into consideration. These are set out in brief below and developed further in this response.

2 We think it is important for a strong signal to be sent out to all affected businesses that the difficult task of resolving the tax issues associated with this area is being looked at 'in the round'. This means that all factors, eg employment costs and all 'taxes', are being considered. For example, we were surprised that the discussion paper did not cover tax credits, or look at the issue of what NI contributors are 'buying' with the type of NI that they pay. We think that both these areas are fundamental to the review and need to be included.

3 This will mean broad thinking that will require all parties (Government, tax advisers and taxpayers) to move away from rhetoric and think widely about solutions. This should include a reconsideration of recent tax measures which have caused considerable problems for small businesses, such as the non-corporate distribution rate, IR35 and the issues related to the operation of ICTA 1988 s660A.

4 We think it is also essential to manage expectations. There are not many easy answers, nor quick wins. In fact, any changes are likely to lead to winners and losers. However, we believe that the tax system can be improved, and it is far better to take the time to arrive at a better situation than to seek to find short-term, temporary answers (eg the introduction of the non-corporate distribution rate) that can give rise to other knock-on tax problems.

5 The majority of tax issues tend to arise in 'micro-businesses', which are those with very few employees. It is important to differentiate these from the definition of a small business, which can encompass entities with up to 50 employees. We believe that micro-business issues should be at the heart of the ongoing consultation. The tax system should be looking to provide this important part of the UK economy with fair treatment, stability in terms of the rules and as much certainty as possible as to the tax implications of their actions.

6 We believe overall there should be more equality in the way that small businesses are taxed, regardless of their structure. We agree that the absence of neutrality between the 'taxation' of profits of individuals, depending on their different legal forms, creates inequality between taxpayers that is difficult to justify economically. However, in arriving at a solution to this problem many complex areas need to be considered. What we can, however, all agree on is the need to remove, or perhaps more realistically *reduce*, the current size of the inequalities.

7 In general, though, we believe that the approach taken in the paper is the right one. Many of the current problems with the way that small businesses are taxed have arisen because the subject has not been considered in the round. A whole host of tax policy initiatives, which might have been commendable in their own right in relation to large and quoted companies, have had an unexpected, often unwelcome impact, on smaller businesses. Therefore, it must be right to start with what is effectively a blank piece of paper, and create a tax regime which is appropriate for small businesses in the modern world.

8 We fully accept that, in practice, it will not actually be possible to start with a clean sheet, and that whatever emerges from this review will, at least in part, have to retain some features of the current system. Nevertheless, we believe that the review should start out with the widest possible remit, and without prejudging what may or may not be possible. We think it is also essential to have an attitude which is prepared to move from previously entrenched positions if a workable and holistic solution is to be found.

The source of the problem

9 The fundamental distinction in tax law is between incorporated and unincorporated businesses: the fundamental divide in micro-businesses is between those companies which are effectively the personal business vehicle of their proprietor(s) and those in which there is separation between ownership and management. It is this tension which is at the heart of the problems with the current system for taxing the smallest companies. Although many small companies are companies in legal format, they have far more in common with sole traders and partnerships of similar sizes than they do with quoted companies. The tax system does acknowledge this to some extent through the regime for close companies, but although small businesses are always close companies the reverse is not the case – many close companies are extremely substantial. (In any event, the close company

regime is anti-avoidance driven, rather than an effort towards a simpler regime for a smaller business.) There is no specific tax regime for small businesses, and it is possible that the outcome of this review should be the creation of such a regime.

10 However, as shown below, it would not be sufficient to look only at the tax system. The difference in NI treatment of the two types of business is substantial, with the unincorporated business suffering lower rates but receiving less in return, and incorporated business taking the burden of higher rates and primary and secondary liabilities, but with its employees getting more in return (although the extent of the differential has been significantly eroded over recent years, with the increase in means testing). In addition, the differing treatment for NI purposes of salary and dividends adds to the tensions within the system, and has created in large part the Government's perceived need for a measure like IR35. We regard it as essential that this review looks at the contributory principle: whether it still stands up in our present tax, National Insurance, tax credits and benefits system, and what needs to be done to produce more equality in the treatment of small businesses.

What is a small business

11 We believe that it is vital that the review is conducted against a proper understanding of what constitutes a small business. The working definition of a small business is one with fewer than 50 employees. In our view, a business with even half this number of employees is not what we have in mind when we are thinking in terms of a small business. To us, a small business is one with no employees, or with a very small number of employees. The Small Business Service defines a micro-business as one with 0 – 9 employees, and 76% of these have no employees¹. Such businesses are at the heart of the UK economy, but are often invisible in any economic model of business.

12 We believe that it is with these very small businesses that most of the taxation problems arise, particularly because they will hardly ever have any real tax knowledge in the business. We would not claim that the tax affairs of the more substantial smaller businesses are trouble-free, but it is in the area of micro-business taxation where the main structural problems arise. If we look at the three most controversial small business areas of recent years – IR35, ICTA 1988 s660A and the non-corporate distribution rate – we see that these all have a disproportionate effect on micro-businesses. Our initial response, therefore, deals primarily with the issues relating to micro-businesses, though clearly the CIOT/ATT remain interested in the way that the review deals with the whole range of small businesses, and we will be happy in due course to give more detailed input into the review if it appears that it will be covering the whole spectrum of small businesses.

¹ This estimate is derived from *Statistical Press Release* DTI, URN 04/92, 26 August 2004. This gives the number of businesses with no employees, at the start of 2003, as 2.9 million. Businesses with no employees are sole proprietorships, partnerships comprising only the self-employed owner-managers, and companies comprising only an employee-director. By definition these are all micro-businesses. The discussion paper indicates that, at the same point in time, the total number of micro-businesses was 3.8 million (para 2.10). 2.9 divided by 3.8 gives 76.3%.

Exploring the problem

13 The discussion document sets out many of the issues under consideration, but it seems to us to concentrate on the perspective of the larger small businesses rather than the micro-businesses which are where the areas of our main concern lie. In the paper 'The Eye of the Storm', written by Anne Redston and published in the British Tax Review (2004 Issue 5), there are set out in more detail some of the major areas of difficulty which we believe are structurally inherent in the current system. That paper might be considered as an annex to this response, and we have, of course, already submitted that paper to you for consideration. As we are primarily concerned with micro-businesses, we believe that it is worth very briefly setting out what we see as the main problems.

What happens in tax terms when a business incorporates?

14 To illustrate the problem in practice, and to show the problems that small businesses face on a daily basis, let us consider what happens when John Smith Plumber – a well-established sole trader – incorporates his business as John Smith Plumbers Ltd. Immediately, his entire relationship with the direct tax system changes. Just to list some of the areas of change is to illustrate the profound difference between the overall 'taxation' position of incorporated and unincorporated businesses:

- Corporation Tax
- CTSA
- New accounting periods
- PAYE on remuneration
- Employers/Employees National Insurance Contribution (NIC)
- National Minimum Wage
- Operating a payroll
- PIIIDs
- Benefits in kind
- Class 1A NICs
- Company car taxation
- Pensions (self-administered pension funds can be set up through the company although the popularity of these will diminish with the advent of the new pension rules from 6 April 2006)
- Dividends
- Section 419 tax on money he takes from the business resulting in his 'account' being overdrawn
- Possibly IR35
- Possibly ICTA 1988 s660A issues
- Possibly Non Corporate Distribution rate
- Tax credits based on income withdrawn.

What changes in the mind of the proprietor?

15 However, it is likely that, in our example of John Smith, nothing changes in his business at the point of incorporation. In his mind it is still his business, and he carries it out in exactly the same way.

16 John Smith Ltd has far more in common with John Smith Plumber than it has with Dynarod Plc, yet it is taxed on a basis which is far closer to that of a quoted company than of a sole trader. We believe that the time may have come to address this fundamental structural issue, and possibly to develop a system for the taxation of small businesses which is designed specifically for the needs of such businesses.

Why do businesses incorporate?

17 Most of the systemic problems in the taxation of small businesses stem from the fact that companies are taxed in a very different way to sole traders and partnerships, even though the underlying businesses may operate in an identical manner. For instance, for all practical purposes, little may change when John Smith puts the word 'Limited' on his nameplate. The separation that incorporation has created between him and his business may be largely theoretical. He may not understand the legal basis under which he is now operating, and may have even greater difficulty in appreciating the basis on which he is now taxed. So why do businesses incorporate? It is important to understand this to know how to deal with the underlying tax problems that incorporation can create.

18 In the first instance, there is no doubt that market forces drive many businesses to incorporate. Many large organisations (including some Government departments and local authorities) have a strict policy that they will only deal with incorporated business. This is undoubtedly in part so that they can lay off the risk of NIC and PAYE if an employment relationship is found to exist, but mainly it is for reasons entirely unconnected with taxation. One key area is the business's unwillingness to take on expensive employment rights. In addition, some large organisations believe – rightly or wrongly – that they are much more likely to be dealing with a small business of substance and permanence where that small business is incorporated. There is absolutely no doubt that any attempts to prevent small businesses from incorporating would be severely resisted by the business community, and the CIOT/ATT do not advocate a solution under which incorporation is limited to businesses of a certain size, even if such a rule were compatible with UK competition law. We do not believe that the solution to the structural problems inherent in the small business tax regime would be to prevent small businesses from operating as companies.

19 Secondly, some businesses undoubtedly incorporate because of the need to be able to separate ownership from management, or to spread equity to individuals or institutions who would not be prepared to accept the joint and several liability which exists in a traditional partnership structure. Such individuals or institutions will invariably require a return on their investment in the company, and the payment of dividends by a company enables this return to be made. (It can be contrasted with the return made by a partner in a partnership, where the profit share will more directly reflect the total profits made by the partnership.) We assume that it is these companies, where external investment is needed to fund growth, at which the 'targeted incentives for growth and enterprise' (first bullet point para 5.4) are aimed. Our preference is simplicity over targeted incentives, as the recipients tend to be hard to identify, and also the legislation is invariably hedged with such extensive anti-avoidance rules that the smallest businesses cannot take advantage of them. Having said this, the existence of very small businesses with external investment must be taken into account in designing a new regime – ie it cannot simply be assumed that all the shareholders work in the business.

20 Thirdly, there is no question that a number of businesses have incorporated to take advantage of the opportunities created by the current distortions in the tax system which favour corporates – particularly the lower rates of corporation tax and the absence of NIC on dividends. We might spend much fruitless time arguing whether or not these businesses have been indulging in tax avoidance or merely undertaking normal planning within the rules as set out by Parliament, but the fact remains that there are a substantial number of businesses which have incorporated for fiscal benefits. If there is to be a change to the tax system for smaller business – and the CIOT/ATT are, in principle, in favour of such a change – then the position of these companies, which have incorporated mainly or entirely for fiscal reasons, will need to be considered carefully. (It will of course be impossible to disentangle this group from those which incorporated for reasons of legal liability, etc.) We discuss this below under the heading transitional issues.

21 Fourthly, there are businesses which will incorporate for the benefit of limited liability. In certain types of business this will be a major factor – for example where there is a risk of being sued or a high risk of the business going bust. However, it is also worth noting that limited liability can be completely illusory for some micro-businesses. Banks, for instance, will lend according to the underlying financial health of the business and its owners, and not by reference to the legal structure of the business. The guarantees the directors have to give to obtain the loans will defeat the limited liability advantage.

The scope of this submission

22 It is accepted that there are no simple solutions to the issues we are considering. At this stage, we do not believe that it is appropriate that we outline a preferred model for the taxation of small businesses. There are a number of ideas in circulation about how a new regime could be designed. Within the CIOT/ATT, as within the business community, there are varied views on the desirability of any particular model. In any event, we believe that there is not yet sufficient underlying data available in the public domain to enable a fully informed decision to be made on the technical merits of the various alternative structures that might emerge. We would hope that much of this data will be made available during the course of the consultation.

23 The CIOT/ATT do, however, have strong and considered views about the key principles and objectives which should underlie the review, and against which the success of any reforms should be measured. We believe that it will be easy to lose sight of these in the plethora of technical detail which will inevitably have to be dealt with during the review, and therefore we wish at an early stage to put these key building blocks on to the record. We will use these principles to inform our own detailed technical submissions and we will also use them to evaluate any proposals which come out of the review.

The way in which we believe the review should be conducted

24 In welcoming the Government's intention to review the whole basis of the taxation of smaller businesses, the CIOT/ATT are firmly of the view that there can only be real progress if all parties are prepared to move from what may have been seen (perhaps unfairly) as previously entrenched positions. The debate must also be free from rhetorical posturing.

25 The CIOT/ATT have no sympathy with those commentators who accuse the Revenue of somehow being out to 'get' at small businesses by making the tax system as difficult as possible for those who run small businesses. Nor do we believe that the Government have deliberately designed a tax system which is prejudicial to the needs of small businesses. The strains inherent in the system are often a knock-on effect from understandable changes made elsewhere in the system. The CIOT/ATT believe that there is a genuine desire at all levels of Government properly to debate the issues, and to work towards a more suitable long-term structure for small business tax. We welcome that intention and wish to work with Government to help improve the current situation.

26 We believe, however, that for their part the Government must understand that some of the rhetoric which has emerged from the Government about abuses of the system is genuinely unhelpful. We do not think, for instance, that adopting a corporate form is a 'tax-avoidance scheme' (para 3.26).

27 CIOT/ATT members would not accept that, in advising their clients about the most effective way to structure the legal form of their business, or pointing out in many cases that paying dividends rather than salary can create a lower tax liability, they are promoting tax avoidance: they are simply carrying out their normal professional obligations to clients.

28 We have no doubt that, whilst the current differences in rates of 'taxation' exist, individuals *will* incorporate to reduce their tax liability. This is human nature, and has been for years. The *Duke of Westminster* case, when Lord Tomlin said, 'every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be', was heard as long ago as 1935. The fact that the lower rates of Corporation Tax would lead to more businesses incorporating was also acknowledged in the Parliamentary debates at the time (Hansard, Standing Committee F, 16 May 2002, col 115 – 'Surely small businesses will not look a gift horse in the mouth').

29 We would also wish to note that the current Government's determination to get small incorporated businesses to pay more 'tax' (what no doubt the Government perceive as the 'right amount of tax') has led to IR35, a new (and still disputed) application of the provisions ICTA 1988 s660A and the new non-corporate distribution rate. None of these are helpful to small businesses and we think they should all be reconsidered as part of this review.

30 What we think needs to be put in their place is a more equivalent rate of 'taxation' for small businesses regardless of their legal form.

31 We all acknowledge the problems and are committed to working towards producing a better system. We should be able to do this from a position of mutual respect.

Key principles which should inform the review

What would the 'average' business want from this review?

32 If you asked the average small businessman what he would want from a tax system, one of the key messages would be simplicity and certainty.

33 In an ideal world there would be an annual reckoning. On one half of a piece of paper would be listed the amount that the business and its owners owed to the Government that year. This would include all taxes (direct and indirect) on the business, but also on the individuals. On the other half would be listed all the amounts that the Government owed the business and the family, for example credits, rebates, pensions grants and incentives. It would then be a simple exercise to compare the two totals. Either the business would write a cheque to the Government or the Government would write a cheque to the business. All of the business's fiscal dealings with the Government could be dealt with on one form at one time.

34 The businessman would not be concerned about what the amount he paid was called: it is all money going out of his hands. The way that this is allocated between VAT, Income Tax, NIC, etc is of little concern to the individual. That would be entirely a matter for Government accounting. Similarly, it is arguable that the Government need not be concerned as to what the money paid to the businessman and his family is called: whether the money is retained in the business or spent by the family is of no concern to Government: they have completed their side of the financial contract by paying what is due.

35 Of course this is completely utopian, and it is hard to envisage how a system as simple as this could ever emerge. However, we use this example to make the point that this review must be conducted in the round. A review which gets bogged down in the minutiae of the tax system too early will be in danger of missing the point. All the small businessman is interested in is how much of his hard-earned money is left for him, his family and his business. In economic theory there is a clear distinction between an individual and his business: the reality is that it is almost impossible to define where one ends and the other begins. Many of the problems in the system can be traced back to this fundamental problem. A system which acknowledges this stands more chance of success than one which only recognises the economic theory and not the underlying reality.

36 It must also be stressed that most small businesses would like to see a reduction in the burdens that arise when they take on their first employee. We provide some more detail on this in our response to the first question posed by the discussion paper (see paras 63 to 66 below). We know that not all these burdens are to do with the operation of a payroll and therefore, to some extent, are beyond the scope of this review as defined by the discussion paper, but it is obvious to us, as advisers to small businesses, that expansion and growth of small businesses is all too often impeded by the proprietors' reluctance to take on the burdens of their first employee. The wider issues of the cost, complexity and risk to employers of employment rights should not be ignored.

The principle of fairness: taxing the business not the structure?

37 All of us want fairness in the tax system. We all, however, have a different concept of what fairness actually means, and one of the key issues coming out of this review will be to establish what is a fair way of taxing small businesses. At the moment the same level of economic activity can give widely different tax outcomes, depending on the legal structure that has been adopted.

38 The present position on rates of 'taxation' is illustrated well by the example at Box 4.2 of the discussion paper so we have reproduced this below in table form, but with the addition of tax credits. (For the tax credit figures we have assumed all three

business owners have two children and no income apart from the business. They work at least 30 hours but have no childcare costs. The computations of the credits assume their income remains constant. The computations are attached at Spreadsheet A, which also shows the tax and NI calculations.)

NET CONTRIBUTION TO THE EXCHEQUER			
	<i>Ah Chan</i> £	<i>Becky's</i> <i>company</i> £	<i>Charles's</i> <i>company</i> £
Business profits	20,000	20,000	20,000
Deduct: Expenses and distributions			
• Salary	Nil	(5,000)	(18,269)
• Employer's NIC (A)		(33)	(1,731)
• Corporation tax (B)	Nil	(2,559)	Nil
• Dividend	Nil	(12,408)	
Profit available for distribution	£ 20,000	Nil	Nil
	<i>Ah Chan</i> £	<i>Becky</i> £	<i>Charles</i> £
Taxable income			
• Profits/Salary	20,000	5,000	18,269
• Dividends	Nil	12,408	Nil
	20,000	17,408	18,269
Deduct: Income tax (C)	(3,114)	(26)	(2,733)
	16,886	17,382	15,536
Deduct: NICs			
• Employee's Class 1 NIC (D)	Nil	(28)	(1,488)
• Classes 2 and 4 (£107 + £1,220) (E)	(1,327)	Nil	Nil
Taxable income net of tax and NICs	15,559	17,354	14,048
Tax credits (F)	2,022	2,582	2,663
Total disposable income	£ 17,581	£ 19,936	£ 16,711
Net Contribution to Exchequer (A+B+C+D+E-F)	£ 2,419	£ 64	£ 3,289

39 The table clearly shows the difference in Net Contribution to the Exchequer according to the structure chosen and the split of salary to dividends. There can be little doubt that something needs to be done to even out the contribution made by these three small businesses.

40 We think it inevitable that part of this 'evening-out' will necessitate changes in the rates of National Insurance being paid and so, alongside this alteration in rates, we believe there must also be a change in the entitlements to Department of Work and Pensions (DWP) benefits which payers of National Insurance receive. Such an 'equalisation', if we can call it that, is already present in some of the tax credits legislation (the Government's most recent 'integration' of tax and benefits). Under new tax credits the self-employed are treated as if they were on maternity/paternity/adoption leave or statutory sick leave even if they do not qualify for these particular DWP benefits. Their tax credit entitlements are the same as those for employees, even though they have no entitlement to the underlying DWP benefits, ie their credits have been 'equalised' even if their DWP benefits have not (see SI 2002/2005 reg 6(2) and SI 2003/701 reg 5).

41 We see consideration of the entitlement to DWP benefits as fundamental to any reform to the rates of NIC, although we would have to note that the benefits can be marginal for many. A reduction in the costs of NI for employers and employees could be really what is needed.

42 Perhaps at the same time an attempt could be made to align and integrate tax and NI more fundamentally, but we realise that this must be seen as a long-term project rather than one which can be achieved whilst solving the problem of the taxation of small businesses. It remains the case, though, that tax and NI alignment is the area of simplification most often called for by our membership. It was also referred to in the Bath report (see para 65), where it was called for by businesses as well. As to how this could be done, several years ago the CIOT produced a paper on tax and NI integration and alignment. We would welcome the opportunity to revisit this issue.

43 On any analysis the 'Net Contribution to the Revenue' shown by the above Table is not a 'fair' outcome as between businesses. However, it may also not be thought to be a fair outcome between the person who conducts his activities through a small company and a person who is an employee. Somebody who is on a salary of £20,000 may well think that it is not fair that a business earning that level of profit can pay much less 'tax' than they do as an employee. This difference arises purely because of the difference in National Insurance rates and is, of course, the principal underlying basis of the IR35 provisions. An employee might think it unfair that somebody who works through a service company can pay less tax on a given level of income than he does, but the service company proprietor may also think that it is unfair that the tax system attempts to tax him as if he were an employee, without any acknowledgement of his lack of employment security. The reality of modern commercial life is that for some there is no clear boundary between being an employee, being a 'disguised' employee and being in business on their own account. The growth of outsourcing and privatisation are just two examples of this. The rigid employed/self-employed principle of UK tax law is increasingly coming into conflict with the realities of working patterns in the modern economy. The review of small business taxation will be incomplete if it does not deal with the issues of the borderline between employment and self-employment. They are just as much part of the problem as the issues between incorporated and unincorporated businesses.

44 If we return to businesses themselves, we accept that a system where an incorporated business pays next to no tax on reasonable levels of business profits is hard to defend. In principle we would support a system where small businesses were taxed on the same amount regardless of the business structure which was adopted. We believe that this would be a fair result. However, we would not be in favour of restricting the choice of legal formats open to any business. We believe that business criteria and not tax considerations should determine the legal structure through which a business operates. There is also the fact that setting up a company has inherent costs, and there is no doubt that any 'tax' differential is weighed up against those costs.

45 Although there is a broad consensus within the CIOT/ATT for the principle that the taxation system should deal with small businesses in the same way, regardless of structure, there are some significant concerns about the way in which such a system might penalise small but growing companies who wish to reinvest profits back into a business. There is little published information about the extent to which small businesses are taking advantage of the lower rates of corporation tax – particularly the 0% rate – to plough profits back into the business, and we hope that this will be one of the topics that will be explored during the consultation. We do,

however, at this stage wish to put down a marker that this will be one of our areas of concern.

Looking at the issue in the round: business and employee tax – credits and debits

46 Any new system which taxes the underlying profits regardless of the business structure would have to cover more than corporation tax. PAYE and NIC would also have to follow the same basis. In other words, if a company were to be taxed as a sole trader it would inevitably follow that there could be no PAYE on amounts drawn from the company, no s419 liability and no question of any benefits in kind arising on the proprietor from the use of company assets or of expenses paid by the company (these would presumably be disallowed as private expenditure in the Sch D computation). This is why it is vital that the whole review is conducted in the round: a solution which only looked at the taxation of profits would not properly address the whole of the structural issues.

47 We also believe that it is fundamental that any review looks not only at the tax payable on profits but also at the way that tax credits would operate in the new system. Furthermore, and as mentioned above, it would also be necessary to review the way that entitlement to DWP benefits would work under such a system. At the moment, the different NIC regimes applying to employees and the self-employed can be justified, at least in part, by the fact that employees and the self-employed have fundamentally different entitlements to these benefits. Clearly the way that NIC is levied in the new regime will be a fundamental part of the review, but the fact that there are benefit implications to any decisions which are made must not be forgotten. If the review is not to create as many problems as it solves, it must take the benefits side of the equation into account.

The principle of certainty under a self assessment regime

48 The cases of *Langham v Veltema* and *Jones v Garnett* have brought into sharp perspective the need for certainty in a self assessment system. Any review of small businesses must take this into account. A further example is the never-ending stream of cases on the fine line separating the application of the status rules to possible IR35 cases. These have no real resonance for the small businessman, who frequently does not know whether or not the rules apply to his particular circumstances.

49 The tax liability of the small business must be capable of being returned under a self-assessment system. The CIOT/ATT remain firmly of the view that the current position under s660A, where taxpayers have to make complex judgements about the precise application of complex provisions, is wholly unacceptable and cannot remain within whatever new regime emerges. The same is often true of IR35.

50 We are also concerned about the time for which the enquiry window is open. The CIOT/ATT entirely accept that the authorities must be given a reasonable time in which to enquire into a business's tax affairs. Once the enquiry window has closed, that should be the end of the matter (subject of course to the Revenue's right to raise out-of-time assessments in the case of negligence or fraud). It is unacceptable that small businesses might face liabilities going back for several years simply as a consequence of the uncertainties inherent in the application of s660A. Many small

businesses do no more than provide their owners with a basic standard of living. The imposition of additional tax for earlier years can come as a real hardship to many people who have conscientiously tried to comply with their obligations.

51 In an ideal world, there would be a common system of enquiry windows for all taxes on businesses, including VAT and payroll taxes, so that a business would be able to know that its affairs for a certain year were now beyond the scope of enquiry (again subject to fraud and neglect). This is probably outside the range of what is possible under this review, but it should still be held up as an ideal during the scoping of the project.

Stability

52 The CIOT/ATT regard it as essential that small businesses must be able to operate within a stable taxation environment. To that aim, whatever system emerges out of the review must be designed for the long term. Clearly, the rates of tax which small businesses will pay will be a matter for Government, and it would be unreasonable to expect any commitment on long-term tax rates. However, we believe that it is reasonable to expect long-term structural stability within the system. This is why we believe that it is essential that a bespoke taxation system for small businesses emerges from this review. There are likely to be major taxation changes for large companies ahead, not least because of the European dimension, and, unless the taxation of smaller companies is de-coupled from the taxation of large businesses, it is all too likely that any system that is introduced could be compromised by developments in large business taxation. The CIOT/ATT are committed to putting resources into a proper review of small business taxation, but we would like reassurance that we will be listened to, and that the end result will be one which, at the very least, has a reasonable expectation of offering long-term stability.

Compliance costs

53 One of the key outcomes must be a reduction in the compliance burden for both the taxpayer and HMRC. From the perspective of the taxpayer this reduction should come in two areas: the tax base itself and the way that liabilities are returned. It is essential that these are both looked at together. There have been too many examples (we might cite tax credits and Form 42 for instance) where many of the difficulties have been caused because policymakers have not adequately considered the practical implications of what, on a theoretical basis, may seem wholly reasonable proposals.

54 The ideal position would be that all of a business's tax liabilities could be returned at one time on a single straightforward form. This is probably too much to ask, but at all stages in the process this should be held as an ideal. At every stage in the development of policy the question should be asked: 'Can this liability/information be returned with others on a single form?' Or, of course: 'Is this information really needed at all?' There must be a compelling reason for any departure from these principles.

55 Much time is wasted, by directors, advisers and the Revenue alike, in sorting out the mess that companies get themselves into by failing to appreciate the tax consequences which arise from the separate legal personality of the business and its

owners. If a system were created in which the separate legal personality was not relevant for taxation purposes, there would be enormous savings of unproductive time all round. This in itself must be an attraction to all parties to work this review through to its logical conclusion.

56 We believe that every effort should be made to make compliance for small businesses as straightforward as possible. We certainly would like to see some work done on whether or not some form of flat tax scheme could be devised to cover businesses' direct and indirect taxation liabilities, and ideally also to cover the tax credit position. The take-up of the VAT flat rate scheme has been less than was hoped, but this should not discourage work on creating a more comprehensive flat tax scheme. Indeed, one of the problems of the VAT scheme is that it is not harmonised with direct taxation. Apart from the issues of accounting for the VAT payable under the scheme, which are considerable and which do not seem to have been thought through at the time that it was introduced, there are the real problems that most small traders for whom the scheme would be appropriate are working on a cash basis for VAT and an accruals basis for direct tax. If it were possible – and of course this is a big question – to devise a single basis for both VAT and direct tax, then the take-up of a unified flat tax scheme could in fact be much higher than the take-up of the current VAT scheme. It is appreciated that there are European law constraints to consider in any changes. There are also issues as to how well a flat rate scheme is understood (for instance, we refer to the recent Reader Query in Taxation on the VAT scheme (Taxation Vol 154 No 3997 3 March 2005 page 552)). We welcome the announcement in the Budget 2005 paper 'Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small business' to look at ways of improving the marketing of such schemes. In doing this it could be that the conclusion is that there may have been better ways of setting up the schemes in the first place.

Transitional issues

Winners and losers

57 It is an inevitable consequence of any reforms which are introduced that some businesses will end up paying more tax than they do at present. Some transitional arrangements will therefore be necessary, and these will inevitably be complex. We would urge at this stage that any transitional rules are looked at in the round rather than on a piecemeal basis.

58 On the assumption that a new basis for the taxation of smaller businesses emerges, it appears to us that there are at least four options:

- Some form of grandfathering arrangements, so that existing businesses can retain their current tax status if they wish. We would not be in favour of this, because it would essentially require two wholly different systems of small business taxation to run in parallel for many years.
- The compulsory disincorporation of small companies. We would be against this for reasons set out above – namely that we do not think that the taxing base should determine the legal form. There are also many other problems with disincorporation. We would again stress the need for a disincorporation relief to parallel the incorporation relief that there is already in the tax system. This is

something we have called for regularly in the past, and we submitted a separate paper on it in February 2004.

- A once-and-for-all-point of change after which all small businesses will be taxed on the same basis. This has the merit of simplicity, but it might well mean that some businesses were faced with a very large increase in tax liabilities overnight. This might well be seen as unfair, and would probably be seen as politically unacceptable to Ministers.
- Some form of limited transitional arrangement. We believe that some form of transitional arrangement is inevitable and, in principle, this would be our preferred option. We would not want the transitional period to last longer than three years, and it should in any case be open to the small business to move directly to the new system.

Choice

59 If a new system is introduced, one of the key questions would be whether or not it was compulsory for all businesses, or whether companies could opt in or out of the system. At the moment we have no fixed views on the matter, and this would largely depend on precisely how the system was designed. There are strong reasons to support a basis that all businesses are taxed in exactly the same way, but there is equally a trade-off between simplicity and fairness.

60 For example, if it were possible to devise an acceptable flat rate scheme for small businesses, a decision would have to be taken as to whether this was the only basis of taxation or whether or not businesses could still be taxed on a 'normal' basis, whatever that might turn out to be. The CIOT/ATT have no fixed views on whether or not schemes should be voluntary, and much would depend on exactly what is on offer. Choice inevitably means that calculations on the alternative bases have to be done in order to determine which choice to make, and this does go against the principle of reducing compliance costs. Similarly, if some form of 'look through' basis of taxation for small companies were to emerge, there are arguments in favour of allowing companies to opt into or out of that basis, or remain taxed as companies. These are difficult issues and at this stage we do not strongly favour any particular approach.

Invitation for comments (Chapter 5)

61 Our comments on the matters particularly raised for comment in the discussion paper (para 5.4) are set out below.

Q1. How the Government can improve targeting of incentives for growth and enterprise – for instance by adjusting the balance of tax and non-tax incentives

62 We would always resist incentives delivered through changes to the tax system, because these inevitably make the tax system more complex. If incentives are required, we think it is better to have non-tax incentives.

63 We think some reduction in the burdens of employment for the smaller business would be very useful, and encourage growth and enterprise. We think it is significant that such a large proportion of micro-businesses do not take on employees, and we are convinced that this is because of the additional burdens which employees bring.

64 Clearly, employing somebody outside the ownership of the business can be advantageous to the proprietor for all sorts of commercial reasons - opportunities to share the load, make greater profits, etc. However, there are considerable responsibilities that come with being an employer (and in many cases rightly so), and these responsibilities and accompanying administrative burdens have become disproportionate for the smallest businesses. The fact that so many small businesses just operate as sole traders or owner-managed companies is quite telling. We think that there is a need to recognise that the employer/employee obligation can be too great for a small business to accept.

65 The burdens brought by employees are well beyond those that the tax system brings. Health and safety at work, training obligations and the like are examples. The employee also has rights against the employer, and in a litigious age these in turn can be burdensome. We are not in any way advocating that employees of small businesses should not have appropriate rights, nor that the small businesses should escape their obligations as an employer. However, the burdens of being an employer are that much greater for the small business simply because of scale. The Bath University study of the late 1990s showed the very significant cost differential between large and small employers; that differential will certainly have grown in the intervening years, given the further obligations that have been created. We recognise that this is outside the scope of this review, but suggest that it would have a significant effect. Is this a case for joined-up government with the DTI, perhaps?

66 Turning back to the tax and related obligations - which to many businesses just seem administrative/bureaucratic procedures rather than having obvious paybacks - we would suggest these be reduced. Having to operate PAYE/NIC for an employee can be burden enough. However, the problem for a small business is the additional burdens - student loan repayment, maternity/paternity/adoption pay, sick pay, attachment of earnings orders and tax credits (though payment of these is moving) all fall to the employer. As an alternative to reducing the burdens, a payment to the small business to help with the costs of taking on its first employee might be worth consideration.

Q2. Whether the Government should consider segmenting owner-managers of companies from other company owners for tax purposes

67 We would prefer the review to begin by looking at all the issues and all the possible solutions. However, as indicated in the detail of our response, we do think that some separate regime may be necessary with appropriate recognition for cliff-edge issues.

Q3. 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

68 We think the paper itself, and our comments above, show the need to reduce the differences. How the trade-offs between any remaining differences can be managed we think is better left until after the major differences have been reduced. We would always tend towards a simpler system to minimise costs on both sides. As we have emphasised above, whatever methods are chosen for reducing and managing differences, we think it is essential that they involve looking at our tax and benefits system holistically, ie at all aspects including tax, NI, tax credits and DWP

benefits.

Q4. Whether, and to what extent, businesses would value the benefits of certainty and simplicity over specific incentive structures

69 We think that certainty and simplicity are always preferable.

Concluding remarks

70 The CIOT/ATT welcome the opportunity to participate in this review, and are keen to play a constructive part in the consultation. We are fully supportive of the need for reform in this area, and are pleased that at this stage there is genuinely open thinking within Government about what might emerge from this review.

71 Our overriding concern is that the matter is looked at in the round, and that the objectives of the small business taxpayer are kept firmly in mind throughout the review. Whatever emerges must be capable of being implemented in a practical manner by businesses that have no dedicated administrative function or large budgets to pay for professional advice. The design of the compliance regime associated with any new structure must go hand-in-hand with the design of the structure itself. Although in an ideal world the CIOT/ATT would wish to see action sooner rather than later, we believe that an opportunity for reform of this nature comes only once in a generation. Getting the structure right is more important than introducing the structure early.

72 We welcome publication of the document 'Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small business' on 16 March 2005, recognising that this deals with some of the issues mentioned in this response. We will look at the detail of this in due course and respond separately.

The Chartered Institute of Taxation
1 April 2005

APPENDIX 1

A1 Para 5.91 of the 2003 Pre-Budget Report heralded this review of small business taxation with the following words:

The Government has introduced a range of measures and targeted tax reductions to support small businesses, including through reform of capital gains tax, reducing the rate of corporation tax for smaller companies and the introduction of a zero rate, Stakeholder Pensions, and the abolition of advance corporation tax. These measures are encouraging the creation of more small companies, including through self-employed people incorporating their businesses. The Government is keen to ensure the measures it has introduced provide support for these firms taking on the opportunities and responsibilities involved in that transition, and to encourage them to reinvest their profits and grow their businesses. At the same time, the Government is concerned that the longstanding differences in tax treatment between earned income and dividend income should not distort business strategies, or enable reductions by tax planning of individuals' tax liability, and that support should continue to be focused on growth. **The Government will therefore bring forward specific proposals for action in Budget 2004, to ensure that the right amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company**, and so protect the benefits of low tax rates for the majority of small businesses.

A2 This theme was continued in para 5.95 of the 2004 Budget Report with the words:

The Government are determined to continue with a forward programme of targeted tax incentives, in support of its objectives for growth, enterprise and productivity. 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 economic characteristics. The reform of the Construction Industry Scheme is an example where Government and the industry are discussing how to address these definitional issues as they relate to construction; in this case the dividing line between employment and self-employment earnings. Across many other sectors, the growth in small owner-managed businesses, as well as the changing nature of employment and contractual relationships, is creating challenges for the definitions and boundaries in the tax and national insurance systems between income from self-employment and the remuneration of owner-managers. The Government therefore propose to consider the strategic issues raised by these developments, to ensure that the tax system reflects the realities of today's changing labour market and business environment. A discussion paper will be issued at the time of the 2004 Pre-Budget Report.

A3 Then followed the words from para 5.102 of the Pre-Budget Report 2004:

The Government remain committed to providing targeted support to small businesses, including appropriate tax incentives to support its growth and productivity objectives. 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 the underlying characteristics of firms. **The Government is today publishing *Small companies, the self-employed and the tax system: a discussion paper*, and welcomes the views of smaller firms and their advisers on the strategic issues raised.**

A4 The paper itself then goes on to say:

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

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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.